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The Argentine Drama: A View from the IMF Board

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"Soft physicians cause festering wounds"
(old Dutch saying)

My vantage point for having a view on Argentina's economic woes is the Executive Board of the International Monetary Fund, of which I was a member during 1994-2002, and in which I participated in the decisionmaking on Fund financial support to member countries, including Argentina. During the course of this period, I developed serious misgivings about the economic and financial policies that Argentina was following, which were basically supported by the IMF for most of that time. I felt that not only were the Argentine physicians too soft in their approach, leading to insufficient adjustment and reform, but also that the external specialists from the Fund that were called in on a regular basis, were not always prescribing the right medicine or in the right dose. The result has been in my view an unnecessary prolongation of agony for the population, and a steeper collapse of the economy than would have occurred had the Fund forced a showdown earlier.

In view of my concerns with developments in Argentina and the Fund's role in it, I took the unusual step in September 2001 of explicitly abstaining from voting in the Executive Board on the proposal to augment by $8 billion the existing Fund credit to that country. In what follows I will attempt to explain why I considered

1 I wish to thank James Boughton, Graciana del Castillo and Jacques J. Polak for their valuable comments, while absolving them from responsibility for any remaining errors.

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that the actions of the Argentine authorities were leading to a dead end. After a look at some of the earlier history of Argentina and the IMF in the second section, an analysis is provided in the third section of the operation of the currency board which was introduced in 1991. The fourth section treats the 'end game' leading up to the disastrous collapse of the Argentine economy. Lessons to be drawn are discussed in the final section.

Argentina and the IMF: 1980-1991

It seems useful to take a step back and briefly review the main economic developments in Argentina during the 1980s, in particular in relation to the IMF. Most helpful in this regard are the passages on Argentina contained in Boughton's history of the IMF during 1979-1989 (Boughton, 2001). What stands out is the large number of programmes that were negotiated with the Fund, all of which failed. The period is characterised by a recurrence of new plans, implementation problems, by pleas for leniency by the largest shareholder of the Fund and, each time, willingness in the end by the IMF Management to provide resources again, despite serious misgivings by some members of the Executive Board.

In December 1983 Raúl Alfonsin was elected President of Argentina, bringing to an end to the military dictatorship that had lasted seven years. This brought new hope to the country that the return to democracy would also bring a return to economic stability. Under the military regime there had been considerable problems, after the relatively stable years 1976-78. Fiscal deficits started to climb again and the external debt rose dangerously, tripling in a mere three years (Boughton, 2001, p. 329). Efforts to stem the problems by a new economic team came to naught when Argentina occupied the Falkland Islands (or Malvinas) in 1982 and came into conflict with the United Kingdom. The result was a massive depreciation of the peso, serious domestic inflation and accumulation of sizeable external arrears. After Mexico stunned the financial world in August 1982 with its announcement of its inability to service its external debt, Argentina soon approached the Fund for financial assistance, as it too was in serious difficulties. After complicated negotiations with the Fund, the BIS – for a bridge loan – and the foreign banks, who were Argentina's main creditors, an agreement was finally reached for a total credit package of just over SDR 2 billion. While developments looked rather positive for a while, a staff team visiting Buenos Aires in August 1983 discovered a variety of problems, particularly a loss of control over wages affecting both the budget and external competitiveness, and the programme failed.

Under Alfonsin, negotiations started on a new programme with the Fund. They led to nothing at first whilst the economy deteriorated.[2] In the meantime the relations with Argentina's creditor banks deteriorated and the sceptre of default hung in the air. In March 1984, four Latin American countries[3] lent Argentina $300 million for three months, followed by a similar amount by the United States.[4] This provided some breathing space as it was not before late September 1984 that an agreement was reached between the Fund and Argentina on a programme. The programme was soon endangered, however, by substantial wage increases. Nevertheless, after fresh negotiations, including with the foreign banks that came up with $6 billion to cover the large financing gap, a new credit from the Fund was agreed on.[5]

Then there followed a series of plans by the Argentine authorities in an attempt to get the economy in reasonable shape and to keep the Fund programme on track. The first was the Austral Plan of 1985, designed as a 'shock' programme. Its centrepiece was the substitution of the austral for the discredited peso, lopping off three zero's in the process. Other elements included a temporary price freeze, a declaration of intent to end central bank financing of the fiscal deficit and a reduction of the deficit itself. In a breach with the past, contracts were to be indexed. The plan did not last long, as fiscal policy was undermined by large off-budget spending and an easy

[2] It is interesting to note that when the Fund's chief negotiator returned to headquarters to report to the Managing Director, senior US officials were also present at the meeting (Boughton, 2001, p. 388). This also happened at later debriefing meetings.

