cover story

When You Cry for Argentina, Should You Cry for Turkey Too?

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Argentina for over a year and Turkey since last November have been in a crisis mode. The structure and history of the economies are quite different, but the nature of their battle to gain investor confidence and put their economies back on track is very similar. They both suffer from an unstable political backdrop and a talk of "significant default risk", triggered in part by a sour investor sentiment toward the asset class as a whole. They both hope to break into a virtuous circle by improving their public finances, restoring investor confidence, and bringing down interest rates. The trouble is when the investor sentiment is really bad, the so-called "fundamentals" matter very little increasing the prospects for a "self-fulfilling" crisis. There is, in addition, the "contagion effect". When things are bad in Argentina, Turkish spreads widen, and vice versa. For instance, Argentina was affected severely when the Turkish crisis began last November and Turkey too, in early July, was so affected when investors gave the verdict that Argentina was about to default. What do you do then, as an emerging market subject to the vagaries of international capital markets? Unfortunately, the options are not too many. You call in the IMF; recruit a strong economics minister who can hopefully coordinate and deliver; and most importantly, you try to give whatever markets are asking in terms of good economic policies. And this is pretty much what both Turkey and Argentina have been doing, albeit slowly and painfully. Yet, they are hardly out of the woods.

The Argentine Story

In Argentina, the IMF has in place a $14 billion stand-by program approved over a year ago, including some money under the IMF's relatively recent Special Reserve Facility (as part of a $40 billion international package). The ride has been somewhat rough, but the program has been generally on track with the third review having been completed in May. When this note was written, Argentina was seeking even more financing, given the difficult circumstances there. Turkey has even a bigger program in place. After having seen an earlier program derailed in February when the lira was left to float, the IMF came back in May with some $8 billion more financing. At some $19 billion total, this was the largest ever exposure to a member for the IMF relative to Turkey's quotas and GDP. Unlike in Argentina, however, the Turkish program did not involve any other international money apart from the World Bank. The ride in Turkey has also been quite rough, but another review was completed and money dispersed in early August.

As to the credible man with perfect credentials, Cavallo in Argentina and Dervifl in Turkey have been trying to build confidence since early March, and act as the countries' point men in relations with the IMF in particular, and the international capital markets in general. As it is well known, Cavallo is the architect of Argentina's impressive reforms in the early 1990s, including the launching of a currency board that ended a prolonged period of stagnation and hyperinflation. He was brought in again, and this time by President De La Rua, at a desperate time, following the resignations of two economics

ministers in a row (Machinea and Lopez Murphy). He was also given special "emergency powers". Similarly, Dervifl, a senior World Bank bureaucrat and perhaps Turkey's most well known and credible name in the international circles, was brought in by a bedazzled government in the wake of a full-blown economic collapse that followed the forced float of the lira in February. He was made state minister in charge of the economy. Both men managed to bring some calm to the markets and successfully borrowed time, but the confidence problem has yet to be resolved fully. Furthermore, the investors' expectation of a possible default, still needs to be crushed.

Have these countries been giving what the market wants in terms of good policies and improved fundamentals? Generally yes, although both with delays, and in the case of Argentina, after adding some Cavallo twists that have been, at times, dazzling for the markets. In Argentina, the problem is mostly fiscal, but also relates to a lack of competitiveness, especially after the devaluation of Brazil's real in January 1999. After a series of wild rides since May last year, a major deterioration in the country's fiscal performance in March disrupted the relative calm of the financial markets once more(although internal political disagreements and increased uncertainty in international markets also contributed to this outcome). In response, Argentina committed itself to a set of measures (amounting to some $4 billion or close to 1.5 percent of GNP) to put its fiscal balances on track. Most significant among these was the introduction of a financial transactions tax on checking accounts, along with measures to promote the use of such accounts.

Measures to improve competitiveness took some creativity, given the rigid currency board system in place. Most noteworthy among these was the introduction of a subsidy to exporters and tariff on importers linked to the dollar-euro rate. For instance, an exporter under the new system could claim a reimbursement, when he converted his dolar receipts into pesos, equal to the average of the peso-dollar and peso-euro exchange rates. This was, in effect, a way "to devalue without devaluing the peso", as an outright devaluation would have meant the end of Argentina's currency board system. At that time, Cavallo apparently did not wish to abandon the system he instituted. In addition to the subsidy/tariff regime, he announced a plan earlier in April to amend the convertibility system by pegging the peso to a currency "basket", consisting in equal parts of dollars and euros. (The measure is not to take effect, however, until the euro reaches parity with the dollar).

