

**TIGHTENING IMF MACROECONOMIC STANDARDS VERSUS  
GROWING FISCAL INDISCIPLINE  
Lessons to be learned from the crisis of the 90's**

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I. - Introduction.

The purpose of this article is to analyze the role of the International Monetary Fund (IMF) in the recent economic crisis of emerging markets during the 1990's and establish some guidelines for future action. Much has been said about the IMF role and this article will describe the policies followed, the historical context in which they were applied, what went wrong and which are the lessons to be learned from this experience.

The Argentine, Brazilian, Mexico, Russian, Korean, Indonesia, Turkey and other country crisis during the end of the last century are crucial cases to study in order to define the IMF role in the future, particularly because some crisis occurred notwithstanding that the economies of those countries were under IMF-supported programs supervised by the Fund. The analysis become relevant both for the economic and political evolution of the world in the next ten years.

There are certain facts that are important to be acknowledged from the very beginning: one of them is that the IMF applauded the program and structural policies followed by some of those countries, particularly in the case of Argentina with the convertibility law. Another is that the IMF was directly involved in the economy of many of those countries through IMF-support programs and that in many of them the lack of fiscal discipline was the main destabilizing factor.

The international community, both private and through state multilateral support, also played an important role in each one of these crisis. Their support together with the IMF consent to those policies, established the framework upon which the international and local financial and investor market relied upon when taken their decisions.

The issue is important as for example The Inter-American Development Bank (IDB) portfolio of private sector infrastructure financing, including A loans and guarantees, together with syndicated loans (B loans), using private capital of banks and institutional investors have supported over \$2.4 billion in total investment in infrastructure and public utility companies in twelve countries. Argentina, Brazil and

Mexico were the most favored ones. The IDB lending to Argentina totaled 17%, to Brazil 26% and to Mexico 13%. In addition you have to consider World, Bank and IFC lending programs.

This support explains the success of the placement of government bonds in the private sector locally and internationally, the increase in foreign direct investments and also the success of local private companies' bond offerings in the local and international market.

Much has been said about the risk that should be taken by private investors in the countries above mentioned and the moral hazard that could be created by IMF bail-outs, but we should be aware that the market invested in those markets taking into account that the IMF was somehow supervising and overseeing the progress of the economic programs of those countries.

The IMF was very much involved in those economies and there is an assumption that the policies applied were properly implemented.

Now, the IMF has slowly adopted new guidelines, based on: a) streamlining conditionality, b) enhancing government ownership, c) promoting Fund's financing through floating tranches tied to the implementation of structural reforms, benchmarks as part of monitoring programs, and greater use of results-based or outcomes-based conditionality, d) avoiding contractual language in letters of intent (LOI) and in the stand-by-arrangements (SBA), e) paying attention to political considerations, f) introducing consultation clauses, g) omitting performance clauses in SBAs that do not go beyond the first credit tranche, h) non discriminatory treatment of members, i) limiting performance criteria to those necessary to evaluate implementation of a particular program, ii) increasing the use of informal procedures by the staff to keep the Board timely informed and iii) improving clarity and transparency.

At the same time, there seems to be an inclination to review the IMF traditional policy of "not lending into arrears" in order to better position debtors in a restructuring scenario, as the recent proposals for some form of international bankruptcy procedures point to.

Are those guidelines in the right direction?

## II. The Crisis of the 1990's

*1) Within this scenario, it is useful to analyze the last crisis of the 1990's, in particular the case of Argentina, in order to understand the role of the IMF and other*

*international lending institutions before and during those crisis. Reference will be made to the new guidelines described above.*

In the case of Argentina, the IMF conducted a close scrutiny of the country's Convertibility program and implementation at the beginning of the 1990's and the Argentina Government implemented an IMF fund-supported program. In this case, ownership, a priority matter today in the IMF guidelines, was respected.

In other cases like Mexico in 1995, Indonesia and Brazil 1998/1999 the IMF fund-supported program started only after the crisis was already under way. The IMF advisory role did not prevent the crisis.

Another case is the Russia program and its crisis of 1998, where most likely the political importance and concerns of reassuring a transition from a socialist to a market society, play a role in the attitude of the Fund. Political considerations were applied.

In the Mexican crisis uniformity of treatment was not applied and certainly political considerations prevailed.

