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The IMF's Dilemma in Argentina: Time for a New Approach to Lending?

CAROL GRAHAM AND PAUL MASSON

In recent years, the international financial system has faced tremendous challenges, from the Asia, Russia, and Brazil crises in the late 1990s, to Argentina's default and ensuing economic collapse in 2002 to new worries about a possible default in Brazil. An increasing number of observers are questioning the way the international financial institutions manage these crises. An alternative approach that is endorsed in principle by many—including Horst Köhler, the new managing director of the International Monetary Fund (IMF)—is a move toward more selective lending with fewer conditions, with the decision to lend based on a more general and ultimately political assessment of the recipient government's capacity to deliver on its promises. Argentina provides a potential test bed for this approach.

Federal Police guard the Ministry of Economy in Buenos Aires as workers demonstrate against the IMF meetings in April 2002.

In this brief we argue that neither this approach—nor the more traditional solution of more rigorous conditions with clear benchmarks for progress—can succeed in Argentina, as the country must first resolve a governance crisis that is at the root of its economic problems. We propose that in this instance, the Fund expedite the negotiations and extend assistance to mitigate the depth of the economic disaster. It should put conditions on that lending to prevent its misuse, but it is unrealistic to expect a well-formulated policy package at this point. It should resist the temptation to make an example of Argentina. Other cases—perhaps Brazil—will serve as a test case for moving toward fewer conditions and more input from local policymakers. Yet in the absence of a new mandate and governance structure for the IMF, any decisions about lending will still have to be made according to economic rather than political criteria.

The past year has brought tremendous challenges for the international financial system. Argentina defaulted on its debt in December 2001, and has fallen into an economic crisis of unprecedented severity, a crisis that stems as much from failures of governance as from flawed macroeconomic policies. Almost a year later, there is no obvious solution in sight. Brazil, meanwhile, the largest economy in the region, is on the brink of default, driven in large part by investor concerns about the outcome of the October elections, in which a leftleaning union leader known as "Lula" was the clear winner. Concerns are high about the policy changes that could result. This uncertainty has increased the spreads (interest rates) on Brazil's debt, creating a scenario where default could become a self-fulfilling prophecy even before the new government has an economic team in place. And only a few years ago, economic crises in Asia, Russia, and Brazil led to major disruptions in the financial markets, with spillover effects for a much larger set of economies. An increasing number of observers question the adequacy of the tools available to the international financial institutions to manage such crises. Some observers even question the utility of the international institutions themselves. Not surprisingly, the IMF—the lead firefighter for the international economy—receives the most scrutiny.

While critics agree that the system is not working well, they disagree radically on the cure. For some, particularly critics on the right like Allan Meltzer of Carnegie Mellon University, the moral hazard induced by IMF bailouts is the culprit, and any solution requires a cutback of the IMF's activities, if not its outright closure. For others who are more supportive of foreign assistance efforts, like Jeffrey Sachs of Columbia University, the problem results from the inadequacy of the resources available to the IMF to put out fires. Unlike a domestic central bank, which can pump in potentially unlimited amounts of liquidity to prevent a financial panic, the Fund cannot play the role of lender of last resort. In the middle, there are those who endorse many of the current activities of the IMF but would like to see a strengthening of the legal and institutional mechanisms to alleviate crises when they occur, for instance, through an international bankruptcy tribunal.

The IMF's new managing director—Horst Köhler—has recognized the need for change. He has increased the Fund's expertise related to early warning of crises and has emphasized prevention as well as cure. He has endorsed in principle a fundamental change in the Fund's way of doing business by streamlining conditionality (the detailed policy measures that countries agree to in order to receive the Fund's assistance). Rather than developing policy prescriptions in Washington, the Fund instead would rely on the recipient country to select the mix and implement the detail of policy reforms. This would go in tandem with another change: the Fund would become more attuned to the political realities in a country, and would make judgements about whether a government's promises were politically feasible. This would answer a criticism that is often made, including by the IMF's newly formed Independent Evaluation Office, that lending should be more selective: the institution should lend when a program has a good chance of success and is not likely to lead to repeated requests for loans.

