Argentina's Historic Debt Swap — One Step Forward, but Miles to Go

Smitha Francis*

1. Introduction

Recently, Argentina gained 76 per cent acceptance from its private creditors for a much vilified debt exchange offer to reduce the $102.6 bn owed to them, which it had not paid since the historic default at the end of 2001. After the biggest default in the modern era of sovereign lending, Argentina has secured the best public debt restructuring in history.

When the Argentine government launched its initial debt restructuring proposal in late 2003, it was told that the proposal was irrational. Many analysts predicted that the offer to cut about 75 per cent of the nominal value of the debt would not be accepted by the required majority of investors. This was despite the fact that market prices of Argentina's defaulted debt had been reportedly floating around 30 cents on the dollar since quite some time. The characteristic condemnation by the financial press was that if it went ahead with this offer, the South American nation would become a pariah on a par with Cuba, Libya, and Iraq. But now even *The Financial Times* has to admit that Argentina has rewritten the rules of the game in emerging market finance through this debt restructuring.

Indeed, Argentina has just proved that debtor countries do have a lot of power in their dealings with its private creditors. The fact is that this is a power that is hardly allowed to be exercised by sovereign borrowers because of the biased role usually played by the International Monetary Fund (IMF) in such debt renegotiations, and the prevailing inefficiencies in the market for international sovereign lending. Quite clearly, the write-down that Argentina achieved on its commercial debt provides a much needed rebuttal to overlending by emerging market investors and the neo-liberal theories of efficient market hypothesis, and raises some serious questions about the role of 'rational' private creditors in developmental finance.

2. The Drawn-out Debt Renegotiation Process

As the lender of last resort, the IMF has financed huge rescue packages and coordinated debt workouts following each of the financial crises in Mexico, East Asia and Russia in the second half of the 1990s. But having contributed to the problems leading up to Argentina's unsustainable debt accumulation and the subsequent default at the end of 2001,[1] the Fund's attempts to interfere in its debt restructuring process were to meet with only very limited success. And this indeed can be seen as the reason behind the historic success of the Argentine government's debt restructuring.

According to the September 2003 agreement between Argentina and the IMF, the country had committed to conclude negotiations with its private foreign creditors by mid-2004. However, the government's initial offer to foreign creditors (in end-2003) to accept 25 cents-worth of fresh bonds for every dollar of Argentine debt they held, on extended maturities and lower interest rates, was rejected by the creditors. They wanted at least 65 per cent repaid and complained that Argentina was not negotiating seriously.

This did become a sticking point in the negotiations with the IMF as the country came up for the second review by the Fund before it approved the second installment of the Stand-by-Agreement (SBA) loan in February 2004. But President Nestor Kirchner refused to budge from his stand that the creditors agree to write off 75 per cent of the defaulted debt. For the Argentine government, any repayment terms better than the one it offered would have meant that, over and above the primary fiscal surplus of 3 per cent of GDP targeted for 2004, it would have to squeeze its taxpayers and social welfare system even further to generate the required additional resources. That would risk plunging the economy back into recession and reigniting the political instability of 2000–02. With his priorities clearly and staunchly in favour of sustainable growth, job creation and poverty reduction, Mr. Kirchner also insisted that the country would make the payment coming due to the Fund as well, but only if it had assurances that the IMF would disburse the latest portion of the September 2003 loan package and help refinance it. But the Fund insisted that it could lend to a country in default only if it negotiated in 'good faith' with its creditors.

There was a complete stand-off in negotiations for a while, as the Argentine government stood unwavering on its debt exchange offer and ready to default on IMF loans (which was not for the first time), an unthinkable in international finance. Clearly Nestor Kirchner must have risked another stand-off with the Fund knowing that despite the hardened stand it was taking, this time around, too, the US would not want to have another 'problem' in the

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* The author is a Senior Economist with IDEAs, New Delhi. Comments and suggestions are welcome at smithsfrancis@yahoo.com

[1] See the background to Argentina's debt crisis in Ann Pettifor, Liana Cisneros and Alejandro Olmos Gaona , 2001, It Takes Two to Tango: Creditor Co-Responsibility for Argentina's Crisis, Jubilee Plus Report, available at www.jubileeresearch.com; and Dani Rodrik, 2002, 'Trade Rout'; Jayati Ghosh, 2002, 'Argentina: A Cautionary Tale from South America'; Mark Weisbrot, 2002, 'Hearing on the Economic Crisis and the Role of the IMF', etc., all available at http://www.networkideas.org/featart/featart_Argentina.htm An IMF internal staff review on the Argentine crisis also admits how miserably the Fund failed in preventing the country's slide into chaos. See IMF, 2003, Lessons from the Crisis in Argentina, Staff Report prepared by the Policy Development and Review Department, 8 October.

region and hence would persuade the other G7 members on the Fund Board to release the funds (as in September 2003 and during the 2004 January review). Which is what the Fund did eventually, and in a last minute deal Argentina signed a new agreement with the Fund on 10 March 10 2004, conceding to several of its demands over the treatment of private creditors.[2]

Subsequent IMF and creditor pressure resulted in the 'Buenos Aires proposal' on 1 June 2004. The new offer doubled interest rates and reduced the haircut from 75 per cent to between 52 and 46 per cent, depending on how many bondholders accepted the restructuring offer.[3] The bond swap was now scheduled to be launched by mid-November 2004. However, creditor groups, especially the GCAB (Global Committee of Argentine Bondholders),[4] were still not happy and the IMF continued to pressure Argentina to raise its offer. But the variety of instruments, the diversity of the investor base and the laws governing these bond contracts made it difficult to get the proposed debt restructuring scheme on track.

This has been one of the major market failures in international financial markets, which do not have any orderly debt workout mechanism in the case of sovereign lending. An orderly and predictable sovereign debt restructuring framework would allow a country in payments difficulties to promptly and 'legitimately' apply a temporary payment standstill and a stay on creditor enforcements (litigation), which would allow it to restructure its payment obligations without endangering a financial collapse.

