# Emerging Markets Fortnightly

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Strategy & Economics

- **The January rally we foresaw is here, and we remain optimistic that conditions for EM debt will continue to be favourable in the months ahead.** Our key assumptions are: 1) the US economy will avoid a recession, and thus the emerging countries that export to the US will not be seriously destabilised; 2) the Federal Reserve will keep on cutting interest rates to the benefit of the most highly indebted countries; 3) world oil prices will settle down in a range that is bearable to both oil-exporting and oil-importing countries; 4) all the key countries (including Argentina and Turkey) will succeed in maintaining the confidence of investors; and 5) with the rally in US Treasuries now over and most US equities range-bound, investors will be favourably disposed to putting money to work in emerging markets. The fact that the sovereign new-issue pipeline appears lighter going forward, following a $6bn avalanche in the past 12 working days, should help the market's technical condition.

- **We continue to recommend overweights in Argentina, Brazil, Colombia and Venezuela and now suggest shifting to an underweight in Mexico debt, given its close link to the slowing US economy and the likely delay in an S&P upgrade.** In Emerging Europe, we continue to suggest a contrarian overweight in Turkey and neutral weightings in Bulgaria and Russia. In Emerging Asia, we suggest an overweight only in Korea. Our favourite assets are the Argentina Par, FRB, '15 and '17 bonds; the Brazil Discounts and long Globals (and we reiterate our long Bra '30, short Arg '30 trade idea); the Venezuela DCB and '27; and the Turkey '09 and '10.

- Our first feature article discusses the financing package for **Argentina** and what lies ahead there. A second essay focuses on the role of oil and contingency funds in **Mexico and Venezuela**. And a third one argues that the potential good news from reform initiatives and compliance with the IMF targets is not fully reflected in **Turkey** bond prices.



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# Argentina: the financing package and beyond

- With the financial package and many of the requisite institutional reforms in place, plus a more benign external environment courtesy of the US Federal Reserve and other factors, chances are good that the Argentine economy will show renewed signs of life after the month of March.
- While there is political opposition to some of the measures passed by decree law, we do not expect them to be overturned either in the Congress or in the courts. In fact, we expect that the ruling coalition will pull itself closer together in the months ahead of the October mid-term congressional elections, in order to avert a defeat.

The revised agreement between Argentina and the IMF (approved formally last Friday, 12 January), the implementation of several austerity and reform initiatives and early evidence of a more favourable external environment, have all combined to produce a rapid turnaround in investors' pricing of Argentina's sovereign risk. Indeed, even before implementing a debt swap involving any portion of this year's maturities, the government is already coming back to the international capital markets with a $500m 30-year Global bond offering. (The province of Buenos Aires has also raised €200m and the privately owned Banco Hipotecario, for its part, has obtained €150m.) Arguably, none of this would have been possible if President Fernando de la Rúa had not gone ahead and enacted several reforms on 29 December – measures that he knew were opposed even by members of his own coalition.

**Figure 1: The presidential decrees of 29 December**

| Decree | Main features |
| --- | --- |
| Pension system reform | Increase in the retirement age of female workers and reduction in state-provided guaranteed floor for retirees. |
| Infrastructure investment programme | $20bn investment plan in basic infrastructure, $2bn of which will occur in 2001; the government will create a fiduciary fund to guarantee the financing of the projects. |
| Workers' insurance | Increase in life insurance ceiling and creation of a fiduciary fund to provide coverage for workers contracting job-related illnesses. |
| Health care reform | Deregulation of the existing, union-controlled system; workers will be allowed to choose their health care provider. |
| Vetoes to 2001 budget law | Veto to Article 18, which allowed for the restoration of salary cuts for government employees and reduction in the transfers from the federal to the provincial governments related to the National Tobacco Fund. |

Source: ABN AMRO

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## The infrastructure investment initiative

The government has put forth a 5-year, $20bn infrastructure investment programme, creating a fiduciary trust whose resources will be used as a guarantee for the financing of various public works. Some $2bn worth of new investments are to be completed this year, with nearly half of the projects involving roads and highways, 30% for the construction of hydroelectric plants and less than 10% for an expansion of rail lines. The fund will be financed with resources contributed by the federal and the provincial governments. The allocation of the projects will be done through an open bidding process, involving only local firms for projects costing less than $45m and both local and international firms for all of the larger projects. The plan was inspired by the British model of public works, in which the government is in charge of organising the bidding process but the projects are undertaken and financed by private companies. Once the projects are finished, the firms recover their investments via tolls and the like. The authorities expect to create some 400,000 new jobs with this infrastructure plan, helping to accelerate the economy's recovery and lowering unemployment (currently around 14%).

