Don't Make Me Cry, Argentina!

Do you ever get the feeling you've heard someone say "It's *deja vu* all over again" before? The year's only a little more than half-over, and we've already seen Turkey and Argentina enter new debt and currency crises. Other emerging markets – and will someone please answer the question, to where will they emerge? – are on the edge as well. The eastern European markets whose currencies are linked to the euro, but whose imports are largely dollar-denominated, like Poland, Hungary, and the Czech Republic, and facing significant cost squeezes in the face of slowing Western European markets for their exports.

The experiences of the Asian and Russian financial crises of 1997-1998, and of the massive devaluation of the Brazilian real in January 1999, were both encouraging and possibly misleading. They were encouraging for those outside of the region who did not have to bear the enormous costs of a collapsed economy and the instant impoverishment produced by a suddenly worthless currency. The Treasury, the International Monetary Fund, and assorted other worthies were able to cobble together various bailout packages with the taxpayers' money, and the crises themselves no doubt kept the Federal Reserve and its fellow travelers in central bankdom from raising rates all through this period. In retrospect, these crises fueled the stock market boom of the late 1990's; we got both monetary ease and flight capital. We also trained a new generation of international financial crisis managers.

The lessons were misleading as they encourage the notion that the unraveling of the Argentine financial markets lead to a similar period of our portfolios swelling on the back of others' misery. Yes, monetary policy will remain on ease, but it was going to do that anyway. Moody's Investors Services has reported that corporate balance sheets are at the lowest credit quality since the mild recession of the early 1990's, the producer price index for June just fell 0.4%, and the dollar remains stronger than many would like. There's no inflationary pressure, despite St. Louis Fed President William Poole's mind-blowing proclamation last week that the Fed needs to maintain a hard line on inflation on the grounds of what he termed a "transitory" slowdown in the economy.

Sure, some grain traders may point to the 27% jump in soybean prices since the beginning of June, but soybeans are still at a low level historically. Besides, the Fed's powerless here, unless the Open Market Committee gathers for a group rain dance at the base of the Washington Monument and adds this capability to their already-bulging arsenal. If they're successful, they'll start messing around with Enron's weather derivative market.

The ARS And A Hole In The Ground

All right, enough Fed-bashing for one week, let's get back to the gauchos with the ouch-o's. In 1992, the same time the Europeans decided they'd seen enough of their perpetual currency crises, Argentina decided to peg its peso (the ARS to foreign exchange traders) to the dollar. The costs of dollarization would include importing U.S. monetary policy and facing strong export competition from other Latin countries with weaker currencies, especially Brazil.

Well, wherever you go, you're there. A leopard doesn't change its spots, and Argentina is still riddled with Peronist politics, a doomed combination of labor union thuggery and socialism that helped propel the country backwards from the world's seventh-wealthiest nation in 1900 to its present august standing. Dollarization removed the only lubricant possible for Peronist frictions, massive inflation, so the government tried to replace it with deficit spending. The government's debt now stands at $128 billion on a 1993 constant dollar GDP of $277 billion, and most of that debt is dollar-linked. If the peg to the dollar is broken and the ARS collapses, this debt, $8.8 billion of which is due this year, will be unpayable. To forestall such a collapse, the overnight rate on the ARS has jumped to 350%. On the downside, these high rates have led to the peso's 23% appreciation against the Brazilian real since the start of the year, and this has placed an unbearable strain on Argentina's balance of trade.

The government is trying to cobble together a package of spending cuts that will remove the Peronists' candy, but even if they succeed in this regard, it's simply a short-term measure. They'll have to do what all managements do to obtain labor concessions, and that's mortgage the future. Who'll hold the paper? The big international banks, the usual suspects whenever an international crisis blows up, are stretched by the decreasing quality of their own portfolios. Citigroup has dropped close to 10% from its recent highs, and J.P. Morgan has shed closer to 15%. A similar pattern holds for non-U.S. banks; both Spanish giant BBV and French Societe Generale match the 15% downturns. International lending agencies can chip in a little; the World Bank will be extending $400 million in August as part of a previously-announced $900 million loan, but the IMF has done little more than send its regards and a statement of support for the austerity package. Will new Brady bonds, sovereign debt backed by the U.S.

Treasury, be issued? The current FRB bonds' yield has jumped from 13.42% a month ago to 36.07% now, which hardly indicates a receptive market at present.

How will this all end? The betting here is:

1) The government will strike a deal with the Peronists to roll the problem forward;
2) The banks will pressure their respective domestic governments bail them out;
3) The IMF will provide the facilities for the bailout;
4) Argentina will devalue the peso formally, but establish a new link to the dollar;
5) Once yields fall, a new generation of Brady bonds will be created

Who'll buy these new Brady bonds or similar bailout instruments? They'll try to sell them to you. In about a year, you'll hear a lot of buzz out of Wall Street about new and exciting opportunities in those forever-emerging markets.