In the case of Argentina, there are an estimated 700,000 retail and institutional holders of government bonds in default, which consist of 152 bonds issued in seven currencies under eight jurisdictions. Complicating matters further is the fact that some of the institutional holders are investment funds (also called 'vulture investors'), who typically buy up the grossly undervalued debt of countries in financial distress with the expectation of demanding repayment on original terms. Wanting more than that offered by the Argentine government, hundreds of bondholders (who in some cases are not even the original investors) initiated legal proceedings as a way to achieve a bigger settlement, a problem typically faced by sovereigns confronted with unpayable debts. Such litigation attempts and the failure of collective action by a sovereign's diverse creditors complicate and delay the process of finalising a restructuring agreement, because the unanimous action clauses

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[2] For a detailed discussion of this stand-off with the Fund, the debt exchange offer and its implications, see Smitha Francis, 2004, 'Argentina at Crossroads: A Conflict of Interests', 13 April, at http://www.networkideas.org/news/apr2004/news13_Argentina_final.htm

[3] Alan Cibils, 2004, 'Argentina and the IFIs: Better off Without them?', America's Program, Interhemispheric Resource Centre. www.cepr.org

[4] GCAB is a broad coalition of Argentine bondholders that is dominated by large holders and includes ABRA (Argentine Bond Restructuring Agency) among its members.

(UACs) in existing bonds means that the present terms of the contract cannot be changed unless all creditors agree.

One of the recurring complaints of the bondholder associations and one echoed by the IMF was that Argentina had not engaged in 'good faith' negotiations with the leading creditor groups.[5] While the Fund (led by the US Treasury) seemed to think that it could coerce the Argentine government to enter into negotiations with the creditor groups through its conditionalities,[6] the Argentine government was interested in seeking out new forms of dialogue than those with self-declared bondholder representatives. However, the government did hold some 70 meetings with a wide variety of creditors in all the markets in which the country had issued debt during the last decade. And, according to the government, several inputs from these consultations were introduced in the design of its offer.[7]

After several inordinate delays due to disruptive litigation by funds and repeated clashes with the IMF over the disbursement of funds, Argentina finally launched its debt restructuring offer officially on 14 January 2005 and the deadline was set for 25 February. The government would consider a 50 per cent level of bondholder acceptance as a success, as this would mean that at least two-thirds of the defaulted debt would be restructured. This contrasted with IMF and bondholder demands that there must be at least a 75 per cent acceptance rate for the restructuring to be considered successful.[8] The pursuit of sustainability should be the basis of any restructuring. But the Fund and other creditors put the sustainability issue aside with the argument that Argentina should restructure with a lesser haircut, which would enable it to return to the capital markets as soon as possible. It is then hardly surprising that such ideological posturing delayed the entire restructuring process more than necessary.

Argentina even included an innovative 'Most Favoured Creditor (MFC) Clause' to protect bondholders who agreed to undertake the exchange offer from being left out of any future

[5] But some analysts point out that all other recent sovereign debt restructurings have proceeded in a similar manner. The debtor hires a legal advisor and a financial advisor who do some extensive market sounding — not negotiations — to figure out which deal is acceptable to a large fraction of creditors. Once this background work is done, the country makes a unilateral take-it-or-leave-it debt exchange offer. See Nouriel Roubini, 2005. 'Argentina Debt Restructuring: It is time for creditors to …', 11 January. Available at Nouriel Roubini's Global Economics Blog.

[6] In its Second Review dated 12 March 2004, the IMF cited the unequivocal commitment of the government to negotiate by 'engaging in meaningful and constructive negotiations with all representative creditor groups'.

[7] See the Speech of the Argentine Secretary of Finance, Guillermo Nielsen, in Global Markets Research, Argentina Seminar 2005, 4 March.

[8] This itself was supposedly a compromise formula from the Fund's and creditors' perspective, as in some countries which have undertaken debt restructuring previously, such as Pakistan, Ukraine, Ecuador, and Uruguay, 99 per cent of creditors accepted the offer and there were very few holdouts.

deal or deals with better terms. This was meant to give an additional incentive to bondholders to accept the current offer by reassuring them that they would be protected in the event that Argentina gave more favourable terms to other creditors at a later date. However, even this was distorted to such an extent that it was made into an argument *against* the transaction. The GCAB issued a position paper warning investors of relying on the MFC clause, citing ambiguities with respect to the language used and practical challenges in the clause which, they argued, made it much less valuable than Argentina claimed.

On 15 February (just 10 days before the deadline for accepting the offer), the GCAB also made a memorandum from its law firm available to its members, which summarised the arbitral remedy that was available to them if they decided to opt out of the offer. This pointed out that under the various Bilateral Investment Treaties (BITs) signed by Argentina, the former has agreed to submit investment disputes against 'expropriation', 'nationalisation' or 'measures tantamount to expropriation' to the International Centre for the Settlement of Investment Disputes (ICSID). And unlike in civil court judgments, under an ICSID award (which is final and non-appealable), compensations may be enforced against sovereign property used for commercial activity *without* showing that the property relates to the claim at issue.[9] With the government claiming that there are hardly any attachable assets left in the post-privatisation scenario, it is not clear how creditors refusing to participate in the restructuring (or 'holdouts') hope to be repaid. But the fact remains that all these tactics, whose validity is questionable, were extensively used by bondholder associations and representatives to create as many roadblocks as possible in the restructuring process.

But in the end, despite their lawsuits, threats of asset seizures and collective rejection of the Argentine ultimatum, the debt deal was accepted by bondholders for the simple reason that they realised that Argentina could not and would not offer anything better and eventually acted 'rationally' in the absence of IMF's interference.

Most institutional investors, hedge funds and other savvy investors (over 90 per cent of them apparently) as well as almost all Argentine domestic investors (99 per cent of them) accepted the deal. The Argentine Bond Restructuring Agency (ABRA), which represents retail investors in Germany and Austria, accepted the deal at the last minute. And a significant number of other retail investors, tired of the long-drawn out 'negotiations', are believed to have sold out to more sophisticated players who hope to take quick profits once Argentina is readmitted into the emerging market bond index. The main resistance had come from the Italian retail investors, but even this group eventually gave up and sold their claims to hedge funds and other investors in huge numbers, which then accepted the deal.

