The Ant Trail

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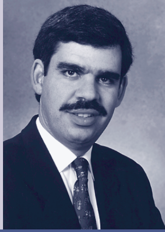

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As many of us living in Southern California will attest, ants can be a real problem. The dryer the summer (and its normally pretty dry), the more likely that these pesky things will come into your home looking for sustenance. And if you are stupid (or tired) enough to leave some food out, expect to face an intense ant trail.

This topic featured at a recent brunch conversation where I was told of a "miracle cure" called Terro. This product attracts ants to the house and gives them toxic food to take back with them to their nest. It takes time to work (the instructions cite a two week period for full effectiveness). In the meantime, the house has to tolerate an onslaught of ants pursuing *short-term* gratification.

To some observers, the recent price action in Argentine bonds resembles the Terro process. On several occasions—including in the context of the $40 billion mega rescue package in December and the $30 billion debt exchange in June—investors have come out in size to drink from the Argentine punch bowl, only to feel sick thereafter as bond prices resumed their decline. Yet, the temptation to go for short-term gratification remains considerable as witnessed by the recent recovery in prices occasioned by talk of a new IMF rescue package (Figure 1).

At this juncture, the trail is heading to the "moral hazard trade." In this trade, investors are not betting on Argentina's fundamentals; they are betting on money being made available from the international community to meet Argentina's debt service obligations.

This type of trade was discredited in 1998 following the Russian default. Many investors, who had bet on Russia being "too big to fail," ended up nursing huge losses. As a result, the industry returned to the business of assessing country economic and financial fundamentals rather than guessing what Washington, D.C. would do. This more sensible process was supported by indications out of the U.S. and other G-5 governments opposing large bail-out packages. But government resolve faded, as reflected in the December bail-out packages for Argentina and two for Turkey. With the latest talk of a new Argentine package, serious credit analysis has been put on hold; D.C. watching is now the in thing.

There is general agreement that, for the market as a whole, the return of the moral hazard trade obfuscates price signals and misallocates investor flows. The jury is still out as to whether this trade will prove remunerative in the case of Argentina. Will this latest money dance prove durable or will it constitute a final fling before another downward adjustment in prices? Similarly, the jury is still out as to the implications of a possible Argentine "credit event" for the asset class. Will the asset class succumb to

Figure 1

Source: J.P. Morgan

long-term Argentine contagion or will it rebound with a more healthy constitution for the medium-term?

In order to discuss these issues, let us start by revisiting the Argentine situation, which continues to dominate the headlines.

Since we last looked at this case (the EMWs of December and April),[1] things have gotten worse. The economy remains in a deep recession. Already unsustainable interest rates have risen to even higher levels. The regional environment has become more unfriendly. And, to top it all, the country's sovereign rating has been downgraded to CCC status by Moody's, shrinking further the country's international investor base.

All this comes ahead of nationwide elections in October that coincide with fragility in the internal cohesion of the ruling coalition. Not surprisingly, depositors have been fleeing the banking system and international reserves have been falling. (Figure 2 updates the April EMW chart on deposits; Figure 3 documents the loss in international reserves). In turn, the outflows accentuate the pressures facing the banking system and, given the operation of the currency board, aggravate the contraction of the real economy.

Ironically, all this is happening at a time when the authorities have been working hard on the policy front. Indeed, it is becoming almost impossible to keep up with the various policy announcements out of Buenos Aires.

Since Minister Cavallo's appointment in April, we have had several rounds of competitiveness measures, fiscal austerity, and financial engineering. And yet the economy continues to contract and the debt dynamics worsen.

No wonder the Argentine authorities have given the impression of repeatedly changing their minds about economic policy priorities. Attempts at fiscal adjustment have been frustrated by the negative impact on the real economy. On the other hand, attempts to stimulate the economy have run against binding funding constraints.

