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## “What are Your Dollars Worth?... Currency Clues”

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“What does it matter what the U.S. dollar is worth overseas, since Americans buy and sell goods to each other predominately within the largest economy in the world?” One reason is because foreign countries loan the United States financial system two billion dollars each day to maintain our system. U.S. National debt exceeds \$8.4 trillion. Foreign-held U.S. government debt exceeds \$1.9 trillion. Foreigners’ investments in the U.S. exceed the value of U.S. investments abroad by \$2.69 trillion. Foreign creditors may demand higher interest rates if the value of the U.S. currency drops (to compensate for principal devaluation). Higher interest rates then will cause the economy to slow resulting in less federal tax receipts, thus increasing the federal budget deficit. Additional borrowing will be necessary at increased interest rates to service existing and new debt.

If the country’s financial condition continues to worsen, theoretically a currency crisis could develop. Have there been any historical precedents? What happens to investors, citizens, savers, and the economy in a currency crisis?

And the Money Kept Rolling In (And Out), Wall Street, the IMF, and the Bankrupting of Argentina is a book recently authored by Paul Blustein detailing what occurred in Argentina in late 2001-2002 as the economy faltered and the Argentine currency lost approximately 75% of its value from January-August, 2002. Argentina’s economy was much smaller than America’s. However, comparisons between Argentina pre-crash and present-day America are worth considering.

Blustein is a financial reporter with the “Washington Post” who in February 2002 was sent to Argentina to report on the Argentine financial crisis. He had previously covered crises in the late 1990's in Asia, Russia, and Brazil. Argentina had borrowed hugely in the international bond markets in the late 1990's. The more people he interviewed, the more he believed that the international community played a significant part in pumping up Argentina’s economy to a dangerous degree and then letting the country down, when some believed further loans would have eased the crunch and financial hardship that followed. His book is based on interviews with more than 125 people including top officials of the International Monetary Fund, U.S., other G-7 governments, the Argentine government, and many within the financial and/or

investment banking community.

The International Monetary Fund (founded in 1944 with 184 member countries in 2004) is an entity that functions like a giant credit union. It lends money to financially-strapped member countries. The book begins by detailing an IMF mission trip in November 2001 when economists from headquarters in Washington D.C. travelled to Argentina to meet with the Ministry of Economy to conduct a review of Argentina's progress in meeting the terms of its \$22 billion loan package from the IMF. Such reviews according to Blustein were conducted every few months on most IMF loans and if the review was "completed" successfully, meaning Argentina's progress was deemed satisfactory, then the Fund would disburse an additional \$1.24 billion installment that was scheduled to be lent to the Argentine government in December of 2001. At that time, a long-running crisis in the Argentine economy (largely due to deficit-spending) had reached an acute stage and global financial markets were panicking over the prospect of a potential default on Argentine government debt.

By way of background, in 1991, a currency system "convertability" existed that kept the value of one Argentine peso fixed exactly to one U.S. dollar and allowed Argentines to use to both currencies interchangeably. Historically, Argentina has had corrosive inflation and the one dollar-per-peso link had proved successful in quelling inflation and imparting a stable financial system for consumers, savers, and businesses. Millions of borrowers had taken out loans in dollars, even though their income was in pesos. If the peso-dollar link was broken, then it would wreak havoc and generate bankruptcy en masse. For instance, borrowers who had taken out mortgages on their homes paid \$1,000 per month. If the peso declined 50%, the mortgage payment would double to \$2,000 per month, being the amount of pesos required to make the monthly payment in U.S. dollars. That scenario loomed menacingly in 2001 as jittery investors and lenders questioned pulling their money out of the country, depleting the reserve supply of dollars that Argentina needed to keep the system alive and functioning.

On the surface, Argentina's fiscal accounts in the mid-1990's looked as if the government had overcome its earlier problems of spending beyond its means. In 1997, a fairly typical budget year, the Argentine government was running a deficit of \$4.6 billion, equal to just 1.6% of Gross Domestic Product (Gross Domestic Product measures the size of an economy and is defined as the market value of all final goods and services produced within a country within a given time). The provinces within Argentina also over-spent. Including their debt, the overall deficit was \$6.05 billion or 2.1% of GDP. Compare this to the budget deficit limits of European nations that use the Euro as their common currency. The Euro countries must conform to their deficit ceiling of 3% of GDP (The U.S.'s 2004 deficit was approximately 4%, not including borrowing from the Social Security Trust Fund). However, Argentina had a special reason to exercise extraordinary prudence in its budgetary policy: the cherished convertability system that required Argentina to be ultra-disciplined about fiscal matters because Argentina was borrowing mainly in dollars, which if abused could destroy the dollar-peso link. If the government's debt started looking excessive, markets would worry that the government lacked the dollars required not only to pay its creditors but also to exchange pesos for dollars. The second reason for fiscal caution was that Argentina needed to maintain more than the usual amount of reserve ammunition in case of a

recession. The government could not use a “printing press” to print money for deficit spending purposes because of dollar-peso convertability. The only way to prepare itself in case of a recession was to adopt a responsible budget policy with sizeable surpluses during boom times to tide the government over when recessions occurred.

