

QUESTIONS CONCERNING ARGENTINA, BRAZIL, AND THE IMF

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Political uncertainty clouds the economic future of both Argentina and Brazil. Moreover, that uncertainty is compounded by the ties of each country to the IMF, since they do not know in advance how it will react once their political situation is better defined than it is at present

I begin by discussing the political quagmire and then the economic troubles respectively in Argentina and Brazil. I also comment on the IMF's demands for reform in each country. I end by noting the irrelevance of the IMF initiative to establish a Sovereign Debt Restructuring Mechanism (SDRM) to the problems of these two countries.

Argentina's Situation

Politics and Reforms

Argentina as a society is in disarray. The political scene is one example. Eduardo Duhalde, the interim president selected by the Congress in January 2002, will leave office by May 25. It is unclear who will be the candidates to replace him in elections scheduled for early next year. Carlos Menem, the Peronist president during the 1990s, who wants to return to power, favors a December primary to pick a candidate. Duhalde, who was vice-president in Menem's first administration, proposes a January primary. He backed Carlos Reutemann as his successor, but Reutemann, the governor of Santa Fe Province, refused to run. With the Peronists divided, and their popularity at a low point, Adolfo Rodríguez Saá, a populist who was president during the last week of December 2001, is campaigning without mentioning his Peronist affiliation and, if there is a Peronist primary that he doesn't win, he would run as an independent. Instead of a

primary, Rodriguez Saa proposes a first round of the presidential election in early January and the runoff on March 30. The courts are to decide whether a primary will be held.

Despite the Peronist party's loss of public support, opposition parties have not forged ahead. Non-Peronist party candidates –Elisa Carrio of the populist Alternatives for a Republic of Equals and Ricardo Lopez Murphy, a former economy minister, with pro-capitalism ideas-- have gained little support. The Radical Civic Union, the main Peronist rival, which the public blames for the economic collapse, has fielded no candidate. So there is a big question mark about the prospects for the emergence of a political leader in Argentina competent to get the country back to normal. What's more, the game the IMF has been playing with Argentina is that the protracted negotiations for an IMF loan will conclude only when a new president has been elected. But what if the IMF disapproves the election outcome?

A deal with the IMF in recent months has hinged less on Argentina's success in convincing the IMF that it has really implemented the reforms that were a condition for a new loan than on a commitment to repay what it owes the international financial institutions. Since December 2001, the country has defaulted on what it owes its private creditors but has continued to service its debts to its official creditors. How has it done so? The IMF has rolled over amounts to cover service on what Argentina owes it, but that can go on only for 12 months according to its bylaws. By December 2003 Argentina must repay \$10.8 billion to the IMF, but its reserves total only \$9.7 billion. The IMF rolled over \$104 million that Argentina was due to pay next week. By November 14, 2002, however, Argentina has to repay the World Bank \$805 million in interest and principal. Its latest approach to the IMF is to request a loan to enable it to avoid default to the World Bank. How the IMF will respond is unknown on November 13. The loan was denied, and Argentina paid the World Bank only \$79.2 million, the interest it owed.

Whatever sum the multilateral will agree to lend, it appears that little will be new money for Argentina. Argentina is ineligible for World Bank development loans. If it is still in arrears in 30 days, it will be denied disbursements from existing loans. If it is still in default in six months, it will be listed as in nonaccrual status meaning that the World Bank does not expect to be repaid.

The political arena has not been the only one in disarray. The courts have been under attack for declaring unconstitutional economic policies adopted by the Duhalde government. The government's decision in January 2002 to convert bank accounts from dollars to Argentine pesos has been upset in thousands of lawsuits by Argentines. The courts have repeatedly struck down the decision as a violation of property rights. The plaintiffs won their suits to have their bank accounts converted back into dollars. Duhalde in retaliation initiated an effort to get the Congress to impeach the Supreme Court. Last month the Congress squashed the effort, so restoring some stability to the judiciary.

The financial system is in disarray. The problem is not only that depositors need to regain confidence in the system but also that banks need to be recapitalized. Nationalist politicians, however, have attacked foreign banks that lost their shirts by investing in local banks. Legislation has been proposed to place new burdens on weakened banks, including a tax to rebuild a health plan for bank employees and making foreign banks legally responsible for deposits at Argentine subsidiaries. A judicial investigation has been undertaken to determine whether foreign bank executives have been approached to give bribes to halt the investigation. Politicians in the Senate have accused foreign bankers of treason and of sponsoring economic sanctions against Argentina. No action has been taken on how to solve the banks' need for capital.

