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The Mistaken Assumptions of the IMF

José Antonio Ocampo

Argentina's adoption of a convertibility regime in the early 1990s was a legitimate attempt to restore a viable monetary and financial system in a country that had lost confidence in its authorities' ability to manage the currency. Among all the available options, however, the system that was chosen was the one that restricted the economic authorities' manoeuvring room the most. At the time, this option was seen as the best mechanism for building credibility in a country in which economic agents had lost faith in the successive Administrations' ability to manage the economy properly. Nonetheless, it was obviously not the only option available and, in fact, none of the other Latin American countries that had been afflicted by hyperinflation in the 1980s or early 1990s (Bolivia, Brazil, Nicaragua and Peru) chose a similar system.

The new scheme worked well for a time. It was effective in bringing about a rapid recovery in the early 1990s, a fairly swift remonetisation of the economy, the reconstruction of the financial system and the reappearance of corporate and personal credit. The convertibility system did, however, have two other very closely related effects: a strong dependency on highly volatile external financial flows and, given the absence of any scope for flexibility in economic policy, a sharp business cycle. The country's heavy dependence on external financing was, in turn, reflected in a strong tendency to run a trade deficit, together with a clearly overvalued currency. Advocates of the system tended to underestimate these

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

effects, and actually saw them as positive outcomes of a properly functioning market in which abundant capital flows were being generated by a highly credible economic policy.

When compared with other Latin American countries, Argentina experienced a peculiar combination of macroeconomic stability and instability during the 1990s: significant price stability coupled with large instability in economic growth rates.[1] Given the sharpness of the business cycle, it is difficult to determine what effect convertibility had on long-term growth, since any estimation of the "potential GDP growth rate" is strongly influenced by the time periods chosen for its calculation. This explains, in turn, why it was so difficult for economic agents to determine what level of income was sustainable.[2] On the other hand, restructuring the country's labour markets was painful. In large measure, this was a result of the currency's overvaluation, since the low rate of job creation in tradable sectors became a structural trait of the convertibility regime. High open unemployment – in a country that had traditionally had low unemployment levels, even during the "lost decade" of the 1980s – was its main corollary. This process was also accompanied by adverse pressure on poverty and income distribution.[3]

Significant trouble built up since the mid-1990s. Indeed, Argentina's economy was the one that was most heavily exposed to contagion from the crisis that broke out in Mexico in late 1994. As we all know, the convertibility scheme managed to survive the "Tequila effect" and generated high growth rates once again in 1996, 1997 and the first half of 1998, largely as a result of the sustained expansion of trade with Brazil. However, with the radical change in capital flows to emerging countries that came in the wake of the Asian crisis of 1997-98, the Brazilian devaluation in early 1999 and the steady appreciation of the dollar from 1998 to 2001, the overvaluation of the Argentine peso led to an outright structural crisis. As the convertibility scheme's exit costs were explicitly high (which was, in the eyes of its advocates, its main virtue), the authorities clung to the system,

1 See ECLAC (2000), vol. III, chapter 1 (see figure 1.1 in particular).

2 This also is a reflection of the difficult "learning" processes involved in the formation of macroeconomic expectations that are characteristic of far-reaching structural changes such as those experienced during these years. See the excellent essay by Heymann (2000) based on reflections regarding Argentina's situation.

3 See Altimir and Beccaria (1998) and Damill, Frenkel and Maurizio (2002).

which, nonetheless, soon collapsed. The breakdown of the scheme, like its gold-standard predecessors, was chaotic and was heralded by a run on deposits in the financial system and a loss of reserves.

The withdrawal of deposits, the loss of reserves and the collapse of economic activity all occurred abruptly and simultaneously in 2001, that is to say, while the convertibility regime was still in full sway. Just as occurred during the gold standard's collapse in the 1930s, the authorities first tried to make the system more flexible (via competitiveness plans and public debt swaps) in an effort to stave off its downfall. When this effort failed, they restricted deposit withdrawals, declared a public debt moratorium and introduced exchange controls. These measures, in themselves, signalled a reluctant abandonment of convertibility. Eventually, with the devaluation of January 2002, the regime was discarded outright. The severe deterioration in the financial system's liquidity disrupted the payment chain and fuelled a strong demand for the central bank to act as a lender of last resort.

