

Is Argentina the *Coup de Grace* of the IMF's Flawed Policy Mission?

By David Felix

The reverberations from the Asian financial crisis of 1997-98 enmeshed the International Monetary Fund (IMF) in a major legitimacy crisis over its recently assumed mission to promote free capital mobility around the globe. The repercussions from the current Argentine crisis threaten to apply the *coup de grace* to that mission. The mission, which deviates drastically from the IMF's original function under its Bretton Woods charter, was designed to support the U.S. free market globalization strategy. The mission crisis of the IMF is thus also a U.S. policy crisis.

Under the Bretton Woods Agreement, reached by the major capitalist powers toward the end of WW II, the World Bank was to provide reconstruction financing, while the IMF was to provide short-term financing to stabilize exchange rates. The basic objective of the agreement, whose terms still serve as the IMF's charter, was to establish an economic order in which multilateral trade and investment (together with stable, convertible exchange rates) would be compatible with full employment, progressive taxation, and other components of welfare capitalism.

Controlling international capital flows was judged essential for these goals to be mutually sustainable. Hence Article VI authorizes member countries "to exercise such controls as are necessary to regulate international capital movements" and empowers the IMF to request tighter controls and to deny IMF credits if used "to meet a large or sustained outflow of capital." In practice, the IMF neither urged borrowing countries to tighten capital controls nor denied credits when used to finance capital flight.

IMF MOVES IN

However, during the first three postwar decades IMF lending was subordinated to bilateral foreign aid driven by cold war politics and, in the 1970s as "foreign aid fatigue" set in, to private bank loans. Beginning in the late 1970s, however, the U.S. found the IMF increasingly useful for handling debt crises in the developing world and for opening that world's financial markets to international capital. From a minor lender of last resort, the IMF became a major enforcer of foreign debt service and a leading advocate of removing all obstacles to the entry of foreign capital. In pursuing these functions, the IMF has attacked capital controls throughout the developing world, thus moving from neglect of Article VI to active violation.

As the IMF pursued its campaign to rid developing countries of capital controls, it steadily expanded the policy conditions it demanded of countries seeking its credits. Prior to the 1980s, the IMF advocated policies intended largely to relieve foreign exchange crises at moderate socioeconomic cost to the borrowing countries. It insisted on monetary-fiscal tightening and devaluation but not

that capital controls be removed or that domestic development and social welfare approaches be reversed. In the 1980s, however, resolving balance-of-payments crises by attracting foreign private capital became a primary goal, and its policy demands now included measures that cut deeply into the socioeconomic structures of the borrowing countries and increased their adjustment costs.

The IMF now required borrowing countries to ease capital controls and to rely on raising interest rates to halt capital outflows and attract inflows. By intensifying domestic bankruptcies, banking crises, and credit crunches, this strategy often deepened the decline of output and employment. To attract equity investment, the IMF also pressured borrowers to privatize state assets, reduce social expenditures, and repeal measures that protected wages and national firms against foreign competitors.

The expanded IMF conditions and their adverse consequences sparked popular unrest and political crises. Fearing popular reaction, many borrowing countries took IMF funds without fully implementing the IMF demands. Mounting resistance to policy meddling and heightened austerity has contributed to the crisis enveloping the IMF.

The IMF is also under attack for failure to provide adequate debt relief. In the past, when developing country foreign debt consisted mainly of bilateral government loans, the IMF could ease the debt-servicing burden by persuading lender governments to stretch out repayment schedules. Under its new mission the IMF, eager to keep private capital flowing, has made sustaining the full servicing of private loans a core principle. Indeed, to reassure private lenders it has even pressured borrowing governments to rewrite debt contracts *ex post* in order to protect the lenders from loss. In the early 1980s the IMF urged Latin American governments to guarantee *ex post* the foreign debts of their private banks, whose copious unguaranteed borrowing had helped bring on the debt crisis. In its 1995 crisis, Mexico, to obtain bailout funds, was required to pay holders of its *tesebonos* in dollars, though contractually these treasury notes had merely required repayment in pesos.