[3] Brazil, Colombia, Mexico and Venezuela.

[4] In May 2002, Argentina made a similar request for bridge financing from neighbouring countries, but there was no follow up.

[5] The Fund package consisted of a stand-by arrangement plus a drawing under the Compensatory Financing Facility (export shortfall). The CFF element was dubious, and was only agreed to by the Managing Director "in desperation" (Boughton, 2001, p. 396). The Dutch Executive Director, J.J. Polak, did not support this part of the package.

monetary policy. Argentina once again fell out of compliance with a Fund programme.

During 1986 and 1987 the Austral Plan faded away. After renewed tortuous negotiations a new Fund arrangement was reached in July 1987, Argentina again getting the benefit of the doubt from Management and the Executive Board. The doubts expressed did prove to be founded, however, since after much patchwork, including a secret meeting between President Alfonsin and Fund Managing Director Camdessus in Madrid, the new programme collapsed in March 1988.

The next move by the authorities was to launch the Plan Primavera in August 1988, consisting of a so-called heterodox package of measures aimed at breaking the momentum of seriously mounting inflationary expectations. Again the programme foresaw too little fiscal adjustment, and this time the Fund, in the absence of firm policies, refused to resume lending to Argentina.[6] Only six months after its introduction, the Plan Primavera collapsed leading to a slide into hyperinflation. These were the circumstances under which the Peronist Carlos Menem was elected president in May 1989. He immediately announced a new shock programme, this time with more fiscal adjustment in view of the size of the huge government deficit (16 percent of GDP for 1989). Importantly, the central bank was given more independence by not having to finance the government anymore. In November 1989 agreement was reached on yet another standby with the Fund, but again the arrangement was eclipsed prematurely as political obstacles blocked a strong adjustment and reform effort. After another bout of debilitating hyper-inflation, which reached 12,000 percent per year, Domingo Cavallo, the minister of finance, introduced a real shock effect in April 1991 by introducing a currency board, fixing the value of the dramatically eroded peso at a rate of one per US dollar.

[6] During this period a serious rift developed between the IMF and the World Bank, which was negotiating separately with Argentina on new loans. The Bank expressed strong doubts about the Fund's insistence on fiscal adjustment, while the Fund staff felt undercut by their Bank colleagues. At a time the Fund was still negotiating with Argentina, the Bank went ahead with providing loans to the country. This highly unusual state of affairs burdened the relationship between the institutions (see Boughton, 2001, pp. 522-23).

Argentina's experience in the 1980s and the Fund's role in it shows that the authorities produced a host of initiatives and plans, initially usually inadequate, which led to a series of Fund programmes, usually after drawn-out negotiations, and about which the Executive Board showed increasing apprehension, yet each time giving the country the benefit of the doubt. The plans tended to fail relatively quickly as a lack of discipline led to Argentina missing its targets time and again. This pattern can be seen as a precursor to that under the later stages of the currency board, to which I now turn.

The Currency Board

The introduction of the currency board was a drastic measure which swiftly led to disinflation and a robust turnaround of the economy. On the basis of the initial success, both the author of the convertibility law, minister of finance Domingo Cavallo, and the president that appointed him, Carlos Menem, could look upon their decision with considerable satisfaction. There was also a show of enthusiasm from the international community, especially since Argentina was at the same time embarking on a large-scale privatisation programme that was drawing in substantial amounts of foreign capital. In this rather euphoric atmosphere, more sceptical views of the wisdom of sustaining a currency board in a country that surely does not constitute an optimum currency area with the United States, that had one of the most closed economies in the Western world and where structural reforms, including in the essential area of the labour market, were very difficult to put in place, did not hold much sway.