[9] This should be read against the backdrop of some earlier attempts by litigating investors to attach Argentine property in the US, which was declared illegal because of the Foreign Sovereign Immunities Act. See Francis 2004, op. cit.

The investors are now believed to have behaved 'rationally' upon realising that holding out would be a losing strategy.[10] The creditors discovered that without the Fund's 'support', they had far less leverage than they had thought.

The government has eventually maintained a write-down of between 50 per cent and 60 per cent on the defaulted debt, such that the total value of the new bonds is $41.8 billion. Thus, investors are recovering only about 32 to 34 cents on their original dollar (with quite varying face-value haircut depending on whether they get 'par' or 'discount' bonds). The deal will enable Argentina to successfully restructure about $82 billion in bonds, plus $21 billion or so in past due interest (PDI) since the default. The amount involved far exceeds that in previous large bond restructurings, such as those of Ecuador ($6.5 billion), Uruguay ($4 billion) and Russia ($30 billion).[11]

What is significant is the fact that this 76 per cent acceptance rate was achieved by Argentina without improving the overall value of its initial offer by more than 7-9 cents on the dollar, which is still only about half the 70-cents-on-the dollar payout that other Latin American countries have offered in the past. Thus, in addition to the fact that the proportion of debt that Argentina has successfully written off already set a new standard, the present restructuring is significant for this historically low recovery value for private creditors. Further, Argentina has also achieved a lengthening of maturity along with a reduction in principal and a reduction in interest payments, all at the same time. In general, creditors have agreed for only any one of the three in the past. The interest burden is also lower, with a coupon of 2–5 per cent in the first 10 years compared with 10 per cent in Brazil.[12] Further, Argentina has offered a 42-year bond, whereas Latin American bonds are usually of a 30-year maturity. Thus, on all these counts, Argentina's restructuring has made history.

Argentina's success with this historic public debt restructuring has clearly proved the extent of leverage that sovereign debtors can legitimately have in their dealings with bondholders without IMF interference in the negotiations and the ensuing biased support for the creditor community. Even though it did succeed in putting pressure on the country each time the Fund undertook a country review, as the IMF has been concerned solely with ensuring that

[10] See Nouriel Roubini, 2005, 'The Successful End of the Argentine Debt Restructuring Saga' 2 March, at www.roubiniglobal.com and *The Economist*, 2005. 'Screeching to the Precipice', 28 February. Some of the vulture funds in fact could have made a profit as well. Funds that had purchased a distressed Argentine bond in the secondary market for 20 cents on the dollar or less in early 2002 (soon after the default) would have fetched a handsome return by swapping it for new peso-denominated paper worth 35 to 37 cents on 25 February 2005. See, for instance, *The Economist*, 2005, 'A Victory by Default', 4 March.

[11] See Brad Setser, 2005, 'Has Argentina changed the rules of the sovereign debt game?', 26 February. Available at the Brad Setser's Weblog.

[12] See *The Economist*, 2005, 'A Victory by Default' 4 March.

Argentina continue to service its debts, and the US (through the Fund) did not put its weight behind the creditors this time around due to its engagements elsewhere and its realisation of the crucial importance of letting Argentina move forward, the Fund took a more hands-off approach in the Argentine debt negotiations, which proved crucially advantageous for the country.

3. The Question of Argentina's Debt Sustainability and the 'Problem' of Official Loans

However, the most ironic and tragic part of the present restructuring is that even with the current debt swap, the write-down has not been sufficient to ensure overall debt sustainability for the country. This is despite the heavy price (in terms of lost output, employment and destruction of asset values) that Argentina had to pay in advance of such a protracted debt renegotiation process, due to the imperfections in the international sovereign lending markets and the prevailing 'ad-hoc debt workout mechanisms'.

The Argentine government made all efforts to ensure equality between its private creditors by not discriminating by bond type, features or bondholder nationality. It also resisted any attempt to ensure preferential treatment among the various bondholders. But, despite its unprecedented success, the Argentine government could not base its restructuring proposals on ensuring minimal debt overhang, because it is hostage to the 'preferred creditor' status of the official bilateral and multilateral creditors.

Apart from the external public debt owed to private creditors that was involved in the current restructuring deal, the country also has a domestic public debt and external debt owed to multilateral bodies and official bilateral creditors. The 152 types of bonds eligible for restructuring accounted for only about 55 per cent of its total debt (as of last year). All bonds issued after the cut-off date of 31 December 2001 were excluded from eligible debt by definition. Further, the government's stand was that investors in BODENs[13] and provincial guaranteed bonds had already incurred substantial loss on their original assets from the first phase of the debt restructuring (involving banking sector restructuring and guaranteed loans) and thus were excluded from the current restructuring. On the other hand, in the case of the debt owed to multilateral financial institutions (IFIs), it is acknowledged that the 'preferred creditor' status they enjoy is the direct outcome of the 'consensus' in the international financial community. Convention requires that the scope and type of treatment that the government would seek from official bilateral creditors also be treated separately.

The outcome of giving preferential treatment to official creditors is that even after the current restructuring, Argentina is left with a dangerously unsustainable debt level. Even

[13] These are issuances resulting from the collapse of convertibility in December 2001.

though a majority of defaulted creditors have taken the Argentine government's offer, total debt is estimated to shrink to only about $130 billion, and the debt-to-GDP ratio will drop from the current high of 150 per cent to only as much as 90 per cent. Even for the European Union, the debt-to-GDP ratio is set at a maximum of 60 per cent as per the Maastricht Treaty. This, in fact, is the gloomiest aspect of the present restructuring.[14]

The country owes $15 billion to the IMF and another $15 billion to other multilateral institutions (including the World Bank). Thus there are extremely heavy debt service payments due in the next five years, which will continue to put tremendous pressure on Argentina's ability to raise money. Servicing that debt will require that Argentina sustain a primary surplus — revenues in excess of non-interest expenditures — of around 4 per cent of GDP.