The situation in Argentina constitutes a difficult dilemma for the management of the Fund. Argentina provides a potential test bed for the new approach. A break with the past seems particularly warranted, given that a series of IMF-

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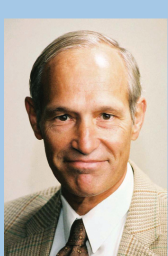

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supported programs with Argentina has failed in a spectacular way, leading to widespread hardship and financial panic. Given that Argentina is Latin America's third largest economy, and given the prominence its crisis has received in the media worldwide, a change in the IMF's approach would receive widespread attention, and have symbolic significance. Yet given the failure of past programs, there is also an argument for more rigorous conditions to try to regain credibility.

We argue that neither approach will work in the current Argentine context. Moves toward greater selectivity and toward the exercise of political judgement on the sustainability of the government's programs are unlikely to be the right recipe—given that they would take place precisely at a time when the Argentines must resolve a crisis rooted in governance failures. Alternatively, an attempt to reestablish credibility by exacting agreement on more onerous conditions is likely to be self-defeating. Instead, the IMF needs to concentrate on the human consequences of the crisis and relax its conditions to the minimum required to ensure repayment of its loans.

More generally, the IMF cannot afford to move away from its economic focus and toward more reliance on political criteria in the absence of wide-ranging changes in the governance of international financial institutions. The international monetary system would be better served in the interim by a continued emphasis on economic criteria but a scaling back of the Fund's intrusiveness into national policymaking.

BACKGROUND ON ARGENTINA

The case of Argentina has received a great deal of attention both because of the extremity of the crisis and because the country was a poster child for market reforms for the international financial institutions in the early 1990s. The Fund was initially opposed to the rigid exchange rate regime, which fixed the value of the peso at parity—one to one—with the U.S. dollar (the convertibility regime), but eventually supported it as part of an overall policy package. And, at least initially, the convertibility regime was an integral part of success in stabilizing the economy after hyperinflation and in stimulating growth. By the mid-1990s, however, Fund officials began warning the Argentine authorities about the sustainability of the exchange rate regime—as well as about the government's failure to rein in fiscal profligacy at the local level, while publicly endorsing the government's overall policy direction.

Finally, in December 2001, when it became clear that the agreed program was no longer sustainable, the Fund refused to disburse a $1.24 billion tranche of its $21.6 billion loan. Shortly thereafter, Argentina defaulted on its debt and allowed the peso to fall. In the ensuing month, several governments were sworn in and then collapsed, until Eduardo Duhalde—the fifth president to take office in two weeks—garnered sufficient political support to stay as interim president until elections are held in March 2003.

In 2002, the economy has gone into a free fall. The financial system is paralyzed:

> *"The IMF cannot afford to move away from its economic focus and toward more reliance on political criteria in the absence of wide-ranging changes in the governance of international financial institutions."*

ADDITIONAL READING

Argentina and the Fund: From Triumph to Tragedy
Michael Mussa
(Institute for International Economics, 2002)