Despite Cavallo's unorthodox and creative measures, it still took a "fiscal rule" to relatively calm the markets at the end. In late July, after much uncertainty, the Congress approved an impressive "zero-deficit rule" that essentially established that the public sector would not spend more than it collected, with expenditures being adjusted every month to achieve a zero overall deficit on an accrual basis. In effect, the rule subordinated wages and pension payments to debt servicing and thus signaled an impressive political commitment to the program. Alas, street protests followed, irking the investors yet again.

Meanwhile in Turkey

The Turkish problem was also fiscal, but the targeted adjustment in the broader public sector balances, i.e. non-interest surpluses, had been on track since the original program was launched at end-1999. The size of the fiscal adjustment is truly massive, especially after accounting for the contraction in the economy. Dervifl' overall approach to reform is much more "orthodox", and hence less dazzling for the markets, than Cavallo's. In a nutshell, Dervifl seems to think that the best course for Turkey now is for it to become a perfect student of the IMF.

The trouble is with an overly ambitious structural reform agenda. With too many structural measures (mostly legislative) lumped together, it is easy to get into trouble, as evidenced several times in recent months, most notably during the appointment of a Telecom Board. Without sufficiently strong measures, on the other hand, it is hard to prove the requisite political commitment to the program and boost investor confidence, especially with the poor track record to date. This, in fact, is the dilemma posed by a front-loaded IMF program with heavy "conditionality". When measures are too many and too ambitious, some of them inevitably go wrong leaving a mixed picture for the markets. Having been confused, markets in turn never give the full seal of approval despite a commendable performance overall and in spite of the IMF's supportive rhetoric (see, for instance, the transcript of Stanley Fischer's July 13 teleconference with the journalists, available at the IMF web site). As a result, interest rates remain high, a major problem indeed from a debt sustainability angle.

The key reasons behind all this instability, common to both Argentina and Turkey, appear to be three-fold: an unstable political landscape; a high sovereign debt ratio; and negative

growth, with high interest rates being its key symptom, rather than its cause. No need to say much on the difficult state of affairs in Turkish politics. As to Argentina, the political situation there has also been tenuous ever since the election of President De La Rua and the subsequent formation of a coalition government (Alliance) in late 1999. For one thing, the allocation of ministerial/social portfolios in the coalition has been raising concerns all along, about the coalition's ability to support austerity measures, especially under the threat of congressional elections scheduled for October. This, in a way, explains the government's slow progress thus far and the granting of emergency powers to Cavallo back in April to get around this problem.

Ironically, messy politics do not stop politicians from implementing very tough measures at the end. In Argentina, the zero-fiscal rule received broad support after an unsuccessful government debt auction that pushed interest rates over 14 percent (note that Argentine inflation has been negative lately). This occurred against the backdrop of credit markets pricing in a significant probability of default for next year. In Turkey, when the IMF money was delayed in July because of a disagreement between the government and the Fund regarding the composition of the Turkish Telecom Board, the communications minister who was behind the trouble was forced to resign as the TL/$ rate exceeded 1.5 million and the Treasury received an extremely weak demand for one of its regular domestic t-bill auctions.

Politics aside, the key economic problem in both countries, at least at first sight, is debt dynamics. Unlike in Asia, where the countries were generally fiscally prudent and held low public debt at the onset of the crises, both Argentina and Turkey had high public debt ratios, reflecting years of fiscal abuse (see Table). Both countries are trying to be prudent now, but alas, markets do not believe this can be sustained, thus they sharply constrain the governments' room for maneuver.

Convergences and divergences

A key difference between the two is that a much higher fraction of Argentine debt is external (64 % of the total at end-2000, though a portion of this is dollar-denominated and held domestically). Over 90 percent of the debt is denominated in dollars, causing fiscal sustainability to be even more a function of the exchange rate than in Turkey, in the event of a devaluation. Whereas in Turkey, domestic debt is the real problem for the moment. After recognizing whatever losses were already there (the so-called "duty losses" of public banks) and after accounting for the impact of the two crises on the banking sector, the overall domestic debt of the public sector rose sharply by about 20 percent of GNP. Meanwhile, however, the appetite of the Turkish Banks for government paper, which thus far have been the most significant holders, shrank significantly. They also have been showing a strong preference for non-lira denominated or indexed debt -- as of end-July, domestic debt was about 80 percent indexed, either to the exchange rate or to some short-term interest rate.

	2000	2001F	2002F
Argentina* ***(as percent of GDP)***			
Public Debt	50.8	53.5	54.5
Domestic Public Debt	30.1	30.6	30.9
External Public Debt	20.8	22.8	23.6
Growth (%)	-0.5	2.0	3.7
Primary Balance	0.5	1.5	1.6
Overall Balance	-3.6	-3.1	-3.2
GDP (US$ billion)	285	291	303
(Source: IMF, Staff Report Argentina, May 2001)			
Turkey* ***(as percent of GDP)***			
Public Net Debt	58.6	78.6	70.4
Domestic Public Debt	38.9	44.3	42.1
External Public Debt	19.7	34.3	28.3
Growth (%)	6.1	-3.0	5.0
Primary Balance	2.8	5.5	6.5
Overall Balance	-19.1	-17.1	-9.7
GDP (US$ billion)	204	167	182
(Source: IMF, Staff Report Turkey, May 2001)			

*These figures had been revised, but not made public at the time of the writing of this note.