Different policy approaches were used and in all these cases, conditionality was applied in a variety of forms. Therefore, the failure must be placed somewhere else. In effect, we must somehow assume that the failure in these cases may have come as a result of the lack of enforcement of a "conditionality policy" by the IMF, during the implementation of the programs.

The "conditionality policy" in the case of Russia was difficult to be enforced because of the structural reforms involved surpassed the IMF areas of competence.

In the case of Argentina, the main issues involved were related to fiscal, monetary and exchange policies. Assuming that no structural reform was needed the IMF attitude should have been more forceful.

It is important to analyze what went wrong, not to assign blame but, as we mentioned at the beginning of this paper, review the guidelines of future international lending and guarantees and which are the risks that should be avoided.

2. *We may identify some key problems in the approach that the IMF took with respect to Argentina before and during the crisis:*

Before the crisis:

- a) Failure to condition its support of the Convertibility Program to a sound fiscal policy during good years of high growth.
- b) Prevention advice as to the extent the program could be applied without being entrapped

During the crisis:

- a) To organize a large international financial support in December 2000 to assist Argentina without proper conditions to be applied
- b) To extend additional financial support to Argentina in the summer of 2001 when the program had no chances of surviving and an early way out was the most advisable solution

*Before the crisis started:*

(i) What becomes more relevant when comparing the Argentine crisis with the crisis suffered by other countries with different monetary and exchange systems is that in all those crisis there was a problem of fiscal discipline. This is the common denominator.

The persisting running of significant fiscal deficits and the subsequent increases in the government debt even during periods of sustainable growth in violation of IMF program targets, was relevant in the Argentine crisis. Prevention measures would have avoided the crisis.

Once the recession started the adoption of austerity measures supported by the Fund to avoid a default or devaluation for political reasons - instead of restructuring its debt and a possible change in the exchange rate regime - aggravated the situation. Intervention could have avoided further damages.

A problem of institutional nature that may explain the attitude of the Fund is the extent of the powers of the IMF. In effect, one of the legal problems the IMF faces is its limited power of intervention in domestic policy decisions or the lack of it. For example, Article V, Section 2, requires the Fund to support the policies selected by a member country as far as there are reasonable expectations of success.

The IMF is a voluntary association of member's countries, which by definition are sovereign. Nevertheless, although the IMF could not impose a particular economic program, it could have intervened more forcefully when, within its lending conditions, Argentina did not comply with a prudent fiscal policy and did not plan for a future exit of the Convertibility plan.

(ii) Borrowing to finance government spending at provincial and federal level, the IMF inability to control that problem and the leniency of the financial market to grant lending in such conditions, are other problems to be addressed.

To recognize this failure is important because it is not the first time that Argentina or other developing countries fall in irresponsible fiscal policies and end up either in an inflationary process, default or violating property rights. Strict control under the Fund support program could have lowered the impact of the crisis.

Now, why the fiscal deficit did not become an issue before it was too late to address the problem? Various factors hide the truth of the Argentine deficit in the good years and somehow exculpate the IMF and justify the success of Argentina in placing bonds in the international market above mentioned:

- a) More than \$ 3 billion in revenues from the privatization deferral of interest expenses as a result of the Brady bond restructuring (which involved a substantial back-loading of interest payments)
- b) The importance given to central-government budget by the international lending community and the IMF without acknowledging the increasing deficit shown by the consolidated budget including the provinces.
- c) Argentina benefited during those years from the failures of Asia and Russia vis a vis the international lending community. Argentina's success confronted with the failures of other emergency economies contributed to the ability of the Government to place bonds in the financial market at attractive spread rates.
- d) The failure of the other markets probably also restrained IMF officers to put pressure on the Argentine Government to keep its expenses within the target. One question that we have to ask ourselves is if the failure of Argentina today is not producing the same paralyzing effect in the IMF with respect to other economies today.
- e) Other external factors contributed to Argentina success in the mid 90's: The US dollar depreciation in 1995 and the strengthening of the Brazilian real, which produced a rapid increase of exports, as well as low interest rates in the US market.

(iii) But the external factors that contributed to the success of the program also contributed to its failure. In effect, by the same token in this scenario, Argentina became also vulnerable to two external factors that placed the country in a "catch 22" situation:

- a) The failure of Brazil's crawling-peg exchange rate in 1999, which directly affected Argentina GDP, through its economy into recession and impaired the success of fiscal adjustments.