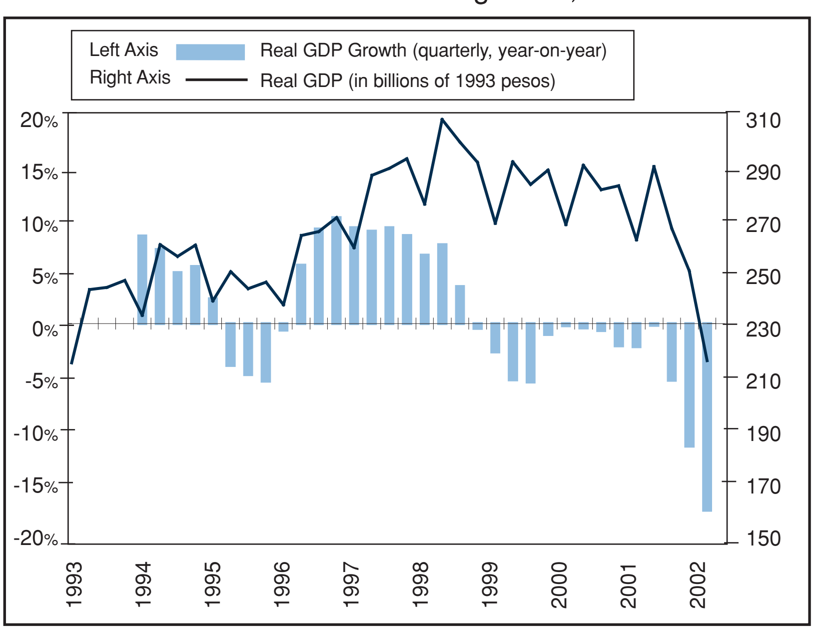
Financial Crises in Emerging Markets
Reuven Glick, Ramon Moono, and Mark Spiegel, eds.
(Cambridge University Press, 2001)

"Argentina's New President to Scrap Dollar Peg"
Financial Times,
January 2, 2002

depositors cannot withdraw their funds (the infamous *corralito*), as there is no agreement on how to value them (e.g., if they are valued at the peso-to-dollar parity rate, this would result in a tremendous loss for the banks, while using the current value of the peso would result in consumers bearing most of the burden). Nor is there a solution in sight for the problem of municipal government finances.

As a result of the financial dislocation, economic activity has contracted sharply (see chart below), with the decline in real Gross Domestic Product (GDP) in the first quarter of 2002 in excess of 15 percent (first quarter over first quarter of 2001)—and the cumulative decline is comparable to figures last reached during the Great Depression. Based on May 2002 numbers, unemployment has risen to 22 percent of the work force, up from an already high 16.4 percent a year earlier, and is likely to go higher. Estimates of the percentage of the population that has fallen below the poverty line are as high as 50 percent. The peso has depreciated from one-to-one parity to its current level of 3.7 pesos to the U.S. dollar. Given the decline in value of the domestic currency, the burden of the public debt, which the government was already unable to service, has become even more crushing, rising from about 65 percent of GDP at the beginning of 2001 to 130 percent by April 2002.

Gross Domestic Product in Argentina, 1993-2002



Source: Quarterly GDP data from Instituto Nacional de Estadística y Censos, http://www.indec.mecon.gov.ar

ECONOMICS OR POLITICS?

Argentina poses a major problem for the IMF, because it exposes the fragility of the IMF's economic advice, and the absence of technocratic solutions to what is essentially a homegrown, political problem of Argentina's making, and for which a solution can only come from within Argentina. In particular, the federal government and the states have to find a way to adjust their spending to available tax revenues, or do a better job in generating revenues while at the same time not hurting incentives to economic activity. Arguably, the continual support offered by the IMF since the early 1990s put off the day of reckoning when the problem of excessive deficits had to be faced. While the convertibility law also contributed to the problem through an overvalued currency, it could have been maintained had Argentina addressed its fiscal problems in a timely fashion.

The Argentine situation raises an important dilemma for the Fund and, more generally, the international institutions, such as the World Bank and the regional development banks. While ownership—e.g., recipient countries choosing the policy mix and taking responsibility for the implementation and outcome—is the current trend, and is at the heart of the principle of streamlined conditionality, what can or should the lending institutions do when a country "owns" a bad policy? After all, the Argentine public supported the convertibility law as recently as the 1995 and 1999 elections. Given that the Fund was uncomfortable with the policy from its inception, at what point should it have refused to support the overall policy package?

