Huge IMF bailout for emerging economies

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1 November 2008

The International Monetary Fund (IMF), backed by central banks in the US and Europe, has taken drastic steps over the past week to prop up so-called emerging economies around the world from Asia to Eastern Europe and Latin America.

At the beginning of the month, the IMF predicted that the emerging economies would continue to grow at more than 6 percent even as the US, Europe and Japan slid into recession. Now many of these countries are confronting economic turmoil—hit by shrinking export markets and slumping commodity prices as well as the global credit crunch. Foreign investors have withdrawn money to seek safer havens and to deal with cash shortages at home, causing currencies and stock markets to collapse dramatically in vulnerable emerging markets.

The Institute of International Finance in Washington estimates that more than $20 billion has flooded out of emerging market stock exchanges in the third quarter. The benchmark MSCI emerging markets index hit a four-year low on Tuesday, falling by 45 percent since September 15, before bouncing back later this week following the announcement of IMF plans.

Writing yesterday in *Der Standard*, IMF managing director Dominique Strauss-Kahn said that the emerging economies "aren't just facing falling exports and tumbling confidence... They're the latest victims of a financial crisis that started in the United States and spread to Europe and is now moving beyond Europe's borders." The drying up of global credit had dealt "a heavy blow" to these countries, he explained, warning of widespread payment defaults, protectionism and banking controls. "That will set not only these countries, but the entire world economy back years," he wrote.

The IMF is in the process of finalising emergency packages for Ukraine ($16.5 billion) and Iceland ($2.4 billion). Hungary joined the list on Tuesday, with the IMF unveiling a $25 billion joint rescue with the World Bank and European institutions. Pakistan, Belarus and Serbia are in talks with the IMF over emergency funding. All of these packages come with onerous conditions, including the slashing of public spending, which will exacerbate the political turmoil in each of these countries.

It is not, however, just the weakest economies that are vulnerable. The IMF announced a new program on Wednesday worth up to $100 billion to shore up the finances of countries considered to be structurally sound. Known as the Short Term Liquidity Facility, it would allow countries to draw three-month loans up to a fixed limit with no strings attached. To qualify for such loans, a country would have to demonstrate what a senior IMF official termed "a good track record" and guarantee that it would continue "strong policies".

In other words, only those countries that already meet the IMF's stringent economic criteria will be given access to the new facility. In a parallel move, the US Federal Reserve announced on Wednesday that it would provided currency swaps of up to $30 billion to four countries—Brazil, Mexico, South Korea and Singapore—an indication of those countries that will qualify for an IMF loan without strings. Previously the Fed has only extended currency swaps to central banks in Europe and other developed economies.

All four countries have been hard hit by the global financial crisis, which has effectively cut off their access to the international capital markets. In South Korea, share values and the won have been plunging amid growing concerns about the stability of the banking sector. Commenting on Brazil, the *Wall Street Journal* wrote on Thursday: "In recent days, Brazil's financial capital of São Paulo has been awash in speculation that the plunging currency and lack of dollar financing could spur a wave of corporate defaults that might even bring down key parts of the financial system... Even healthy companies are finding it difficult to obtain dollar-denominated financing they need to do business."

The IMF and Fed announcements produced a resurgence in currencies and shares in emerging markets. The South Korean won, which had fallen by over 30 percent against the US dollar this year, rose by 10 percent on Thursday. The Hungarian forint, the South African rand and the Brazilian real have all risen by more than 5 percent since Tuesday. The MSCI emerging markets share index has soared by over 24 percent since its low on Tuesday.

In the present highly volatile markets, these gains could rapidly evaporate. Moreover, the division of countries into what the *Wall Street Journal* termed "an A-list of nations that qualify for loans without strings, and a B-list for everyone else" could be deeply destabilising. One reason for the flight of capital from the emerging economies was the announcement of huge rescue packages in the US and Europe, making those markets more attractive. Now the financial umbrella has been extended

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to a select few countries on the "A-list", which places a question mark against those countries not included.