MOUNTING RESISTANCE

In compensation for such government guarantees, the IMF has been enlarging emergency credits. But as currency/banking crises have become more frequent and severe, there is mounting resistance in the U.S. and other creditor countries to the increased fiscal burden of replenishing IMF coffers and providing supplemental bailout funding. The \$50-billion

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Mexican bailout of 1995 dwarfed previous packets, yet was nearly quadrupled by the sum of the Asian-Russian-Brazilian bailout packets of 1997-98. Since 1995 the international bailout packets have amounted to over \$300 billion, with around 35% supplied by the IMF. Its coffers nearly emptied, the IMF has been campaigning for enlarged replenishment quotas from its members to enable it to respond more expansively to future crises. The campaign is falling flat. The conservative U.S. economists advising Bush II condemn IMF bailouts as a major cause of the recurring crises by distorting risk assessments of lenders and borrowers. Eliminate the bailouts and the financial markets would assess lending risks and returns correctly. This view accounts for Argentina's difficulty in extracting additional IMF credits.

The IMF is being buffeted as well by growing criticism that its "sound" crisis policies have had a low success rate, and that the substance of what it dubs "sound" has evaporated in a fog of *ad hoc*ism. Typically, the IMF's pre-crisis assessment failed to foresee the impending crisis. Its "sound" crisis remedies over-concentrated the adjustment costs on the borrowers while protecting the lenders. The IMF then sought to obscure overt failures by *ad hoc* alterations of its remedies, in the course of which the over-optimistic projections of the initial IMF policy package fade from view, along with clarity as to which fiscal, monetary, and exchange rate policies are indeed "sound." Accordingly, mainstream economists have been defecting from the theoretical perspective on financial market behavior that has underpinned the IMF's current mission—compounding the IMF's legitimacy crisis.

REVERSAL OF CAPITAL CONTROLS POLICY

The Bretton Woods Articles of Agreement were shaped by the Keynesian view—widely shared at the time—that deregulated financial

markets are prone to excessive volatility and speculative mispricing of assets, with adverse repercussions on production and trade. The recent IMF (and U.S.) drive to promote free capital mobility around the globe stands the Bretton Woods perspective on its head. It is argued that if financial markets are allowed to operate freely, these markets will price assets efficiently and optimally. Interventionist policies that distort the markets—and not markets themselves—are deemed the root causes of financial disorder. The corollary of this theory is that lifting capital controls globally advances rather than undermines the basic Bretton Woods goals.

This theory holds that free capital mobility produces an international converging of real interest rates and a more accurate global pricing of capital assets, thus elevating the returns on global capital and the efficiency with which global resources are allocated. In addition, it is claimed that by rewarding "sound" policies with capital inflows and punishing "unsound" ones with capital outflows, the globalized financial markets will also improve domestic policymaking. All this is supposed to accelerate productivity and output growth—especially in the capital-short, technology-deficient developing world, where the return on capital should be highest. Hence, the increased socioeconomic costs of IMF policy demands merely swap short-term pain for greater long-term gain.

Such theorizing, however, builds on an assertion about the innate efficiency of financial markets that has negligible backing from economic theory and is refuted by actual trends after the 1960s. Lifting capital controls has opened the gates to an accelerating volume of international financial flows. But these have been accompanied in most of the developing and industrialized world by slackened growth of investment, savings, output, trade volume, and productivity, compared to the Bretton Woods decades.

Increased capital mobility has caused global growth to slacken for two main reasons: 1) heightened volatility of both nominal and real exchange rates, and 2) much higher real interest rates generated by the explosive growth of cross-currency financial flows. Higher volatility raises the risks of investing long-term, while higher real interest rates raise the cost of capital. Combined, they have tilted private investment after the 1960s toward projects with quicker payoffs, which have contributed less to productivity growth than did the long-term investments characterizing the less volatile Bretton Woods decades.