The current situation in Argentina could plausibly induce one of two very different reactions from the international financial community. The past failure of Fund conditionality to eliminate the fiscal problem could be addressed by being more rigorous in the application of that conditionality: lending would only occur if ambitious targets were met. The IMF, having been stung before, naturally would want to make sure that it resumes its lending only when the authorities have bitten the bullet (which seems to be the general direction that any new agreement is headed in). In contrast, the complicated political situation and the absence of domestic support for clean economic solutions argue for a shift away from the Fund's previous approach of lending on the basis of a detailed list of policy measures, in favor of a much more political judgement concerning the advisability of lending, while leaving the detailed measures up to the government.

In Argentina's case, both reactions are likely to lead to the same outcome, namely a refusal by the international community to provide any new financing—or only enough to prevent the government's default to the international financial institutions. First, Argentina's economic situation is such that what would have looked like a moderately weak program in the past is now unattainable—the depth of the collapse in economic activity is such that revenue collections are way down, and there is no hope of increasing them to previous levels anytime soon. Government spending must be slashed, not least because the authorities have exhausted their sources of financing and destroyed the confidence of financial markets. So the realistic objective of any financial assistance package will be not to aim for a strong package of growth-inducing policies combined with absence of money creation and inflation, but rather simply to alleviate somewhat the severity of the financial crunch. Second, the crisis has created such a chaotic political situation that any realistic political judgement on the success of a potential program would surely imply that agreement should be delayed at least until after the presidential elections in March and the formation of a cohesive government.

Of course, such problems often arise for countries coming to the Fund after a financial collapse. The IMF attempts to concur with the authorities on policies that have some hope of establishing a sustainable recovery rather than to aim for the policies which would theoretically be optimal—assuming initial conditions were different and there was the time and the fiscal margin to implement them. All this is implicitly understood even if the dividing line between what is possible and what is not is unclear. It makes the job of selling the resulting program to the Argentine public and to the IMF's board a

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delicate exercise, since the true set of achievable policies is clearly much more the outcome of the domestic political process than the result of clever design by Washington economists.

Making the Fund's lending more sensitive to political realities no doubt has its attractions. It would also move toward reducing the scope of economic conditionality—streamlining it, and increasing country ownership, both of which are current goals of the IMF. Recognizing the political reality in Argentina is likely to involve weaker conditions, but would require an assessment of whether the current government would likely deliver sound policies. This is an extraordinarily difficult decision to make, but in Argentina's case, it would likely come down to a decision to postpone lending. In contrast, in the case of Brazil, the Fund's decision to push forward with the approval of a $30 billion loan prior to the October elections seems to have been based on the notion that economic fundamentals were sufficiently good to justify support, regardless of the electoral outcome. In any case, decisions on disbursement of later tranches will be made after the new government has been formed. (Of the $30 billion total, only $3 billion in new cash has so far been disbursed, along with $10 billion liberated by the agreement's lowering the floor on Brazil's foreign exchange reserves.)

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GOVERNANCE

While it is true that IMF-supported programs are voluntary agreements between the Fund and the government concerned, countries facing a crisis are not in a strong negotiating position in deciding which policies to follow, nor is it likely that there will be sufficient time to reach a national consensus in support of those policies. (In both Argentina and Brazil, it should be noted, major policy decisions about the exchange rate regime and the structure of fiscal policy were homegrown, not the result of IMF pressure.) The current structure of international financial organizations does not justify international civil servants—no matter how well-intentioned—overriding national sovereignty in the name of the greater good. It is possible to imagine a global governance system that would legitimate such actions, one based on representative democracy at the global level, with the counterweights that function at the national level in democratic societies: a legislature and judiciary whose powers relative to the executive were clearly defined. However, we are far from that world.

Instead, the international financial institutions constitute an embryonic executive branch in the economic domain, controlled only by their executive boards, where voting power reflects economic power, but only imperfectly, since it is still heavily influenced by relative power in the early post-war period. In particular, the east Asian emerging market countries that have grown rapidly in the past three decades are severely underrepresented.