- b) Changes in the international market towards Latin America at the end of the 90's (financially and economically). Foreign direct investment diminished dramatically in the last two years of the last century.

After the crisis started:

In the year 2000 the crisis was already a given fact. The IMF was facing a tough decision by the end of the year: *whether to provide a large financial aid package or force the country to adopt a more drastic solution.*

According to the IMF policy enunciated by its Finance Committee in Prague once it became clear that a country could not reasonably be expected to continue servicing its private credits on their contractual terms, the Fund would continue to provide financial support only on the condition that a country seeks a reasonable understanding with its private creditors that would reduce debt-service requirements to sustainable levels.

Argentina by December 2000 had large international reserves above the size of its domestic monetary base, no trade deficit, bank deposits remain high and sovereign debt spreads were not yet at historical high levels. Its inability to meet debt payment came from diminishing revenues as a result of a longer than expected recession, increase government spending and lower levels of FDI. Sustainability of the convertibility was in doubt (structural – political issue)

Therefore, the options at that time were:

- a) Dollarization of the economy
- b) To implement a large bailout plan enough to cover financing requirements for several years
- c) to provide only reasonable amounts and impose a strict fiscal policy
- d) to convince the government to an involuntary sovereign debt restructuring

The Financial aid package of December 2000 was in line with IMF policy of “uniformity of treatment” subject to appropriate level of conditionality but it was not according to the Prague guidelines that were already under discussion. By that time the IMF was well aware of the inherent economic, financial, fiscal and political structural and operational problems of Argentina.

One of the causes of Argentine's debacle was its continue excess of public spending over revenues: If during each year of the Convertibility Plan the balance of the Argentine Government would have been 2 percent of GDP better, the cumulative effect would have lowered Argentine sovereign debt in 2001 by \$ 60 billion.

The IMF and the Argentine government knew about the existence and extent of this fiscal indiscipline. This knowledge is what raises questions about the IMF role after the package was granted. The excess of public spending over revenues continued after the aid package was provided. To control this problem was an IMF responsibility under the Fund-supported program.

### III. Disclosure, accountability and transparency issue

The IMF plays an important role in the international financial market. It has a responsibility vs. private investors and international lending institutions (projects, bonds or FDI).

The IMF Role as of today is that of either: an Advisor or a Controller.

The IMF role when engaged in a fund-supported program is that of a Controller and should be tough and strict. Furthermore, accountability should be another concern as well as corrective measures should automatically come into place externally (vis a vis the host country) and internally (check to assure that measures are taken properly and timely).

The objective of such control is: not to defraud its members and the market expectations.

The impact of the IMF role during a fund-support program on the private sector involved in project finance lending cannot be ignored, particularly because related multilateral institutions are also involved (IFC, IDB, etc.). Lenders are risk takers but within the parameters of a wider policy framework, particularly when a fund-support program is in place. If the IMF in order to facilitate a particular economic program fails in its conditionality efforts, or in some cases bail out a country and not in others, it is directly affecting the very basis of the fairness and equality of the markets for any kind of transactions, project finance, foreign direct investment, bond market, etc.

Though more indirectly, there is a correlative responsibility in the case of bondholder's investors. I acknowledge that there may be considerations of moral hazard in a bailout scenario. But I refer to the specific case in which the IMF does not exercise proper control of the host country compliance with the IMF requirements and conditionality and knowingly allows a country to place new bonds in the market without issuing proper warnings.

In the Argentine case, the December 2000 and successive support or augmentation programs in 2001 may have created the impression that the IMF was going to bail out Argentina or that the corrections were instrumented properly. Argentina successfully

placed Eurobonds during 2001 after the support received by the IMF. Investors may have trusted the IMF.

One of the indirect effects of the IMF role is to establish or reestablish confidence in the financial market. The market participants take its actions seriously.

#### IV. The IMF supervisory role

The approach taken by the IMF in Argentina is not an isolated event. Perhaps, the best way will be to call it is “pattern of behavior” rather than a mistake to avoid the liability content of the latter.

Certainly, these patterns of behavior become relevant because in practice the IMF exercises a role of supervisor of the international financial system. In this case, the IMF should make public when a fund-supported, or other program, go substantially off track.

Furthermore, any Fund financial support should be strictly conditioned on a program of successive adjustment measures with automatic type sanctions and corrective actions in case of non-compliance for the purposes of achieving the very same program objective.

