

# Global downturn could set off financial turbulence

Nick Beams  
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Concerns are growing in international financial circles that the ongoing world slowdown and the insecurities arising in the aftermath of the September 11 events could create global financial problems, possibly set off by a debt default along the lines of the Russian collapse of 1998.

The two most obvious potential flashpoints in the global financial system are Argentina and Turkey. Both countries are under IMF bailout programs and are experiencing severe contractions in the economies.

Turkey, which is on a \$15.7 billion IMF lending program, following the near-collapse of its banking system in February, is looking for a further loan of \$9 billion. According to the government, plans to borrow \$12 billion on international market to meet financial shortfalls have been dealt a major blow with the drop in tourism and the increasing wariness of investors after September 11.

The Turkish economy is continuing to contract with an expected 8 percent fall in gross domestic product this year, contrary to predictions by the economy minister Kemal Dervis that it would start to turn around in the second half.

Political considerations—Turkey is the only Muslim member of the so-called anti-terrorism coalition and its strategical significance for US military operations—mean that it is likely to receive a further financial boost from the International Monetary Fund.

But it could well be a different story in Argentina. There the economy is entering its fourth year of recession and there is discussion in the international financial press that it is heading for default on its international debt, after the IMF boosted its stand-by credit to \$21.6 billion in September.

According to an editorial in the *Financial Times* of October 16: “Given the country’s currency regime,

poor growth prospects and debt burdens, lending more, would be throwing good money after bad.” Former IMF chief economist Michael Mussa has warned that “Argentina is not solvent by any stretch of the imagination.”

Some of its major problems, however, arise from measures which received enthusiastic backing from the IMF when they were introduced. Argentina operates under a currency board in which the value of the peso is pegged to the dollar. This system was introduced in order to try to combat the inflation of the early 1990s. But with the increase in the value of the dollar against all major currencies in the latter part of the 1990s, Argentine exports have been priced out of international markets, leading to the development of recession in the domestic economy.

The conventional economic wisdom suggests that the currency should be devalued to lift exports and boost the economy as a whole. But scrapping the currency board would give rise to inflation and enormously increase the peso-value of dollar-denominated debts, leading to financial collapses.

The on-going domestic recession has had a major impact on the capacity of the government to raise finances to repay loans. For example, tax collections fell by 14 percent in September compared to the same month last year, setting off new concerns about the viability of the financial system.

There are also continual fears of a run on the banks. In July and August some 10 percent of private sector savings were withdrawn. The flow was staunch by the provision of \$8 billion in IMF funding but there are doubts whether such measures would work again. Capital flight is also a major problem with more than \$10 billion flowing out of the country in the first seven months of this year.

In a bid to ease its financial problems, the government has announced a plan to force domestic pension funds and banks to swap about \$30 billion they hold in high-yielding government bonds for new securities at a lower interest rate. Holders of domestic credit are being told to accept the deal “for the patriotic good of the nation” as the financial implications of a widespread default would be more serious in the long run.

But it is doubtful whether the measure—regarded in some quarters as a last ditch attempt by the government to retain financial viability—will restore confidence. In fact it is being viewed as the first step to a complete default.

Earlier this month two international credit-rating agencies, Moody’s Investors Services and Fitch, cut their rating on Argentine debt on the grounds that the government was forcing financial institutions to incur losses on their bonds. Fitch said that if bond holders did suffer losses it would “consider the debt exchange a default event.”

According to the *Financial Times*, “some IMF officials are beginning to talk about when, not if, Argentina will default.” It recalled remarks made last August by outgoing deputy IMF managing director Stanley Fischer that he detected an “emerging view that the [1998] default wasn’t so bad. But it nearly brought in a worldwide recession and frightened the heck out of everybody.”

An Argentine default could have even more serious international consequences than the Russian default of three years ago. One reason is that the world economy is in worse shape. In 1998, world economic growth fell to 2.8 percent but rose to 3.6 percent the following year. However growth for the next two years is expected to be only around 2 percent. Another factor is the fall which has already taken place in lending to so-called emerging markets. According to the International Institute of Finance this will drop to \$106 billion this year, down by 37 percent from \$167 billion last year.

While Argentina and Turkey are the most obvious weak links in the chain of international finance, they are by no means the only source of so-called “systemic risk.” The global economy has entered its most serious downturn since the 1970s and possibly in the entire post-war period. And like previous slumps, the present global recession is sure to create financial problems.

There are any number of areas where a crisis could arise—from within the insurance industry, hit by the events of September 11, the heavily-indebted telecom firms, or a major crisis in the Japanese banking system—to name but a few of the sources of potential turbulence.



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