THE IMF INFIRMARY

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In 2001 three emerging market countries have been in the IMF infirmary: Argentina, Brazil, and Turkey. Despite the critical reviews to which the IMF was subjected in 2000, not much has changed in its response to the pleas for assistance by troubled countries. This is the case even though there has been a change in the top command at the IMF who, on taking office, initiated some cosmetic changes in its structure. In addition, the new personnel in the Bush administration Treasury Department before their appointment had expressed some dissatisfaction with the way the IMF operated, in particular, the size of the rescue packages it orchestrated. Yet the pattern of IMF action has been basically unchanged: it offers countries in distress money, doled out in installments when they have fulfilled or made efforts to fulfill conditions they agreed to to obtain an IMF loan. The Bush Treasury has not objected.

I now summarize the problems confronting each of the countries in the IMF infirmary, the solutions the IMF has proposed, and the prospects that the problems will be mitigated.

Argentina

1. <u>Problems</u>

- Of the three countries, Argentina's condition is the most critical. It suffers from a triple set of maladies: overindebtedness, a budget shortfall, and an overvalued peso.
- With a $130 billion debt, it has been unable to generate funds to service it.
- It pays an enormous risk premium on its short-term international borrowings, which spills over into domestic interest rates. A 180 –day peso loan bears an interest rate of around 37%. The spreads on Argentine bonds are over 1700 basis points.. The

domestic financial sector has made clear that the government cannot rely on it to finance the budget shortfall.

- Its fiscal arrangements are such that spending at the federal and provincial levels is in excess of the revenues it collects from taxes.
- Argentina has had a currency board monetary regime since 1991 that issues pesos 1 to 1 backed by U.S. dollars. The currency board ended chronic hyperinflation in the country. Tied to the U.S. dollar, however, the peso becomes overvalued when the dollar appreciates. Argentina now experiences deflation because the peso is overvalued. In addition, the depreciation of the Brazilian Real has further damaged the competitiveness of the peso.
- Fears of devaluation have led domestic holders of bank deposits to withdraw their peso accounts to convert into dollars, as a result weakening the banks.
- For the past three years, Argentina has been in recession. Unemployment is 17 percent. Workers have staged riots in various cities.

2. IMF Solutions

The IMF initially approved a stand-by credit for Argentina on 10 March 2000 that was put in place December 2000-January 2001 as part of a total of $40 billion by a consortium of donors. Only $20 billion came from official institutions. Private sector participants were to provide the remainder, but Argentina rejected much of this funding as too expensive.

The IMF credit was augmented by $21.57 billion in January 2001. In August $5 billion was provided to stabilize the banking system. On 7 September $6.3 billion was made immediately available, with about $1.24 billion to be advanced later in 2001. A further $6.93

billion is to be made available in 2002 and $973 million in 2003. Besides IMF money, Argentina also obtained additional funds from the World Bank and the Inter-American Development Bank.

What conditions accompany the loans?

- The IMF expects Argentina, as a first condition, to support a voluntary and market-based operation to improve its debt profile. Voluntary means that global investors will acquiesce to a stretch out of the due date of short-term Argentine bonds and to deferring interest payments. What they reluctantly agreed to in 2000 was a swap of maturing bonds for 11s of 2006.This year Argentina faced the same urgency to stretch out the date for other maturing bonds, although it apparently was able to raise funds to refinance $13 billion in debt. A new 2008 bond with a 7% coupon until 2004, after which the coupon rises to 15.5%, was swapped for the 11s of 2006. The 2008 bond was priced 79 when issued on 4 June. It is now trading around 58.5. Plans for a debt swap in 2002 were discussed in August 2001 when the IMF announced that it would speed up a fresh loan of $3 billion to Argentina if the parties reached agreement. The new loan could be used as collateral for new bonds or to buy back some government debt. The events of 11 September have left the proposals for a 2002 swap unresolved.
- A second condition of the official loans is fiscal adjustment and fiscal reform. To restore credibility of the fiscal position, in July the government adopted a "zero deficit" law, increased the financial transactions tax to 0.6 percent, eliminating all exemptions, reversed a reduction in gasoline taxes, suspended the increase in income tax deductions, and postponed indefinitely moving the VAT from an accrual to a cash basis. Primary spending is to be cut 13 percent, including wages and pensions. The zero-deficit rule applies also to the provinces.