Leniency has been a pattern of behavior that in the case of Argentina has proven to be fatal in the long run and raise doubts about the true situation of other countries today, for example Brazil.

The sooner we address these problems the better because they are triggering other problems. Part of the public opinion and political leaders of many countries in the world have misread the Argentine default, as the failure of open market oriented reforms. Again, the failure to act decisively will be another mistake.

Political implications cannot be ignored. We now have four leftist governments in Latin America: Lucio Gutierrez in Ecuador, Luiz Ignacio “Lula” da Silva in Brazil, Fidel Castro in Cuba and Hugo Chavez in Venezuela. Could Argentina or Bolivia become the next country? If that happens many of the efforts to implement homogenous standards will be delayed. A new pan-Latin American movement with socialist overtones may be forming.

The common belief of part of the people in many of those countries (with of course different degrees) is that free market reforms and globalization did not bring prosperity to their nations but trade deficits and an enormous foreign debt. The direction in which each one of these countries leaders will proceed will depend on the

actions taken by international institutions and the G7 in order to defuse an alliance, particularly the way in which the foreign debt is rescheduled and by expediting ALCA in a way that the G7 (specially the US) become part of the solution and not of the problem in the eyes of the people of those countries.

The Argentine crisis has not been solved. The IMF, after one year of extenous negotiations, has only postponed the payment of a \$1billion debt repayment at the end of January and rollover \$6,6 billions in debts through August of 2003. No structural reforms are included in the package, only fiscal targets. The Agreement essentially transfers the burden of the structural reforms and of negotiating a sustainable economic policy to the new government.

#### V. Ideas to be explored

Large support package programs are a matter of great concern but usually they are implemented at the end of a process, when the country is already immersed in a deep crisis and the possibilities of not succeeding are larger than advisable. Moral hazard then becomes an issue. Though the conditions upon which these programs are based should be tightened the problem lies in the earlier stages of a Fund program, well before a crisis occur. It is here where the guidelines should be changed.

Tougher and stricter enforcement of conditionality policies in an IMF support program are a must in the years to come. These powers should be implemented within the framework of an increasing regional and global economic integration. In this sense, I believe the implementation of the following ideas should be explored, within the philosophy of free trade, open markets and free capital flows of the Washington consensus.

A clear policy towards global established standards, automatic sanctions, specific intervention powers and objective criteria in order to eliminate the subordination of economic considerations to political motivations must be implemented.

Financial markets have become increasingly complex with a diverse set of players and instruments. A crisis in a particular country may affect many private investors or lenders in different regions of the world. A set of instruments must be put in place to provide a framework to secure transparency, fair rules, efficiency and stability, for example: Information, Prevention and Incentives, Conditionality and Enforcement, and Accountability. I will expand on some of them.

#### Information

- Information is crucial for the markets to operate. A global economy requires access to accurate information to run efficiently.

Governments and private institutions, for their own benefit, can manipulate information. There must be a source of independent information. The IMF can play the role of a provider of information under homogeneous standards. I understand that the IMF is working in this direction.

- A more difficult role, but extremely important, is the role of supervising the accuracy of information released by a particular country. The assumption is that such country, let us say Brazil, is working with the IMF under a program and is already subject to certain standards of information. The IMF in case of false or incomplete data should make a proper disclosure to the market. This obligation of the IMF shall be part of any support program with any country. In this sense, it will put pressure on them to come out with sensible information.
- Adequate disclosure of IMF policy and actions is required. Press releases do not provide enough data for proper evaluation. This is a crucial element of any solid and transparent market place, as it is being done in the banking sector through the Basle Agreement.<sup>1</sup>

Accurate information is vital for the formation of a global international financial system and its stability. Private sources, though relevant, are not exempt from conflict of interests. The IMF could be the appropriate source.

### *Prevention and Incentives*

The IMF is in a position to induce structural changes on debtor countries with the aim of securing efficiency and stability to the financial market.

These changes may be introduced by a set of incentives, international agreements or by conditioning further lending to their implementation. It also requires a plurality of actors.

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<sup>1</sup> The Basle agreement has established a set of measures to guarantee private sector banking transparency:

- All international banking groups be supervised by consolidated supervision in their home country.
- Home and host country should mutually agree to the setting up of foreign branches
- Supervisory authorities should possess the right to gather information from cross-border banking establishments of the banks for which they are home country supervisors
- If a host country is not satisfied with the standards of the bank they may impose restrictions on that bank.

