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Some Lessons from the Argentine Crisis: A Fund Staff View

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In December 2001, Argentina was forced to abandon the peso's peg to the US dollar, to default on its sovereign debt, and to impose restrictions on the use of bank deposits. The crisis now facing the country is as profound as that which has faced any of countries that have suffered capital market crises over the last seven or eight years. The crisis is intractable and is causing enormous social and political tensions in Argentina and suffering to the Argentine people. Nevertheless, the catastrophic nature of the crisis in Argentina does not come as a surprise: the Fund's financial support was given to Argentina in the period up to late 2001 in an attempt to avoid precisely the outcome that has occurred.

The Argentine crisis is only one in a series of crises that has affected emerging markets since the mid-1990s. Following the crisis in Mexico, there have been crises in Korea, Indonesia and Thailand, Russia, Brazil in 1999, Turkey and then Argentina. Nor, as events in Uruguay and Brazil indicate, was the Argentine the last of that series. These crises have been remarkable for their virulence and often their unexpectedness. Following each crisis, there has been a concerted effort to analyse its lessons and to direct the Fund's Article IV surveillance towards applying those lessons to help other countries

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reduce their vulnerability. Nevertheless, each crisis has new elements, and when analysed, each throws light on its predecessors. In this way, we are gradually coming to a better understanding of the demands placed on governments whose countries are integrated into the global system. However, acquiring such knowledge and the will to apply it comes at a considerable cost to the people of those countries struck by crisis.

This chapter reviews the lessons that the International Monetary Fund drew from previous crises, and how it viewed economic policy in Argentina in light of these lessons. It then examines the factors that precipitated the crisis in Argentina and asks whether these were obvious to the Fund and its staff at the time. Finally, it draws some lessons from the Argentine crisis that may be helpful in assisting other countries from falling into the same traps.

Background to the Argentine Crisis

Argentina's history since the Second World War, and maybe for most of the 20th Century, has been one of decline in relative position in the world. A country that seemed destined to progress in step with Australia and Canada, countries of similar resource and human capital endowments, has instead gradually lost ground.[2] While analysing the roots of this disappointing long-term performance are beyond the scope of this chapter, inadequate macroeconomic policies have played a major role. Persistent inflation, punctuated by bouts of hyperinflation, and usually reflecting fiscal indiscipline, had so discredited economic management by 1990 that the prospects for reversing this secular decline looked bleak.

In this situation, the Convertibility Plan offered a way out, and for a considerable time delivered on its promise. The plan adopted in 1991 centred on the establishment of as firm a nominal exchange rate anchor as possible, i.e. a currency board peg to the US dollar, macroeconomic policies consistent with this anchor, and a sweeping structural reform programme. This plan delivered growth of 6 percent a year over the period 1990 to 1997, virtually unprecedented for Argentina and among the highest in Latin America. The authorities' strategy gained further credibility when Argentina

[2] See Colin Clark, *Economics of 1960*, MacMillan, London, 1942.

showed itself able to withstand the market pressures emanating from the Mexican crisis of 1994-95, and the subsequent Asian crisis. This relatively strong overall performance during most of the 1990s cautions against attributing the Argentine crisis solely to fecklessness.

What Were the Lessons of Previous Crises?

Mexican Crisis Lessons: Exchange Rate Policy

The first lesson of the Mexican crisis of 1994-95 was that fixed or pegged exchange rates are dangerous in a world of free capital movements. This lesson should already have been apparent from the EMU crises of 1992-93 and has been repeated in subsequent crises.[3] Almost all these capital account crises have involved as a major element a battle to defend the exchange rate. One initial, if superficial, lesson was that a fixed exchange rate provides the market with an easy target and the opportunity for making a killing out of the authorities' foreign exchange reserves. The markets are able to mobilise more ammunition in attacks on an exchange rate than is available to the authorities to defend it, even with large financing packages from the Fund and bilateral sources. However, the pros and cons of fixed exchange rates are much more complicated than this conclusion implies.

Fixed exchange rate systems were viewed at the end of the 1980s and the start of the 1990s as being important tools for controlling inflation and creating a stable environment. They provided a nominal anchor to macroeconomic policies and, if credible, could reduce the costs of disinflation. This rationale was particularly important in Argentina, in light of its history of monetary mismanagement, culminating in hyperinflation at the end of the 1980s. The Convertibility Law, involving most of the elements of a currency board, was central to driving inflation out of the Argentine system and rebuilding confidence in the currency. It was associated with strong economic growth in the early 1990s, a phenomenon that also accompanied other exchange-rate-based stabilisations. However,

[3] A theoretical explanation is Mundell's concept of the "impossible trinity": free capital movement, a fixed exchange rate, and an effective domestically oriented monetary policy.

exchange-rate-based stabilisations have a number of costs, including the danger that the residual inflation will push the real exchange rate to a point that it endangers competitiveness. If changing the exchange rate is ruled out, any adjustment in relative wages and costs has to come from domestic price adjustments and wage cuts, and these can be politically and socially painful. So, in addition to presenting a target for speculation, a pegged exchange rate runs the risk of overvaluation.

The third main danger of a fixed exchange rate system was less apparent at the time of the Mexican or EMU crises, and has only become clear as the Asian crises have been more extensively analysed. That is that a fixed exchange rate can allow serious weaknesses to develop in economic agents' balance sheets. The more successful the authorities are in convincing domestic residents that the exchange rate is immutable, the less inclined residents will be to hedge their exposure to the currency of the peg. If interest rates are higher on domestic currency instruments than on those denominated in the currency of the peg, as will typically be the case for an emerging market, especially one undergoing disinflation, residents will tend to become more exposed to foreign exchange risk, with their liabilities increasingly in the currency of the peg and assets in the home currency. Should the exchange rate then be changed, contrary to initial expectations, residents will have large losses on their balance sheets.[4] While sound prudential regulations can limit the extent to which the financial sector runs an open foreign exchange position, there is no such prudential mechanism to discourage the corporate sector taking on such risks, and banks often miscalculate the risks run by their clients. Indeed, data may not be available to the authorities to show how large this risk is.

One lesson that was drawn from the crises was that, while pegged exchange rate regimes offered an unnecessary hostage to market attacks, it was possible that a really strong peg, such as that which a currency board gave, could withstand speculative attack. Countries with currency boards seemed in general to be less subject to successful attack, and Hong Kong, Estonia, and Bulgaria's currency boards survived earlier crises, as had Argentina's. However, when the currency board arrangement came under attack, as the Hong Kong board did during the Asian crisis, the authorities had to be prepared

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4 See Allen *et al.* (2002).

to accept the impact on the domestic economy of the sharply higher interest rates that its defense required. This was the corner-solution model, leading to the recommendation that countries either float or adopt very hard pegs, and which was in vogue in the second part of the 1990s.[5] The sense was that every time the country ran a successful defense, and the more money the speculators lost in the process, the greater the credibility of the arrangement and the lower the subsequent costs of any attack. However, if the country is to establish the needed credibility, it must ensure that the structure of domestic balance sheets is such that the costs of defending the peg through higher interest rates remain politically acceptable. Argentina indeed showed itself willing and able to defend its currency board when it came under attack in 1995, and again during the Asian crisis.