### Pension reform

The pension system has been changed to encourage women to retire later starting in 2002, and this is done by applying a 15% discount to the benefits for which all female workers are eligible if they apply for them before turning 65 years old. In addition, a $200/month pension supplement that was given to all retirees, no matter their eligibility for a small or large pension, was replaced by a smaller variable complementary payment for all those receiving pensions of up to $1,950/month. The reform does not affect current pensioners but only new ones. Still, the elimination of the guaranteed floor is expected to generate savings for the Treasury of at least $1bn per year within a decade. A remnant of the state-run pay-as-you-go system, which originally was going to be abolished, in the end was kept in place because its existence does not affect the current system appreciably. Since a private capitalisation system became effective seven years ago, more than 95% of new contributors have chosen to enrol in the private, contributory regime. However, from now on, no single pension fund administrator is allowed to maintain a market share above 27.5% of total managed funds.

### Deregulation of the HMO system

Traditionally, the health care market for unionised workers in Argentina has been kept captive by the *obras sociales sindicales*, a series of union-controlled health maintenance organisations (HMOs) that have tended to deliver poor-quality care considering their cost. Now workers will be allowed to choose their health care provider freely starting on their first day of work, and the new deregulated system is expected to be operational within three months. There will be quotas for the affiliations to different providers, which will have to provide a primary care physician and offer a basic health coverage programme. Should an insured worker with a pre-existing condition wish to switch health care providers, his/her coverage will be paid by the original provider for 12 months. In addition, the ceiling for a government-provided life insurance programme for workers was increased from $110,000 to $180,000. Lastly, the government will establish a fiduciary fund to provide coverage for those contracting illnesses on the job.

In the past couple of weeks, however, it has become apparent that the new HMO system is off to a slow start, because virtually none of the private health care providers have expressed much interest in participating. The companies are apparently concerned about the excessively low government financial contribution to guarantee basic health coverage, which would barely cover operating costs. Chances are good, therefore, that the December decree will be modified to accommodate the demands of the privately run HMOs.

## Vetoes to the 2001 budget law

President de la Rúa vetoed Article 18 of the budget law as passed by the Congress, which allowed for the restoration of the salary cuts imposed on civil servants in the middle of last year if savings were realised elsewhere. A cut in subsidies to tobacco growers, which the legislature had been against, was restored. Marginal increases in spending on national defence and some decentralised government entities were eliminated. However, subsidies to fuel consumption in the Patagonia region, which the administration had originally sought to eliminate, were maintained.

## The financial package

Following several weeks of guessing games over the amount of the so-called 'financial shield' for Argentina, the size of the package came in at the upper end of expectations, totalling $39.7bn. Almost $33bn of that total has been formally pledged to the authorities although with different degrees of commitment. Some $19.7bn is fully secured because it comes from official sources (with the IMF having by far the largest participation with $13.7bn), provided, that is, that the Argentine government qualifies by meeting its commitments. The existing Stand-by agreement was expanded from $7.2bn to $11bn, and an additional $2.7bn from the Supplementary Reserve Facility (SRF) was also made available for this year. The package is significantly front-loaded, with $11.8bn worth of official funds available before the end of this year. The interest rate charged on the Stand-by funds ranges from 5.8% to 8.8%, increasing with the amount disbursed, while the interest rate on the SRF funds is a punitive 10.8%, and the repayment schedule is quite short – no more than 18 months.