There needs to be little doubt that in 1991 shock therapy was what was needed in Argentina, and the introduction of a currency board was probably the most convenient way of administering it. What seems to have fallen by the wayside, however, is the insight that the conditions for a sustained maintenance of a currency board – as distinct from administering a temporary anti-inflationary shock – are very stringent. Following Larraín and Velasco (2001, pp. 10-11) a number of requirements can be listed: the criteria for an optimum currency area need to be satisfied, implying among other things, that large countries are less likely to qualify; the bulk of the pegging country's trade should be conducted with the country to which it

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pegs its currency; inflation preferences should not diverge much between the pegger and the 'main' country; the need for a flexible labour market to help avoid rising unemployment; strong institutions and a consistent application of the law. To this list I would add the need to conduct a stringent fiscal policy, especially when the currency board is primarily intended as protection against inflation – as was the case in Argentina.[7] Keeping up with increases in labour productivity in the country whose currency serves as the peg can also be considered necessary for the longer-term viability of a currency board. Usually this requires a sustained effort in the area of structural reform. It is quite clear – of course the more so with the benefit of hindsight – that practically none of these conditions were met by Argentina. That the currency board continued to function as long as it did, had much to do with the lack of an exit strategy, or the willingness to contemplate one, and the unattractive prospect of having to introduce a different monetary approach fraught with short-term political risk.

The literature recognises the need for an exit strategy for most currency board regimes. A thorough analysis of the exit problem is contained in Baliño and Enoch (1997).[8] It is useful to keep in mind that there are no instances of relatively large countries with relatively closed economies successfully operating a currency board over an extended period of time. After its initial success in bringing down inflation in Argentina, the currency board introduced in 1991 increasingly constituted a drag on the economy, especially since the authorities allowed it to function more as a suppressor of symptoms than as an engine for fundamental change in the economy. What was especially damaging was that the authorities took insufficient action to bring Argentina's perennial fiscal problems, including with its provinces, under control.[9]

[7] Blejer and del Castillo (1998, p. 460) state that: "A policy of utilising the exchange rate policy as an anti-inflationary instrument can only succeed if the authorities stick … to a fiscal policy compatible with the exchange rate …".

[8] It is interesting to note that Argentina twice exited from a currency board before, i.e., in 1914 after 12 years (onset of World War I) and in 1929 after only two years (depression), both instances leading to a strong loss in the value of the peso (Baliño and Enoch, 1997, p. 26). See also Eichengreen and Masson (1998) for an analysis of exit strategies from fixed exchange rate regimes in general.

[9] While Stiglitz (2002) correctly mentions the wrong exchange rate regime in Argentina as a major reason for its woes, he fails to recognise the contribution of the lack of fiscal discipline. By saying that a 3 percent of GDP fiscal deficit is not an

In its programmes with Argentina, the IMF concentrated only on the budget deficit of the central government, whereas the focus should have been on the general government. Equally undermining the currency board was the continuation of external borrowing which eventually led to an unsustainable situation, a development that was recognised too late not only by the country itself but also by the international financial institutions and the international capital markets. Hence, it is too simple to only blame the currency board for having brought about a seriously overvalued exchange rate and consequently an eventual economic collapse. It was the fact that the conditions for a sustained operation of the currency board did not exist in the first place, in combination with an endemic lack of fiscal discipline,[10] and a penchant for excessive borrowing that led to Argentina's slide into the morass of default and depression. This combination of a closed economy, with exports of goods and services amounting to no more than 9 percent of GDP (the average for Latin America is 19 percent; for emerging Asian countries 50 percent) which remained closed in part because of the overvalued exchange rate, and the high level of external borrowing by the government proved to be unsustainable.[11] Argentinean claims, made right up to the end, that its government debt position was sound since at 57 percent of GDP (at end-2001) it was not higher than that of many OECD countries, completely missed the point. The fact that Argentina's external debt to export ratio had climbed to the astounding level of around 500 percent and that by 1999 it needed to use around 40 percent of its export proceeds to pay interest on its external debt (see figure 1) was what should have set alarm bells ringing not only on Wall Street and in Washington (as it eventually did), but also in Buenos Aires.