Mexican Crisis Lessons: Financial Systems

Another lesson of the Mexican crisis, and reinforced by the Asian crisis, was the need for strong financial systems. In this respect, Argentina made a very creditable showing. As part of the reform strategy at the start of the 1990s, the authorities had liberalised their financial system and strengthened prudential supervision. An open environment was established for foreign banks to operate and to acquire Argentine banks, and as a result, a good part of the Argentine banking system was owned by non-residents.

The advantages of this were thought to be several. Firstly, widespread foreign ownership meant that the higher operating standards in the banks' home countries would also be applied in Argentina, with a consequent increase in the stature and probity of the financial system. Equally important, extensive foreign ownership was thought to be particularly consistent with Argentina's currency board. One major drawback of a currency board arrangement is that the system lacks a true lender of last resort. The authorities no longer have the ability to print the additional money needed in connection with the extension of liquidity support to banks in trouble, and so can only give support if a domestic public agency has accumulated very large reserves in addition to those committed to backing the currency. Foreign ownership of banks was thought largely to overcome this problem, since the banks' headquarters could provide their own

[5] Stanley Fischer (2001).

subsidiaries with dollar liquidity when needed. Thus the lender of last resort for the Argentine banking system would be the US Federal Reserve, and not the Argentine central bank.

Argentina's own response to the Mexican crisis and to pressures on its banks also served to generate confidence. There was a massive withdrawal of funds from many countries in Latin America in early 1995, and in Argentina this led to the collapse of a bank, Banco Extrader. This failure, as well as the absence of a lender of last resort under the currency board, fueled further runs on deposits in both pesos and dollars, amounting to about a fifth of deposits by May 1995. Accompanying the run was a shift in deposits from local to foreign-owned banks, and the activity of several of the former had to be suspended. The authorities' response also included the release of some reserve requirements, the provision of emergency liquidity through limited rediscount and repo operations, and the onlending of some excess international reserves to distressed banks. Once confidence had been restored later in 1995, bank supervision was strengthened, stricter liquidity requirements were introduced, a deposit insurance fund focusing on small deposits was established, and steps were taken to privatise the provincial banks.[6]

As part of the programme to strengthen international financial architecture, the Fund was called upon to step up its surveillance of members' financial systems to ensure their soundness and stability. This resulted in a joint Fund-World Bank initiative launched in May 1999, the Financial Sector Assessment Programme. An assessment was undertaken of Argentina in the first half of 2001 and found that the main risks to the domestic financial system arose from the macroeconomic situation, rather than from institutional or regulatory weaknesses. Indeed, before Argentina was forced into default, the banking system was strong as conventionally measured. Banks had strong capital ratios and liquid balance sheets. There had not been any asset price or credit bubble whose bursting might have been expected to put pressure on the banking system, indeed bank assets were quite low by international standards at 30 percent of GDP in 2001. As far as direct exposure to currency risk was concerned, banks had long positions in US dollars, and would be expected to benefit from a devaluation. However, the indirect impact of devaluation on the balance sheets of their customers and the

[6] See Michel Camdessus (1996).

resulting credit losses more than offset this. And when the crisis occurred, the banking system was affected by its claims on an insolvent sovereign and by the loss of confidence in the issuer of the domestic currency, neither of which could be averted by measures taken by the banks themselves. In general, however, Argentina had learned the lessons of earlier crises as far as the banking system was concerned, and its financial system was a source of strength, not of weakness in the economy.[7]

Mexican Crisis Lessons: Data Standards

The suddenness and virulence of the Mexican crisis was attributed in part to the surprises that the market had received when the true state of Mexico's economic situation was revealed. In response, the Fund was asked to do more to ensure that all its members published reliable and prompt data on key macroeconomic variables. This resulted in the 1996 Special Data Dissemination Standard initiative, to which Fund member countries, and in particular emerging market countries were invited to subscribe.[8] Argentina was one of the first countries to subscribe, and its record of compliance is among the best. And it is clear that data deficiencies were not an issue in the case of Argentina. The markets were not surprised by Argentine developments and there were no sudden discoveries that the situation was worse than thought: the crisis occurred as a consensus grew as to the meaning of the available information.

Mexican Crisis Lessons: Domestic Savings

One reason adduced at the time of the Mexican crisis to explain why the Asian countries had not been hit by the contagion threatening Latin America was that savings rates in Asia were much higher. These higher savings rates were thought to give Asian countries a considerable cushion, since they gave greater scope for domestic financing and allowed the countries to be less subject to the whims of international capital markets.

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7 Subsequent actions to lower the cost to the budget of servicing debt held by local pension funds and insurance companies weakened parts of the non-bank financial sector.

8 http://dsbb.imf.org/

This lesson was an important one, but may have contributed to a lack of vigilance in Asia. The subsequent Asian crises made it clear that high savings rates did not make emerging markets immune from capital account crises. Vulnerabilities can arise from the structure of sovereign, bank, or commercial sector balance sheets, even when domestic savings are high. The lesson should have been reformulated to read that high savings rates may be necessary, but are not sufficient, to eliminate vulnerability.

Argentina, with much of Latin America, continues to suffer from relatively low savings rates, and this has been a source of vulnerability. Low domestic savings rates may contribute to shallower domestic capital markets and increase dependence on foreign capital. Domestic residents are less likely to be willing to keep their assets denominated in domestic currency, and thus can provide less domestic currency finance to domestic borrowers. Non-residents supplying capital, on the other hand, have shown themselves generally unwilling to accept the exchange rate risk that lending in domestic currency entails. Evidence shows that their aversion to exchange rate risk is such that they even try to hedge the exchange rate exposure of foreign direct investment. Thus an economy relying on foreign savings is inevitably exposed to considerable exchange rate risk. Should the exchange rate depreciate, the balance sheets of domestic borrowers in aggregate will suffer losses, as discussed above. This may cause great distress in the corporate sector, may threaten the solvency of the banking system, and may worsen the debt position of the sovereign, from its own foreign exchange liabilities or because contingent liabilities emerge in these circumstances.

Asian Crisis Lessons: Transparency, Standards and Codes

Weaknesses in banking systems and corporate balance sheets were central to the Asian crises. These weaknesses were known anecdotally to some market participants, but the full extent of the problems only became clear as the crises developed. As investors lost confidence in the creditworthiness of local banks and their corporate clients, credit lines were cut and exchange rates came under pressure. One important lesson drawn from these crises was that, if banking and corporate sectors were to be integrated safely into international capital markets, investors needed to be given the same sort of assurance about the standards met by their counterparts as they would have with counterparts in industrial countries. (Of course, this lesson was drawn before the round of corporate scandals in the United States).

