C | A

CAMBRIDGE ASSOCIATES LLC

# GLOBAL MARKET COMMENT: IF ARGENTINA DEFAULTS: ASSESSING CONTAGION IN EMERGING MARKETS

July 31, 2001

Celia Dallas
Robert Lang
Stuart Wall
Laura Brooks
Jenny Chan

Copyright © 2001 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC. Copying of this publication is a violation of federal copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. This means that authorized members may not disclose any information or material derived from this report to third parties, or use information or material from this report, without the prior written authorization of Cambridge Associates LLC. An authorized member may disclose information or material from this report to its staff, trustees, or Investment Committee with the understanding that these individuals will treat it confidentially. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but members are required to provide notice to Cambridge Associates LLC reasonably in advance of such disclosure. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that are described in the report. This report is provided only to persons that Cambridge Associates LLC believes to be "Accredited Investors" as that term is defined in Regulation D under the Securities Act of 1933. The recipient of this report may not provide it to any other person without the consent of Cambridge Associates LLC. Investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Factual information contained herein about investment firms and their returns which has not been independently verified has generally been collected from the firms themselves through the mail. We can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results delivered through the mail. The CA Manager Medians are derived from Cambridge Associates LLC's proprietary database covering investment managers. Cambridge Associates LLC does not necessarily endorse or recommend the managers in this universe. Performance results are generally gross of investment management fees and do not include returns for discontinued managers.

**If Argentina Defaults: Assessing the Likelihood of Contagion in Emerging Markets**

**Argentina's Untenable Position**

Argentina is urgently trying to stave off default and devaluation. In recent weeks, Buenos Aires has made emergency spending cuts, passed a measure to immediately eliminate its fiscal deficit, announced cuts in central-government salaries and pensions, and negotiated a debt swap larger than the markets had expected. But investors remain nervous. Recently, interest rates on three-month T-bills (*Letes*) reached 14%, overnight interest rates jumped to 400%, prices of its US$-denominated debt have plunged, and spreads on the country's borrowing reached nearly 17%, the highest level since the Tequila crisis rocked Argentina in 1995. Most troubling is that bank deposits have shrunk by 7.0% during July (nearly -9.8% for the year), while international reserves have fallen 14.0% year-to-date (see Table A). Shrinking bank deposits not only underscore the perils of capital flight, but they also threaten the government's ability to repel bank runs and meet its debt obligations.

Over the last decade, Argentina made remarkable progress in implementing structural economic reform, but it put off confronting many of the most challenging problems. Its tax collection system is notoriously ineffective, and government spending famously extravagant. External pressures have aggravated its weaknesses and transformed stress points into potential flash points. For example, the government cannot inject liquidity into the economy by lowering interest rates because the peso is tied to the U.S. dollar. Although the currency board was remarkably successfully in reducing inflation from 3000% in 1989 to -0.3% so far in 2001, in recent years the appreciating dollar has pulled the peso up along with it. Argentine products have also been put at a comparative disadvantage by the depreciating currencies of its export markets. Since the beginning of 1999, the Brazilian *real* has depreciated 53% against the euro and 27% against the dollar; together these markets comprise half of Argentina's export revenues.

Furthermore, Argentina is buckling under the pressure of US$-denominated debt ($156.9 billion in total) comprising 19% of the emerging markets debt index (EMBI+). Sixty percent of loans to its domestic households and businesses are denominated in US$, while 95% of its external debt are non-US$-denominated. No doubt a devaluation (which would entail abandoning the currency board) would deepen the recession and wreak havoc throughout the economy.

Buenos Aires may be able to eke out of its current crisis by restructuring its debt profile, but it faces extremely serious internal and external financing limitations. The second half of 2001 and all of 2002 will stretch government coffers to the breaking point. Out of a total of $4.8 billion *Letes*, $3.3

billion will come due between mid-July and the end of October this year, while an additional $9.2 billion in amortization of medium- and long-term instruments will mature before the end of 2001, most of it between August and October. Furthermore, in 2002 it will have to roll over $19.8 billion in debt. These formidable financing requirements point to the likelihood that Argentina will seek help-if not this year, then in 2002—from international capital markets, which could charge upwards of 20% if current spreads are maintained. The country will be in no condition to make these payments if its economy and tax revenues do not improve. (The economy shrank 0.6% in 1998, 0.3% in 1999, and 2.1% in 2000, and it is expected to fall another 2.1% in 2001, with no rebound in 2002.)