The controversy over the treatment of official debt is not new. Typically, comparison is made between the Fund's status as a 'senior' or 'preferred creditor' in sovereign lending with senior claims under the US corporate Chapter 11 bankruptcy, where, if a creditor provides new money at the time of crisis (debtor-in-possession or DIP financing), its claims are considered senior. It is argued that since the IMF is the DIP financer in sovereign crises and lends 'at risk-free rates' which helps resolve the crisis, IMF loans should remain senior. Or else, the argument goes, the Fund would also have to lend at high market rates as private creditors do, in which case IMF's lending would only exacerbate a crisis.[15]

Surely, a fair debt workout mechanism should have seniority treatment of *new* claims written into it (as in corporate bankruptcy laws). This would ensure that lenders would have an incentive to provide the much needed new financing during and after a restructuring process if they are assured that they will be repaid in advance of existing claims. It needs to be highlighted that the seniority applies only after the restructuring deal has been completed, and not when an agreement is being worked out. However, the case for giving preferential/seniority treatment to the Fund for lending at lower rates does not stand reason on various counts:

1. First of all, the two cases are fundamentally different. While profit-making is the sole objective of a corporate firm, a sovereign's core concern is development. So, clearly it

[14] In fact, an August 2003 NBER working paper by Carmen M. Reinhart, Kenneth Rogoff and Miguel A. Savastano (all with the IMF at the time) finds that serial defaulters may struggle to 'tolerate' debt levels that other economies manage quite comfortably. Such countries' credit rating begins to suffer even at relatively low levels of debt. The authors estimate Argentina's safe threshold of external debt at just 15 per cent of GDP. The latter is currently at 50 per cent of GDP. See National Bureau of Economic Research (NBER) Working Paper 9908, Debt Intolerance.

[15] See, for instance, Nouriel Roubini, 2005, 'The Successful End of the Argentine Debt restructuring Saga', 2 March, www.roubiniglobal.com

is unfair to use the same criteria for treating seniority claims in the case of sovereigns and corporate entities.

2. Even technically, in the present sovereign debt restructurings, seniority treatment is currently being provided not just for new IMF loans, but for existing IMF loans as well.
3. While corporate bankruptcy proceedings allow a general stay on payments and on creditor litigation during a restructuring process, currently, there is no stay on creditor enforcement in the case of sovereign debt crisis. The IMF demands continued payment obligations from the country on its existing loans, even as the stretched out negotiations take place in a chaotic fashion, eroding the economy's asset values in the process.
4. Further, in cases such as Argentina's, it is not clear to what extent the Fund takes care of the need for cheaper-than-markets liquidity in crisis situations. Clearly, the maturity of the loan also affects the degree of concessionality. Given that the average life of loans from the IFIs to Argentina is just 2.8 years compared to 6.2 years for public bonds, it is clear that servicing IFI loans continues to put short-term liquidity pressure on the country.
5. Also, given that countries undertaking a restructuring are forced to service existing IFI loans, there is hardly any net benefit to the country from new funding from the IMF during an ongoing restructuring, as this generally goes into repaying the old loans.
6. Further, the rolling over of IFI loans also undermines medium-term debt sustainability as it just adds to the government's gross debt in later years.

Granting 'preferred creditor' status to official loans thus leads to a situation where government revenues are diverted from the more pressing needs for public expenditure for a country in crisis. Further, debtor countries typically have had to adhere to IMF conditionalities related to fiscal constriction in order to meet official debt repayments. It has been observed that these deflationary policies inevitably exacerbate the socio–economic conditions of countries in crisis. To top it all, the country in question continues to remain enslaved to the deadlines and programmes of the Fund, with the international financial community building up a scenario of apocalypse as each deadline approaches.[16]

Coming to the possibility of debt reduction from bilateral creditors (Paris Club), countries like Egypt, Poland and ex-Yugoslavia have obtained deep debt reduction. However, this has been on a purely ad hoc basis, perhaps driven more by geo–political concerns than concerns of debt sustainability. For the first time, in its new 'Evian Framework', Paris Club has officially named debt reduction as an option for middle-income countries with unsustainable debt. However, the weakest point is that the new Framework also does not guarantee debt reduction for all eligible cases, and it will remain ad-hoc and exceptional, as

[16] This is why this author argued after the stand-off between the Argentine government and the IMF last year, that the only lasting solution to the continuous occurrences of these 'impending-doom' scenarios and a solution to Argentina's solvency problem is for the Fund and other multilateral and bilateral lenders to also accept a proportionate 'hair-cut' in the debt owed to them.

it is today.[17] Thus, while Argentina can request rescheduling from the Paris Club under the new 'Evian Framework', its scope for obtaining debt reduction will still remain dependent upon its creditor nations' geo–political concerns.

Therefore, the large public debt (90 per cent of GDP) which remains even after the restructuring, leaves Argentina on the verge of another impending crisis. Argentina's top priority is expected to be a resumption of loan talks with the IMF, which were suspended last August. But the Fund is expected to demand the following in return for refinancing: a) that Argentina should thrash out an agreement with the holdouts (creditors who rejected the debt offer); and b) that it should resolve the three-year old deadlock with the mainly foreign-owned utility companies.[18]

In earlier debt restructuring cases, it has been observed that agreements were often reached with holdouts because the volume of defaulted debt that they held was only marginal and thus could be restructured to protect the 'credibility' of the sovereign. However, in the case of Argentina, holdouts would never be 'insignificant' enough in terms of volume so as to make it preferable to satisfy the claim.[19] Further, the government believes that having spent three years in default, and having made sustainability the centre stage in the restructuring, its 'credibility' would consist precisely in not yielding to the holdouts. The debt that is not swapped might thus remain indefinitely in default.

The demands of the utility companies are also unreasonable. Certain water companies like 'Aguas' have asked the authorities for a 60 per cent hike in utility rate and additional assistance for paying off its debts and funding water-supply improvements.[20] The government, however, has rejected a sharp rise and is considering only a 16 per cent increase in tariff.[21] The energy companies are in a similar bind. The Argentine government is also under pressure from European Union countries to raise utilities tariffs, because most of the utilities operating in Argentina are European.[22] It is again 'predicted' by some analysts that failure to reach an agreement with the privatised utility companies could jeopardise the suspended loan agreement with the IMF and also discourage foreign investors. Some others have suggested that October's mid-term elections might mean

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[17] Further, the link to IMF conditionality also remains in the Evian Framework.