To implement this lesson, the Fund and World Bank established a transparency initiative, under which member countries would be encouraged to adhere to international standards and codes, and the quality of their adherence would be assessed. Under this initiative, some eleven areas were identified for which adherence to standards was considered essential to reduce the risk of crisis.[9] The Fund and Bank established a mechanism to assess members' adherence to standards in these areas, Reports on the Observation of Standards and Codes (ROSCs). The areas fall into three broad groups: those related to macroeconomic transparency (data standards, fiscal policy transparency, and monetary and financial policy transparency); those relating to the financial sector (banking supervision, securities market supervision, insurance supervision, and payments systems); and those related to the corporate sector (corporate governance, accounting, auditing, and insolvency and creditor rights).

In 1999, Argentina was one of the first three countries to volunteer to have a comprehensive report prepared on its adherence to standards.[10] While some weaknesses were identified, Argentina received generally high marks for the standards it applied. This impression was shared by other observers. A study done by Oxford Analytica, commissioned by the important institutional investor, CalPERS, put Argentina first of 27 emerging markets on basis of eight criteria: political stability, transparency, avoidance of abusive labour practices, market liquidity and volatility, market regulation and legal system, capital market openness, settlement proficiency and transaction costs.[11]

Russian Crisis Lessons: Debt Dynamics

While during the Asian crises there was no serious concern about the solvency of the sovereigns, such concern was the main feature of the

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[9] A twelfth area relating to money laundering and the financing of terrorism was added later.

[10] The report can be found on the IMF web site, www.imf.org. The report used experimental procedures, and the Fund and Bank have refined their approach since Argentina was assessed.

[11] http://www.oxan.com/columns/wkcol_28022002.html

Russian crisis. The crisis occurred because the Russian government's ability to service its debt was growing less rapidly than the costs of debt servicing. The debt servicing capacity was constrained by low tax mobilisation and the poor prospect of improvement in tax administration. As concerns about debt servicing grew, the maturity of the debt shortened and the interest premium increased, thus raising the costs of the debt. In this situation of unstable debt dynamics, international financial support to Russia, primarily through the International Monetary Fund, was intended to give a breathing space until measures to improve tax collections and reverse debt dynamics could work. But the effort failed, the debt dynamics spun out of control, Russia was obliged to default, and the economic programme collapsed.

Russia's default was not seen immediately as a typical capital account crisis, since there was a tendency to see events there through a *sui generis* political prism. However, the problem of sovereign debt dynamics has also been central to the crises in Turkey, Argentina, and most recently Brazil. The Fund staff was rather slow to focus on the importance of making sound judgments on debt sustainability in the context of its ArticleIV surveillance work and in its lending decisions. Only following the controversy connected with the augmentation of Argentina's stand-by arrangement in September 2001 and the Argentine default did the Fund staff present new analytic tools to help make these judgments.[12]

Lessons from the Argentine Crisis

As the previous section has shown, Argentina not only grew strongly during much of the 1990s, experiencing its best economic performance for many decades, but in many ways it learned from the lessons of other crises. Nevertheless, things went badly wrong, and this section discusses what those things were, and how they were viewed by the Fund. The main problems were the exchange rate regime, fiscal policy, the sustainability of the sovereign's debt, and the stagnation of the reform effort.

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12 IMF (2002).

Exchange Rate Policy

The fixed exchange rate policy, which had served Argentina well during the first part of the decade, was not able to withstand the shocks at the end of the period. While the attack on the currency board in 1995 took place at the time of a weakening of the US dollar and thus a strengthening of Argentina's competitive position, this good luck ran out at the end of the decade. The balance of payments was subject at that point to three serious shocks: the collapse of Brazil's *real* plan in 1998 and the subsequent Brazilian devaluation, the unexpected strengthening of the US dollar against the euro, and the economic slowdown in industrial countries in 2001. When these shocks combined with periodic uncertainties in the access of emerging markets to international capital, the costs of maintaining the peg increased sharply. Restoring competitiveness then required tightening macroeconomic policies to an extent that the authorities were unable to deliver. And even if the targeted fiscal adjustment had been achieved at that point, it would have placed yet more pressure on the public debt dynamics as discussed below.

Why did Argentina not abandon the exchange rate peg earlier? With hindsight, it would have been best to have exited in 1996 or 1997, in the aftermath of the successful weathering of the Mexican crisis. One reason for maintaining the peg was an unwillingness to jeopardise the confidence in the currency that had been achieved through the Convertibility Law. Given the undoubted successes that the fixed rate regime had achieved, it was very popular politically. There was a risk that a change in the peg could result in a sharp reduction in demand for the currency and that the economy could quickly revert to rapid inflation. The ideal time for leaving such a currency peg would be when macroeconomic conditions were such that the exchange rate could be expected to appreciate. However, these ideal conditions never materialised. And in addition, it is human to wish to avoid taking a possibly risky action, abandoning the peg, in times when there was no pressure on the exchange rate. The Argentine currency arrangements had been buttressed by legislative and constitutional provisions designed to make changing the peg difficult. While this framework helped ensure the initial success of the Convertibility Law, it also made it that much more politically onerous to change it. In the circumstances, the authorities were not keen to take on these political labours.

Another reason why abandoning the peg was inopportune was that the private sector had accumulated large open foreign currency positions. A move in the exchange rate would damage the balance sheets of many private sector companies, cause problems for the banks with credit outstanding to those companies, and lead to a contraction in output. Events subsequent to the abandonment of the peg show that these concerns were well founded. At the same time, given the inflexible structure of Argentina's exports, a devaluation would have done little to improve export performance, although it might have reduced the amount of deflation Argentina had to face.

What should have been the attitude of the Fund? Michael Mussa makes the point that the Fund's Articles give to its members the explicit right to follow the exchange rate regime of their choice.[13] The Fund must accept the member's choice, but in its Article IV surveillance it should make clear the economic policies that are needed to support the member's choice. Argentina's currency board imposed a number of requirements on policy, particularly in a world of open capital markets. It required very tight supporting fiscal policies, low public debt, a much more flexible labour market, and an opening of the economy. In Mussa's view, the Fund should not have given its support to Argentina and its fixed exchange rate without a credible commitment by the authorities to such policies. It is hard to argue with this judgment in the light of events. But the corollary is that, if the Fund had been realistic about Argentina's capacity for adjustment, then it should have argued for abandoning the peg, rather than supporting inadequate policies.