**Assuming Default, What Happens Next?**

These stark figures underscore the inevitability that Argentina will be compelled to resolve its debt problem. This may not occur via an outright default/devaluation, but rather through the involuntary restructuring of its debt, which would include unfavorable terms and conditions. If so, what would be the consequences of this "forced resolution" for other emerging markets? It could play out in an orderly manner if Argentina's politicians remain in control and if they manage to negotiate its terms. Under this scenario, emerging markets will probably remain fairly stable, particularly relative to past crises. However, if politicians lose control, the default process could develop into a contagion force, spreading chaotically and unpredictably. Contagion would spread primarily through financial market linkages and the impact of investor psychology. International banks would likely refuse to roll over the country's debt, interest rates would spike upward, bank spreads widen, currencies fall, and capital flight increase. History has shown that international investors not only sell the assets of the country in default, but also other emerging economies with similarly weak fiscal and balance of payment profiles. In addition, investor psychology can transform economic weakness into panics, as investors dump their holdings with little regard for the sale price. Under this scenario, Brazil and other emerging economies would come under increasing stress from inflationary pressures, falling currencies, and rising interest rates.

**Economic Linkages - Now vs. Past Contagions**

The 1997 contagion in Asia spread so quickly and widely partly because of Asian economies' deep trade linkages. Emerging Asia conducted about half of its trade with other Asian countries, and countries responded to the regional collapse in demand by swamping the rest of the world with underpriced goods. Argentina in 2001, however, is not a very important trading partner for Brazil, Latin America, or developed economies. It has a rather closed economy, with exports accounting for only 8.5% of its GDP. Argentina's exports to Brazil account for 27% of its total exports and 26% of its imports. However, Brazil's exports to Argentina are only 12% of its total exports, while only 12% of

Brazilian imports come from Argentina. In addition, only 3% of Latin American exports are destined for Argentina. Therefore, if Argentina defaults, it is unlikely that a contagion could be transmitted through its trade linkages.

**Financial Market Linkages—Now vs. Past Contagions**

Market commentators who downplay the likelihood of a looming emerging market contagion (and there are many) stress the difference between the present state of the global economy and the 1994 Tequila crisis, the 1997 Asian meltdown, and the 1998 Russian default/Long-Term Capital Management (LTCM) failure. Most emerging economies have since abandoned their fixed exchange rate regimes in favor of floating exchange rates that tend to absorb the effects of global capital flows more effectively than more rigid and brittle fixed-rate regimes. Second, optimists note there is a lot less "hot money" in emerging markets compared with 1998. JP Morgan estimates that hedge funds hold only about 10% of emerging debt markets today, relative to 35% to 40% just before the Russian crisis.

Third, over the last few years many emerging markets have put their fiscal houses in order and strengthened their debt profiles. In 1997, emerging economies had a combined current-account deficit of $70 billion; by 2000, they enjoyed a *surplus* of $110 billion. In addition, most emerging economies are now cushioned with greater amounts of foreign reserves and less short-term debt, both of which combined forces to trigger past crises (see Table B). For example, in 1994, 28.0% of Mexico's external debt was short-term debt, of which its official reserves could cover only 15.5%. In 1997, Korea's short-term to external debt ratio and reserves to short-term debt ratio were 39.9% and 32.1%, respectively; the ratios for Thailand were 35.0% and 70.5%; and Indonesia, 26.4% and 59.4%. In 1998, Russia's short-term debt accounted for only 8.7% of its total external debt, but its official reserves could only cover 52.0% of its short-term debt. In contrast, in 2000, Russia's ratio of reserves to short-term debt was a much-improved 233.7%, while Mexico's was 138.1%. In 2000, Brazil's short-term to external debt and reserves to short-term debt ratios were 13.1% and 108.6%. In 2000, Argentina's short-term to external debt ratio was 19.8%, while its reserves to short-term debt ratio was 78.8%. Improvements in the overall debt profiles of other emerging markets indicate that relative to prior crises, the ripple effects of a prospective default by Argentina would probably be limited.

