ARGENTINA'S SOVEREIGN DEBT DEFAULT AND THE IMF

Global Financial Governance in a Tailspin

Jwala Rambarran*

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"We suffer pressures, a lack of understanding, unclear answers and delays from the international organizations, which seem not to understand the need for growth in order to resolve the debt problem in an efficient way. In our latest Agreement with the IMF, we agreed on conditions with which we are doing our utmost to comply, yet we are constantly faced with new requests and demands that seem not to want to take note of our country's extreme situation." Argentine President Nestor Kircher at the close of the Special Summit of the Americas, January 13, 2004.

1. Introduction

Argentina plummeted from star performer of emerging market finance to the bottom of an abyss when an unfortunate conjuncture of factors triggered its sovereign debt default and disorderly exit from the decade-long currency board arrangement in late 2001/early 2002. The country was subject to a vicious cycle of falling confidence, capital flight, large depreciation of the peso, which previously had been rigidly linked to the U.S. dollar through the Convertibility Plan, the threat of hyperinflation, collapsing output, social turmoil, and political turbulence (Figure 1).

These disastrous events raised serious questions concerning Argentina's relationship with the IMF because the country had a succession of Fund-supported programs (some of which were precautionary) through much of the 1990s. Indeed, the Fund had organized in December 2000 a large international financial support package to assist Argentina, and continued to extend substantial additional support, especially in the summer of 2001 when it became evident that heterodox efforts to avoid sovereign default and simultaneous collapse of the Convertibility Plan and the financial system had little reasonable chance of success.

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* The author is Chief Economist of Caribbean Money Market Brokers (CMMB). The views expressed are those of the author and not necessarily those of CMMB.

Once the Argentine crisis was fully evolved, however, the Fund reversed its earlier lenient stance, but the international community was prepared to give the government the benefit of the doubt in developing an orderly resolution to the deep crisis. Following protracted negotiations on a program that could be supported by the Fund and the authorities, the G-7, led by the United States, overruled the IMF's staff and brokered a new loan accord. On the margins of the IMF/World Bank meetings in Dubai, the IMF agreed in September 2003 to support Argentina's economic reform program with a US$12.5 billion Standby Arrangement over the next three years. In return, Argentina would pursue key structural reforms and negotiate in "good faith" with its private creditors to complete debt restructuring talks by 2004, in the process complying with requirements of the Fund's policy for lending into arrears.

While there are recent encouraging signs of macroeconomic stability in Argentina, the international community (including the IMF) is increasingly frustrated by the government's slow progress particularly in regularizing its external debt payments with institutional investors. Argentina's seemingly "unmovable" position from its opening gambit of offering 25 cents worth of new bonds for every dollar of Argentine debt held by creditors has raised concerns that a restructuring deal on current terms would fail. After pricing in past due interest and the greater risk of the new bonds, it is estimated that investors face a write-down of at least 90 percent off the full value of their bonds – the largest "haircut" in recent debt restructuring history.

The fact that the Argentines are also masterfully playing the game of chicken with the IMF and that a degree of personal bitterness has crept into these negotiations has worsened the situation. Last September, Argentina temporarily defaulted on a $2.9 billion payment due to the IMF until the new Standby Arrangement was hammered out. This March, the Argentines threatened to withhold payment of a $3.1 billion payment unless the IMF staff recommended completion of the second review of the loan accord. Fortunately, both parties were able to find a middle ground that averted a possible loan default. Argentina's actions have drawn condemnation from many IMF member countries. As a result, there was a rare show of dissent by the IMF Executive Board in its first review of Argentina's Standby Arrangement in late January 2004. Eight Chairs or a third of the Fund's governing board, including three members of the dominant G-7 countries, declined to support approval of the review.

The Argentine crisis has exposed the deficiencies of the international financial system, specifically the lack of established procedures for dealing with sovereign default in the bond markets, and appears to have thrown global financial governance into a tailspin. The way in which the resolution of the Argentina's sovereign debt default is handled will set important precedents for the functioning of the international monetary system.

Accordingly, this paper examines the dynamics of the interaction between Argentina and the Fund mainly in respect of sovereign debt restructuring, with a view towards identifying possible strategies for moving forward. The rest of the paper is organized as follows. Section 2 reviews the anatomy of the Argentina's multiple crisis, focusing on the how the Argentine government moved from a situation of floating large volumes of debt on the global capital markets to the point of insolvency. Section 3 describes the more recent engagement of the Fund in Argentina in respect of public debt restructuring talks. Concluding remarks are made in Section 4, calling for the IMF to have a more proactive stance in bringing creditors and the authorities to the restructuring table and outlining a possible roadmap.