- Fears of devaluation led bank depositors to withdraw their accounts in order to convert pesos to dollars, threatening bank stability. Deposits declined 10 percent in August, and increased 1 percent thereafter.

3. Prospects for the Viability of the IMF Solutions

- Even before 11 September, it was dubious that the policies the IMF supports would reduce the risk premium on Argentine debt and domestic interest rates and achieve its projections of modest GDP growth in the final quarter of 2001 and 2.5 percent growth in 2002.
- Investors are unlikely to regain confidence in Argentina when they have been obliged to take a haircut on its bonds in consecutive years and expect the same situation in the year ahead. Since 11 September, the risk premium on Argentine debt has widened by about a percentage point. (Technically, a haircut applies only to a reduction in the principal amount of a debt instrument. I use the term to refer to the losses bond holders experienced when the market priced the bonds at a huge discount.) In October both Standard & Poor's and Moody's downgraded Argentine debt, Moody's from Caa1 to Caa3.
- Fiscal reform is also questionable. Buenos Aires has issued its own currency, patacons. Casinos, owned by the province, have agreed to accept the patacons. They and individual recipients of the currency will undoubtedly use it to pay provincial taxes. Why this phony currency should add credibility to the currency board and to the fiscal situation is hard to fathom.
- In any event, the austerity program will not revive consumer and investment spending.

Some observers have proposed devaluation of the peso as a cure. It could result in inflation, raising interest rates and stifling recovery. Others propose dollarization as the way to eliminate the risk premium. Giving up the peso, however, means that a recession in the U.S. would also bring a continuation of the Argentine recession. Its annual debt service exceeds export earnings. Restructuring the public debt is inevitable, if default is ruled out. Both the banks and pension funds, whose assets include government bonds, will be hurt (By.restructuring, I mean stretching out the debt repayment dates and changing the original interest rate terms. By a default, I mean a reduction in the principal amount and interest rate of a debt instrument.) The government has called on the local banks and pension funds to swap $14 billion of bonds for new debt at reduced interest rates.

Whether Argentina will emerge from its ongoing problems even with new IMF funds is murky at this juncture. How did the IMF overseer ever allow its patient to get into this fix?

Brazil

1. Problems

Brazil's standby arrangement with the IMF for a period of 36 months dating from 2 December 1998 was implemented when the Real was linked to the dollar at the crawling peg parity instituted in 1995. The market's loss of confidence in the pegged Real rate was attributable to lax government fiscal policy. In late January 1999 the Real slipped its peg. The IMF 1998 loan of $17.5 billion was part of a $41.5 billion package. In succeeding months the government cut spending and raised revenue. The country's economic recovery in 1999 – it grew nearly a percentage point --was linked to a $30 billion inflow of direct foreign investment.

In April 2000 Brazil announced that it would make early repayment of $10.3 billion in loans due in October to the IMF, the Japanese central bank and the BIS. It had drawn about $20 billion of the $32 billion offered by these lenders. After the repayment, Brazil owed the IMF $1.8 billion and about $9.5 billion to the World Bank and the Inter-American Development Bank. These loans were non-emergency funds with lower interest rates and longer maturities.

Brazil's growth in 2000 was 4.2 percent, inflation was under 10 percent, short-term interest rates were 19 percent, and the fiscal performance was improving.

In 2001 Brazil was again in trouble with an accelerating fiscal deficit, the Real depreciating one-fourth, bond spreads widening by 200 points, declining share prices, and double-digit short-term interest rates. Economic activity slowed. A change in the external environment and a domestic energy crisis apparently accounted for the reversal of Brazil's fortunes. In addition, prices of coffee beans, of which Brazil is the world's largest exporter, collapsed.