Thus far, global markets seem to be optimistic that the ramifications of a default would be contained. Yield spreads of the overall EMBI+ benchmark to ten-year U.S. Treasuries hover around its post-1996 average and spreads of emerging economies in the EMBI+, other than Argentina, have not even reacted. In addition, short-term interest rates for emerging economies (except Argentina) are at or near their 15-year lows (see Tables C and D). This seems to indicate that the relatively stronger emerging market economies are in the process of decoupling from Argentina.

How likely is it that financial markets could transmit contagion to developed economies? If Argentina's default gathers contagion force, financial institutions in Europe will probably be the first to be tested. European banks hold 71% of Argentina's total $68.8 billion in bank loans, of which Spain is the largest holder, 28%, while the United States holds 16%. For Brazil, European banks account for 60% of its total $67.7 billion in bank loans, compared with 21% for the United States. Non-Argentine banks do not seem to hold dangerous levels of exposure to the country. The two most exposed foreign banks (FleetBoston and Banca Nazionale del Lavora) have 3.7% to 3.8% of their total loans in Argentina. Excluding these two, the exposure for the top foreign banks in Argentina averages 0.51% of their assets.

### Psychology—The Great Unknown

Although the economic and financial fundamentals of many emerging markets have improved over the last decade, the key unknown concerning the likelihood and strength of contagion is investor psychology. One important difference between Argentina in 2001 and the prior emerging markets crises is that the current situation is unfolding gradually. One would like to presume that with so much lead-time, a default would not take investors by surprise, unlike Russia's default and LTCM's blowup—but conjecture is the hallmark of speculators rather than risk-averse investors. In addition, to what extent would global investors react by cashing out *en masse* of emerging market debt if Argentina were to default? If liquidity strains force them to unload their Argentine debt at fire-sale prices, a vicious downward spiral could occur. Clearly, the risks to these unknowns are to the downside.

Within the country, Buenos Aires is also grappling with inflationary expectations that have only fairly recently been declared dead and that remain quite vivid in the memory of its population. During the government's battle against hyperinflation during the late 1980s and early 1990s, one of its most onerous tasks was overcoming the popular presumption of 30+% inflation per month. Argentina cannot afford to rekindle beliefs that pricing pressures are on the verge of resuming, as they would generate a self-reinforcing cycle of behavior and expectations that would be extremely difficult to reverse.

## Developments to Monitor

Because the task of assessing whether Argentina's troubles will develop into a contagion force will play out amid a highly fluid environment, it may be useful to identify some of the key issues and variables to monitor going forward.

- In Argentina, how will the people react to the government's fiscal austerity package and what will they do with their bank deposits? The austerity package just passed Argentina's Senate, but it remains highly unpopular among the population. However, the IMF and other multinational regimes will be reluctant to extend further loans unless Argentina makes noticeable progress on reigning in spending and improving tax collection. It is also crucial to gauge changes in the level of bank deposits to determine whether the populace is losing confidence in the government and whether the government could withstand a run on its banks.
- Will Argentina derail Brazil? For emerging markets as a whole, what happens to Brazil if Argentina defaults will probably be more important, rather than the specific events in Argentina. Brazil's and Argentina's combined debt account for 40.5% of the EMBI+ benchmark, and a double-whammy of defaults would send shock waves through global capital markets. Brazil is currently fortifying itself against a possible default by its southern neighbor by raising interest rates to curb its own inflationary pressures, intervening in foreign exchange markets to stabilize the *real*, and securing commitments from the IMF. However, it too faces fiscal strains, growing inflationary pressures, and mountains of debt.
- Will the ongoing global slowdown weaken the ability of Latin America and other emerging economies to withstand the contagion? After 1998, Russia and Asia relied on exports to improve their national balance sheets. Now, however, the export-driven economies of Asia (technology exports to the United States accounted for about 40% of Asia ex Japan's overall GDP growth in 2000) are deteriorating under the grind of the global slowdown. If Argentina defaults, global markets will test the currencies and capital markets of Turkey and of Asia's weakest economies, the Philippines and Indonesia. Next in line will be the relatively stronger emerging economies of Malaysia, Mexico, Poland, and Hungary.