2. Anatomy of a Multiple Crisis, 1998-2001

Argentina's crisis involved vulnerabilities that were already present during the boom years of the 1990s - when the country was already seen as star performer and held up as a model for other emerging markets to emulate. The key element of the vulnerability was the public debt dynamics, which were made explosive by the effects of prolonged recession and difficulties in rolling over debt. The inability to mount an effective policy response stemmed from the constraint imposed on the use of monetary policy by the currency board, placing the burden of stabilization on fiscal policy, and from wage and price inflexibility that made adjustment to shocks difficult. There was little urgency to address these growing vulnerabilities given the euphoria associated with the 1991 Convertibility Plan, which seemed to usher in a new era of non-inflationary high growth, and allowed Argentina to weather severe contagion from the 1995 Tequila crisis.

This overly optimistic view of Argentina's growth potential deflected attention from the underlying public sector debt dynamics that resulted in the federal government's financing needs doubling between 1995-1998 to about US$20 billion or around 25 percent of total private emerging market bond financing. Private creditors held more than 70 percent of Argentina's sovereign debt; the remainder was held by official creditors, mainly the IMF (Table 1). Even with shrewd debt management, evidenced by relatively low average maturities and limited reliance on short-term debt or floating rate instruments, rollover risks for the Argentine government had risen sharply. A low share of exports at around 10 percent of GDP implied a heavy debt-to-exports ratio of 455 percent in 1998, even though the external debt-to-GDP ratio was relatively moderate at less than 50 percent. This left the public sector vulnerable to shifts in investor sentiment and a slowdown in growth.

All these vulnerabilities came into play in mid-1998 when the Argentine economy unexpectedly slipped into a prolonged recession. Several other factors contributed to the downturn, including a cyclical correction, political uncertainties, and financial contagion from Russia's August 1998 debt default and Brazil's 1999 devaluation of the real. However, amidst the global contraction in capital flows, Argentina was not affected as severely as other Latin American economies. Figure 2 shows that spreads on Argentina's sovereign bonds rose by some 250 to about 750 basis points above US Treasuries between July-December 1998, at a time when average spreads on emerging market sovereign debt (EMBI) rose about 550 basis points.

The De La Rua administration assumed power in December 1999, as the recession deepened and the debt build-up eliminated any room for stimulating the economy through fiscal expansion. Stabilizing Argentina's debt ratio at about 50 percent of GDP would have required primary surpluses of about 3 ½- 4 percent of GDP. This compares with targeted primary surpluses of 1-2 ¾ percent envisaged under Fund-supported programs and actual outcomes that were far lower. As confidence eroded and growth failed to materialize, the December 2000 IMF support package was negotiated to allay fears of a possible debt default.

Spreads on Argentina's sovereign debt fell to about 650 basis points in early 2001 following monetary easing by the US Federal Reserve and augmentation of its Standby Arrangement with the Fund. The authorities took advantage of renewed access to international capital markets to float a large euro bond issue. Unfortunately, financial contagion from Turkey in February and the deteriorating domestic fiscal situation led to a widening of sovereign spreads between 850-1,050 basis points through the spring. Preventing a further rise in the public debt ratio would have now required a primary surplus of 8 percent of GDP – this was neither politically feasible nor economically sensible. Financial markets seemed to have already concluded that Argentina's Fund-supported program had little chance of avoiding a de facto default and a likely collapse of the Convertibility Plan. However, the IMF appeared to never seriously address this issue.

In the face of deteriorating market confidence during the spring of 2001, Mr. Cavallo assumed the post of Minister of Economy and used his prestige to pursue numerous heterodox initiatives, some of which were often announced without consulting in advance with the Fund. Perhaps the most important Cavallo initiative was the voluntary mega swap of nearly US$30 billion in Argentine government debt at the end of May. The effect of the swap was to obtain temporary breathing space by reducing some US$12 billion in debt service obligations falling due in 2001-2005, but at a very high cost of additional payments of about US$66 billion in later years. A very high discount rate of over 17 percent – far greater than the expected economic growth rate – was needed to make the present value of this swap break even. By accepting the mega debt swap on such onerous terms, the Argentine government was effectively declaring that it shared the market's assessment that sovereign default was virtually inevitable.

By late June and July spreads for Argentine paper were rising well above 1,000 basis points (Figure 2), and the authorities all but lost access to credit markets, which brought Argentina to the brink of default. As Argentines became increasingly concerned about a possible breakdown in the Convertibility Plan, large-scale withdrawals of bank deposits, which were halted and partially reversed in spring, resumed in July,

By the summer of 2001, the Argentine government was publicly insisting on substantial additional support from the Fund to avoid a debt default and calm the fear of depositors. The outcome was the second largest disbursement in Fund history of over $6 billion (announced in August and approved in early September), with a pledge of $3 billion more to support an unspecified debt restructuring. According to Mussa (2002) the Fund was guilty of two failures in this respect. First, there was the failure of intellectual courage to face up to the realities of the situation in Argentina. Second, there was the failure of moral courage to take the difficult decision to decline substantial additional support for policies that no longer had any reasonable chance of success. Unfortunately, the large disbursement would do no more than postpone the catastrophe in Argentina by three months.