As the government has lost policy credibility, it has sought to tie its hands through "fundamentalist" steps. The latest is the adoption of a "zero deficit law" that forces spending cuts if revenue

Argentina: Bank Deposits
(in millions of USD)

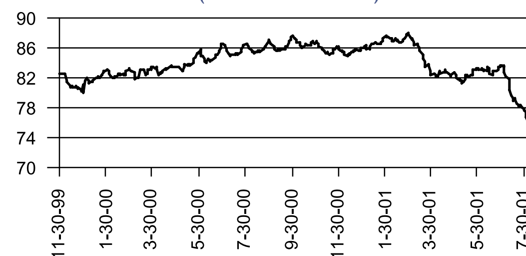

Figure 2

Source: J.P. Morgan

Argentina: International Reserves
(in millions of USD)

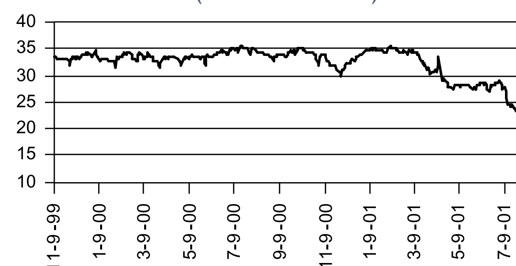

Figure 3

Source: J.P. Morgan

targets are not met. While seemingly appealing, this approach imposes greater rigidity: Now *all* major policy levers are pro-cyclical at a time when the international environment is deteriorating and the country has virtually no financial cushions.

Clearly, there are no painless solutions to Argentina's predicament. Recall, in this regard, the simple hypothesis that we have been adhering to for quite a while now: Given the country's socio-political situation and its external environment, its policy stance remains over-determined. Or, put another way, there are too few policy instruments, too many objectives. Accordingly, large financing packages buy time, at best. As illustrated by the December $40 billion package, the impact is both limited and distortionary *unless, and until* the policy parameters change in a fundamental manner. That is also why the Russian '98 international funding package failed; and it is why the Mexican '95, Korean '98, and Brazilian '99 ones succeeded.

The Argentine authorities have now put their

fate squarely in the hands of the international community, hinting that they have done all that they can. While hesitant, there have been comments out of D.C. pointing to more willingness on the part of the international community to increase lending to Argentina. It is not that officials do not understand the policy dilemma; they do. More likely, having been masterfully put on the spot by Argentina, they do not wish to be blamed for a "credit event."

Many investors have taken the official community's reaction as a signal that Argentina is too important to fail. The resultant price action is reminiscent of an ant invasion prompted by the application of Terro: Fear of an Argentine default has given way to greed prompted by the honey pot coming from Washington (pardon the mixed metaphor).

Accordingly, the rush to buy Argentina at this point is not motivated by economic fundamentals. Few investors believe that outside money can lower interest rates to sustainable levels. Rather, it is motivated by signals out of D.C. The moral hazard trade is finding support from those advocating Argentina's systemic importance—this on account of perceptions in certain quarters that the country is the poster child for the implementation of the "Washington policy consensus."

Given Argentina's domestic situation, the moral hazard trade logically prices *not one, but several* rounds of international rescue packages. If the trade fails, two new exercises will spring to life: "Who lost Argentina;" and "What Next for the EM Asset Class?"

Who Lost Argentina?

Many fingers will be pointed at the Argentine politicians. Their lack of solidarity has been key in delaying the implementation of policies aimed at reversing the country's vicious cycle of economic contraction and deteriorating debt dynamics. The more the politicians have delayed, the less responsive the economy to corrective measures.

In an attempt to divert attention, some politicians would point to the country's economic policy regime. They would argue that the currency board system was simply too rigid to deal with the impressive array of external shocks that have hit Argentina. These shocks include severe competitiveness erosion resulting from the depreciation of the Brazilian currency and the Euro, unfavorable commodity prices, and weaker demand conditions in virtually all trading partners.

Other politicians would blame international investors for fleeing Argentina at the exact point when the country needed them most. The shrinkage of the international investor base has led to high and volatile borrowing costs that further undermine the already fragile debt dynamics. It has also diverted policy makers' attention away from important economic reforms and to an almost-obsessive focus on short-term financial engineering.

To this, international investors would be surprised. After all, they stuck with Argentina for a long time, having been promised that decisive policy actions would be forthcoming; that local creditors, be they banks or pension funds, would be large and repeated providers of funds to the government; and that the banking system would withstand the pressure. Moreover, it is not until the last few weeks that most analysts on Wall Street have been willing to provide explicit assessments of Argentina's precarious financial situation, including the possibility of a debt restructuring.