As a result, the IMF has increasingly been criticized (at times unfairly) for imposing conditions on countries—including liberalization of trade and financial markets—that serve the interests of the rich countries. Thus, under the current structure, placing greater emphasis on political factors poses a great danger for the organization. Doing so provides ammunition for the exercise of political criteria by the IMF's largest shareholders, principally the United States. It is no doubt inevitable that countries' fitness for financial assistance will be assessed by the United States in part by whether they are "allies" in the current geopolitical structure. This was true during the cold war and is just as true now, with the war on terrorism. However, giving in completely to such pressures would doom the IMF's claim to be a global institution with a global mandate to serve all equally, as its Articles of Agreement require. At least at this juncture, and with its current structure of governance, the only way the IMF can resist these pressures effectively is to rely on economic arguments where it has recognized expertise and a clear mandate.

THE WAY FORWARD

The IMF's dilemma in the case of Argentina is that neither of the two obvious strategies—to impose greater rigor in the economic criteria it will accept before lending (proving that the IMF can say no), or to give greater emphasis on the political judgement that support is justified (leaving the country to work out the economic details)—is likely to allow a resumption of lending that is necessary to ease the humanitarian disaster that is afflicting that country. And neither strategy will do much to enhance the IMF's credibility. Both are likely simply to delay agreement on a new program, and in the meantime the IMF will be subject to an increasing blame, from left and right, for contributing further to economic hardship by refusing to provide assistance. If the IMF and Argentina do not reach agreement soon, the country will not be able to honor its repayment obligations to the international financial institutions, and this will greatly deepen the financial crisis.

Making the IMF more political raises a host of governance issues. Already, the Fund is at risk of being seen as a tool for furthering the political (and economic) objectives of the Group of Seven industrialized nations—Britain, Canada, France, Germany, Italy, Japan, and the United States. If it abandons its focus on economics to become overtly political, the continued existence of the IMF in its current form will no doubt eventually be subject to challenge by the remaining countries, which constitute 90 percent of the world's population.

Unfortunately for the management of the Fund, therefore, the Argentina crisis will not provide an opportunity to make a break with the past and to take the IMF in the new directions that Horst Köhler has enunciated. Instead, the institution needs to accept that the humanitarian crisis there demands quick disbursement with relaxed conditionality.

Rather than making an example of Argentina and attempting to recapture credibility by demonstrating new rigor, the IMF should make the best of a bad situation by rapidly making available financial assistance to prevent further hardship and financial meltdown, with conditionality that is only aimed at safeguarding Fund resources (and ensuring that they are not misspent) rather than attempting to obtain agreement on extensive and comprehensive policy

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reforms. Such lending would be consistent with the IMF's objectives, as embodied in its Articles of Agreement, which allow for providing countries with financing "… under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balances of payments without resorting to measures destructive of national or international prosperity" (Art. I. v).

The conditionality on that lending to Argentina should address the safeguards issue, not the various aspects of bank restructuring, protection of supreme court justices from impeachment, and so forth, that have been the object of press reports on the negotiations.

The IMF should not use Argentina as a demonstration model of a "new world order" or a new modus operandi. The situation in neighboring Brazil could create an opportunity to test its intent to move toward streamlined conditionality, assuming that uncertainty in the markets does not precipitate a default before the government has a chance to get its feet on the ground. Decisions about future disbursements of the $30 billion loan to Brazil will be made as the newly elected government develops its economic program, which will give the fund an opportunity to re-evaluate the extent and nature of conditions in that agreement. The current agreement explicitly acknowledges the need to reevaluate the target for the primary surplus in the light of updated information.

Finally, even though Brazil might serve as a test case for moving toward fewer conditions and more ownership by national policymakers, in the absence of a new mandate for the IMF, any decision about lending will still have to be made according to economic rather than political criteria.

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