An IMF briefing paper circulated in April of 1997 documented concerns about Argentina’s fiscal policy. It noted that the government’s total debt had risen rapidly in the past several years approaching 40% of GDP. To pay principal and interest coming due on that debt, the government would have to borrow an additional \$10 billion-\$13 billion annually over the next several years. The IMF intended in 1997 to press for a package of deficit-reduction measures, including a tax-reform plan that was being considered in Argentina already. Reform of the National Security Health Insurance System for retirees was also considered. Even with these potential reforms, it was assumed that Argentina’s GDP would grow at a rate of 5% or more. Argentina’s GDP did grow more than 8% in 1997, but then slackened considerably. The fiscal austerity measures were delayed and never adopted until it was too late.

Argentina’s debt rose from 29% to 41% of GDP despite the overall economy’s health from 1993-1998. International investment banks were able to sell a large quantity of Argentina government bonds even in difficult international markets. Currency crises in Asia and Russia had caused capital flows to dry up in other markets. The ability of Argentina to tap the bond market limited the leverage that the IMF could exert on Argentina thus contributing to the delay of adoption of needed fiscal austerity measures. (With \$8.4 trillion of debt and a 2005 GDP of \$12.49 trillion, the U.S.’s debt to GDP is approximately 67% according to the C.I.A.’s World Factbook.)

Similar to the United States, Argentina’s imports exceeded exports by as much as \$8 billion in 1998 (The U.S. trade deficit for 2005 was \$725 billion). The current account deficit(a term roughly equivalent to a trade deficit though broader) was problematic. The IMF wanted to cool down the economy to reduce imports and the current account deficit, but the bonds owed by the international investment bankers produced the funds to maintain the status quo and maintain convertability. To buy more goods from abroad than they exported, Argentine consumers and businesses had to borrow dollars from foreigners, which pressured the ability to maintain the peso-dollar convertability system. The Argentine government ignored the warnings of the IMF. Monetary crises in Russia, Malaysia, and Brazil in 1998 and 1999 caused the IMF to back off of Argentina because of the worldwide panics present in the other countries.

The currency woes in Brazil produced serious economic problems for Argentina. Brazil was an important market for Argentine exports. That market became much less receptive to Argentine goods when the Brazilian currency depreciated sharply following the Brazilian crisis in 1999. Competing Brazilian products were suddenly much cheaper and the result was a 28% drop in Argentine exports to Brazil. In addition, worldwide prices of grain and other commodities that Argentina exported declined by 20% in 1998. Meanwhile, the U.S. dollar was rising on foreign exchange markets, pulling the Argentine peso up with it which made Argentine goods of all kinds less competitive on world markets. Argentine exports fell by 10.5% in 1999

according to Blustein. Cheap imports were decimating some Argentine industries, such as shoes and clothing just as we see today in the United States. Further, interest rates were rising on all loans of all sorts to developing markets following Russia's default in 1998. Thus, recession was setting in and Argentina was not prepared.

The recession over the next few years depressed tax revenues widening the deficit. As the situation worsened, the IMF and others with a stake in the outcome of Argentina kept quiet about the troubles brewing for fear that there would be a run on the deposits of dollars in Argentina. In a bid to shore up the system, the IMF had twice granted emergency loans in 2001 to the Argentine government. Promises were made to fix the country's underlying problems, but the country was in a recession and austerity moves caused the recession to deepen lowering business activity resulting in lower tax receipts. The total Argentine government debt that required payments of interest and principal was \$140 billion. (Contrast Argentina's government debt with current U.S. government's debt of \$8.4 trillion).