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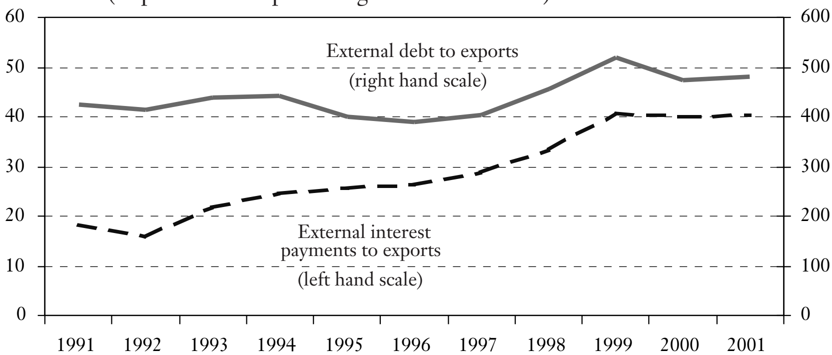
outrageous number, and that the United States has had bigger deficits, he forgets that Argentina's deficits had to be financed through – increasingly expensive – external borrowing in foreign currency; a very different situation than the one facing the United States.

10 Mussa (2002, p. 6) notes "...the chronic inability of the Argentine authorities to run a responsible fiscal policy."

11 See "Debt Crises: What's Different About Latin America?", in chapter II of IMF (2002). This excellent section explains in considerable detail how the combination of a low export base and a high degree of openness to international capital markets importantly increases a country's risk of default.

Figure 1 External Debt Indicators

(in percent of exports of goods and services)



Source: IMF.

Argentina's serious problems did not come to the fore until a few years ago, but as described at some length by Mussa (2002), earlier signs of trouble were discernable to those willing and able to see them. The country got through the Tequila crisis of 1995 quite well, but most probably would have been better off today had it had the foresight in the 'good' years up to 1998 to abandon its currency board and to float its currency in combination with establishing an inflation targeting regime as an anchor. Politically, this was a non-starter, however. But it is precisely what Brazil did in early 1999, after waging a futile battle against overwhelming capital outflows in attempting to maintain an overvalued exchange rate. Since the real effective exchange rate of Argentina had already appreciated quite considerably since 1991 and the plunge of Brazil's currency added significantly to that, any exit strategy – had it existed – should have called for abandoning the currency board in Argentina at that time.[12]

Failing that, a second-best solution may well have been to devalue within the currency board regime. While this would have been highly unusual it would appear to have been possible with some clever political manoeuvring. However, the solution that Cavallo,

[12] Blejer and del Castillo (2001) pointed to the failure of Brazil to address its chronic fiscal deficit as a major reason for this exit. They also expressed the view that the crisis in Brazil, the leading economy in Latin America, had "…set the stage for a new phase of instability, protectionist pressures, social distress, and political changes in Latin America."

who returned as Economy Minister in June 2001, pursued was to adjust the parameters of the currency board[13] and to manipulate tariffs and introduce export subsidies. This was a serious miscalculation, as was the dismissal of the central bank governor under not very clear circumstances, as it served only to undermine confidence and convince the markets that Argentina's currency board was doomed, or that the country would default, or both.

The role of the Fund during Argentina's initial, apparent, success and its subsequent swift decline is described in considerable detail by Mussa (2002), who was Director of Research at the IMF until 2001. I concur with his main conclusions that (a) the Fund failed to press Argentina hard enough on fiscal policy, especially during the period of rapid economic growth from 1995-97,[14] and (b) that it went on too long providing financial support to Argentina.

I am not convinced of his view, however, that whereas the Fund had been sceptical initially concerning the currency board, it was right to support Argentina subsequently in its decisions to maintain the peg. The argument for this position has been that the choice by a government as regards the exchange regime it wants to operate should be respected by the Fund, and supported with financial programmes as well if it is requested to do so. I have during my eight years on the Executive Board continuously taken a different view, arguing that while a country has the freedom to choose or maintain its preferred exchange rate regime, the Fund has no obligation to financially support an unviable exchange rate. In fact, it is doing a disservice to both the member country with an unsuitable exchange rate and to itself and its creditor members by lending under such inauspicious conditions. Indeed, the pendulum is lately swinging toward this view. I therefore do not expect a recurrence of the spate of large-scale IMF-led financing packages that were put together in recent years for emerging market countries, several of which – in the end unsuccessfully – tried to maintain clearly overvalued exchange rates.

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13 The peso was to move with both the US dollar and the euro in equal weights, once the euro reached parity again with the dollar. In the event, the dollar appreciated further against the euro raising expectations of a devaluation of the peso.

14 Mussa (2002, p. 12) asserts that waivers were granted to Argentina for missed fiscal criteria on many occasions and that "…violations … were simply ignored by the Fund and effectively swept under the rug."