From the vantage point of 2002, it seems that the authorities should have shown the foresight in 1996 or 1997 to abandon the peg. To do so without setting off inflation and sudden depreciation would have required a tightening in fiscal policy. Having failed to abandon the peg at that point, the series of shocks the country faced in the next few years almost guaranteed a crisis. A crisis might have been avoided with good luck – for example, had the dollar depreciated against the euro, had Brazil not been forced to devalue, or had international capital market conditions not deteriorated – but Argentina's luck ran out. But the judgment that 1996 or 1997 was the moment to abandon the peg is only evident with hindsight. At that point, the peg seemed to be serving the country well, it was politically

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13 Michael Mussa (2002).

Table 1 Argentina: Consolidated Governments Operations
(in percentage of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Revenue	**20.1**	**23.4**	**24.6**	**24.1**	**23.2**	**22.2**	**23.2**	**23.7**	**24.3**	**24.7**	**23.5**
Tax	13.6	16.2	16.1	16.2	15.6	15.8	16.8	17.4	17.5	18.1	17.5
Social security	4.6	5.1	5.9	5.7	5.3	4.4	4.2	4.0	3.8	3.7	3.6
Other	1.8	2.1	2.5	2.2	2.4	2.0	2.2	2.3	2.9	2.8	2.5
Non interest expenditure	**20.6**	**21.9**	**23.1**	**24.1**	**23.7**	**23.3**	**22.9**	**23.2**	**25.1**	**24.2**	**25.0**
Wages	8.0	8.4	8.8	8.9	8.9	8.3	8.2	8.3	9.4	9.5	9.9
Pensions	5.4	6.0	5.6	5.9	6.0	6.2	5.9	5.8	6.2	6.1	6.2
Other	7.1	7.5	8.8	9.3	8.7	8.8	8.8	9.0	9.5	8.6	8.9
Primary balance	**–0.5**	**1.4**	**1.5**	**0.1**	**–0.4**	**–1.1**	**0.3**	**0.5**	**–0.8**	**0.4**	**–1.5**
Interest (accrual)	3.0	1.9	1.4	1.6	1.9	2.1	2.3	2.6	3.4	4.0	4.8
Overall balance	**–3.5**	**–0.4**	**0.0**	**–1.5**	**–2.3**	**–3.2**	**–2.1**	**–2.1**	**–4.2**	**–3.6**	**–6.4**
Other debt-creating operations	0.0	0.1	0.3	0.4	0.8	0.5	0.3	0.4	0.5	0.0	0.0
Overall balance, incl. off budget	**–3.5**	**–0.5**	**–0.3**	**–1.9**	**–3.1**	**–3.6**	**–2.4**	**–2.5**	**–4.7**	**–3.6**	**–6.4**
Memorandum items:											
Consolidated debt											
Arg. peso, billions	65	69	78	90	101	108	112	124	134	145	172
percent of GDP	38.8	32.9	32.8	35.1	39.2	39.8	38.1	41.3	47.4	50.8	64.1
Real non-interest expenditures (1995 = 100)	31.5	73.9	82.5	98.5	100.0	103.8	106.2	105.3	104.3	96.2	98.5

Source: http://www.imf.org/external/np/speeches/2002/071702.htm popular given Argentina's tradition of inflation, and with the Asian crisis still dominating markets, floating might have precipitated a crisis. The Fund certainly did not have the prescience to push for abandoning the peg at that time.

Fiscal Policy

Argentina's fiscal policy throughout the 1990s was at first sight not conspicuously profligate (Table 1). The primary balance was close to zero and the average overall deficit was about 2.5 percent of GDP in the years up to 1999. The debt ratio grew from 32.9 percent of GDP in 1992 to 41.3 percent in 1998, not because of current fiscal deficits, but because judicial decisions added 10 percent of GDP to the debt over this period.

Nevertheless, Argentina should have done much more to strengthen its public finances. As Mussa points out, in the years of exceptional growth, Argentina should have run a surplus, if it was going to have room for a fiscal stimulus in the event of a downturn. Only substantially larger primary surpluses would have reduced the vulnerability posed by the debt stock. And the importance of a strong fiscal position and a resilient tax system had long been recognised in Argentina. Nevertheless, the government was unable to strengthen public finances sufficiently, and the central authorities lacked the ability or the political will to enforce discipline on the provincial governments. Thus deficits were run throughout this period, and the markets were content to finance them.

By the time the economy fell into recession at the end of 1998, there was no scope for letting automatic stabilisers work, as the markets were beginning to have doubts about the sustainability of the debt. Thus it became necessary to try to reduce the deficit at precisely the most difficult time, when fiscal consolidation would have a negative effect on output. By this point the dilemma was virtually insoluble: worsening debt dynamics called for much higher primary surpluses, but higher surpluses, by worsening growth prospects, would exacerbate the debt dynamics. The authorities introduced fiscal responsibility legislation, aiming at a zero deficit, but it proved impossible to get the support of the provincial legislatures, which were often in the hands of the political opposition. The attempt to meet the demands of the law by expenditure cuts in the face of declining revenues proved politically unsustainable.

The fundamental fiscal problems in Argentina relate to revenue mobilisation, the structure of expenditure, and the finances of the provinces.

The Argentine tax system failed to deliver the resources to finance the state, with the overall revenue to GDP ratio at about 23 percent lying well below comparable countries. The system was complex and inefficient, and it was not able to respond by mobilising more revenue when needed. Relatively well-designed value added and income taxes were undermined by exemptions, the cross-crediting of taxes and payments, and the consequences of tax amnesties. The system became more distorted with Economy Minister Cavallo's Competitiveness Plan in 2000, which introduced a highly distortionary financial transactions tax, as well as establishing a system of taxes and subsidies to mimic the devaluation that the exchange rate peg precluded.

Tax administration has been a chronic problem in Argentina, leading to notoriously low tax compliance with relatively high administrative costs. This was partly a consequence of the distorted tax system just described, but also reflected organisational and resource deficiencies. Taxpayer databases were not properly coordinated, legislation did not provide for adequate disclosure, particularly by banks, and neither the government nor the judiciary showed a full commitment to tax enforcement. To a large extent, these deficiencies have to be attributed to lack of will, since there was no shortage of technical assistance from the Fund and others in this area.

Public primary (non-interest) expenditure in Argentina has been dominated by wages (40 percent of expenditure in 2001), pensions (25 percent) and other transfers, often wage related (20 percent). Thus public outlays for goods, services and investment were less than 15 percent of the total. This expenditure structure was inflexible and not consonant with Argentina's needs. The agenda for reform in public expenditures encompassed staffing levels, the wage bill, social security, social welfare, and education, especially at the university level.