Fig 2: The financial package ($bn)

| | | Total | 2001 |
|---|---|---|---|
| **Non-market sources:** | | | |
| IMF | | 13.7 | 8.8* |
| World Bank | | 2.5 | 0.8 |
| IADB | | 2.5 | 1.2 |
| Spanish government | | 1.0 | 1.0 |
| **Market sources:** | | | |
| Local market-makers | | 10.0 | 10.0 |
| Local pension funds | | 3.0 | 3.0 |
| Liability management | | 7.0 | 0.6 |
| Euros | 1.0 | | |
| Pesos and dollars | 3.0 | | |
| Coupon reinvestments | 3.0 | | |
| **Total** | | **39.7** | **25.4** |

*Includes $2.1bn disbursed in December 2000.
Source: ABN AMRO

The package also includes $20bn from private sources, $13.6bn of which should be available this year. Local market makers (including ABN AMRO) made a commitment to the authorities to participate in all the Treasury security auctions this year although there was no deal on the pricing at which the instruments will be purchased. Market-making banks are slated to supply $10bn, including some $2.7bn in the form of an exchange of maturing promissory notes (*bonos pagaré*). Local pension funds are expected to absorb most of the issuance of Global bonds in 2001, plus some additional Treasury bonds totalling $3bn – the full expected increase in their investable funds for the year. In addition, the government is counting on sources stemming from debt swap transactions for $7bn over the next three years, although only $600m is planned for 2001. Naturally, these are the minimum necessary levels, and the authorities will make constant efforts to increase the participation of private capital sources in the overall financial package. This would serve the purpose of maintaining a large portion of official funds for purely precautionary purposes.

**Fig 3: 2001 official financial programme ($bn)**

| | | |
|---|---|---|
| **Uses:** | Amortisation of medium- & long-term debt[1] | 15.3 |
| | Fiscal deficit | 6.5 |
| | **Total uses** | **21.8** |
| **Sources:** | **Official** | |
| | IMF[2] | 6.7 |
| | World Bank | 0.8 |
| | IADB | 1.2 |
| | Spanish government | 1.0 |
| | **Market transactions** | |
| | Liability management | 2.7 |
| | Net increase in Letes | 0.2 |
| | Promissory notes | 0.6 |
| | Bontes | 3.0 |
| | Global bonds | 2.6 |
| | Euro and yen bonds | 3.0 |
| | **Total sources** | **21.8** |

1. Excluding rollover of Letes (Treasury bills).
2. Does not include the $2.1bn disbursed from the IMF in December, which will be maintained as financing cushion.

Source: Ministry of Economy, ABN AMRO

Once the rollover of Letes (Treasury bills) is included, it becomes clear that Argentina needs $3.3bn in net market financing this year. It should be noted, however, that the authorities have said that the $2.1bn disbursed in December from the IMF credit line will be held as a cushion and thus it is not considered as a financing source in 2001. Thus, net market financing needs could be held even lower – just a little over $1bn – should the entire amount of official funds be taken into account.

**Fig 4: Net market financing needed 2001 ($bn)**

| | |
|---|---|
| Amortisation of medium- & long-term debt | 15.3 |
| Amortisation of short-term debt | 4.8 |
| Fiscal deficit | 6.5 |
| **Total uses including Letes** | **26.6** |
| Less: | |
| Financing from official sources | 9.7* |
| Local pension funds | 3.0 |
| Local market-makers | 10.0 |
| Liability management | 0.6 |
| **Net market financing** | **3.3** |

*Does not include the $2.1bn disbursed from the IMF in December, which will be maintained as financing cushion.

Source: Ministry of Economy, ABN AMRO

The official funds will be available in quarterly disbursements, contingent on the government complying with several quantitative fiscal targets and sticking to an ambitious structural reform agenda. The fiscal deficit ceiling of the federal government in 2001 was set at $6.5bn (the equivalent of 2.2% of GDP), while the combined deficit of the provinces was targeted at $2.8bn (1% of GDP) – although the latter is only an indicative goal rather than a performance criterion, because the federal government cannot be held legally responsible for the behaviour of the provinces. The programme also includes a target for the increase in the consolidated (federal plus provincial governments) debt at $9.5bn for the year. In addition, the programme is contingent on the completion of the pension reform, the ratification of the agreement to freeze primary spending between the federal government and the provinces as well as the vetoes to the budget.