The End Game

I will now briefly review the end game of the Argentine tragedy, as it can provide useful insights for the future. The first clear signs of trouble emerged in 1998 as Argentina slipped into a recession out of which it was unable to extricate itself. As depicted in figure 2, declining output led to an increase in the already substantial rate of unemployment, which reached nearly 18 percent in 2001 (and is likely to have increased substantially since then). As the recession became more drawn out, fiscal adjustment became increasingly difficult, with the tax ratio showing no improvement instead of the increase that was desirable,[15] and shrinking since 2001. Tax evasion – an endemic problem – probably increased and bouts of capital flight resumed.[16] While initially the financial system was considered to be sound, residents started to convert their peso into dollars and later also took out their dollars in large amounts from the banks as they started to doubt their solvency. Kiguel (2001, p. 29) has asserted that because Argentina was operating a fixed rated regime, it was better prepared to deal with financial shocks than under alternative systems. This has proved to be not true. Once confidence wanes under a currency board regime, the risk of a crisis is probably (much) greater than under a system of floating exchange rates. Argentina's international reserves, which were adequate in relation to the formal requirements of the currency board,[17] declined sharply after reaching $26 billion in 1999, to a mere $14 billion by the time of the abolition of the currency board in December 2001. In the meantime Argentina continued to borrow from international capital markets, except for an interlude after the Russian crisis of the summer of 1998 when it could not access these markets unless it was willing to pay a huge premium. It is this combination of inadequate fiscal adjustment and (external)

[15] Argentina's ratio of tax revenue to GDP has remained at around 18 percent in recent years, which is low compared to around 30 percent for Brazil.
[16] Estimates of the amounts of assets held abroad by Argentineans are as high as $100 billion (see The Economist, 2002, p. 28).
[17] That is in relation to base money. Reserves fell considerably short of covering short-term external debt, which according to Guidotti (Deputy Minister of Finance of Argentina until 1999) was the amount that was minimally needed, as it allowed a country to go without borrowing for a year. If one adds an estimate for potential capital flight, Argentina's reserves were clearly inadequate already in 1999 (see de Beaufort Wijnholds and Kapteyn, 2001, pp. 22, 23).

borrowing in foreign currencies which in the end proved so damaging for Argentina's attempt to maintain the currency board and avoid default.

While Argentina's policies were clearly inadequate, and the international financial institutions were often insufficiently critical of them,[18] its problems were aggravated by unfavourable external developments. The dollar, to which the peso was pegged, kept appreciating, thereby further weakening the Argentine competitive position which had already been dealt a severe blow by the Brazilian devaluation of 1999.[19] But instead of exiting the currency board, albeit under unfavourable conditions but in order to avoid worse, the Argentine authorities stubbornly continued along what Mussa describes as "the road to catastrophe". Markets were starting to contemplate the likelihood of an Argentine sovereign default, as during the course of 2000 the economic malaise worsened and the administration of President De la Rúa demonstrated a lack of decisiveness. In early 2001, the IMF once again came to the aid of Argentina with a huge financial package. It provided $14 billion (around 500 percent of Argentina's quota in the IMF, for which the general rule is that it can surpass 300 percent only under exceptional circumstances), the World Bank and the Inter-American Development Bank contributed $5 billion of what was essentially balance of payments financing for which they are not ideally suited, and the Spanish government provided $1 billion. The private sector was to provide an additional $20 billion or so, but the details of this part remained vague and seemed to serve mainly to be able to announce a total package of around $40 billion.

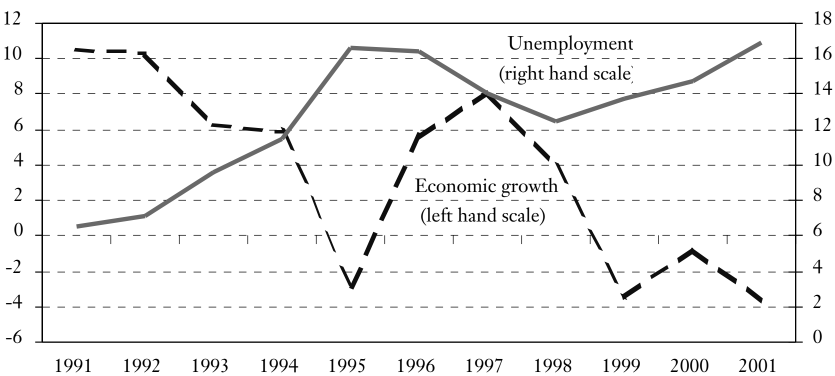
Other possible options in lieu of a large bailout package orchestrated by the IMF would have been a large-scale restructuring of Argentina's sovereign debt or full dollarisation. Much has been written about the pros and cons of these choices, and I will emphasise only one point here, i.e. that adopting the dollar without a sizeable devaluation would have solved nothing. In fact it would have provided only some short-term solace, but would have locked Argentina into a weak competitive position for a very long time, from