Thus, the credibility that had been built up on the basis of the convertibility regime was more than offset by the recessionary effects that the system generated during crisis periods. In the end, the lack of confidence in the sustainability of public and private debt servicing won out, thus overpowering the system. What is more, because the exit costs were avowedly high, private agents' mistrust in the economic authorities' ability to maintain the rules of the game gave rise, at a critical juncture in this chain of events, to an explicit call for a run on deposits and thus, inevitably, to a chaotic denouement at the end of 2001.

Alternative explanations for the collapse will, of course, continue to be offered. One of them is that there was not enough price or wage flexibility. Actually, there was a moderate degree of flexibility. However, it should be recalled that, during the era of the gold standard, it became clear that flexibility is not a panacea. In fact, flexibility actually tends to exacerbate crises because nominal debt balances are not flexible and the actual burden they represent therefore increases rapidly in the presence of deflation. In other words, deflation is equivalent to a steep rise in real interest rates; for this reason, it has adverse effects on economic activity and banks' portfolios. This was also a point made by John Maynard Keynes when arguing against the orthodox formulas for dealing with crises that prevailed up to the 1930s.

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Another explanation is that fiscal austerity was lacking. This is partially true – especially in the second half of the 1990s – but it is also true that the fiscal crisis of the late 1990s was, in large measure, endogenous. The contraction of production activity – as transmitted through the downturn in tax receipts, rising country risk spreads and, hence, the higher cost of public sector borrowing – set in motion a vicious circle in which primary spending cuts were invariably insufficient to offset the upward trend in the budget fiscal deficit. What is more, the authorities were faced with the paradox that, insofar as the convertibility regime was characterised by an endemic tendency to run a trade deficit and by dependence on external financing, the fiscal deficit was, in a sense, functional. It made it possible to maintain aggregate demand and economic growth while at the same time providing a portion of the necessary external financing that the economy needed in order to grow during boom periods.

Wrong Assumptions

In 2001 the International Monetary Fund handled the Argentine crisis in a radically different way than it had dealt with other episodes since the Mexican crisis and, in fact, than it had managed the crisis in Argentina itself up to December 2000, when international financial institutions had provided it with its "armour-plating". The first assumption underlying the new approach adopted in 2001 was that, in order to avoid the much-touted problems of "moral hazard", market discipline ought to be reflected both in losses for investors that have assumed excessive risk and in a severe adjustment for the country whose policymakers have erred. The second assumption was that the "contagion" of other economies in the region could be avoided or, in other words, that the "explosion" could be contained.

The first assumption was based on the mistaken idea that the international community could find a way to wash its hands of the events in Argentina. No one doubts today, either in Argentina or elsewhere, that errors were made in managing the country's convertibility regime. But it is also clear that the international financial community played a role in creating the conditions that ultimately led to the collapse of the country's monetary and financial system. Favourable expectations spurred what proved to be an avalanche of private capital, and its subsequent flight was one of the factors that triggered the crisis. This herd behaviour during both phases of the business cycle is nothing new; rather it is an intrinsic feature of private capital movements. International financial authorities were not mere bystanders either. While recognising that the ultimate responsibility for the economic policies that were implemented rests with the national government, and despite the reservations that the IMF may have had and may have voiced on different occasions, the fact remains that the Fund backed Argentina's economic programmes throughout the decade that the convertibility regime was in place. In fact, at the annual IMF meeting in 1998, the Fund's Managing Director heralded Argentina's economic policy as "the best in the world". The private and multilateral sectors of the international community had a hand in creating the crisis, and they must have a hand in its solution.

The second assumption was just as mistaken as the first. The delay in the support of IMF for Argentina no doubt exacerbated financial markets' hypersensitivity towards Latin America. Foreign direct investors' perception of risk in the region was heightened, since Argentina was one of the favourite destinations of such investments during the 1990s. There are, of course, exceptions; some countries have managed to access financial markets at reasonable spreads, but even they have had to deal with investor caution, and none has experienced rapid growth. Through the capital account, as well as through trade, tourism, the reduction in remittances from migrants living in Argentina and the losses sustained by Latin American firms that have invested in that country, the Argentine crisis has been transmitted to other countries of the region.[4] The idea that it was possible to isolate the crisis and prevent contagion thus tumbled like a house of cards. In an economic climate marked by the perception of severe uncertainty in Latin America and, it should be added, highly unstable financial markets in the industrialised countries themselves, the Fund's belated response to the situation in Brazil and Uruguay also yielded diminished returns.

