

Policy Memorandum 1

International Economics
Monterey Institute of International Studies
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Instructions: You may use any material you believe necessary to answer each question, to include lecture notes, the recommended readings, or other materials. You may not collaborate in any way with another student in this class. The instructor reserves the right to give any student an oral exam in lieu of this written exam if collaboration is suspected. The deadline for this exam is Monday, October 7 at 4pm. You may email your answers before the deadline or present your completed exam in person. The instructor will not accept exams that are turned in late.

Read the quiz objective carefully. You may conduct additional research on the country in question if you believe such additional research will provide additional breadth and depth to your response. As with all examinations, the structure, content, and style of your answers will count in the determination of your final grade. Clear, complete, and concise answers will be awarded higher grades than complete answers that are not concise or ambiguous. Additional information included in your answer will be graded. If there are questions, contact the instructor for immediate clarification.

The objective of this quiz is to provide you with an opportunity to make policy recommendations based upon the material presented in class and in the readings. You should take time to read the supporting materials and to develop a series of recommendations. You should also note that you probably will have many more recommendations that could be conceivably funded given the current resources of the Bank, thus you must prioritize and make recommendations for those programs that you believe will have the highest impact over time. Write your policy memoranda as if you were going to present them in class (which you might).

Objective

As a recent graduate of MIIS, you have been hired by the Inter-American Development Bank (<http://www.iadb.org>) by the Regional Operations Department (<http://www.iadb.org/regions/re123eng.htm>) to assist the Department's mission to program, appraise, implement and evaluate loan and technical-assistance projects. Specifically, you have been hired by the Regional Operations (RE) Department that **RE1** includes [Argentina](#), [Bolivia](#), [Brazil](#), [Chile](#), [Paraguay](#) and [Uruguay](#).¹

A primary concern in RE1 is that the economic and financial crisis in Argentina will spill-over to its neighboring countries and eventually engulf South American in a financial and economic crisis similar to that of the Asian Financial Crisis of 1997-1998. Given the reliance of the region on the United States' economy and the precarious growth prospects of the U.S. economy at this point in time, there is significant concern that the U.S. would not be able to respond robustly to a Latin American economic and financial crisis in 2003 as the U.S. responded to the Asian Financial Crisis in 1997-1998. There is also concern that a housing asset-price bubble has developed in the United States and that if such a bubble collapses, that this would lead to a further outflow of foreign investment from the Latin American region.

With respect to Argentina, the Argentinean Peso continued its depreciation trend in June, losing approximately 6% of its value relative to the U.S. Dollar. While there was a mild appreciation in July, the deterioration has continued, with the Peso trading at approximately 3.7 Pesos to 1 U.S. Dollar in September. The lack of consensus on the economic policy front and the continued failure of negotiations with the International Monetary Fund are key reasons for the continued decline in the Peso as Argentines convert Pesos to Dollars. As a result, international hard currency reserves have continued their precipitous decline, falling from \$25 billion in 2000, \$19 billion in 2001, to approximately \$9 billion in August 2002. If the reserve drain continues at its current rate, the Central Bank of Argentina will no longer be able to intervene in foreign currency markets and the Peso could enter a freefall.

Recently, as a response to the decline in currency reserves, Argentina broached the subject of defaulting on public loans, that is, loans held by the International Monetary Fund, World Bank, and the Inter-American Development Bank (IADB). If Argentina were to default, this would place significant pressure on the Inter-American Development Bank's resources and possibly impinge upon its ability to lend to other countries. In the worst case scenario, Argentina defaults, spurring a regional economic and financial crisis, and the Inter-American Development Bank is unable to assist affected countries due to its loan losses in Argentina and the other affected countries.

¹ There are two other Regional Operations Departments: **RE2**, which oversees operations in [Mexico](#), [Central America](#), the [Dominican Republic](#) and [Haiti](#) and **RE3**, which encompasses the English-speaking [Caribbean](#), [Colombia](#), [Ecuador](#), [Peru](#) and [Venezuela](#).

In response to the continued deterioration of the Argentinean economic environment, you have been asked to join a special technical assistance group within RE1. The objective of this group is to develop two proposals that would receive priority in terms of funding and personnel. The objective is to assist in the stabilization of the Argentinean macroeconomic environment.

There are currently two proposals under consideration:

1. Should the IADB consider outright debt relief for Argentina similar to that underway with the World Bank's Highly Indebted Poor Countries (HIPC) (<http://www.worldbank.org/hipc/>) initiative?

1.a. If debt relief is to be considered, what will be the impact on the IADB financial position?

1.b. What type of debt relief should be considered if you recommend this policy option? Should we consider unconditional relief or some form of conditional relief? What are the benefits to each approach?

1.c. If you do not wish to consider debt relief, how would you argue that the external debt of Argentina should be addressed? Should the IADB consider some form of restructuring or forgiveness?

1.d. What are the potential benefits to debt relief (or some other debt program) for Argentinean citizens? How can the IADB make sure that Argentinean citizens benefit from such a program and that the benefits are not siphoned away by corrupt public officials?

2. Should the IADB provide additional financial assistance in terms of a significant loan package to the Argentinean government with the express purpose of enhancing international reserves?

2.a. If the international hard currency reserves of the Argentinean central bank are significantly enhanced, would this be of benefit to the Argentinean populace and businesses?

2.b. Assuming such a loan package is provided, what would be the likely affect on the value of the Argentinean Peso?

2.c. Would such a loan package have a beneficial impact on the export sector? Could we increase the size of the trade surplus which would in turn increase hard currency reserves?

2.d. What are the potential arguments against the provision of additional IADB resources to the Argentinean government?

You have been asked to evaluate one of the above proposals. You have also been tasked to develop a separate, additional policy proposal to be presented to the working group in the same vein as the above policy proposals, that is, a policy proposal that will make best use of IADB funds to stabilize the environment in Argentina and to promote economic development in the long-term.

Using the information presented in class and on the class website, you are to develop a three-page memorandum (maximum) for each policy proposal illustrating where the IADB could be of greatest assistance and where the Bank's funds could complement the efforts of other international institutions. Each memorandum should be single-spaced and supporting materials may be included as appendices, but appendices are not required or encouraged. An executive summary of recommendations may be included.

Each policy memorandum should include a brief overview of macroeconomic, and if necessary, microeconomic, conditions that motivate the recommendations included in the rest of the document. The memorandum should rely on the principles and discussion presented in class as a foundation for the policy recommendations. For example,

Example 1: As the macroeconomic environment has improved over the past year, the ability of the country to service its existing debt has also improved. Debt-to-GDP ratios remain high relative to other countries of similar per-capita income, suggesting that debt service is reducing the growth potential of the country. While outright debt relief may provide the country with a temporary increase in funds available, we are concerned that corruption and the lack of institutions may soon lead to an evaporation of the funds released by debt relief. We therefore recommend, in concert with the country's poverty reduction strategy, that the Bank consider conditional debt relief supported by grants to improve institutions and reduce corruption.

Example 2: The continuing deterioration in the country's terms of trade has placed pressure on the country's ability to maintain critical oil imports and the exchange rate. We are concerned that if the deterioration of the country's terms of trade continues, the country will be unable to import sufficient oil, leading to an energy shortage that could significantly impact the development of the infant capital-intensive industries. We believe that diversification of the export sector is critical to the long-term growth prospects of the country and thus recommend the provision of low-interest loans and grants to assist in the development of the export sector and, if necessary, the importation of oil in the short-term.