Finally, Argentina has to resume negotiations with its private creditors to restructure its debts. Even if it succeeds in getting the face value of its debts reduced by as much as 70%, it will still be open to question that it can achieve a budget surplus adequate to service the restructured debt. Its initial approach to financial institutions to bid on running the restructuring process has not been propitious. It has excluded banks from the bidding that managed a debt transaction for Argentina during the two-year period before the default. It thereby denies America's top banks the chance to earn investment banking fees for renegotiating its \$95 billion debt.

The reforms the IMF has demanded include a sharp reduction in the permanent government deficit, much of it due to spending at the provincial level. The provincial governors have pledged to reduce local spending, but there are doubts about their sincerity. The government has begun to lift the freeze on deposits, another demand by the IMF. Last month the government ordered banks to allow depositors to withdraw at least 7,000 pesos from nine-month frozen time deposit accounts. There has been no mad rush to make withdrawals. Deposits which amounted to 85 billion pesos in 2001 are about 35 billion this year. The freeze on current accounts remains to be removed. Depositors are given pesos, not dollars that they originally deposited. Other conditions for an IMF loan include a pledge by the central bank not to print new pesos, nor to intervene in the foreign exchange market to bolster the peso, currently valued at 3.56 to the dollar and to eliminate exchange controls, An additional precondition is to permit privatized utilities whose charges have been frozen since January 2002 to raise charges

Economic Conditions

Before Duhalde was appointed president in mid-January 2002, a deposit freeze and de facto exchange controls had been adopted. The peso was devalued and most of the public debt was defaulted. Dollar-denominated private debts were converted to pesos, loans as one peso to

the dollar, deposits as 1.4 pesos to the dollar. Under Duhalde the deposit freeze was extended, and the public was forbidden to transfer accounts from one bank to another bank. Bankruptcies increased as corporate and bank balance sheets were impaired. The payments system could not function.

The demand for Argentine currency collapsed following the devaluation, but there was no way for the public to get rid of unwanted pesos. As Sebastian Edwards (2003) noted, Argentina confronts a massive monetary overhang similar to the experience of Eastern European countries at the end of the last century.

Under fixed exchange rates, the undesired domestic money would leave through a reduction in international reserves, which depletion of its reserves made unavailable to Argentina. Under floating exchange rates, the overhang would be absorbed by nominal exchange rate depreciation and price level increases. The danger is that hyperinflation might result. For this reason the IMF during the first half of 2002 opposed lifting the deposit freeze but instead favored exchanging long-term bonds for frozen deposits. The public could not be persuaded to accept the exchange.

The economic collapse in Argentina has been staggering. GDP this year is estimated to be 13.6% lower than last year's. Unemployment is said to be over 20%. Yet there are signs of improvement. GDP in the second quarter this year is reported to be higher than in the first quarter and industrial production has increased since April. The annual inflation rate at just under 40% is nowhere close to hyperinflation. Why has inflation been subdued? One possibility is that, while the public would be eager to spend pesos, its holdings have been limited by the deposit freeze. It hoards the dollars that it holds and refrains from spending them.

Exports have grown thanks to the depreciation of the peso. One bank has begun to offer personal loans at an annual interest rate of 69% that is astronomical judged by American practice. Likewise, credit card balances in Argentina are charged 85%. The financial landscape is clearly far from normal. The revival of business loans, the mortgage market, and investment banking is still far off.

Brazil's Situation

Politics and Reforms

The landslide victory of President-elect da Silva leaves unsettled the question of how he will govern once he takes office in January. His left-wing Workers' Party (PT) has fewer than 20% of the seats in Congress. To govern da Silva will need the help of Cardoso's Social Democrats (PSDB) and the Brazilian Democratic Movement (PMDB). While the level of uncertainty about Brazil's prospects that prevailed in the months before the election has been lowered, it is still rampant. The big question about da Silva is whether his policy will be to act responsibly with respect to fiscal matters, and whether he can win the confidence of local and foreign investors

Capital flight engulfed Brazil while the election campaign was under way. That seems to have abated with the announcement in August of an IMF commitment of backing. It approved a \$30 billion loan to Brazil, of which \$6 billion was immediately available the following month once the IMF Board gave its formal approval. The rest could be drawn if the new administration continued to observe the policies of the outgoing Cardoso administration. In addition, the IMF agreement allows Brazil to use \$10 billion of its foreign reserves to bolster the exchange value of the real and to inject liquidity into the credit market. In return, Brazil has pledged to achieve a

primary fiscal surplus in 2003 of 3 ¾% of GDP and an inflation target of 6.5%. So investors decided it was worth sticking with Brazil as long as the IMF was prepared to bail it out.