[18] In end-2001, all the utility companies had their tariffs converted into devalued pesos and then frozen.

[19] With an assumed 80 per cent participation rate, holdouts were estimated to include more international sovereign bonds ($16 billion face value and over $20 billion including past due interest) than had been restructured prior to Argentina. See Setser 2005.

[20] Aguas Argentinas, controlled by the French group, Suez, serves the Buenos Aires province.

[21] See *BBC*, 2005 'What Next for Argentina?', 2 March , and 'Water Firm Suez in Argentina Row', 24 January.

[22] Further, the utility companies have lodged claims with the World Bank's arbitration body, the International Centre for Settlement of Investment Disputes (ICSID). They are demanding more than $15 bn in compensation. With rulings due shortly, this is expected to add greater urgency to talks.

further delays in reaching an agreement with the utilities and complicate things further. But, Argentina might yet again prove its doomsayers wrong. It is likely that some sort of compromise agreement will be reached between the government and the companies.

If Argentina does not manage to reach some sort of refinancing arrangement with the IMF, most of the country's $15 billion debt with the Fund will have to be paid off in 2005–2007. Thus, the American government's stance will become crucial once again in the months ahead. Argentina might yet again prove lucky in obtaining refinancing from the Fund due to the fact that the US might be disposed to adopt a reconciliatory stand with its Latin American neighbour.

However, as we have seen, this will (still) not get rid of the problem of medium-term debt sustainability. And it has been adequately clear from earlier sovereign debt restructuring exercises that a debt restructuring that does not involve a significant reduction in present value, in addition to medium-term liquidity relief, will not lead to a sustainable solution. Therefore, lending new money or capitalising interest arrears while refusing to acknowledge sovereign insolvency and granting adequate debt relief involving the official creditors, only helps postpone the inevitable slide into an unsustainable payment situation at yet another level of debt. Failure by the official creditors to follow the principles of burden sharing under a debt write-down scheme can therefore undermine Argentina's success in the present commercial debt restructuring.

This is most crucial given that the country in question is not in a static position, and future borrowing requirements may arise which will add to the existing debt servicing obligations. While it can be argued that higher economic growth than that is applied in the present debt sustainability simulation exercises can take care of any new commitments, this is only hypothetical. Argentina's high GDP growth of 8.8 per cent in both 2003 and 2004 owes a lot to high soya bean prices and the use of capacity left idle by the economic collapse in 2001–02. Commodity prices have already declined from their peaks and capacity constraints are likely to be felt again this year, so fresh capital will be needed.[23] Further, the country still has to deal with potential internal and external shocks which can easily drain out its foreign exchange reserves and affect its debt servicing capability. Thus it is essential and logical that the country be left at a sustainable debt level at the conclusion of the current restructuring deal, which has not happened.

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[23] Argentina, like other Latin American countries, is enjoying good times, as the prices of primary products and raw materials are rising. In particular, Argentina is benefiting a great deal from the tremendous increase in soya demand from China, a third of whose soya needs are met by Argentina. But with soya farming already occupying some 50 per cent of the arable land in the country, concerns are already being voiced about the implications of this mono-culture. See *BBC*, 2005, 'China's Soya Needs Lifts Argentina', 8 March ; and *The Economist*, 2005, 'Screeching to the Precipice', 28 February.

This is even more crucial given that there is hardly any change in the macro-economic conditions (capacity building for income generation) that are addressed by the IMF, with its associated implications for debt sustainability and development expenditures.

4. IMF's Macroeconomics and Issues in Development Financing

First of all, while there is acknowledgement of the increased instability in the international financial markets, developing countries are still advised by the IMF to remain open and expand liberal commitments in the financial sector. At the same time, in a rather hazy admission of the likelihood of future financial crisis, the Fund's concern now is on changing around the fiscal structures in developing countries to ensure that the generation of primary surpluses necessary for continuous debt repayments can be 'worked out' smoothly and quickly in the immediate aftermath of a crisis. These are the observations that can be made from the conclusions of the most recent IMF study of macroeconomic policies in Latin America in the 1990s.[24]

Banking and financial crises in emerging market economies in the 1990s have been observed to have been caused by mostly externally-induced shocks to export dependent real sectors, and unregulated and often highly externally exposed financial sectors. The empirical evidence drawn by the above IMF study also shows that financial 'reforms' have led many Latin American developing country banks to exhibit a tendency towards replacing non-performing loans with sizeable portfolios of high-yielding relatively safer government bonds, in response to a tightening of supervisory standards and experience with high default rates on lending to households and corporations. As a result, the ratio of bank lending to economic activity remains low in many of these economies and interest spreads on private lending remains high,[25] depressing productive investments. Rather than reversing the deflationary macroeconomic policies that are reducing private sector demand for loans, the policy solutions offered by the IMF staff are to increasingly replace the role of bank by more vigorous development of capital markets. Such measures would tend to exacerbate the observed imbalances (internally and externally) and lead to even more increased vulnerability of these financial systems to external shocks, particularly in the absence of prudential regulations and capital controls, which are discouraged as deterrents for international investors. Simultaneously, these countries are being advised to reduce taxes on financial intermediation across both the sectors (banking and capital market). While in the case of securities markets, taxes like 'Tobin tax' help reduce capital market

[24] See Anoop Singh et al., 2005. Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience since the Early 1990s, IMF Occasional Paper, February.

[25] Note that financial liberalization was supposed to bring about efficient banking and reduce the cost of borrowing for the private sector. On the contrary, according to the observations in the IMF study itself, in several Latin American countries, banking restructuring that occurred during the 1990s led to rising foreign ownership (foreign banks owned more than half of banking-system assets by 2000) and increased concentration, which have resulted in excessively high prices or quantity rationing for customers. See IMF, 2005, opcit., pp 66-67.

volatilities, in banking sector these may deter financial deepening. While such suggestions may provide short term solace in certain contexts, they do not provide any long term solutions to financial market failures.