This strategy was adopted in 1999 with the Financial Stability Forum. Its composition includes representatives of finance ministers, central banks, and regulatory agencies of G7 countries - including among others Australia and The Netherlands - and by international financial institutions or committees (The Basle Committee for banks, IOSCO for securities markets, IAIS for insurance industry, or IASC for accounting standards).

Its objective is to establish international understandings that are not implemented in a domestic jurisdiction. They include standards, governance and incentives. It works by consensus. The Group of Twenty works in a similar way.

Among the measures to be promoted are clear governance rules, transparency and availability of information, global accepted accounting principles, international ratings, international cooperation through institutions similar to the Basel Committee and the Committee on the Global Financial System of the Bank for International Settlements, homogeneous bankruptcy legislation, supermajorities clauses in public and private bonds, trade agreements, regional integration, among others. Coordination is a factor.

All these ideas if implemented by the IMF through conditions or under its advisory role -though they do not entail an automatic application - will be gradually extended through the number of countries under an IMF lending programs.

Incentives will of course not avoid a crisis but will diminish its effects by prevention. This will facilitate other roles of the IMF.

More serious involvement of countries in intergovernmental groups, central banks cooperation will generate more guidelines and consensus. But only multilateral institutions like the IMF will have the power to impose standards and to verify its compliance. Conditionality and structural conditionality become indispensable instruments.

#### Conditionality and Enforcement

When we talked about conditionality we talked about macroeconomic (monetary, exchange rate and fiscal policy measures) and microeconomic policies (market operating rules, disclosure, accounting and auditing standards). Conditionality should also include an efficient system of incentives and penalties and a set of procedures to apply and check its compliance. Structural conditionality in its broadest sense is a must.

The official IMF policy on conditionality is vague and uniformity of treatment is not assured. Without disagreeing on the need of a pragmatic approach, boundaries should be put in place to assure transparency and fair market conditions.

Finally, the IMF is the only international institution today with the possibility of imposing policy changes to its members. Decisive enforcement of IMF selected adjustment and structural conditions may solve internal political weaknesses and facilitate international compromises in the long run. Conditionality without a clear strict enforcement does not work.

### Accountability

As in many other areas of life, governance regulations and accountability go hand in hand if we want to achieve results. This rule has to be applied to the IMF too and its members, particularly the G7 that control the decisions of the Board.

Guidelines and recommendations have to be adopted as well as internal reporting.

### VI. Conclusion

In this debate about the role of the IMF or the very existence of an institution with the power to intervene and harmonize the world financial markets in the public sector, two traditional groups have fought, which position could be very simply summarized as follows:

- a) Those advocating the wisdom of free market solutions (“let the crisis happen, the penalties that a country will suffer will be sufficient incentive to introduce the structural reforms and transparency to balance the effect in the long run”)
- b) Those advocating the need of a lender of last resort with enough flexibility to understand the locally and international political implications of each particular situation

I am a staunch believer in free markets but sometimes in order to provide the scenario for the players to interact there must be a set of flexible regulations in place. It is my view that the flaws have been in the lack of clear non-arbitrary policies in the IMF as a result of an absence of automatic sanctions, the application of imperfect conditionality policies, political influence, no internal or external accountability, lack of enforcement, no prevention strategy, no transparency and disclosure obligations, no incentives in the market and poor coordination with international institutions.

The recent Guidelines on Conditionality discussed by the Executive Board of the IMF and briefly enunciated at the introduction of this paper seem to me contradictory to the general direction of global integration and harmonization of legislation the world should be going. In effect, streamlining of conditionality and ownership could be harmful to the integration of certain markets (banking, stock exchanges or trade) by promoting local solutions justified only by political reasons. Likewise, the lack of contractual language in the LOI and short term stand-by-arrangements may encourage the lack of accountability and transparency of politicians. The discussion is open.

In a global economy we should pursue harmonization of rules and patterns of behavior. Is a daunting task but is a step-by-step strategy in the right direction. I am not talking about subordination of the political power of a country to a bureaucratic supranational institution. I am talking about a framework that set the rules of the game to be played by its participants in which there are incentives and premiums for those that play in fairness and penalties or sanctions for those that do not.

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