The incoming administration's position with respect to the central bank is obscure. When he campaigned, da Silva said he would replace Arminio Fraga, the president of the central bank. He has since promised to approve a measure to grant central bank independence. His attitude with respect to the fiscal situation is also unclear. To achieve the fiscal surplus that the agreement with the IMF requires entails spending cuts including reduction of generous civil-service pensions. At the same time da Silva has promised programs to fight poverty and to raise the minimum wage and public servants' pay. How will these conflicting goals be reconciled?

Support for the measure to increase the minimum wage has been expressed by the PMDB and PSDB, while the PT leaders have been hesitant. This may be an opportunity for the new administration to demonstrate a commitment to responsible fiscal policy.

Another positive sign is that the PT after the election rejected calls from several state governors for renegotiation of their debt to the federal government. The 27 states pay 13% of their budgets to the federal government, leaving many of them short of funds for education or fighting crime. The PT, however, stipulated that nothing could be done to revise the terms of the states' payments until social security and tax reform had been negotiated.

With a public debt of \$259 billion, Brazil's solvency depends on its ability to borrow at home and abroad at reasonable interest rates. To attract investors Brazil currently pays interest rates on its bonds 20.9 percentage points above its U.S. Treasury counterparts. Quite apart from the market's assessment of da Silva's soundness, it rates Brazil's government debt as highly risky. The central bank pays whatever interest rate the market demands to roll over debt and to support the exchange value of the real. From late August until the end of October, the central

bank was unable to roll over debt coming due. It managed to do so in auctions only following the presidential election.

Economic Conditions

Economic activity has been weakened by high interest rates and tight credit. GDP growth this year is barely 1%. Industrial production is even lower. The inflation rate this year is about 8%. To bring it down to the 6.5% Brazil has agreed to achieve in 2003 will enforce continued high interest rates and tight credit. The real has depreciated from about 2.7 to the dollar in 2001 to 3.7 in 2002. Exports have increased, but the current account is a negative \$13 billion. Foreign reserves are flush at \$37.6 billion.

How Brazil will fare in 2003 will depend on whether da Silva can quickly convince financial markets that his policies are sound. In that event the interest rate spreads that Brazil currently pays on its debt rollovers should recede. Economic growth would then pick up. In the opposite case, the spreads would remain high and restructuring of Brazil's debt would become a priority. How much financial market turmoil would result is difficult to predict. Economic activity would be bound to suffer.

The IMF and its Clients

Both Argentina and Brazil have accumulated excessive sovereign debt. They have borrowed too much not only from the capital markets but also from the multinational lenders. This doesn't seem to concern the IMF while the countries' debt burden is growing. It is prepared to lend to its clients even when they are already under water. As a result, there is no incentive for the borrowers to cut back on public sector spending. Much of the debt is owed to foreigners, so foreign exchange earnings are under pressure to service the debt. The financial markets in turn

are strained by concerns about the likelihood of default. Yet this goes on without IMF insistence that the sovereigns cease and desist their borrowing.

Because of mounting criticism from many quarters, the IMF after big bailout packages for Argentina in March 2000 and a supplement in January 2001, refused to do more for it when it defaulted in December 2001. It has strung Argentina along this year with the bait that money will be forthcoming if it fulfills certain promises. Brazil, nevertheless, was awarded a package with strings attached.

Instead of addiction to borrowing, emerging market countries need to learn to live within their means and without the IMF crutch. If their decisions were autonomous, they would learn to bear the consequences. If they chose to be profligate and were driven to insolvency, they would need to work out a solution with their creditors..

The IMF, however, has a different idea. It doesn't believe that sovereign debtors are competent to negotiate a restructuring deal with their creditors. The IMF wants to establish something like a bankruptcy court for sovereign debtors that it has named the Sovereign Debt Restructuring Mechanism (SDRM). A statutory change to the Fund's Articles of Agreement would be required and possibly statutory changes in the countries' legal provisions. The Bush Administration initially opposed the IMF's idea and proposed a contractual solution, whereby countries would issue bonds permitting a supermajority of creditors to make decisions binding on all creditors. The administration, however, backtracked, and now wants both proposals to go forward. Ironically, the sovereign debtors and their creditors support neither proposal. The market knows how to go about restructuring debts and isn't seeking unwanted advice on how to do the job.

In any event, restructuring debt is not the basic problem. The problem is too much debt. It would be better to rely on the sovereigns themselves rather than the IMF to control their appetite for borrowing. The IMF has miserably failed this test

Reference

Edwards, Sebastian. 2003. "The Great Exchange Rate Debate After Argentina." NBER Working Paper 9257.