RISING FINANCIAL FRAGILITY

Since the 1970s there has been an upsurge of investments in mergers and acquisitions and in financial instruments that add nothing to productive capacity. Over 80% of global foreign exchange (forex) turnover—which exceeded \$375 trillion in 1998 compared to \$4.6 trillion in 1977—involves round trips of a week or less. Only 3% directly finances trade in commodities and non-financial services, compared to 30% in the 1970s. The other 97% represent financial transactions that exploit discrepancies between inter-country interest rates and corresponding exchange rates, speculate on movements of bonds and equities in different markets, and hedge against or speculate on exchange rate movements. The short-term focus of these flows makes them highly skittish. Hence, as their volume has increased, so has the frequency and extent of disruptive flow reversals. Since 1980 around 80% of IMF member countries, industrialized as well as developing, have suffered one or more bouts of currency/banking crises or near crises. In contrast to the localized crises of the Bretton Woods era, the reactions of the globalized financial markets have rendered recent crises far more contagious.

The changing economies of the industrialized countries contribute to the rising financial fragility. Since the mid-1950s, each of the G-7 countries has experienced rising shares of gross domestic product (GDP) devoted to finance, insurance, and real estate (FIRE)—activities that facilitate asset trading and risk transfer. Rising FIRE/GDP ratios were associated until the mid-1970s with faster output growth of goods and non-financial services in each of the G-7 countries. But the correlation turned negative thereafter, indicating that the surging financial activities since the demise of Bretton Woods have been crowding out production of goods and non-financial services.

The rise since 1980 of real interest rates to double real GDP growth rates in the G-7 countries is also indicative of increasing financial fragility. Reinforced by increased debt leveraging, the holders of financial assets—mostly the wealthy elite—have been garnering rising shares of national income and wealth. Over the past 115 years, only the inter-war decades experienced such a prolonged rise, and then mainly because real GDP collapsed in the deflationary 1930s. The massive booms in shares and real estate prices of the 1980s and 1990s, despite the

THE ARGENTINE CRISIS AS *COUP DE GRACE?*

For most of the past decade Argentina was the poster child of the IMF and Wall Street. No developing country in the 1990s had opened its financial markets more avidly, or privatized its state assets more fervidly. These structural reforms were supported by monetary reforms in 1991 that froze by law the peso/dollar exchange rate and tied the money supply tightly to the changing stock of hard currency reserves. To further gain Wall Street confidence, the Argentine government in 1991 announced a major foreign policy shift from non-alignment to an all-out pro-U.S. position—"in carnal embrace"—Foreign Minister Di Tella sardonically put it.

Argentina was thus graded A+ by Wall Street and the IMF. U.S. and European capital flowed in, giving the depressed economy a strong initial boost. And although foreign direct investment slackened by the mid-1990s as the stock of assets still to be privatized shrank, portfolio capital inflows kept rising, notably for the purchase of Argentine dollar bonds. Pleased with the strategy, the IMF was quick to protect it with back-up credits against the flightiness of portfolio capital. The defense worked during the 1995-96 *tequila* crisis, but repeated injections of emergency credits failed to revive private capital inflows, or the economy, following the 1998 Brazilian crisis. The strategy had reached dead end.

Essentially, the capstone of the strategy, the frozen peso/dollar exchange rate and the lifting of capital controls, had transmuted from a magnet for foreign capital into a millstone depressing the economy and a repellent to foreign capital. As the dollar rose relative to the currencies of Argentina's chief trading partners—Europe and its Latino neighbors, notably Brazil—the peso became severely overvalued. Badly squeezed, industrial exporting declined while cheapened Asian consumer goods displaced domestic production. Since 1998 GDP has been falling and unemployment has risen precipitously, as have bankruptcies among small and medium industrial firms.

Concurrently, the strategem of floating more dollar bonds to finance the rising current account deficits and to service the foreign debt has fallen into a "debt trap," in which the increasingly onerous terms on which bonds have to be sold each period worsens the next period's debt servicing requirements. By 2000 the international financial markets, sobered by the recent Russian and Ecuadorian defaults, and aware that the likely denouement of a debt trap is default, became virtually closed to new Argentine flotations. Neither a 1999 bailout package nor a much larger one in December 2000, were able to reopen the foreign bond market to new Argentine placements on viable terms. In desperation the Argentine government has been high-pressuring local banks and pension funds to hold more of its dollar bonds, thus obtaining dollars by further

weakening the ability of these institutions to survive the adverse impact on their balance sheets of a default or devaluation. Cognizant of this, Argentines began a run on dollar deposits in June of this year, which by mid-August had reduced central bank dollar reserves by a fourth.