Public sector wages were an important source of expenditure pressures. The public sector accounted for about 12.5 percent of employment in Argentina in 1999, about the level of a typical European country. This is a much higher level of public employment than is found in most emerging markets, and can be compared with levels of 7.3 percent in Brazil, 7.1 percent in Chile, and 4.5 percent in Mexico.[14] During the 1990s, this level of employment stayed approximately constant, with a reduction in federal employment, but an increase in employment at the provincial level (Table 2). The wage bill, already high, was made more burdensome by an upward creep in public sector wages. While the average wage in the private sector remained virtually unchanged between 1994 and 1999, as did that for provincial employees, the average wage of federal employees rose by 22 percent.

Much of the wage bill and staffing pressures originated at the provincial level, with considerable growth from about 1997. The autonomy of the provinces is such that the federal government does not have the authority to require the introduction of sweeping reforms. The provinces have spending authority, combined with the ability to borrow directly, and the system contains complicated tax-by-tax arrangements for the transfer of revenues to the provinces. The revenue-sharing arrangements cannot be modified without the unanimous agreement of provincial governments.

The system failed to deliver a hard budget constraint at the provincial level, and Economy Minister Cavallo's fiscal strategy and the credibility of the Fiscal Responsibility Law foundered on his inability to impose discipline at this level. Rather than make spending conform to the level of revenues, provinces tended to borrow excessively, receive bailouts from the federal government, or even at the end, issue their own currencies. Missing reforms in this area included a more efficient revenue-sharing and interprovincial transfer system, the development of local tax sources, and statutory limits on provinces' borrowing capacity.

The Fund clearly took too accommodating a position with regard to Argentina's fiscal targets in its adjustment programmes during the 1990s. Starting in 1994, Argentina failed each year to meet the fiscal objectives of its programmes. The slippage on the revenue side was never because growth was lower than projected, but because of the failure to mobilise revenue and to reform the tax system. Expenditures were also greater than targeted in every year except 1995. The Fund sought a tightening in fiscal policy, but did not insist on it. It pushed the time horizon for the correction of slippages into the future, where it was overtaken by events.

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14 Anne Krueger (2002a).

Table 2 Argentina: Public Sector Personnel Expenditure

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Wage bill, in percentage of GDP												
Total		**7.63**	**7.98**	**8.82**	**8.89**	**8.87**	**8.35**	**8.25**	**8.33**	**9.39**	**9.47**	**9.87**
Federal		2.97	2.70	2.83	3.03	3.01	2.93	2.91	2.70	3.02	2.96	2.91
Provinces		4.66	5.28	5.99	5.86	5.86	5.42	5.34	5.63	6.37	6.51	6.96
Public sector workers, in thousands												
Total	**1,801**	**1,753**	**1,675**	**1,608**	**1,629**	**1,653**	**1,720**	**1,731**	**1,739**	**1,780**	**1,815**	**1,815**
Federal[1]	694	646	556	500	515	518	496	482	465	462	462	462
Provinces	1,108	1,106	1,119	1,108	1,114	1,135	1,223	1,249	1,273	1,318	1,353	1,353
Public sector workers, in percentage of total labour force												
Total		**13.6**	**12.8**	**12.2**	**12.2**	**12.2**	**12.5**	**12.4**	**12.3**	**12.5**	**12.6**	**12.4**
Federal[1]		5.0	4.3	3.8	3.8	3.8	3.6	3.5	3.3	3.2	3.2	3.2
Provinces		8.6	8.6	8.4	8.3	8.4	8.9	9.0	9.0	9.2	9.4	9.3
Average annual wage, in Argentine peso												
Total		**7,266**	**9,971**	**12,972**	**14,049**	**13,845**	**13,211**	**13,953**	**14,329**	**14,936**	**14,875**	**14,609**
Federal		7,671	10,165	13,389	15,143	14,980	16,065	17,654	17,354	18,503	18,269	16,934
Provinces		7,030	9,874	12,783	13,544	13,327	12,054	12,526	13,224	13,686	13,716	13,815
Private Sector					12,103	12,220	12,012	11,856	11,999	12,181	12,246	12,090

Note:
1 Excludes public enterprises.

Source:
http://www.imf.org/external/np/speeches/2002/071702.htm

Debt Sustainability

The increase in the ratio of debt to GDP during the 1990s was modest and its level did not appear particularly high. As mentioned above, the increase was largely caused by judicial decisions recognising obligations to various resident groups. The growth in the ratio was not seen as worrying, partly because of its one-off nature, and partly because the economy was now believed to be on a new, higher growth path. But underneath the surface, the debt was becoming unsustainable.

The dynamics of the debt-to-GDP ratio depends on the rate of growth of GDP, the interest rate on the debt, and the rate of accumulation of new debt. A country's debt is sustainable if the debt ratio is projected to stay within bounds in the foreseeable future under all reasonable assumptions, or if the domestic adjustment likely to be needed to keep it in bounds is moderate.[15]

In Argentina's case, the economy was struck starting in 1998 by a series of shocks which plunged it into recession, a recession from which policymakers had no way of extracting the country. This meant that taxes, the basis for servicing debt, only grew slowly. In any case, Argentina's tax collection effort was not impressive, and the tax system was not capable of generating large additional resources rapidly. Debt service as a share of exports was high, because the Argentine economy was relatively closed, with exports hovering around 10 percent of GDP. Given the structure of exports, a devaluation would have done little to stimulate exports in the short run, and would immediately have had a negative effect on companies with open dollar exposure and would have increased the debt-to-GDP ratio. Thus a devaluation would have done little to ensure debt sustainability.

With the resulting reappraisal of growth prospects, Argentina's future capacity to service debt began to look more worrying. As this problem became clearer to market participants, spreads rose on Argentine paper and maturities shortened, creating increasing difficulty in rolling over the debt and increasing debt-servicing costs. This again worsened the debt dynamics, making it likely that Argentina would default on its debt.

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15 IMF (2002).

In an effort to stave off the immediate crisis, the authorities took a number of policy actions that would create problems for them in the future. In June 2001, the authorities tried to arrange a comprehensive exchange of their debt with the aim of lengthening maturities. The exchange succeeded in doing this, but the price of the exchange was very high, as the market demanded a substantial premium for the lengthening of maturities. The additional breathing room in 2002 was to be paid for with very much higher debt payments in subsequent years. And in order to increase the rate of take-up for the debt exchange and to ensure current financing of the budget, the authorities exerted moral suasion on domestic financial institutions, in particular pension funds and insurance companies to take up more government paper. This exploited a captive market, but at the cost of making these institutions even more dependent on the state of Argentine public finances.