Argentina may have dodged the bullet with its recent debt swap, but pressures will continue to build. Because its day of reckoning is unavoidable, the more compelling issue is the effect of the forced resolution on other emerging markets. The current consensus seems to be that the structural improvements of most emerging economies will insulate them from possible contagion. However, because emerging markets are notoriously volatile and unpredictable, risk-averse investors should tread cautiously in this asset class for the time being.

**Table A**

**ARGENTINE BANK DEPOSITS IN FOREIGN AND LOCAL CURRENCIES**

**January 1, 2001 - July 31, 2001**

Source: Banco Central de la República Argentina.

## Table B

## COUNTRY COMPARISON OF DEBT VARIABLES

## (US$ Billions)

| | Asia 1997 | | | | | | Latin America 2000 | | | | Mexico | Russia | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | Thailand | Korea | Malaysia | Philippines | Indonesia | Total | Argentina | Brazil | Mexico | 1994 | 1998 | 2000 |
| **External Debt** | 494.0 | 109.3 | 159.2 | 43.9 | 45.4 | 136.2 | 562.2 | 156.9 | 231.5 | 173.8 | 140.2 | 172.8 | 141.5 |
| Short-Term Debt | 157.5 | 38.3 | 63.6 | 11.1 | 8.4 | 36.0 | 87.2 | 31.1 | 30.4 | 25.7 | 39.3 | 15.0 | 10.4 |
| Official Reserves to ST Debt (%) | 62.9 | 70.5 | 32.1 | 195.5 | 102.4 | 59.4 | 106.7 | 78.8 | 108.6 | 138.1 | 15.5 | 52.0 | 233.7 |
| Short-Term to Total Debt (%) | 31.9 | 35.0 | 39.9 | 25.3 | 18.6 | 26.4 | 15.5 | 19.8 | 13.1 | 14.8 | 28.0 | 8.7 | 7.3 |
| External Debt to Official Reserves (%) | 498.0 | 405.0 | 780.0 | 202.0 | 525.0 | 636.0 | 604.0 | 640.0 | 702.0 | 489.0 | 2,280.0 | 2,215.0 | 583.0 |
| External Debt to GDP (%) | 48.2 | 72.3 | 33.4 | 43.8 | 55.2 | 63.1 | 38.6 | 55.1 | 38.8 | 30.3 | 33.4 | 64.6 | 57.4 |
| **Official Reserves** | 99.1 | 27.0 | 20.4 | 21.7 | 8.6 | 21.4 | 93.0 | 24.5 | 33.0 | 35.5 | 6.1 | 7.8 | 24.3 |
| Official Reserves to Broad Money (%) | 12.4 | 14.8 | 4.9 | 21.6 | 24.0 | 33.1 | 8.7 | 4.5 | 11.6 | 14.4 | 4.6 | 37.5 | 60.8 |
| **Foreign Debt Service - Due** | 58.3 | 11.8 | 15.1 | 7.1 | 4.5 | 19.7 | 116.7 | 32.2 | 40.4 | 44.1 | 21.9 | 12.9 | 14.6 |
| Debt Service to Exports (%) | 16.5 | 20.2 | 11.1 | 9.0 | 18.0 | 36.9 | 47.1 | 122.3 | 73.4 | 26.5 | 36.0 | 14.4 | 12.5 |
| Exports | 352.2 | 58.5 | 136.2 | 78.9 | 25.2 | 53.4 | 247.8 | 26.3 | 55.1 | 166.4 | 60.9 | 89.6 | 116.6 |
| Broad Money | 797.1 | 182.8 | 413.2 | 100.3 | 36.0 | 64.7 | 1,071.2 | 541.4 | 283.4 | 246.4 | 133.4 | 20.8 | 39.9 |
| GDP | 1,025.9 | 151.1 | 476.5 | 100.2 | 82.3 | 215.7 | 1,455.8 | 285.0 | 596.3 | 574.4 | 419.7 | 267.7 | 246.5 |