On the fiscal policy front, the paper points to “inflexibilities in government spending” as a major obstacle to imposing fiscal discipline and as impairing allocative efficiency. It lists out the following items as “government spending rigidities”:

1. Measures to earmark revenue to specific expenditures, particularly for social purposes such as health, social security and the Poverty Fund; and constitutional or legislative mandates that set floors on certain types of social spending;
2. Automatic adjustments of expenditure items to movements in other macro-economic variables (e.g., linking social and pension benefits to the minimum wage);
3. Inflexible labour legislation and powerful unions that constrain the public sector’s ability to adjust personnel costs (one of the largest components of fiscal outlays); and
4. Mandatory revenue transfers to sub-national governments.

The authors’ argue that such ‘non-discretionary’ public spending measures undermined the Latin American countries’ ability to adapt to changing macro-economic circumstances. Local autonomy is stated to have been particularly strong in Argentina, where provinces received automatic shares of tax revenues and the federal government was constitutionally prohibited from infringing upon provincial autonomy.

It is now widely acknowledged that the Fund itself was a major contributor to the circumstances and policies that led to the Argentine crisis and the default, and that its conditionalities for rescue packages during the crisis led to severe fiscal constriction that caused further economic and social damage. While insisting that the government pay off its debt to the IFIs, the IMF had demanded measures that would deeply cut government revenue. With the government committed to reducing export tax and financial transactions tax under the IMF conditions, the sources of government revenue have been only the standard income tax, VAT and some non-tax revenues. Ironically, during this fiscal constriction, it is precisely what the Fund calls ‘fiscal rigidities’ which enabled the Argentine government to support and maintain some minimal support for its social sector in the midst of the serious recession that gripped the economy in the crisis period.

Partially, Argentina has been able to keep social programmes running over the last three years by reallocating large loans from the World Bank that enabled education, health and anti-poverty systems to avoid fiscal collapse.[26] However, as Soederberg and Taylor (2004)

[26] In the health sector, the crisis placed a huge fiscal burden on public provision. On the one hand, the growth in poverty and unemployment and the fall in real wages reduced the contributions of workers to their public health funds. At the same time, the number of people using the public system grew owing to their inability to afford private care. On the other hand, the transfer of public resources came under significant pressure,

have rightly pointed out, the major drawback of this form of maintaining social services is the creation of substantial amounts of new public debt, with significant implications for the sustainability of such arrangement.[27]

It is most distressing therefore, to note that while constitutional earmarking of public spending and the setting up of minimum floors are two of the most important ways of ensuring the continuity of pro-poor policies and, in particular, enable counter-cyclical support during downturns, the IMF is advocating the removal of such measures through the fiscal reforms being propagated. With 50 per cent of the federal government expenditure distributed roughly equally between social security and transfers to provinces, any reduction in the latter will mean a drastic reduction in pension, health, education and other components of the Argentine social welfare system.

These advocacies from the roof-top economists also contradict the present understanding on the decentralisation processes to be carried out for equitable economic development. It seems that the Fund will never find the ability to address the conflicts of interests between the developmental credit needs of a sovereign and the speculative interests of financial market players in emerging markets. There is then all the more reason for developing country borrowers like Argentina to take the ownership of their policies and development process back into their own hands.

5. Response to Debt Crisis- Increase in Emerging Market Moral Hazard or 'Rational' Policy Choices by Developing Countries?

In this context, it is also important to address some of the responses of financial analysts and mainstream economists following Argentina's deal with its private creditors. One of the main arguments by financial market players and analysts opposing Argentina's large debt write-down was that such precedents will increase the risk involved in lending to emerging markets (since there is an increased probability of similar defaults by other sovereigns) and would push up interest rates on emerging market debt.[28] The same doomsday predictions were made for emerging market borrowing prospects at the end of 2001, when Argentina's default had become imminent. But, as *The Economist* rightly points out, emerging market lending as an asset class has been as lively as ever and the prophets of doom that predicted massive serial default and the drying up of emerging

including late payments and the deterioration of their real value owing to high levels of inflation during the crisis.

[27] See Susan Soederberg and Marcus Taylor, 2004, The New Latin American Debt Crisis and Its Implications for Managing Financial and Social Risk. FOCAL Policy Paper, March.

[28] See *The Financial Times*, 2005, 7 March.

market lending if a few countries default, have been proven totally wrong.[29] In spite of Argentina's default in 2001, emerging market returns have been high in the last four years.

One explanation for this as put forth by some analysts is that the whole process of a historic default and debt restructuring has been so costly and painful for Argentina that other countries facing unpayable debt burdens will rarely hope to imitate it in future. The extent of economic and social disruption that Argentina had to go through during the crisis was the most severe, with output falling by over 25 per cent. After two years of high growth, Argentina's real GDP is still below the 1999 level.

Further, economists like Roubini and Setser argue that if the markets indeed perceived the successful winding up of Argentina's debt restructuring to have increased the risk of other sovereign defaults and subsequent large debt write-downs, then such a perception would have led to a rise in the emerging market (EM) spreads and a reduction in the value of emerging market bonds. However, at just 3.35 per cent, the premium over American Treasuries of J.P. Morgan's index of EM bonds (the EMBI Global) is at a 10-year low.[30] In fact, the value of almost all EM bonds has gone up over the past two years. This implies that Argentina's current deal and debt write-down have not affected the overall emerging market debt situations.

Clearly, Argentina's default and its debt swap have made international finance come a long way — from a time when sovereign debt defaults and restructuring were considered 'taboo', to the present times when *The Financial Times* and *The Economist* candidly write about how debt and default are two sides of the same coin like risk and return, or how defaulting is natural for a sovereign.[31] It then appears that since this was an event which the financial markets kept trying to avoid by playing prophets of apocalypse, when it did happen, the next best thing seems to be to pretend that nothing that seriously warrants one's attention has actually happened as this was the most natural turn of events and was expected to happen anyway.