As the recession lingered, within the IMF, a powerful sentiment had taken hold that further assistance to Argentina would be an exercise in futility. Economists and investment professionals and others began to fear about the safety of bank deposits in Argentina causing a steady withdrawal of dollars from banks such that during the last three days of November, 2001, thousands of depositors pulled \$3.6 billion out of their accounts-about 6% of total deposits. On Saturday, December 1, the Economy Ministry announced restrictions on withdrawals aimed at halting the run. It limited Argentine citizens withdrawals at \$250 in cash per week, although they could make payments by check or debit and credit cards. Furthermore, a comprehensive ban was imposed on transfers of money abroad except for those related to trade. Government assurances that the measures would be lifted after ninety days were dismissed as lacking credibility. The IMF was not informed that these currency restrictions concerning withdrawals would be instituted. They had been informed that the convertibility system-the interchangeability of dollars and pesos without hindrances- was sacred. The IMF felt their institution's money and credibility were on the line based on Argentine insistence that the convertibility was inviolate. Then, for Argentina to change the rules without even consulting the Fund, caused the fund to lose confidence in the leadership of Argentina. The IMF announced two days later that it was unable at this time to complete the review necessary to disburse the \$1.24 billion.

The Argentine economy collapsed shortly after the withdrawal of the IMF mission in December of 2001. The country descended into anarchy. First came scenes of people thronging the Plaza de Mayo, banging pots and pans, and mobs looting shops and sacking government buildings all over the country, resulting in mayhem and more than two dozen deaths. The President was forced to resign on December 21. A succession of five presidents to office over the next ten days occurred, ending on New Year's Day 2002 when the emergency session of Congress handed the Presidency to Eduardo Duhalde.

A severe downturn in the economy beset the country following the government's default on the bulk of its debt and this decision led the peso to sink in early 2002. New restrictions on

bank withdrawals led to a breakdown in the system by which people in businesses paid each other, and bank credit that companies depended upon for day-to-day commerce dried up. National output shrank 11% in 2002, leaving one quarter of the workforce unemployed and a majority of the population living below the poverty line. Meanwhile, prices soared for basic food items such as bread, pasta, and sugar. Average annual income per capita, which in the late 1990's peaked at \$8,500-double Mexico's level-sank to \$2,800 in 2002. The peso dropped 75% in its exchange rate against the U.S. dollar. Living standards plummeted. Personal savings withered in value.

Argentina's downfall was especially painful for its citizens to bear because its citizens believed Argentina was an advanced country. Argentina is the most Europeanized of Latin American countries boasting the region's highest education levels with high intellectual and cultural activities. From 1991-1998, the economy grew at an average rate of 6% a year, reaching a total gross domestic product of nearly \$300 billion, with almost no inflation. That contrasted with previous decades' stagnation, hyper-inflation bouts, repeated currency devaluations that had occurred several times since the mid-twentieth century.

Argentina had prided itself during the 1990's for following free-market, economically-orthodox policies. It had followed the economic Ten Commandments described by the IMF, World Bank, and the U.S. government. Among the main elements of this recipe are the eradication of inflation, the privatization of industry, the deregulation of the economy, and the removal of trade barriers. According to one conservative economic think tank Argentina in 1999, tied Chile for having the best policies of Latin America and almost equal to that of Australia and Taiwan.

Banks and investment firms did not escape losses. Argentine banks were pressured by the government to buy government bonds. When the government defaulted, the bonds' value dropped dramatically causing the net worth of the banks to fall dramatically. International bond money managers often bought an index of emerging-market bonds. Argentine bonds were a large part of those indexes. Individuals in Europe and Japan ended up holding about \$24 billion in claims on the bankrupted Argentine government according to Blustein. Argentine bonds had paid interest at a rate of twice what Europeans could expect on government bonds prior to 2001 and thus had been attractive to investors.

One money management firm was not hurt as bad as others due to the actions of Mohamed El-Eran, the recently named Head of Investments at Harvard University. El-Eran had been at Pacific Investment Management Company(PIMCO), the largest bond management firm in the world in April of 1999 when he began overseeing the emerging-market portfolio. He was the son of an Egyptian diplomat father and a French mother, and had an undergraduate degree from Cambridge and a doctorate from Oxford. He also was a former colleague of some of the economists at the IMF. He had a downbeat view on Argentina well before the perspective became common place, and began to quietly unload all of the \$2 billion-plus of Argentine bonds held by PIMCO by the end of 2000. He saw that the rise in the peso, which was linked to the U.S. dollar was hurting exports and that the fiscal tightening required to try to maintain budgets

would lead to recession(lowering tax receipts) which would be almost impossible to escape.