As Michael Hugman, a strategist at Standard Bank, told the *Financial Times* yesterday: "There's always a danger, particularly in the current market environment, that any intervention... will have negative effects on those excluded from the new facility." As the newspaper noted: "Exclusion may signal unsustainable policies, weakness or a lack of international support."

Vulnerable economies

Those countries on the "B-list" forced to seek IMF emergency funding will be compelled to impose tough austerity measures. The conditions applying to the deals with Iceland, Ukraine and Hungary have not been made public, but the impact is already evident.

Iceland was forced to lift interest rates by 6 percent this week to a crippling 18 percent—just two weeks after dropping the figure by 3.5 percent to stimulate the economy. Brian Coulton, managing director at Fitch Ratings, told the *Financial Times*: "Putting up interest rates means they are going to go through the mother of all recessions, but the key is stability." By many estimates, the economy is expected to contract by up to 10 percent, with inflation reaching more than 20 percent and unemployment at 8 percent.

The Ukrainian bailout has intensified the country's already bitter political divisions. After repeated delays, the parliament passed the final piece of legislation changing banking regulations yesterday—243-0 with the opposition abstaining. The hrvynia hit a record low of 7.2 to the US dollar on Wednesday after the government, at the IMF's insistence, ended the currency's trading band. The stock market is down more than 70 percent this year and the country is expected to plunge into recession next year. Steel production, which accounts for 6 percent of gross domestic product (GDP) and 40 percent of exports, is already down by 30 percent.

Hungary will be compelled to slash government spending on top of cutbacks and tax increases that have already been made. Bonus payments to retirees and public sector employees could be among the first targets. According to the *Financial Times*, a budget surplus and a cut in consumption of 3.7 percent is under discussion in official circles. The verdict of the public is summed up in the widely circulating phrase—"the black soup is yet to come". The economy is expected to grow by 2 percent this year and to shrink by up to 1 percent next year.

The list of vulnerable economies extends well beyond those immediately in discussions with the IMF for emergency funding—that is, Pakistan, Belarus and Serbia. According to *BusinessWeek*, emerging markets owe some $4.7 trillion in foreign-denominated debt, up 38 percent over the past two years. Eastern Europe in particular has been awash with cheap credit. High levels of foreign-denominated debt has left many of these emerging economies with high trade deficits and badly exposed to the global credit crunch.

Low-interest loans denominated in euro, yen and the Swiss franc were made available in Eastern Europe not only to banks and businesses but for home mortgages. As the value of the local currencies has plummeted, financial institutions, companies and individuals have been left with steeply rising repayments. In Romania, Hungary and Bulgaria, more than half of all debt is foreign denominated. All three could move into recession, joining the tiny Baltic states. The financial crisis in Eastern Europe will in turn impact on major European banks. Rating agencies recently lowered their outlooks to "negative" for the three biggest foreign lenders—Italy's UniCredit and Austria's Erste Bank and Raiffeisen International.

Neil Shearing, analyst at Capital Economics, told Associated Press this week that Romania, Estonia, Latvia and Bulgaria were all possible candidates for IMF emergency funding. He also pointed to Turkey, widely regarded as a success story, saying that it needed nearly $190 billion in foreign financing in 2008. "A recent visit to Istanbul convinced us that Turkey is much closer to calling on the Fund for financial assistance than many in the market believe," he said.

Financial crises could quickly exhaust the IMF's resources, which stand at about $200 billion plus access to an additional $50 billion. The IMF is already committed to about $50 billion in emergency bailouts and $100 billion for its new Short Term Liquidity Facility. As former IMF chief economist Simon Johnson, told the *Financial Times* on Tuesday: "Maybe if the IMF had $2 trillion it could be a serious global player. But $200 billion can go very quickly. There is a lot of countries in the same position as Ukraine, and you only need to add one or two of the really big countries to use it up."

Whatever the immediate outcome of the financial storms, the deepening recession in the US, Europe and Japan will have a devastating impact on many of the emerging economies as markets for their exports shrink. The contraction of the US economy in the third quarter announced on Thursday will reverberate throughout Asia, Europe and Latin America in the form of an economic slowdown, factory closures and mass layoffs.

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