Such a perception by financial markets of the successful restructuring of Argentina's defaulted external debt as an isolated and resolved event could partly explain the prevailing disconnect between default risk and bond spreads- or the inability of bond markets to price in the default premium into individual country's bonds. The Philippines offers an excellent example of this. While public debt-GDP ratio has been above 125 per cent for the country since the last five years, public sector debt service payments has increased from 46 per cent

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[29] According to the Institute of International Finance (IIF), net private capital flows to emerging market economies registered a sharp increase in 2003 from just $124 billion in 2002 to $211 billion, and accelerated again (by 32 per cent) in 2004 to reach a seven-year high of $279 billion.

[30] See *The Economist*, 2005, 'A Victory by Default', 4 March.

[31] See *The Economist*, op cit. and Martin Wolf, 2005, 'Argentina's debt leaves it holding a weak hand', *The Financial Times*, 9 March.

of total national government expenditure in 2002 to 68 per cent in 2004. Thus, it is painfully obvious that Philippine debt servicing is unsustainable. But, inexplicably, investors are disregarding the obvious, pushing down Philippine international bond spreads to ridiculously low levels.[32]

Related to the above-discussed argument on increased emerging market moral hazard, there has been another argument made by financial markets and others in opposing sovereign defaults. This has been that a sovereign in default will find it impossible to obtain re-financing or new financing in the international markets at preferential rates. But, this again does not have empirical support. Specifically, the fact that there have been serial defaulters among sovereign borrowers has been a direct outcome of the new financing extended to them by lenders - private and official alike- and the subsequent build-up of unsustainable debt situations yet again.

In the present instance, J.P. Morgan has already announced that Argentina's weight in the EMBI Global will rise from 1.9 per cent to about 2.7 per cent once the debt swap is declared a success. The index weights countries according to how much debt they have issued. Thus, any fund manager tracking the index must, in effect, lend more to the countries borrowing the most.[33] It is therefore expected that the price of Argentine bonds will go up by 20 per cent, since the reintroduction of Argentina in the EMBI index will give a technical boost to the demand for its bonds. The rating agency Standard & Poor has said that it would give Argentina a B-minus debt rating after the restructuring, a status that Ecuador did not attain for five years after its default.[34] It is pointed out that even if foreign investors will probably not want to lend to the Argentine government directly for a while after taking such a heavy 'loss', the country's new credit rating will increase access to capital for its 'best-behaved companies'.

What all these analysts seem to be missing is the fact that the willingness of emerging market investors to lend and the spreads on emerging market bonds are likely to be determined more crucially by other factors such as the real interest rates in developed country markets and the extent of liquidity in the international financial market. Further, the question of emerging market moral hazard does not appear to be of much relevance, with developing country borrowers attempting to deal with the now widely accepted and acknowledged threat of financial crisis in a completely different fashion.

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[32] The president of an emerging market investment risk analysis consultancy has predicted the Philippines' slide into an inevitable default. See Jephraim P. Gundzik, 2005, 'Philippines follows Argentina's debt path', *Asia Times*, 2 March.

[33] In the heady days before the default, Argentina accounted for 23.3 per cent of the index on average. See *The Economist*, op cit. Also note that this is a telltale example of the 'logic' of emerging market lending — this manner of giving weight to countries in the Index and then allocating funds according to these weights will inevitably lead to over-lending by investors in particular emerging markets.

[34] See *The Economist*, 2005, 'Screeching to the Precipice', 28 February.

Developing countries have been under pressure from the neo-liberal agenda which imposes liberalised financial markets and open capital markets on them as essential for economic growth, despite no such proven direction of causality and despite the growing acknowledgement even in official institutions about the inherent instability in growing financial integration for developing countries. At the same time, under the same compulsions, except for a handful, emerging markets have been unable to introduce strategic capital controls required to regulate the huge amounts of speculative capital flows,[35] which flow in especially due to the low interest rates that have been prevailing in the developed country markets. Faced with such a scenario, the 'rational' response of many emerging country governments has been to hoard large amounts of foreign exchange reserves and to squeeze out and maintain large primary surpluses, as the most important indicators of their willingness and ability to repay their external debt.

Apart from the fact that no amount of foreign exchange reserves may prove sufficient to support a concerted speculative attack on an emerging market currency as the East Asian crises of the late 1990s showed, the thrusts towards accumulating both primary surpluses and foreign exchange reserves are severely problematic. The pressure to accumulate primary surplus is not just squeezing out public expenditures on capital formation and social expenditure, but is also creating recessionary tendencies in most economies, which will further exacerbate the socio-economic situation by reducing output and employment and putting more pressure on government revenues. The tendency to hoard up large foreign exchange reserves as a defence mechanism against speculative attacks and external shocks while remaining open to huge inflows of private foreign capital inflows and carrying out inflation targeting, is also leading to deflationary tendencies and imbalances in the world economy, which many heterodox economists have been warning against.[36]

At the same time, the existence of a dominant few emerging market countries with surplus current accounts in rotation (different countries at different points of time) is a part of the explanation for the low interest spreads on emerging market bonds. Together with these large foreign exchange reserves, the high savings rate in developed country markets like Japan and Germany is contributing to a global surplus of liquidity and in turn, the low long-term interest rates worldwide. Meanwhile, the recessionary tendencies which the current set of deflationary fiscal and monetary policies tend to feed leads to a drop in corporate demand for financing and other investment opportunities domestically and pushes investors

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[35] This is despite widespread acknowledgment by even strong proponents of capital account liberalization that many countries that avoided the worst effects of the 1990s' financial crises were those that used various kinds of capital management techniques, including China, India, Malaysia and Chile. See for details, Gerald Epstein, Ilene Grabel and Jomo, K.S., Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990's and Lessons For the Future, available at http://www.networkideas.org/featart/apr2003/Management_Techniques.pdf

[36] See, for instance, the analyses by several authors in Ann Pettifor (ed.), 2003, *Real World Economic Outlook: Debt and Deflation*, Palgrave Macmillan.

towards international sources, which then contributes to high bond prices. Thus, the prevailing regime will encourage substantial build-up of external debt by emerging market governments to their own detriment.