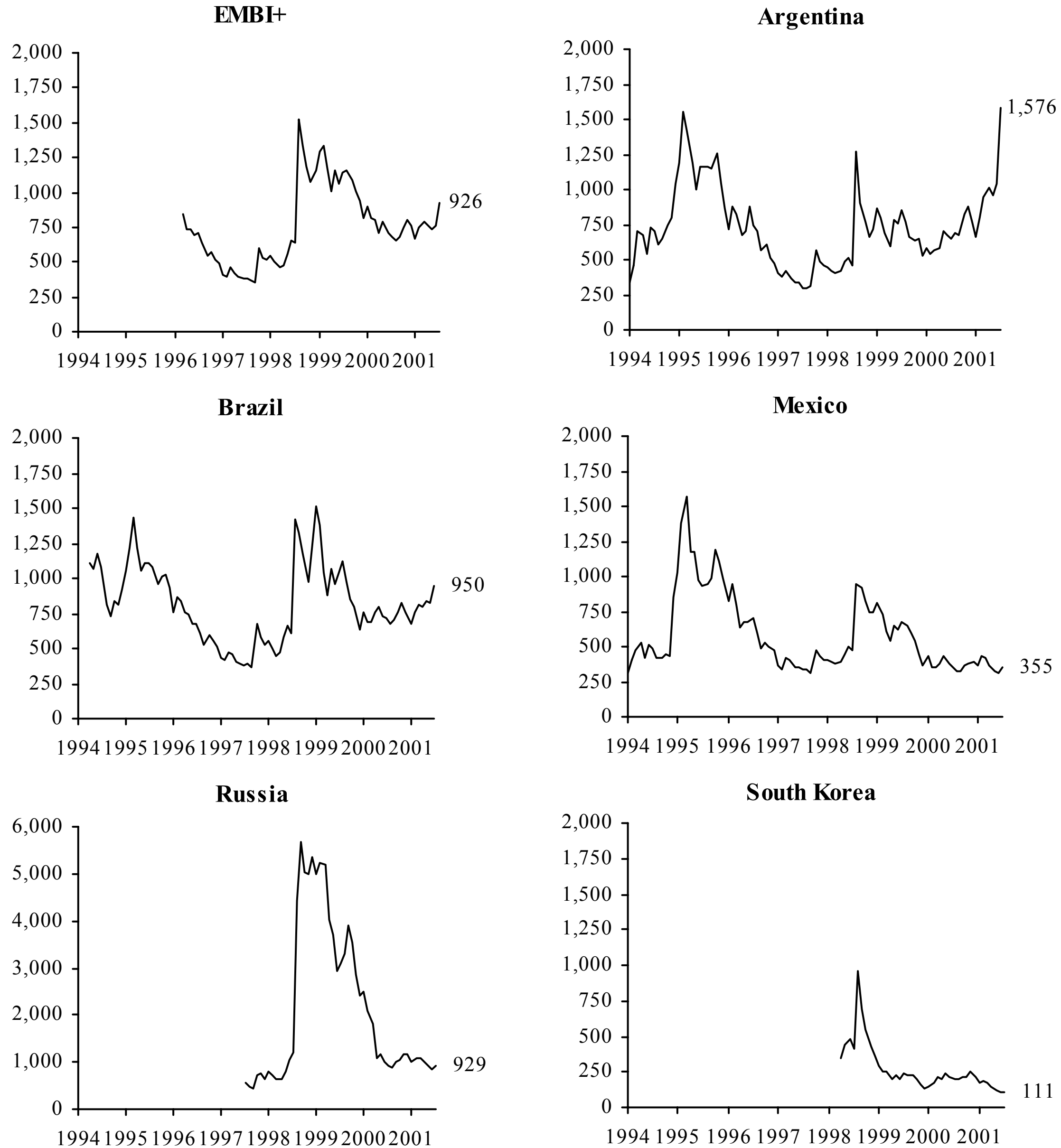
Source: Morgan Stanley Dean Witter & Co.

Notes: Data may contain forecasts. Some figures may use Morgan Stanley calculations.