And finally, there is every crisis country's favorite scapegoat—the IMF. The Fund has repeatedly given the Argentine authorities the benefit of the doubt. Some argue that the institution should have done more; others argue that it did too much, allowing the country to remain for too long on the "muddle through" path.

Consistent with its tradition, the IMF would most likely maintain a stiff upper lip. Internally, it would probably lament the set of circumstances that inhibited Argentina from using IMF financing to bridge to better economic and financial dynamics. After all, the Fund could legitimately argue that had the various actors stuck to their script—the politicians, the external environment, international investors, domestic creditors, etc.—Argentina could have, should have and, perhaps, would have ...

So, round and round this type of discussion could go, yielding little in terms of concrete answers. But the exercise need not necessarily be futile. If undertaken in a cooperative and serious manner, it could help identify additional ways to strengthen crisis prevention and management. And the benefits of this should not be under-estimated: While we will never eliminate

the risk of financial crisis in individual emerging economies, every effort should be made to limit both the frequency and collateral damage.

What Next for the EM Asset Class?

So, what should we focus on now?

First and foremost, Argentina is not lost. What is likely to go is the opportunistic adherence to rigid policy parameters. Time is quickly running out for Argentine society to choose decisively one of the two corner solutions and stay the course. This is not an easy choice as it involves significant short-term disruption. But it is the only way to progress towards sustainable medium-term growth. The strategy of combining ad hoc policy reactions and hope for an "immaculate recovery" has served only to increase the already-high risk of a disorderly devaluation-default scenario.

Second, this latest bout of Argentine-inspired contagion has again highlighted the importance of contingency policy/funding plans for even the strongest emerging economies. Mexico offers useful demonstration effects. Along with Brazil, it has made significant progress in reducing vulnerability to adverse external developments. The result is far from perfect and is yet to be fully tested; but, already, it is significantly better than historical precedents.

Third, the international financial community, led by the IMF, is now even better placed to press ahead with policies aimed at reducing systemic risk. At times, this may force the institution to make the sort of difficult decisions that doctors face on a routine basis: Act decisively, and seemingly with little compassion, on the source of the dislocation in order to limit its contamination to other parts of the body. Indeed, the experience of the last few months suggests that attempts to support a muddle-through, even if compelling from a narrow country perspective, can undermine the rest of the asset class.

Finally, investor action may itself reduce contagion risk as recognition spreads of the efforts that countries have made to decouple from the source of adverse contagion. And for support, they need only look at the country components of the most widely-followed emerging market sovereign bond index, JP Morgan's EMBI+. While the overall perception has been one of wide-spread contagion, only three countries had registered negative year-to-date returns as of the end of July—led by Argentina's sharp 26% drop; the remaining 14 had positive returns of between 7% and 25%. Not bad for an asset class in the midst of a contagion process. This differentiation reflects a better understanding of two basic realities:

- Argentina is relatively small in global economic terms, and its trade links are limited. Even its largest trading partner, Brazil, has only a small part of its GDP that is sensitive to Argentine developments.

- The other contagion channel, operating through financial linkages, has been blunted by the progress that most emerging economies have achieved on the economic and funding fronts. The resulting "self-insurance" derives from: tighter fiscal policy and the adoption of more flexible exchange/interest rates; stronger institutions and more transparent/market-compatible frameworks (e.g., inflation targeting); improvements in debt profiles and responsive liability management; and the accumulation of considerable international reserve cushions.

Differentiation can be expected to prevail over time in the event of an Argentina "credit event." In the process, this would further discredit the "closet index" approach to EM investing in favor of one driven more by economic and financial considerations. Accordingly, by enabling EM to aspire legitimately to a more respected place in traditional fixed income platforms, such a development could encourage a wider, deeper and more stable source of flows to emerging economies.

So, should we enter a period of renewed EM uncertainty, and it is likely that we will, it is important to remember that the medium-term outcome could be welfare-enhancing. If only we could skip the short-term (and the ants...).

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[1] *See "IMF Delivers Packages for the Holidays," Emerging Markets Watch, December, 2000 http://www.pimco.com/bonds_commentary_emerging_market_watch_1200.htm and "Distracted by Reality," Emerging Markets Watch, April, 2001 http://www.pimco.com/bonds_commentary_emerging_market_watch_0401.htm*

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