The prudent ratio of government debt to GDP for an emerging market is lower than many had thought. The Maastricht criteria, which rather arbitrarily set a 60 percent debt-to-GDP ceiling for EU member countries as the condition for entry into the euro-zone, may have acquired an unwarranted normative status. Some EU members, such as Belgium and Italy, had successfully coped with debt to GDP ratios double this level for a number of years. In addition, many developing countries have much higher ratios of debt to GDP than this as a consequence of decades of development assistance. Research done subsequently in the Fund suggests that for emerging markets the probability of a default increases quite sharply at a debt-to-GDP ratio of 40 percent.[16] For an emerging market with a debt-to-GDP ratio below this level, the chance of a default or major balance of payments crisis in a given year is only 2-3 percent; above this level, the default probability rises to about 20 percent, or a one in five chance of a crisis. In any case, it is clear that the higher the debt-to-GDP ratio, the more difficult it is for the government to run a counter-cyclical policy in the event that credit dries up.

The Fund did not foresee the inevitability of Argentina's restructuring its debt. Indeed, in its internal analysis it presented a remarkably consistent series of optimistic scenarios for the debt-to-GDP ratio. Figure 1 shows how consistently the Fund staff expected a small rise in the debt ratio for the year ahead, but then a smooth

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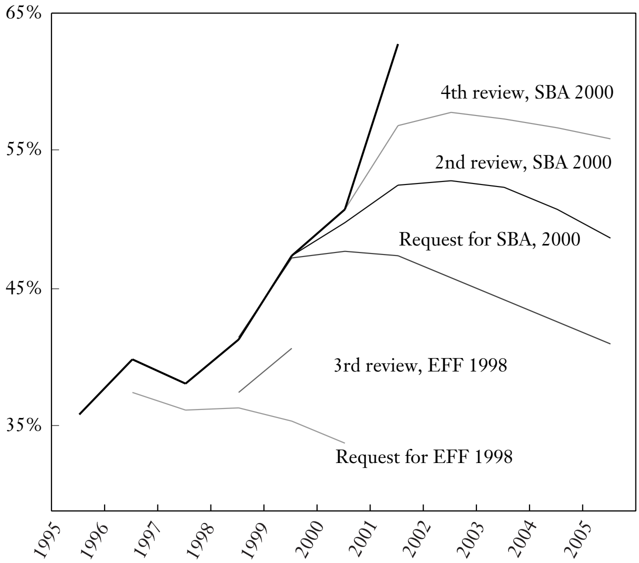
16 *ibid.*, page 19.

return to lower levels. These forecasts were based on the assumption that growth would be resumed, that the fiscal deficit would be on target, and that interest rates would fall to more normal levels. Of course, they also assumed that the currency board peg would remain in place indefinitely.

Figure 1 Argentina: Projections of Public Debt to GDP Ratio



Source: IMF (2002).
http://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf, page 19.

While there were those who predicted disaster for Argentina at an early stage – as early as 1995 in some cases – the consensus that the authorities' strategy could not work only solidified in July-August 2001.[17] The disaster looks much more certain in retrospect than it did at the time. Indeed, if by late 1998 it was too late to abandon the peg without disaster, careful analysis at that time would have shown

[17] An indication of this can be found in the movement of Argentina's bond spreads. After jumping from 500 to around 1,000 bp at the time of the *real* crisis in late 1998, spreads returned to the 500 bp level in the course of 1999. They resumed their upward movement in May 2001, shot up to 1,500 bp in August, and have subsequently risen to almost 7,000 bp.

that the probability of unsustainable debt dynamics was already so high that a restructuring was probably needed. However, a restructuring, even at that relatively early stage, would have been associated with very severe disruption in the domestic market, and could have had spill over effects to other emerging markets facing problems. By September 2001, when the Fund agreed on the final augmentation of the stand-by arrangement, the chances of bringing the debt dynamics under control were very small.

Structural Reforms

In addition to the currency board arrangement, fiscal policy, and debt sustainability, failure to continue with structural reforms was another key shortcoming in Argentina. After a spurt of deregulation and privatisation at the start of the 1990s, the steam went out of the structural reform agenda. Two areas stand out where deep reforms might have made the Argentine economy more flexible, have boosted growth, and allowed it to cope with the strains that emerged, labour market reform and trade liberalisation.

Argentina has a tradition of giving extensive protection to individual employed workers, with high barriers to dismissal, and extensive fringe benefits. Collective bargaining is done at the industry level, a mechanism that is not generally conducive to wage moderation. Reforms to the labour market were introduced in 1991 and again in 1995, but the attempt to introduce more sweeping reforms in 1996 foundered on the rock of political resistance, and in 1998 there was some backtracking. As a result, the labour market remained quite rigid. Unemployment rose at the start of the reform programme in 1991-92, and failed to fall thereafter, despite the strong growth.

The low ratio of exports to GDP in Argentina (about 10 percent) hampered performance in a number of ways. The low ratio meant that the foreign trade balance could only play a limited role in cushioning swings in domestic demand, thus making the economy less flexible. It also made Argentina dependent on borrowing to supplement export receipts and thus vulnerable to swings in investor confidence. It also meant that the debt-to-export ratio was at the high level of about 400 percent, despite the more comfortable debt-to-GDP ratio. By the late 1990s debt service was absorbing some three quarters of export earnings.

The structure of Argentina's exports also served to make the country more vulnerable. Exports are concentrated in primary, especially agricultural, products and manufactures derived from them. These are subject to relatively large international price swings, as well as import barriers in importing countries. During the 1990s, the share of exports going to Mercosur markets rose from around 20 percent to about 45 percent, of which 30 percent went to Brazil. Thus Brazil's difficulties in 1998-99 hit Argentina particularly hard. Mercosur is also believed to have had a strong trade diversion effect, promoting the growth of regional trade in uncompetitive capital-intensive goods.

Unlike the Fund-supported programmes for the Asian crisis countries, the series of programmes with Argentina were remarkable for how little formal structural conditionality they contained. Thus the 1992-95 stand-by arrangement only had two formal elements of structural conditionality: tax reform and reform of the social security system, of which the latter was postponed. The programme contained no formal conditions relating to the labour market. Similarly, in the 1996 arrangement, while the Fund indicated the importance it attached to the legislation on labour reform then before congress, it did not attach formal conditionality to it. And again in 1998, it did not go further than expressing concern about the lack of progress in this area.

How Should the Fund's Role in Argentina Be Judged?

The Fund cannot be considered a bystander in Argentina, since it had successive arrangements with the member for virtually the entire period preceding the default.[18] But neither can it be considered to be responsible for all that was done and not done in Argentina. But it can be held responsible for its judgments and its advice, given both in

[18] Stand-by arrangement November 25, 1989 to March 25, 1991;
Stand-by arrangement June 29, 1991 to March 31, 1992;
Extended arrangement March 31, 1992 to March 30, 1996;
Stand-by arrangement April 12, 1996 to January 11, 1998;
Extended arrangement February 4, 1998 to March 10, 2000;
Stand-by arrangement March 10, 2000 to March 9, 2003.

public and in private. Was Argentina the poster child for the Washington Consensus, or was the Fund aware of the difficulties facing the country and the risks it was running? What did the Fund actually say?