[18] This is also the view of Guillermo Perry, Chief Economist for Latin America and the Caribbean at the World Bank; see Perry and Servén (2002, p. 6).
[19] Perry and Servén (2002, p. 24) estimate the overvaluation of the peso to be about 55 percent in 2001.

which it could only exit by means of prolonged austerity. Adopting an irrevocably fixed exchange rate while suffering from lack of competitiveness condemns a country to long-term high unemployment, especially in the face of low mobility of the labour force and other labour market rigidities.[20]

As matters became worse for Argentina, it came to fall on Domingo Cavallo in March 2001 to assume the role of *deus ex machina*. Starting off energetically, he introduced a financial transactions tax to generate much-needed government revenue. Less well received was his decision to change the terms of the currency board, as mentioned earlier, and his firing of the central bank governor. After all the rigid application of the rules of the currency board and the independence of the central bank had been main pillars of the success of the board of the early 1990s. Another desperate act aimed at staving off default at all cost was the massive operation designed to swap a huge amount of Argentine government bonds for paper with longer maturities so as to lighten the debt service in the immediate years ahead. Although it is very difficult to ascertain how costly the swap was, Mussa (2001, p. 27) notes that the operation led to a lowering of the debt service of $12 billion between 2001 and 2005, while adding a staggering $66 billion to the payment of interest

Figure 2 Growth and Unemployment



Source: IMF.

[20] Pastor and Wise (2001, p. 64) state that "...Argentine labour markets are anything but flexible …".

and amortisation in the years after 2005. Market interpretation generally was that a default was imminent.

Still it took another six months before the final showdown came. During this period the Argentine economy went from bad to worse, with growth falling more rapidly and unemployment nearing 18 percent (see Figure 2).

Against this background Cavallo unveiled a 2002 budget deficit plan which envisaged substantial budget cuts, especially in salaries. The plan was not realistic, however, in view of falling revenue caused by the recession and widespread tax evasion. Moreover, the assumptions underlying the budget (a positive rate of economic growth) were unrealistic.[21] When it became clear during the summer of 2001 that Argentina's efforts were proving futile, as for instance indicated by a rise in spreads on its bonds to risk premia levels that indicated a virtual certain default, the IMF once again made a rescue effort. To be sure, this was a very difficult decision to make for the Fund's Management, as well as for the Executive Board. The proposal put before the Board was to augment the ongoing programme with $8 billion (300 percent of Argentina's quota), of which the bulk was to be disbursed up front. While there was considerable unease about the operation, the Board adopted it on September 7, 2001. Having reached the conclusion that this augmentation was the wrong response to Argentina's plight, I stated that I could not support Management's proposal.[22]

In motivating my position I stated that I considered most of the assumptions underlying the revamped Argentinean programme unrealistic. For instance, the programme foresaw an increase in the primary (i.e. non-interest) fiscal balance to a surplus of 6 percent, which I considered a leap of faith in view of the fact that in the previous 10 years the primary surplus had never been higher than 1.5 percent. Besides, I expressed doubts about the wisdom of such a severe fiscal contraction and the austerity it would bring about in the

[21] As late as November 2001, in a meeting with the Dutch authorities at the margin of the IMF ministerial meeting in Ottawa, minister Cavallo expressed confidence in reaching a zero deficit outcome, while the Fund staff was already expecting economic growth to fall by at least 3 percent, with a concomitant fall in revenues.