Argentina is somewhat less reliant on banks as the primary holders of its debt, since a significant chunk is held by local pension funds and international investors. Furthermore, the banking sector in general is in much stronger shape, with three-quarters of the sector dominated by foreign banks. Argentina's significance for international debt markets is best revealed by its large share in the EMBI+ global index, at about 20 percent. (The EMBI+ is an index capturing spreads on external debt of the most actively traded emerging market bonds). This, of course, has its disadvantages as well, as the sentiment of international investors shifts more dramatically and unexpectedly, compared with that of the locals.

The reliance of both sovereigns on the health of the banking sector to service government debt makes deposit withdrawals an eerie issue. In Argentina, the total reduction in deposits has reached 10 percent since March 2001, before it has slowed down more recently. In Turkey, the banking sector has also been losing deposits, although it appears, at a somewhat slower pace than in Argentina. Both countries have been trying to ease the rollover burden through a special use of IMF financing and debt swaps. Unusual for IMF programs, the strengthened Argentine and Turkish programs, crafted in December 2000 and February 2001,

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respectively, included IMF financing for budgetary purposes to provide room for less than full rollover of government debt. In Argentina, IMF financing and a coordinated commitment by domestic pension funds and banks financed $4.3 billion of the rollover. Domestic banks then generated $6 billion and thus provided some breathing room and kept the country from having to tap external debt markets. In Turkey, the program foresaw an average of 75 percent rollover rate, providing room for less than full rollover by state banks and banks under administration.

Further relief was provided in both countries by debt swaps. In Argentina, the government successfully extended the maturity for 23 percent of total public debt ($29.5 billion, of which $8 billion foreign participation) and also shifted interest payments to the future, paying a yield of approximately 15 percent (some 300 basic points above second half 2000 levels). This led to a lowering of financing need of $16 billion until the end of 2005. (The flipside of the coin is the postponment of the problem with a sharp increase in amortization and interest payments from 2006 onwards). Turkey also had a successful debt swap in mid-June, exchanging bonds of some $8 billion (or 25 percent of eligible bonds), extending the average maturity from slightly over 5 months for the old bonds to over 3 years in new bonds. Notably, in Argentina the duration of the new bonds in the debt exchange was much longer at around 14.5 years.

High public debt ratios are a problem, but it seems that the real problem is even deeper:lack of growth.In other words, high indebtedness is one thing, having no income to pay the debt is another. On this score, Argentina appears to be doing somewhat worse, as it has already been in recession for almost three years with investment declining by over 20 percent in the past two years. Lack of growth has many reasons (including domestic politics and corruption scandals, weak global growth, a strong dollar, and rigid labor markets), but it is unclear what exactly will pull Argentina out of its recession, given the need to adhere to the current fiscal orthodoxy and with the U.S. fighting off a recession itself.

Turkey is also contracting massively - growth forecast for this year has already been scaled down to negative 5.5 percent from 3 percent earlier - but it is known for its resilience and an ability to recover quickly from crises. Still, the worry is that this time recovery may take a while, complicating the debt dynamics significantly. The mechanics that helped Turkey restore growth right after the 1994 and 1998-99 crises - the confidence boost by a "fresh" IMF program, a predictable monetary policy built around exchange rate stability, and a financial sector willing to lend or borrow from abroad - are simply not there. Nevertheless, the currency regime plays to Turkey's advantage. In Argentina, the currency board, in place since 1991 left an overvalued real exchange rate despite substantial productivity gains. What is worse though is that devaluation is not a fix either, because the economy is extremely dollarized on the liability side. In this regard, Turkey is in a totally different situation. Current controversies notwithstanding, a floating exchange rate regime, combined with "inflation targeting", is not a bad way to go, barring a more radical currency reform. This, combined with a competitive lira, adds a certain degree of flexibility to the whole adjustment effort.

In the bigger scheme of things, what does it take to save Argentina and Turkey? The truth is, no one knows. Good economic policies are essential, but most likely are not sufficient to change market perceptions radically and rapidly. Occasional periods of calm notwithstanding, these countries will likely remain vulnerable for some time to come. One way out of the quagmire perhaps, is to step up efforts and reorient policies toward building closer economic ties with a regional anchor, such as the European Union for Turkey and the U.S. for Argentina.

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