While the Fund initially cautioned against the Convertibility Plan in 1991, once it was adopted and supported with structural reforms, the Fund became very supportive. This set of policies seemed to be a decisive break with the past and the initial results were very promising. In the immediate aftermath of the Mexican crisis, the Fund publicly praised Argentina's quick response to emerging pressures, firstly the tightening of fiscal policy, and then the way the authorities had taken advantage of the crisis to press ahead with needed measures, in particular rectifying the situation of provincial banks.[19]

The 21-month stand-by arrangement approved on April 12, 1996 focused largely on fiscal reform and privatisation, together with labour market reform. In announcing its support of this programme, the Fund flagged that it was crucial that fiscal developments, particularly revenue collections, be monitored closely and that implementation of structural reforms was essential for a sustained increase in employment.[20] While the programme agenda seems to have been the right one, the Fund did not withdraw its support when fiscal targets were not met, nor did it set programme conditionality on the key reform of the labour market.

Immediately following the approval of this arrangement, the Managing Director visited Buenos Aires and gave an assessment of Argentina's achievements and the challenges ahead.[21] He stressed the need for consistent and stable macroeconomic policies, especially a disciplined fiscal policy. This should encourage increases in domestic saving and provide room for a well-targeted social safety net and a satisfactory level of public investment in basic infrastructure and human capital. Argentina needed to maintain international cost competitiveness, which meant further consolidation of the fiscal position, both to underpin the Convertibility Law and to enhance confidence, with the aim of reaching over the medium term a balanced fiscal position for the entire public sector, including

19 See Michel Camdessus (1995).
20 IMF Press Release Number 96/15.
21 Michel Camdessus (1996).

provincial governments. Much reform work would have to be done on provincial finances, as well as directing government expenditure to more productive purposes, including more effective social spending and employment generation. Under the heading of structural reform, he emphasised the need for privatisation, both to raise resources and to allow the government to concentrate on its proper functions; labour market reform, and in particular reform of the labour code to increase market efficiency, together with a reduction in payroll taxes once the fiscal situation permitted; trade liberalisation, and measures to increase domestic competition. With hindsight, this diagnosis still seems correct: if the Fund is to be criticised in this context it is in not having made its assistance conditional on its implementation.

At his press conference on September 18, 1997, in response to questions about the scope of negotiations with Argentina on a new arrangement, the Managing Director again listed the priorities for Argentina as the Fund saw them. He stressed measures to promote greater flexibility in the labour market; reforms to make the tax system more equitable and more efficient; financial market reform; and a solid macroeconomic framework. While this agenda was the right one as far as it went, the new arrangement was not effective in persuading the authorities to implement the necessary structural measures. With hindsight, as discussed earlier in this chapter, this might have been the time to abandon the currency board, but this did not figure in the Fund's advice, nor were there concerns about debt sustainability.

The views of the Fund Board at that time on Argentina's policies were expressed in the summing up to the 1997 Article lV consultation.[22] Directors were complimentary about the way Argentina had coped with the financial pressures of the Asian crisis, and drew attention to the need for action on the familiar structural reform agenda. Their main macroeconomic concerns at this point were connected with the external sector, the increase in the current account deficit and Argentina's vulnerability to changed international capital market conditions. They stressed that the authorities should take further fiscal action should a revenue shortfall materialise, or should financing prove difficult in 1998. They welcomed the

[22] Press Information Notice (PIN) No. 98/9 February 23, 1998. http://www.imf.org/external/np/sec/pn/1998/pn9809.htm.

authorities' commitment to restrain domestic demand, should the current account deteriorate further or prospects for external financing worsen. They also called for action to diversify export markets with a view to expanding exports, in light of the high ratio of external debt service to exports.

The increase in the current account deficit became a growing worry for the Fund as 1998 continued. Thus at a press conference in April 1998,[23] the Managing Director flagged that Argentina had to be careful with current account developments, and that there was a case for moderating the rate of economic expansion, and for postponing certain less urgent fiscal expenditures, for instance on highways. He also noted that Argentine measures to reform the labour market were not in line with the spirit of the Fund's recommendations and would worsen labour market rigidities.

In his press conference on the World Economic Outlook in September 1998,[24] Michael Mussa, the Fund's Economic Counsellor, drew attention to the rapid growth of Argentina's trade and current account deficits over the previous two years. He pointed out that financial markets saw the current account as a major source of vulnerability, and that the financing environment for Latin America was deteriorating. He noted the large trade flows between Brazil and Argentina, and that "if an accident happens in Brazil," it would have a serious effect on Argentina. As a consequence of the change in external circumstances and the reduced access to external financing, Argentina was pursuing a somewhat tighter fiscal policy than before, and this would inevitably cause a slowdown in the economy.

In reviewing Argentina's policies again in March 1999,[25] Executive Directors were clearly concerned about the impact of the Brazilian crisis and the devaluation of the *real* on Argentina's growth and foreign trade, and noted that the current account deficit had widened in 1998. They were clearly aware of the dilemma facing fiscal policy in the slowdown, calling for "an appropriate balance"

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[23] Press Conference of Michel Camdessus, Managing Director, IMF, April 14, 1998, 9:00 a.m., Washington, D.C.
http://www.imf.org/external/np/tr/1998/tr980414.htm.

[24] Press Conference of Michael Mussa, Economic Counsellor, on the World Economic Outlook, September 30, 1998, 9:00 a.m., Washington D.C.
http://www.imf.org/external/np/tr/1998/tr980930.htm.

[25] Public Information Notice (PIN) No. 99/21, March 11, 1999.

between using automatic stabilisers to support output, and the need for fiscal policy to be oriented to preserve external credibility. Directors endorsed the continuation of the currency board, noting "that the currency convertibility plan has served Argentina well, and continues to be an adequate framework for stable growth." Nevertheless, competitiveness needed to be improved and external debt kept under control. They thought that a reduction in payroll taxes, together with labour market reform, might stimulate competitiveness, and called for steps to increase domestic saving through further medium-term fiscal consolidation and financial deepening to reduce Argentina's vulnerability to adverse financial market developments.

With hindsight, by early 1999, Argentina was in a recession that policies proved unable to reverse, and debt sustainability was to become more and more difficult. This was not fully evident at the time, however. In his press conference on the World Economic Outlook in April 1999,[26] Michael Mussa considered a forecast of a 3 percent growth in Argentina for the year 2000 to be an entirely reasonable expectation. He noted that the capital market financing of emerging markets had improved considerably since the previous autumn, and that should the recovery continue, Argentina would not have problems in terms of accessing private international capital flows.