In 2001, Blustein states the IMF economists had another possibility that might have saved the citizens of Argentina much of the pain and financial calamity later suffered. Matthew Fisher was the IMF's chief specialist in countries that are close to going "belly-up". He was a former official of the British Treasury and headed the Capital Markets Division in the Policy Development and Review Department. He was thus thrust in the middle of the most emerging-market crises. His idea was to compel creditors of Argentina to accept less than full payment in a way that would inflict the least amount of collateral damage. However, the Argentine officials could not come to grips with the reality of restructuring and its possible implications because of their past experience with hyper-inflations. Fisher's idea was to inform creditors that Argentina needed to reduce its debt by about 30-40% which the Fund reckoned would be a substantial enough cut to make the debt sustainable without unduly ravaging the balance sheets of Argentine banks. For its part, the IMF or other elements of the official community would take action aimed at shoring up the banking system and calming depositors during the time which was estimated to be at least 3-4 months required for a fully legal debt exchange to occur. For example, Argentina might get a fresh supply of dollars for its central bank reserves, one purpose being to assure the nation's public that there was no shortage of cash in the banking system and that there would not be a run of the banks. One way to express Fisher's idea was that it was better to receive a majority of the debt owed rather than to risk losing a much larger portion when the probabilities of a default were high.

Argentina's economic unravelling was not an isolated case. Prior to 2002, other fast-growing "markets" such as Mexico(1994 crisis), Thailand(mid-1997), Indonesia, South Korea(1997), Russia(1998), and Brazil(1999) had also experienced currency crises.

Could the United States be in a similar situation? Interestingly, Chris P. Dialynas, a Managing Director of PIMCO, published his paper entitled "The Trouble Ahead-Trouble Behind" in December of 2004. He called for a restructuring of the global economy and a Marshall Plan for the United States dollar. Dialynas believed the real current account deficit was nearly 6% of United States' GDP, and that this had resulted in huge economic imbalances and indebtedness in favor of Asian countries and to the detriment of the United States. His solution is a new "Marshall Plan" named after the United States general who oversaw the United States' loans and reconstruction efforts of Europe following World War II. Dialynas' plan calls for a broad mix of U.S. domestic policy initiatives designed to boost savings, cut the federal budget deficit, and shift the federal reserves objective from promoting consumption into a current account readjustment. The United States standard of living must decline substantially if these initiatives are to be achieved. Overseas, the new Marshall Plan calls for a 40% revaluation of the Chinese yuan, Indian rupee, and Russian ruble versus the United States dollar and the renegotiation or even forgiveness of U.S. debt held by countries with large trade surpluses with America.

Dialynas wrote that the United States had borne the majority of the costs associated with substantial structural change in the global economic architecture over the period from 1994-2004

because it had assisted other nations with their economic problems and had opened its markets to purchases of foreign-made goods. He also suggested cutting by 15% across the board all U.S. social spending programs, increasing U.S. tax rates, increasing incentive to save in the United States (consumption taxes), devising capital controls such that capital cannot be exported out of the United States, targeted protective tariffs if needed, renegotiation of the World Trade Organization, and other recommendations such as prohibiting the Fed from purchasing bonds from foreign holders of U.S. debt.

The IMF is in agreement with Mr. Dialynas that the U.S. dollar must fall in value. In April 2006, the IMF stepped up the pressure for far-reaching shifts in exchange rates, declaring that the U.S. dollar will have to depreciate significantly over the medium-term if global economic imbalances are to be resolved in an orderly fashion. The IMF was quoted by the Financial Times stating that it was essential that currencies in Asia and those of oil exporters be allowed to appreciate as part of the required realignment of exchange rates. The statement came in the IMF's twice-yearly World Economic Outlook, published in mid-April, 2006. It highlighted the global imbalances as being the biggest threat to the generally favorable economic environment.

If history is a guide, depreciation of a currency requires higher interest rates to attract additional capital. Thus, U.S. dollar-denominated fixed-income investments such as bonds and CDs are susceptible to decline in market value. The fixed-income investments based in currencies of other nations with relatively strong currencies and economies would not suffer similarly. The majority of asset classes, including bonds, stocks, and real estate generally are affected negatively when interest rates rise significantly. Added loss would involve the potential drop in market value likely due to dollar devaluation.

Blustein ended his book by saying that the United States may dodge the financial-crisis bullet indefinitely. However, he questions whether the talk about U.S. budget and trade deficits, a relatively strong currency versus trading partners' currencies, economic strength, and national pride sound familiar? Blustein states it could happen in the United States. He states that Americans who give Argentina's story fair consideration and conclude otherwise are deluding themselves. He even quoted Argentina's former Finance Undersecretary who stated, "Once you know the markets are there, there is financing, you behave as if financing will be there forever." Blustein believes the United States has shown every sign of adopting that same cavalier, incautious attitude in the first few years of the twenty-first century.

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