SLOWEST TRAIN WRECK IN HISTORY

The dilemma for Argentina is that, while essential for reviving the economy, devaluation and reduction of foreign debt servicing would, because of the extensive domestic dollarization, be very difficult to pull off without some combination of capital controls plus IMF and big power financial support to minimize the transitional financial turmoil. Lacking the latter, the policy stance has remained status quo. Avoid devaluation and debt default by further cutting wages and social expenditures in desperate hope that this will somehow improve productivity and revive investor confidence. But in the real economy status is not quo. The more skilled and educated are emigrating in growing numbers, taking their human and financial capital with them: the less mobile demonstrate against the deepening austerity with increasing numbers and violence, while foreign investors, convinced that default is inevitable, have been pulling out rather than increasing their exposure in Argentina.

A Chapter 11-type payment standstill and negotiated workout with bondholders, plus devaluation and controls against capital flight, and backed by generous transitional credits from the IMF and G-7, could substantially reduce the transitional turmoil. Such a policy package, however, would be a complete reversal of the IMF's current mission, and an undesirable precedent for other hard-pressed debtor countries.

The IMF and the U.S., following the failure of the December 2000 bailout, have instead acceded with great reluctance to Argentine pleas by extending merely \$8 billion credits, while offering Brazil a \$15 billion precautionary line of credit against contagion from an Argentine default. These disproportionate allocations indicate that the IMF and the U.S. also believe that default is inevitable.

Wall Street analysts view the credits to Argentina as a foreign policy gesture that merely postpones default a bit longer. "Some people are calling this the slowest train wreck in history," is the way one analyst put it. But coming on top of the Russian and Ecuadorian defaults, the much larger default is likely to accelerate the withdrawal of private financial institutions of the industrial countries from Third World portfolio investment, rendering the IMF's mission futile. This should also require Washington to revisit its original Bretton Woods position on the incompatibility of free capital mobility with free trade and stable full employment growth.

slow growth and high real interest rates, also imply an excessive reduction of investor risk perceptions, resembling the Roaring Twenties that preceded the Great Depression.

TIME TO END THE FREE CAPITAL MOBILITY CRUSADE

Washington has been crusading simultaneously for worldwide free trade and free capital mobility. But the architects of Bretton Woods were right. These two goals conflict in both theory and practice. If economies are unable to directly restrain destabilizing capital flows, they will be tempted to do so indirectly by imposing trade restrictions. The mission crises of the IMF and the World Trade Organization (WTO) are thus causally linked. Curbing hot money flows is essential for reducing exchange rate volatility and contagious currency crises. Controlling short-term flows is also essential for allowing countries more scope to implement monetary and fiscal policies and to initiate environmental and other programs that complement their socioeconomic structures and social welfare objectives.

Discussions now under way among the G-7 leaders and at the IMF aim to curb exchange rate volatility and contagious currency crises by “reforming the global financial architecture.” But the reforms under active consideration still target government policies, not market failures, as the root cause of financial disorders. They stress greater “transparency” from governments, calling for governments to provide more timely and comprehensive information to the financial markets on domestic economic conditions and impending regulatory and policy changes. Proposed reforms aim to further reassure foreign investors by pressing developing and “transitional” economies to model their banking and capital market institutions and bankruptcy laws on those of the advanced economies.

Underlying these official discussions about financial architectural reform is a mounting tension. While there is a continual reaffirmation that capital decontrol for all IMF members remains the long-term goal, there is rising anxiety that the polarizing distribution of income and wealth accompanying the free market globalization is threatening the effort. Also haunting the discussions is a growing awareness that new demands for increased transparency can't fulfill the lack of information about the future, condemning mortals who invest competitively to form imperfect expectations about future returns from their capital assets. It cannot, therefore, prevent recurrence of the sudden reversals of financial flows that afflicted the European Union in 1992, Latin America in 1982 and 1995, East Asia (as well as Russia and other former Soviet Union republics) in 1997-98, and Turkey and Argentina today.