[4] For a detailed analysis of the Argentine crisis' regional effects, see ECLAC (2002), and the chapter by Ffrench-Davis and Studart in this volume.

Lessons

The lessons to be learned from this experience are well known. The effects of volatility in financial markets are devastating. One of their inherent features is the alternation of periods of under and overestimation of risk, i.e. of periods of "irrational exuberance" (the term coined by the Chairman of the Federal Reserve, Alan Greenspan) and "irrational panic". Just such "irrational panic" has been seen in the cases of Brazil and Uruguay in 2002. Levels of indebtedness which, shortly before, had been regarded as manageable were suddenly reinterpreted as being unsustainable. This turnaround is particularly serious because – as demonstrated by models of multiple equilibria and "self-fulfilling prophecies" and, for that matter, as recently observed by the international financier George Soros in relation to Brazil – the market sometimes has a way of imposing its own expectations on reality, even when they are irrational. It should perhaps be added that, above and beyond any errors that may have been made by economic policymakers or any mistaken decisions made by individual investors, such self-fulfilling prophecies have certainly been a factor in the Argentine crisis.

Given these circumstances, prompt action by the IMF is required to correct what are essentially market failures. Such action is also critical in order to prevent contagion, since the formation of expectations about the situation in a country cannot be divorced from the regional context. These observations therefore point to something much more profound: an international financial system that generates this type of hypersensitivity and, hence, this high a frequency of financial crises, is flawed and must be reformed.

The management of the Argentine crisis has two additional lessons to teach us that should be borne in mind as we move forward. The first is that, in the presence of great uncertainty and lack of confidence, if the parties involved – i.e. national authorities and the IMF – are to advance in the right direction, they will have to take a highly pragmatic approach and be willing to learn as they go along. This is the only way that the economic authorities can, slowly but surely, gain credibility. In Argentina, the restrictions that have been placed on financial transactions cannot be entirely dismantled until confidence in the new monetary and exchange rate regime has been built up. Production activity has to be returned to some degree of normalcy in order for tax revenues to recover so that a lasting fiscal balance can be achieved. Trying to bring about a fiscal adjustment by making even greater cuts in expenditure does not lead to fiscal equilibrium but rather to deeper recession and fiscal imbalances, as became clear in 2001. Refraining from intervening in the foreign exchange market when inflationary expectations are based largely on the exchange rate would simply open the door to hyperinflation and then dollarisation. It is important to recognise that no one knows exactly how events are going to unfold in the near future, nor has an alternative route been plotted out in detail. This is why, once the ultimate objectives have been clearly defined, pragmatism is the only possible avenue. Under present conditions, to demand a comprehensive blueprint is simply not realistic.

This points up to the final lesson. Precisely because there is so much uncertainty and because events are unfolding in a very dynamic way, the conditions for the commencement of formal negotiations between the Fund and Argentina have been subject to significant changes through 2002. This has sparked a lack of confidence on both sides. The Government of Argentina has said, with some justification, that each time it has met the stated requirements, new demands have been made. For its part, the International Monetary Fund has had misgivings as to whether those requirements have genuinely been fulfilled, and this has often been because of decisions, whether actual or potential, made by the legislature or the courts rather than by the government as such or by the central bank, which are the parties directly engaged in negotiations with the Fund. Apart from this, excessive public pronouncements by IMF authorities have heightened the two parties' mutual distrust. Under these conditions, in addition to the pragmatism mentioned earlier, the requirements for the commencement of negotiations should be clearly established, a high degree of confidentiality must be maintained in those negotiations, and whatever public statements are made by the Fund must be carefully considered (and even avoided).