In fact, the flow of investment to emerging markets is mostly going to government spending in those countries. While this is a reflection of the appetite of emerging market investors for relatively risk-free investments for their money compared to corporate investments as well as the lack of demand from the corporate sector in deflationary environments, the mainstream interpretation is that the former is due to the lack of adequate development of developing countries' equity and financial markets. The obvious policy prescription to developing countries is to open up their financial markets further,[37] with the advantages to investors from the developed financial markets amply evident. Indeed, the most explicit comment on this issue was recently made by a US Federal Reserve governor, who pointed out that pro-growth US policy will need to look at "helping developing and emerging country markets to improve their investment climates, strengthen domestic financial institutions, so that they become international borrowers to finance domestic growth, rather than shipping capital to the US".[38]

That is, from different directions, neo-liberal policies are compelling governments to accumulate more risky external debt to undertake their public expenditure commitments, by forcing them to forgo less risky options in domestic borrowing. The whole process is a recipe for the entrapment of the developing countries into an already unviable global financial system. And eventually, if the US Federal Reserve raises its interest rate substantially and sharply to deal with emerging domestic inflationary trends or falling dollar, there will be an outflow of funds from the emerging markets,[39] once again testing the strength of their foreign exchange reserves and potentially pulling them further into external debt at yet higher levels.

6. Conclusion

It is clear that under the prevailing regime, the hope offered by the success of Argentina's recent debt swap may not be long-lasting either for Argentina or for other sovereign borrowers. The manner in which Argentina quite successfully assumed rightful ownership of the issues related to its debt restructuring may appear to imply that other developing countries who will end up in debt distress situations will also find it possible to achieve such large debt write-downs from its private lenders. But Argentina's success in writing off past-due-interest and getting such a large cut on the principal amount on longer maturity

[37] Pension reforms are being promoted as central to those meant for encouraging capital market development and to increase private sector's use of bond and equity markets.

[38] See *The Financial Times,* 2005, 'Fed Governor Takes on Global Savings Glut', 11 March.

[39] The IMF and the financial markets then tend to call them "market corrections". See the IMF Managing Director's latest statement on global capital markets available at http://www.imf.org/external/np/speeches/2005/040105.htm

periods is hardly because market rules prevailed, as argued by proponents of the existing 'ad hoc debt workout mechanisms'. While it is certainly true that Argentina successfully utilised its sovereign capacity to bargain, the significance of the geopolitical interests of the IMF and its G-7 creditors that rule the game and decide the fate in individual sovereign debt restructuring cases at different points of time, cannot be overlooked.

The only way to break this 'ad hocism' in sovereign debt restructuring processes is to get the discussions on an international insolvency procedure for the 'prompt' and 'orderly' resolution of sovereign debt crises back on track. The previous attempt to formulate such a system (amidst talks of a reform of the international financial architecture following the series of emerging market crises in the 1990s) — the IMF's Sovereign Debt Restructuring Mechanism (SDRM) –– had to be abandoned partly because of the opposition of private creditors who objected vehemently to the pivotal role that was attributed to IMF under an evolving framework,[40] and partly due to the opposition of developing countries who found it untenable on the following grounds: it was as biased in favour of the creditor community as the present 'ad hoc' proceedings because of the attempt to put sovereign insolvency on an equal footing with corporate bankruptcy; there was no agreement on the need to apply payment standstills and stay disruptive creditor litigations; and also, the need for an independent authority performing a centralisation function similar to that of a judge in corporate bankruptcy proceedings could not be resolved with IMF granting itself the authority, when it is more than clear that it just cannot be in that role.

Some analysts argue that Argentina's success in concluding a debt deal with its private creditors under the prevailing regime implies that the present 'ad hoc' way of going about negotiations is efficient enough to deal with future sovereign debt crisis. The lessons from Argentina's long drawn-out crisis, its default, the economic and social collapse that followed, and finally, the still unsustainable level of its public debt after a restructuring of its commercial debt, are just the opposite. As has been shown, Argentina's state of affairs once again buttresses the need for a system of arbitration that will balance the debtor's and creditors' interests fairly. One of the recent advances in the direction of a more fair system of sovereign debt workout mechanism are the ongoing attempts at the UN Financing for Development Office to address the related issues.[41] Eventually, the way to avoid a lengthy and uncertain negotiation process involving the private sector alone which inevitably

[40] This is why some analysts found it ironic when private creditors, who argued during the discussions on the SDRM that the IMF should stay out of sovereign debt restructurings, were desperate to get the IMF to weigh in on their side over the weeks leading up to the deadline on Argentine debt swap. However, the truth is far from this. It could be that, powerful private creditor institutions opposed the SDRM precisely because they were desperate to keep the IMF on their side exclusively — as has typically happened in the past — but wanted it just as it is exercised now by the Fund and the creditors, and not through any statutory bureaucratic procedure which would surely bring in more institutionalised ways of dealing with the negotiations.

[41] See UN Financing for Development Office, 2004, Strategic Issues in Managing Sovereign Debt for Sustained Development: An Issues Paper for the Multi-Stakeholder Dialogue on Debt, UN Department of Economic and Social Affairs, for a discussion of the wide-ranging issues that need to be considered in this context.

reduces their incentive for an early settlement is a proper mechanism for sharing the burden of dealing with sovereign bankruptcies more equally between all the stakeholders.

One of the arguments against putting in place an orderly sovereign debt workout mechanism has been that the sheer disorderliness and economic pain of a default currently ensures that governments do not resort to it lightly. It seems that financial markets need to be educated on the fact that even if a more orderly system of payments standstill and debt restructuring mechanism may lead to a greater number of defaults than currently occurs, such systems will also reduce the damage done to the debtor country's asset values and this, in turn, will raise the repayment rate for creditors. So, the rationality of creditors should in fact support such an orderly system for sovereign defaults. In the meantime, it would be wiser for sovereign borrowers to reduce the possibilities for the emergence of unsustainable debt situations in externally-driven growth strategies, particularly given the contradictions emerging under the prevailing regime.

4 April, 2005