Given this shortcoming, is it politically wise to increase the pressure on widely diverse countries to reshape their central institutions primarily to comfort opportunistic foreign investors? From a Bretton Woods perspective, the official architectural reform agenda is short on proposals to deal with market failure. The official agenda, therefore, is dangerously one-sided in demanding that developing countries reform to accommodate the needs of the financial markets of the creditor countries, while devoting little attention to taming the volatility of these markets.

RETURNING TO THE BRETTON WOODS POLICY PERSPECTIVE

Bretton Woods-like proposals that would redress the global financial balance have been kept off the official agenda. A prime example is James Tobin's well-known proposal to impose a small globally uniform

tax on all foreign exchange (forex) transactions. The tax, a “market friendly” substitute for direct capital controls, reduces hot money flows by squeezing the profitability of large-volume, quick round-trips (maneuvers that exploit interest rate differences across currencies and speculate on exchange rates) while barely affecting returns from the longer round-trips related to foreign trade and direct investment. Exploratory guesstimates suggest that a 0.1% tax might cut forex turnover by up to 50% and generate annual tax revenues of perhaps \$200 billion. An annual tax revenue—collectively administered, perhaps by a reformed IMF—could be an important building block of the international architectural structure needed for more stable worldwide financial integration and a more equitable sharing of the costs and benefits of globalization.

Such a move would facilitate another Bretton Woods objective, stabilizing key exchange rates. Since 1985 the financial powers have intermittently sought to realign their exchange rates within target zones that set bounds to rate movements. But these efforts broke down, because large speculative flows dwarfed the capacity of central banks to use their forex reserves to counter opportunistic attacks on exchange rates. This is not surprising, since official worldwide forex reserves had shrunk from 17 days of global forex turnover in 1977 to a one-day turnover by 1992. By shrinking private flows, the Tobin tax would improve prospects for jointly curbing dollar, euro, and yen fluctuations. This would enable the Big Three currencies to replicate the dollar's stabilizing role during the Bretton Woods era, when the greenback served as a relatively reliable anchor for the lesser currencies.

The tax would also reduce the power of financial markets to coerce domestic policies. A 0.1% tax allows country A's interest rate on 30-day notes to diverge from B's by an additional 2.5% before triggering profitable arbitraging and speculative capital outflows, thus strengthening the economic feasibility of socioeconomic measures that take time to bear fruit. And the annual tax revenue—collectively administered, perhaps by a reformed IMF—could be an important building block of the international architectural structure needed for more stable worldwide financial integration and a more equitable sharing of the costs and benefits of globalization.

Led by the U.S., both the G-7 and the IMF have blocked consideration of the Tobin tax. In 1996 the U.S. forced the UN Development Program to cease promoting a volume of expert papers assessing the tax. In 1999 the U.S. Treasury forced the World Bank to fire its chief economist, Joseph Stiglitz, for taking too critical a stance toward capital decontrol and the distributional inequities of free market globalization.

Defecting mainstream economists offer diverse hypotheses to explain the tenacious U.S. commitment to globalizing capital decontrol, notwithstanding its collapsing theoretical and empirical support. Many emphasize that the risk/reward structure biases its bureaucrats toward status quo positions—some asserting that the frequent interchange of personnel has formed a Wall Street-U.S. Treasury complex. Others stress ideological antipathy toward reinvigorating welfare capitalism or toward subordinating U.S. sovereignty to strengthened international institutions. The hypotheses imply that for such Bretton Woods-like reforms to be adopted, they must first be made politically feasible by grassroots support that is strong enough to change the political climate and bureaucratic risk/reward parameters. For this to happen before the next crisis hits, unions, environmentalists, and social welfare advocates here and abroad must step up their demands for real reform of the international financial architecture. Taming global financial markets is essential if social reformers are to achieve their broader objective of a more stable and equitable world economy.