## Table C

## SPREADS BETWEEN J.P. MORGAN EMBI+ COUNTRY YIELDS AND 10-YEAR U.S. TREASURY YIELD

### January 31, 1994 - July 31, 2001



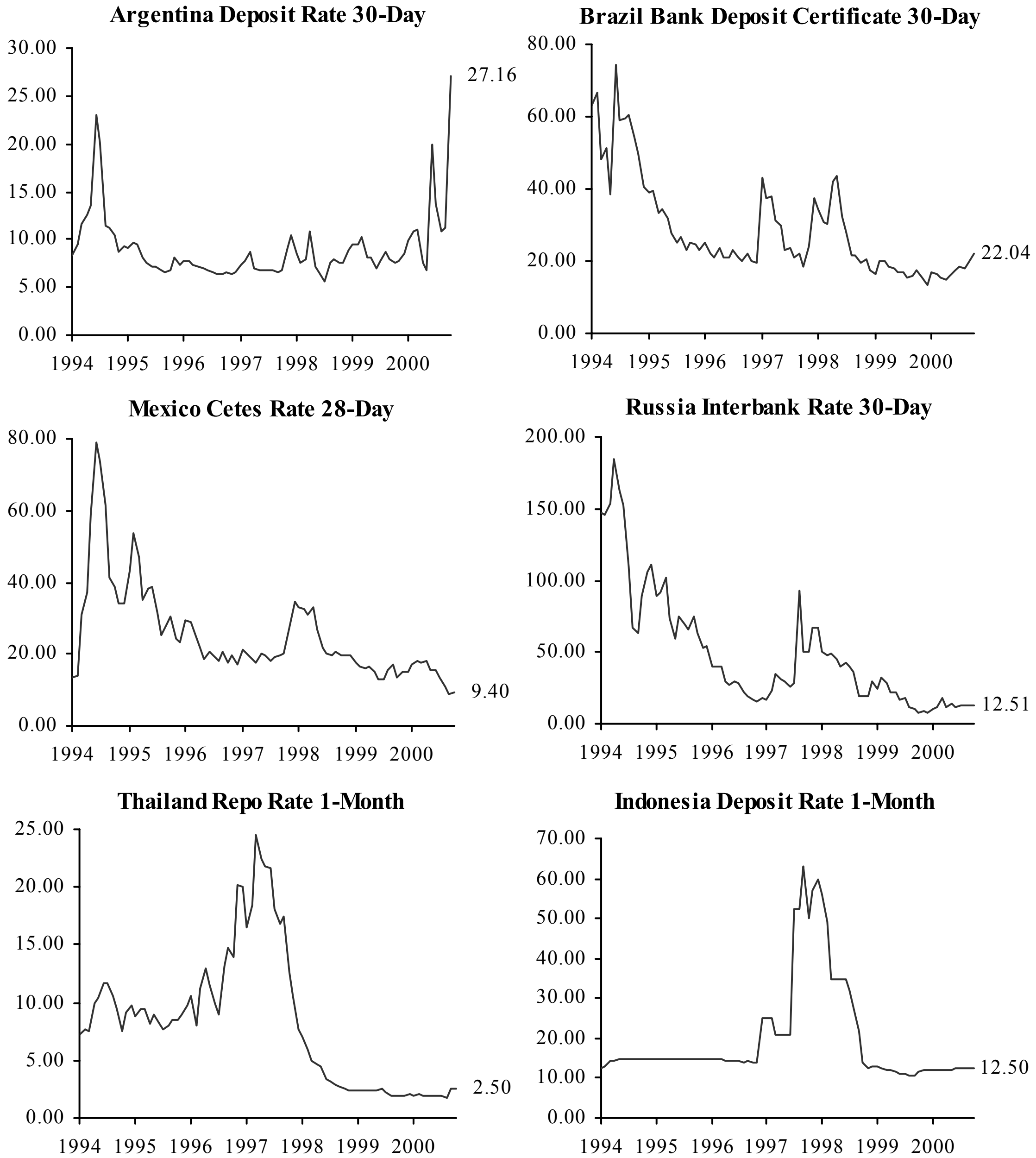

Sources: Datastream International and J.P. Morgan Securities, Inc.

Notes: Spreads are in basis points and Russian spreads use a scale of 0 to 6,000 basis points. EMBI+ spreads are from March 31, 1996, Brazilian spreads are from April 30, 1994, Russian spreads are from July 31, 1997, and South Korean spreads are from April 30, 1998.

## Table D

## SHORT-TERM INTEREST RATES FOR VARIOUS EMERGING MARKETS COUNTRIES

### October 31, 1994 - July 31, 2001




Source: Datastream International.

Notes: Interest rates are in percentage points. Scales vary among countries.