It seems clear that the Fund's analysis of developments in Argentina failed to pinpoint the growing vulnerability of the economy during the 1990s. In addition, once the economy moved into a recession at the end of 1998 and capital account pressures mounted, the Fund did not produce a sufficiently clear analysis of the situation to catalyse an early decision to restructure the debt. In mitigation it could be pointed out that our knowledge and understanding of capital account crises has been growing crisis by crisis, and the wisdom of experience is that which one gains immediately after one needed it. Nevertheless, the Fund staff was overly optimistic in its assessment of underlying trends in Argentina, and did not sufficiently stress the growing weakness of the sovereign's balance sheet.

[26] Press Conference of Michael Mussa, Economic Counsellor, on the World Economic Outlook, April 20, 1999, 9:00 a.m., Washington, D.C. http://www.imf.org/external/np/tr/1999/tr990420.htm.

Another criticism is that the Fund was excessively indulgent in the application of its conditionality during the 1990s. Since the lack of openness of the Argentine economy, the inflexibility of the labour market, the weakness of the tax base, and the lack of fiscal consolidation ultimately made the policy mix unsustainable, the Fund should have only supported programmes that addressed these issues. In practice, there was relatively little conditionality linked to progress in structural reforms, and while the Fund expressed concerns about slippages, it did not allow these to interrupt disbursements. On fiscal policy in the narrow sense, targets were frequently missed and subsequently waived. It is clear now that fiscal policy should have been more ambitious and the Fund should not have acquiesced to slippages.

Finally, the Fund's actions once the crisis was unfolding can be criticised. Again with hindsight, the Fund seems to have placed excessive weight on the hope that Argentina's luck would at some point turn for the better. While this may have been a reasonable judgment in 1998 – and the Fund must be prepared to take some risks to help its members when they are making serious adjustment efforts – by September 2001, it was clear that Argentina almost certainly had to reschedule its debt. At that point, a case can be made that the Fund should have made such a rescheduling a condition for further financial assistance. Apart from this, it is not clear that another policy package at that point – for example, one involving either fiscal stimulus or the abandonment of the exchange rate peg – would have helped Argentina escape disaster.

Costs and Benefits of Globalisation

The Argentine crisis is only one of a series of crises that can be loosely linked to the process of globalisation. Why has there been this series of crises over the last decade, and what more general lesson can be drawn from them? The succession of capital market crises in the more advanced developing countries is a sign that the world has changed. Many developing countries have sought to benefit from the open international trade and financial system that is so helpful to the industrial countries. They have opened their economies to inward and outward investment and financial flows, without fully appreciating the constraints that this puts on the policies they can pursue. The learning process, which is also a learning process for the International Monetary Fund and the international community as a whole, is a painful one for several of the countries involved.

The liberalisation process for emerging markets has been pushed, not so much by the agenda of the industrial countries or by the International Monetary Fund, but by forces working within the emerging markets themselves. From the government's point of view, the deepening of domestic financial markets and the access to international bond markets has relieved its own financing constraints by presenting it with abundant and cheaper financing, at least for a time. The domestic corporate sector has pushed for financial liberalisation so that it could have access to the same financial services and terms of financing that were available to its competitors abroad. The banking system has been able to expand and offer more attractive products thanks to the deepening of its financial links abroad. And also important has been the demand from the population, at least that part of the population with financial assets, to invest that money where it wants and to borrow abroad when it chooses.

A government has little choice than to respond to some of these pressures for liberalisation. Keeping the economy closed can inhibit development, particularly of more dynamic sectors. Restrictions on the freedom to transact with non-residents has a political cost, the more so when people travel more freely and have access to more information than ever before. Even where technology does not allow the circumvention of restrictions, the restrictions create opportunities for corruption. Still, the incidence of crisis, and Argentina's experience, shows that liberalisation can entail huge costs if not properly handled.

Emerging market economies are exposed to losses of confidence by creditors. The latter may lose confidence in the state's ability to service its debt, as in the case of Argentina, or the loss of confidence may be in the solvency of the banking system or the corporate sector. The creditors who lose confidence are not restricted to foreign creditors, but include domestic creditors too, who may actually lead the pack. Once confidence in a debtor is lost, a liquidity problem rapidly turns into a solvency problem and domestic creditors of the debtor face problems in their turn. The attempt by domestic and foreign creditors to protect their assets rapidly turns into a run on the currency in the search for safer havens abroad, and the whole economy can be plunged into catastrophe.

These crises can be avoided, but only by great vigilance. Proper supervision of financial institutions can help ensure that banks do not become dangerously overexposed. Transparency for the corporate sector can help markets monitor increases in vulnerability and correct for them. But financial markets are always prone to crises, and it is ultimately the responsibility of the government to ensure that its own finances are in good enough shape so that it can help resolve a crisis and not be itself the cause of one. This means that governments have to resist the blandishments of bond salesmen and ensure their own balance sheets are strong by keeping their debt and vulnerability low. Experience shows that prudent level of debt for an emerging market sovereign is closer to 20 percent of GDP than to 60 percent, although other factors, such as maturity and currency composition, are important.

The very severe constraints that globalisation places on fiscal policy are part of Thomas Friedman's "golden straitjacket".[27] While the benefits of globalisation are very real, and the costs of crisis very high, remaining within the confines of the straitjacket poses huge problems. For an emerging democracy, with enormous social needs and a population well aware of the gap that separates its living standard from that to which it aspires, maintaining the needed fiscal restraint is a very difficult task. It is made more difficult for politicians by the ready availability of financing in the good years. Nevertheless, to avoid Argentina's path, such discipline has to be internalised, supported by high domestic savings rates and strict supervision of financial institutions.

The process of helping to get emerging markets to the place where their people can benefit fully from their integration in the global economy will be a long one. The world has an interest in providing sufficient financing to the International Monetary Fund to ensure that it can give countries the financial support they need when they run into problems, and the experience of recent crises shows that such support may have to be very substantial. However, once a country's position becomes unsustainable, further financing cannot resolve the problem without direct action being taken to reduce the country's debt. The decision that debt reduction is needed will always be a difficult one, and even if better mechanisms are put in

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[27] Thomas Friedman (2000).

place to restructure debts more smoothly,[28] the process will cause considerable distress to the domestic economy.

Looking further ahead, there need to be mechanisms for transferring capital from capital-rich industrial countries to capital-poor developing countries which do not serve to make the recipient countries more vulnerable to crisis. In the current system, as capital is transferred, the creditor tries to avoid currency risk. Thus emerging markets can, in general, only borrow in foreign currency and so have a large cumulative open foreign exchange position. Attempts by individual banks, corporates, or the government to hedge against that risk only serve to transfer it from one domestic debtor to another. This open foreign exchange position leaves the country vulnerable to the foreign exchange crises discussed in this chapter. It is therefore time to look again at direct investment and the development of local currency capital markets as vehicles for the transfer of resources to support the development process.

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