Current Conditions and Outlook

The effects of the explicit abandonment of convertibility in 2002 did not bear out the more pessimistic projections that had been made. In particular, despite great uncertainty and the absence of external backing, neither the exchange rate nor inflation went through the roof. A prudent wage policy has no doubt contributed to this result. The demand for money has been stronger than initially anticipated, even in relation to the more optimistic expectations. The fiscal situation has changed for the better, although this improvement is based on factors that would be difficult to maintain over the long term (a wage freeze, a moratorium on the external debt, and export taxes).

The severe deterioration in production activity experienced in 2001, which was only exacerbated in December of that year by the paralysation of the payments system, bottomed out in the early months of 2002 and activity has normalised somewhat since the second quarter. The trade surplus has remained high, largely because of slack demand for imports. Exports have been hurt by the paralysis of credit and the contraction of intra-Mercosur trade, but some signs of a reactivation are beginning to appear. It is true, however, that it was not until mid-2002 that the country's favourable trade balance began to be reflected in a stabilisation of international reserves, which indicates that significant capital outflows continued throughout the first semester.

On the negative side, the combination of the higher unemployment levels associated with the slump in production activity and the decline in real wages was reflected in a steep increase in poverty and indigence. Nevertheless, since the collapse of production activity and the breakdown of the convertibility system both occurred in 2001, it is difficult to lay the blame for those events on the way the crisis has been managed in 2002. The main problem in the latter case has been that, even though steps have been taken to alleviate the most extreme situations by setting up a programme to provide subsidies for heads of household, the efforts to reverse these trends have not succeeded.

The recovery of production activity has been hindered by policymakers' indecisiveness regarding the distribution of the costs and benefits of the devaluation. This has given rise to varying solutions and to conflicts between the government and the central bank which have delayed the normalisation of the payments system and of credit for working capital. Court decisions protecting the rights of bank depositors and the protraction of the process of reaching an agreement with the Fund have also been part of the problem. The fiscal costs of resolving the financial crisis therefore remain uncertain, and it is possible that the prolongation of the crisis

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

may dim the country's future financial development prospects. On the positive side, it may be said that bankruptcies have fallen and that firms have learned fast how to operate without credit.

There is still a long way to go. There is some degree of consensus as to the main things that need to be achieved, but there remains a great deal of uncertainty as to how to go about it. First, and foremost, it is necessary to restore the confidence in private contracts.[5] The normalisation of the payments and credit systems is an element in this process. This is certainly an area in which innovative solutions should be devised. Unlike earlier crises, the cost of restructuring the economy cannot be absorbed entirely by the State. Instead, it will have to be shared with debtor firms, depositors, banks and taxpayers. Explicit, active external support that will help build up the new regime's credibility must also be forthcoming.

There is also a clear consensus as to the need to put public finances in order. This includes low budget deficits, an enduring fiscal covenant between the central government and the provinces, a better tax system and, above all, an improved tax administration capacity. There is also clarity as to the need for a flexible monetary policy that can ensure low inflation and an orderly floating exchange rate regime.

The renegotiation of the external debt is another piece of unfinished business, but in some ways it is a less urgent task, since no arrangement could conceivably attract significant amounts of additional capital in the near future. Consequently, reaching a debt agreement has only short-term costs, since its benefits will only be realised in the long run. The country's dependence on multilateral financing will therefore be very marked in the immediate future. The task of remedying the debt problem may, however, be an appropriate field in which to explore innovative mechanisms for speeding the transition to the normalisation of private external financing. One possibility in this regard might be a scheme for the provision of multilateral guarantees for additional financing (i.e. "bailing in" operations with the support of guarantee schemes) in exchange for the normalisation of the servicing of their financial claims. Reducing protectionism in developed countries for temperate zone agricultural products in which Argentina has a strong comparative advantage could also be part of the solution.

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[5] See the chapter by José María Fanelli in this volume.

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In designing the new macroeconomic environment, it is important to bear in mind a basic lesson learned during the past decade: neither innovative "shortcuts" (at the moment, dollarisation) nor "no-holds-barred" liberalisation (which to a great extent is already in place) are magical solutions. It is even more evident to all observers that, above and beyond whatever economic policy can accomplish, a definitive resolution of the Argentine crisis must necessarily entail a settlement of its political and institutional crisis. There is only one possible actor capable of achieving that: the Argentine people themselves. Nonetheless, the international community, and especially the Latin American one, has an important supporting role to play in this respect.

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