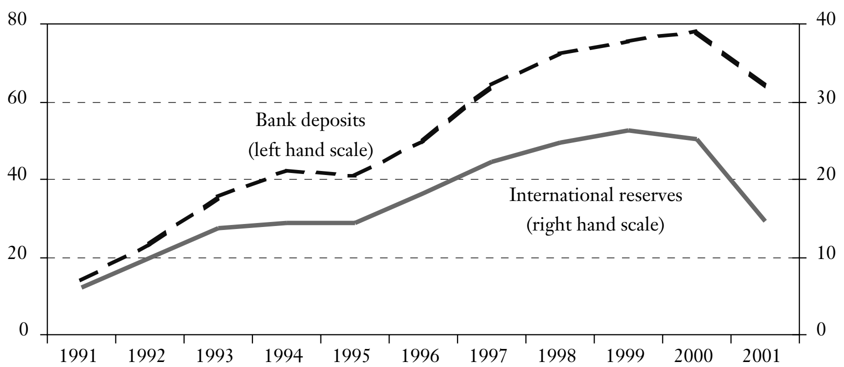
[22] My Swiss colleague made a similar statement and our abstentions were recorded in the minutes.

midst of a long drawn-out and deep recession. The export assumptions I also considered much too optimistic in view of the overvalued exchange rate and the weakness in the world economy. Moreover, the programme assumed that Argentina would be able to regain access to international capital markets, while it was actually on the brink of default. I concluded by saying that I did not believe that a virtuous circle would be achievable for Argentina, as matters had been allowed to deteriorate for too long, and I expressed concern that under the programme the Argentine people were going to be condemned to years of stagnation, if not negative growth, with no real prospect of a medium-term solution.

In October 2001, after it became abundantly clear that the additional $8 billion provided to Argentina had made very little impression on markets, Cavallo announced that a rescheduling of sovereign debt was needed, but that it would be a voluntary operation and market friendly. Again the rhetoric proved to be inaccurate. As the downward spiral of the Argentinean economy continued, and deposit withdrawals from the banks became a flood, a bank closure was ordered and cash withdrawals limited (figure 3 demonstrates how the fall in bank deposits affected official reserves).

The resignations of first minister Cavallo and then president De la Rúa soon followed amidst widespread unrest and violence. A declaration of sovereign default by the new regime was the next step in the drama, soon followed by the flotation of the peso by President

Figure 3 Bank Deposits and International Reserves
(in billions of dollars)



Source: IMF.

Eduardo Duhalde, who had taken over the reigns on December 30, 2001. New negotiations were started with the IMF on a programme that could be supported by a credit, but months elapsed as political differences, including a great reluctance by the provinces to agree to restrict their fiscal autonomy, delayed decisive action. In the meantime the banking system was showing increasing signs of strain and depositors subject to the corralito – the restriction that had been imposed on the withdrawal of deposits – became increasingly upset.

Indeed, the economic challenges facing the present government in Argentina are of a magnitude seldom seen in modern times and perhaps best compared to what occurred in the countries in Eastern Europe and the former Soviet Union after the fall of communism. A steep fall in the standard of living is taking place and economic uncertainty has increased dramatically, while the country has fully lost its creditworthiness. It is likely to take years for these developments to be reversed. It is widely recognised – except in Argentina itself, where opinion appears to be divided – that under these circumstances there is no real alternative for Argentina but to come to an agreement with the IMF, unless it chooses to turn its back on integration in the world economy.[23] Since at the time of writing negotiations are underway between Argentina and the Fund, I will refrain from commenting on what policies need to be followed. The analysis in the foregoing should, however, provide some clear pointers as to what should be done, and perhaps more importantly not done, for Argentina to engineer a turnaround from the dire straights in which it finds itself.

Lessons from the Argentine Drama

The main lessons to be drawn from Argentina's present predicament, as well as from its earlier experience, and the Fund's involvement in both, can be formulated as follows:

Soft physicians cause festering wounds. By not consistently conducting policies aimed at bringing about a more permanent improvement in the economy, Argentina never progressed to the point where reforms became ingrained. While the political class in

[23] Experience with such an approach has generally been disastrous, as for instance borne out in Peru under President García in the mid-1980s.

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Argentina is rightly blamed for the major part of this state of affairs, the IMF played some part in it by being insufficiently vigorous in its approach to the Argentine programmes which it financially supported, often for large amounts. Too often a blind eye was turned to serious deviations from agreed performance criteria. Financial support went on too long, in effect prolonging the agony unnecessarily since deep-seated adjustment was inescapable in the end. The IMF, like truly independent central banks around the world, should not be concerned about popularity, but aim solely for objectivity and consistency which in fact may earn it (grudging) respect in several quarters. Political pressure from member states should be resisted as much as possible.