**Figure 5: Quantitative performance criteria agreed with IMF ($bn)**

| | 2000 | Q1 2001 | H1 2001 | Jan-Sep 01 | 2001 | 2002* |
|---|---|---|---|---|---|---|
| Federal government budget balance | -6.70 | -2.10 | -3.80 | -5.10 | -6.50 | -5.00 |
| Federal government primary spending | 52.93 | 13.31 | 26.17 | 39.90 | 53.21 | NA |
| Provincial governments' budget balance* | -3.40 | -0.60 | -1.40 | -2.00 | -2.76 | -2.00 |
| Change in federal government debt | 5.70 | 2.15 | 3.90 | 5.25 | 6.70 | 5.00 |
| Change in federal short-term government debt | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | NA |
| Change in consolidated public sector debt | 9.20 | 2.75 | 5.30 | 7.25 | 9.46 | 7.00 |
| Change in net domestic assets of the central bank | -1.08 | 2.47 | 2.40 | 2.10 | 1.84 | NA |

*Indicative targets

Source: Ministry of Economy

## Prospects

The macroeconomic performance of Argentina this year depends largely on the renewed willingness of consumers and investors there to spend on new goods and services. Since wages and profits are not likely to rise much, greater spending may well have to be underwritten by borrowing from banks and other financial intermediaries and, in this connection, it is good to note that domestic interest rates have fallen precipitously in recent weeks. For instance, the 30-day prime lending rate on pesos has dropped from over 18% pa in early December to around 11% currently – though it has not yet fallen to the 9.25-10.25% range seen prior to last October. As things stand, the external environment is already shaping up to be more benign for Argentine growth this year. US interest rates should settle down at lower levels this year vis-à-vis 2000, while the US dollar, to which the Argentine peso is tied 1-to-1, should average weaker versus the euro, facilitating Argentine exports to Europe. In addition, Brazil is expected to post another 4%-plus GDP expansion this year, with positive spill-over effects on demand for Argentine products so long as the Real remains relatively stable. However, Argentina is a relatively closed economy, with exports accounting for less than 10% of GDP.

In order to consolidate the still tentative improvement in expectations that followed the announcement of the financial package, it will be crucial for the government to make sure that the deregulation decrees issued by the de la Rúa government in late December are not overturned either in the Congress or in the courts. Congress is now in recess but its ordinary sessions will re-start in February. We believe that the infrastructure decree will go untouched, especially because it counts on the support of the provincial governors who need to stimulate growth and lower unemployment in their jurisdictions. The HMO deregulation, although opposed by the unions who stand to lose from it, should also survive any challenges because it is a very popular reform, given the prospect of better health care. It is the pension reform that could be challenged most successfully, because it is disliked not only by all those who are affected but also by most Peronist leaders and also by a group of dissident legislators from the ruling coalition (mainly from the Frepaso group).

The de la Rúa administration plans to negotiate with the opposition during the coming weeks to avoid a possible reversal of the pension reform in Congress, which would be very costly in terms of the government's reputation and the country's continued access to IMF funding. As it is, the reform, as enacted, is already a softened version: the original, for example, raised the minimum retirement age for working women from 60 to 65, rather than encouraging later retirement.

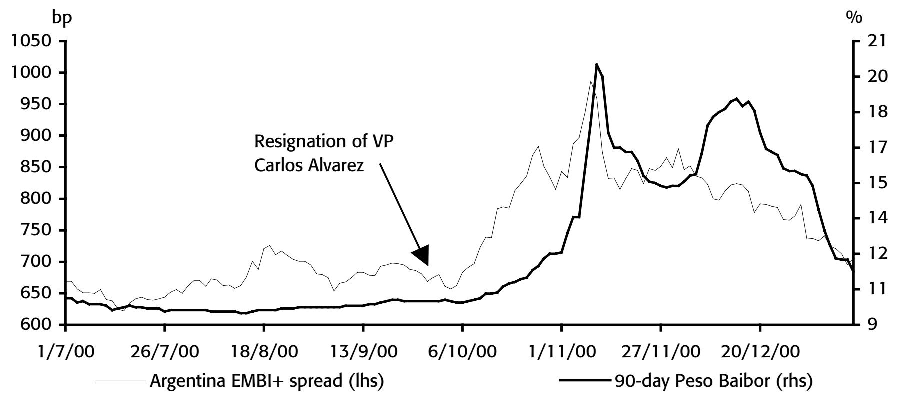
So far the legislators from the Radical Party, one of the two main components of the ruling alliance and de la Rúa's own party, have provided support for the presidential decrees. If the Frepaso lawmakers decide to challenge the Executive decree, joining forces with the Peronist opposition, the coalition would likely come to a formal end. In this connection, the attitude of former Vice President Carlos Alvarez is key. Initially, he made public statements against the pension reform but recently he has taken a friendlier line towards the de la Rúa government. Alvarez is at a crossroads, since his potential frontal opposition to the pension reform would align him with the Peronists. Yet his political career was built around confronting the allegedly corrupt practices of the Menem administration, such that siding with Peronist lawmakers would damage his standing and political *raison d'être*. Thus, we believe that Alvarez and his core group of Frepaso legislators in the end will support the pension reform or at least look for a compromise solution, introducing very minor changes to the decree law that the IMF would tolerate.

