Argentine debt crisis threatens global turbulence

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In the aftermath of the Asian financial crisis of 1997-98, the government of Argentina won praise from the International Monetary Fund for its embrace of privatisation, government spending cuts and free market “reforms” of its financial system.

But now an emerging debt crisis has the potential to create turbulence on international financial markets equivalent to or even greater than that which followed the default of the Russian government in August 1998.

The government of President Fernando de la Rua is in negotiations with the IMF to arrange standby credit facilities, totaling at least several billion dollars on top of $7.2 billion credit line granted last March, to enable Argentina to repay $19.5 billion in loans falling due next year. There are growing concerns in financial markets that the country could be heading towards a crisis on the scale of Mexico in 1994 or that which hit Brazil in early 1999.

And if Argentina is unable to refinance its debt—some $4.5 billion of which falls due in the early months of next year—global markets could be severely affected.

As a *Financial Times* article put it: “The stakes are high. If Argentina's problems get worse, other Latin American countries could be affected. Brazil's currency is at its weakest level in more than a year and its bond yields have risen. But a potential crisis could have repercussions far beyond the region.

“Argentine debt accounts for between a quarter and a fifth of tradable emerging market debt—its debt is widely held by investors all over the world. In the extreme case that Argentina was unable to meet its obligations, the effect could eclipse even the financial panic produced by Russia's debt default two years ago.”

The debt crisis, which had been rumoured for several weeks, came into the open when President Rua interrupted national television programs on November 10 to declare that the country was “in bad shape” and faced a “veritable catastrophe if we don't act well and quickly.”

In what was clearly a joint operation with the IMF, de la Rua foreshadowed a series of measures, including privatisation of the social security system, cuts to the civil service and commitments from all levels of government, including the provinces to freeze spending levels. Following the speech, IMF managing director Horst Koehler declared the commitments a “significant strengthening of Argentina's economic policy framework” enabling negotiations on additional assistance to go ahead.

But the government plan ran into some opposition from provincial governors who raised particular objections to a freeze on spending until 2005. However, after four days of talks and offers of a $250 million job-creation package from the central government, officials reported agreement.

While the IMF has been anxious to try and avoid the charge that it is dictating government policies, it seems that the freeze has been imposed at its insistence. “It's hard to see how you can have a program without [the agreement of the governors] because the medium-term-fiscal sustainability depends on that,” IMF first managing director, Stanley Fischer told reporters last week.

The imposition of further cuts will worsen the situation confronting millions of working people. One of the reasons for the present financial crisis is that Argentina never recovered from the downturn following the Russian default and the Brazilian crisis of early 1999. The economy has been in recession for the past two years, investment is falling and unemployment stands officially at 15 percent, with estimates that around 50 percent of the workforce is underemployed.

The two-year recession has had a severe impact on government finances. Local governments are unable to pay workers and pensioners while the federal government has been running deficits at around 4 percent of gross domestic product.

Investors have been increasingly reluctant to buy Argentine stocks and bonds. The leading stock market index has fallen by 20 percent over the past few months, while interest rates on government bonds have jumped to 16 percent, from a level of 9 percent in July. In recent days overnight interest rates have reached as high as 21 percent.

One of the reasons for the severity of the recession is that the Argentine currency is tied via a currency board to the US dollar. With the dollar appreciating in currency markets against nearly all currencies this has meant that Argentina has become increasingly less attractive to investors looking for opportunities to manufacture exports to the world market. It has been calculated that in order to turn Argentina into a competitive investment site, productivity would need to be increased by about 20 percent.

But any devaluation of the currency or an abandonment of the currency board has been ruled out because it would create an even greater crisis of confidence than exists at present.

While attention is being focused on Argentina and its specific problems, in many ways the crisis is an expression of imbalances in the world financial system as a whole, the chief source of which is the growing indebtedness of the United States.

The US economy has undergone a continuous expansion over the past decade. But with the private sector now running a financial deficit equivalent to about 5 percent of national income, it has had to attract funds from the rest of the world. This has meant that interest rates elsewhere are higher than they would otherwise be.

In addition, the increased possibility of a downturn in the US economy and fears of a decline of investments in high-tech areas are having an impact on stocks in the so-called "emerging markets" of Asia, eastern Europe and Latin America.

Following the crisis of 1997-98 these markets rose quite rapidly, but the gains are close to being wiped out. According to the *Financial Times* "emerging economy" stock markets have lost two-thirds of last year's rise in dollar terms and are 20 percent lower than they were in the pre-crisis years of 1996 and 1997.

Reflecting the general tightening of credit, the risk premium attached to government debt—the amount which interest rates exceed that on US treasuries—has widened by more than a percentage point in the past month.

In an editorial comment last Friday, the *Financial Times* warned that while it appeared that a generalised crisis involving "emerging economies" did not appear imminent the risk was there, with the most likely trigger a debt default in Argentina.

It pointed out that markets had lost confidence in Argentina's ability to repay even modest debts, noting that the interest rate spread over US treasuries had increased by over half during to the past year to more than 8 percent and that at this level "public finances become unsustainable."

The IMF package might help resolve the liquidity crisis, it said, but if it did not then "all bets are off". "A loss of confidence in Argentina might rapidly become contagious. In these circumstances, the acute vulnerability of emerging market economies to external shocks would once again be evident."