2. IMF Solutions

In September 2001, the IMF approved a new stand-by arrangement for Brazil for the period through December 2002. Under the new arrangement, Brazil will obtain $15.58 billion. About $4.72 billion can be drawn on immediately. By the end of 2001, $460.2 million will become available. The remainder will be made available at four dates in 2002.

Brazil has offered a program to achieve the IMF's conditions.

- The expectation is that foreign direct investment will continue to cover the current account deficit.
- Expenditure control is expected to raise the primary surplus of the consolidated public sector to a growing percentage of GDP, but the debt-to-GDP ratio is projected to rise. Reforms of the pension system for civil servants and the system of indirect taxation are planned.

- Monetary policy will operate under the inflation-targeting framework. Annual inflation at year-end 2001 could exceed the 6 percent target, but is supposed to decline to 3.5 percent at year-end 2002.
- To permit the central bank to intervene in the foreign exchange market, the program establishes a net international reserves floor of $20 billion.
- Brazil has mandated an average cut of 20% in power use until December.

3. Prospects for the Viability of the IMF Solutions

Some of the planned bases for Brazil's recovery have been undermined by the mounting difficulties in Argentina and the events of 11 September.

- It is already evident that foreign direct investment will not be sufficient to cover the current account deficit. Exports are down by a third. Even if imports are reduced, the weak Real makes them more expensive. Recovery will be negatively affected.
- The plunge of the Real since year-end 2000 has not been checked by government measures.
- The debt total will rise. Higher interest rates and auctions of dollar-linked government bonds to support the Real make borrowings more expensive.
- The inflation rate will be higher than the anticipated margin above the 6 percent target rate in 2001. Reserve requirements have been raised. Compulsory deposits at banks have been increased, tightening credit.
- The central bank's action to prop up the Real by selling dollars from its reserves, boosted by $4.7 billion from its September IMF credit, hasn't succeeded. The market fears exchange controls will follow.

To overcome Brazil's problems, the only proposal on offer is additional austerity measures that have no political appeal in view of presidential elections a year from now.

Turkey

1. Problems

For many years Turkey was known as The Sick Man of Europe. Its present condition is not much different, but because it aspires to join the European Union, there may be reason to believe that it will finally adopt financial and economic policies to match EU standards. At year-end 1999, the EU accepted Turkey as a candidate for membership. Since 11 September, Turkey's strategic importance to the U.S. has increased, so that the U.S. may well wish to see it helped.

In 1999 Turkey's annual inflation rate was 65 percent, its annual budget deficit 10 percent of GDP. Its public sector debt was rated as highly risky. Real interest rates on government debt were above 30 percent. In February 2001, it abandoned its crawling peg exchange rate and switched to a floating lira. Banks were hard hit by the devaluation, but were not declared insolvent because they were protected for political reasons. Output has declined 8 % so far in 2001.

2. IMF Solutions

A three-year stand-by arrangement for Turkey was approved by the IMF in August 1999. It contributed $15.7 billion of a total of $19 billion. The conditions for the loan included:

- Banking sector reforms. A new banking supervision agency has been created to restructure the banking system. It will be forced to eliminate unprofitable activities.
- Fiscal adjustment including a cut in state spending. The Treasury borrows foreign exchange from the central bank to obtain Turkish lira that it needs to finance its budget. Transparency in public sector management is a goal

- A voluntary domestic debt swap.
- Adoption of formal inflation-targeting monetary policy.
- Large state enterprises to be privatized.
- Bank depositors and creditors to be insured.

3. Prospects for the Viability of the IMF Solutions

Markets are skeptical that Turkey will accomplish the reforms. Political opposition is formidable. The market also doubts that the government will be able to roll over its debt. The uncertain global economic situation does not help create confidence in Turkey. Turkey's economy minister, however, predicted that the IMF by the end of this month would agree to provide $9 billion funding for an anticipated financing gap in 2002. He attributes the gap to his country's failure to obtain $1.2 billion projected from privatization proposals and $10 billion from tourism.

The IMF and the World Bank are responsive to pressures from the U.S. to serve its foreign policy interests. The international financial institutions are therefore more likely to be receptive to a request for additional funding from Turkey than from Argentina or Brazil.