The larger political picture is that the parties and their leaders will soon be positioning themselves for a good showing in the October legislative elections, in which the entire Senate and two-thirds of the Lower House are to be renewed. Government sources have indicated their intention to have Alvarez run for the Senate, representing the city of Buenos Aires, because his candidacy would convey a message of lingering unity within the coalition. Meanwhile, local sources also indicate that former President Raúl Alfonsín could run for a Senate seat for the province of Buenos Aires. Despite his usually controversial public statements, Alfonsín would make a strong candidate, at a time when the coalition will be forced to compete with its best-known political figures – regardless of all internal political disagreements – in order to avoid a possibly crushing defeat. What this all means is that the ruling coalition may well pull closer together in the months ahead, generating fewer adverse headlines in the press and standing more firmly behind the de la Rúa administration.

## Investment implications

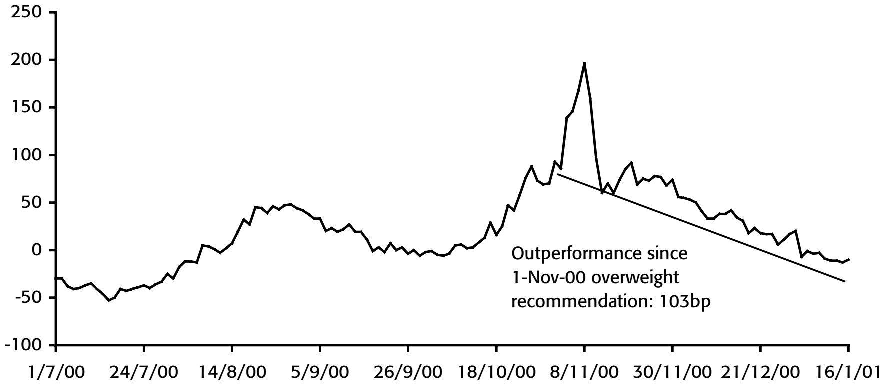
Argentina's sovereign risk, as measured by the spread of the Argentina EMBI+ composite bond index, has compressed almost 300bp from its peak in early November. Since the publication of our overweight recommendation (see the 1 November edition of this publication), the outperformance of the Argentina composite index versus the EMBI+ has been in excess of 100bp, and our calls to increase exposure to FRBs, Pars and Arg '15s have generated total returns in the neighbourhood of 10%. Domestic interest rates, as mentioned previously, have come down even more.

Figure 6: Country risk and domestic interest rates




Source: ABN AMRO

Figure 7: Argentina EMBI+ composite spread less EMBI+ spread (bp)




Source: JP Morgan, ABN AMRO

Although further spread and local interest rate compression is possible later this year, current levels represent a good starting point to think that Argentina will be in the position to see some consumption and investment growth in the coming months. In our view, despite the impressive rally of the past weeks, Argentina debt still has potential for outperformance in the near future, mainly because during Q2 the economy probably will show signs of renewed life and political conflicts within the ruling coalition will tend to die down. In addition, Argentina stands to benefit the most from the interest rate reductions that are looming in the US, while it stands to be hurt the least by the economic slowdown in the US – because, relative to other emerging markets, the country is the most heavily indebted in terms of its exports earnings, and Argentine exports to the US account for less than 1% of GDP.

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