A lack of strong institutions, including a dysfunctional judicial system, insufficient protection of property rights, inflexible labour markets, inadequate central control of government finances, weak tax administration and insufficient respect for the independence of the central bank, has made it very difficult for Argentina to gain the confidence of investors for longer than a few years at a time. Argentina has a rich potential in natural and human resources, but is in dire need of a strong framework for increasing investment, both from foreign and domestic sources. Institution building should figure prominently in future reform efforts.

Large-scale external borrowing can be very dangerous for a country's economic health, especially if denominated in foreign currency as is usually the case in emerging market economies.[24] While Argentina's currency board precluded monetisation of the persistent fiscal deficits, the massive borrowing by the government on international capital markets provided an alternative escape route from the fiscal discipline that is an essential requirement for the successful operation of a currency board. The combination of a quite closed economy, with a rather modest export sector, and a very significant openness with respect to international capital markets, constituted a major element of external vulnerability. Both the IMF and the private sector seem to have paid insufficient heed to the build-up of an unsustainable external debt situation. When international reserves started dipping below short-term external debt

[24] Horiguchi (2001) argues that one of the most salient lessons from the Asian financial turmoil in 1997-98 is that excessively high external indebtedness helped precipitate the crisis and greatly complicated its resolution.

outstanding, and the sceptre of default started to appear, a more resolute reaction from creditors could have been expected. As borrowing from the market continued until a quite late stage and from the IMF beyond what was in Argentina's own interest, the collapse was especially devastating when the plug was finally pulled.

Stringent conditions apply for the successful operation of a currency board on a sustainable basis, i.e. beyond its temporary application aimed at combatting hyperinflation. Currency boards constitute an extreme in the continuum of exchange rate regimes and are not suitable for everyone; in fact they constitute an optimal regime for probably only a handful of countries. Quite a few policymakers as well as academics were blinded by the initial results of the Argentine currency board, apparently forgetting about the lack of fiscal discipline, the lack of labour market flexibility, as well as the fact that Argentina does under no definition constitute an optimum currency area with the United States.[25] It is also important to keep in mind that changing the rules of a currency board arrangement is bound to be bad for confidence.

One of the most debated questions concerns the optimal currency regime for Argentina, and other emerging market countries. This is a complex matter as countries differ sufficiently in their economic structures and institutions to make generalisations hazardous. In a world of increasingly mobile capital flows there is, however, a clear shift in the direction of floating rates for emerging market countries.[26] In recognition of the need for some intervention in the usually thin foreign exchange markets in these countries, a managed float is increasingly seen as the appropriate policy. In order to provide an anchor against inflationary excesses, managed floating has been combined in a number of cases with an inflation targeting regime.[27]

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[25] A country like Canada, which conducts the bulk of its foreign trade with the United States and which has other close economic and financial ties with its southern neighbour, does seem to fall clearly within the definition. However, Canada decided several decades ago to decouple from the US dollar.

[26] This constitutes something of a return to a view already expressed some 40 years ago by McKinnon (1963), who stated that: "Freely floating exchange rates are always preferable to fixed rates in the presence of substantial monetary instability of the kind associated with, say, Latin America."

[27] See Goldstein (2002) who calls this combination "managed floating plus", which he considers a superior approach for most emerging market countries.

In adopting such an approach, Argentina would follow in the steps of countries such as Brazil, Chile, Mexico and Turkey (which has agreed to but still has to adopt the inflation targeting framework). However, the situation seems to be more complicated in Argentina, where the dollarisation, particularly of liabilities, plays an important role and the preference of the population for dollars appears to be extraordinarily strong.[28] It is not surprising therefore that full adoption of the US dollar by Argentina, as done recently in Ecuador and El Salvador, is considered by quite a few observers to be the best – or perhaps the least bad – regime for Argentina. It is worth emphasising, however, that whatever exchange rate regime Argentina chooses to operate, there is no escaping the need for sound economic policies, both macro and structural. Without strong and consistent policies economic results are likely to be unsatisfactory, whatever the exchange rate system.

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[28] Calvo and Reinhart (2001) have pointed out that a case against floating rates can be based on the prevalence of dollar debt; this "fear of floating" has undoubtedly been a long-standing consideration in Argentina.

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