By October, the value of Argentine sovereign bonds plummeted further, with spreads rising above 2,000 basis points. Minister Cavallo announced a two-phased approach to debt restructuring. Phase I of the operation was directed at domestic holders of Argentine government debt, primarily banks and pension funds, who were strong-armed into accepting domestic guaranteed loans with lower interest rates and longer maturities. This involved the exchange of US$42 billion of federal bonds, or about 65 percent of the total eligible amount. Phase II bonds amounted to almost US$58 billion, but this exchange which was aimed mainly at external creditors was never completed. The Argentine government has remained current on Phase I debt.

In the last week of November, the run on Argentine banks escalated, reaching more than US$1 billion per day and eroding 6 percent of the total deposit base. With barely enough foreign exchange reserves to cover domestic currency in circulation, the government was forced to close the banks and announced a range of banking and foreign exchange restrictions when they reopened. The social fabric unravelled. Riots erupted in the provinces and spread to Buenos Aires and more than 20 demonstrators died. Minister Cavallo was forced to resign and President de la Rua soon followed on December 20. A state of emergency was declared.

After passing through three interim Presidents in barely ten days, the new President Duhalde took two important decisions. On January 3, 2002, he confirmed the almost US$100 billion sovereign default announced by President Saá – the largest debt default in recent history - suspending debt service payments to external creditors, and he declared an official end to the convertibility regime, which was replaced by a dual exchange rate system. Regrettably, many of the initial decisions of the Duhalde administration not only failed to stabilize the economy, but also complicated any eventual resolution of the crisis. Especially damaging was the decision to convert most banks loans, but not bank deposits, into pesos. This measure merely shifted the burden of devaluation to the banking system and ultimately to taxpayers as banks would eventually be issued compensation bonds.

3. Post-Crisis Sovereign Debt Restructuring

On September 20 2003, the IMF's Executive Board meeting in Dubai ahead of the joint World Bank/IMF Annual Meetings approved a 3-year, US$12.5 billion Standby Arrangement for Argentina. The program builds on the country's recent success in stabilizing the economy and will pursue reforms in three areas:

- A medium-term fiscal framework to meet growth, employment, and social equity objectives while providing a sound basis for normalizing relations with all creditors and ensuring debt sustainability;

- A strategy to assure the strength of the banking system and facilitate the increase in bank lending that is essential to support the recovery; and

- Institutional reforms to facilitate corporate debt restructuring, address issues of the utility companies, and fundamentally improve the investment climate.

In their Letter of Intent, the Argentine authorities committed to intensifying negotiations with external creditors and completing a comprehensive and orderly restructuring of public debt in 2004. During the Dubai meetings, the Argentine government presented its debt restructuring plan, some features of which were subsequently elaborated. The proposal seeks to:

- Restructure an eligible stock of debt of US$99.4 billion, of which US$18.2 billion represents past due interest (PDI). PDI accumulated since the default in December will not be paid.

- Reduce the nominal stock of debt (including PDI) by 75 percent.

- Exchange the defaulted debt for a choice of bonds, including a par bond, a discount bond, and a capitalization bond, each offered with an upside option on GDP growth but with lower coupon payments.

Market analysts and various creditor groups have responded critically to the Argentine debt restructuring proposal. It is estimated that, after pricing in past due interest and the riskiness of the new bonds, this proposal implies a very large write-down for creditors of about 90 percent. That would be the biggest "haircut" in the recent history of debt restructuring. It would also leave Argentina with a colossal debt: the full write-down would cut the public debt from 140 percent of GDP to a mere 90 percent.

Creditors have also begun to coordinate their actions through the formation of committees (ABC, for U.S. institutional bondholders, and TFA for Italian retail investors), and the creation of a special purpose vehicle (ABRA) mainly for European retail bondholders. Moreover, it is becoming increasingly difficult for Argentina to argue that it has no party with whom to negotiate. On January 12 2004, creditors formally established the Global Committee of Argentina Bondholders (GCAB) to initiate debt negotiations. The GCAB is composed of bondholder representatives of the United States, Germany, Italy, and Japan and is open to other creditors who have not initiated litigation relating to Argentine bonds. Although the GCAB appears to be a heavily represented group and is vocal about its concerns, the Argentine authorities have discredited and diminished its significance, preferring to create a bondholder registry instead.

The Argentine government is of the view that it has stepped up its dialogue with private creditors, consistent with the requirements of the Fund's lending into arrears policy. Creditor groups and analysts, however, have accused Argentina of not showing enough inclination to engage in timely, constructive and open negotiations with its creditors. The Argentines have chosen to cling to their opening gambit to foreign bondholders of a reduction of more than 90 percent in net present value, and have indicated that they do not have the resources to sweeten the aggressive proposal. Furthermore, they have warned creditors and the IMF that no amount of pressure will change the reality of Argentina's debt problems and that it is time to share the pain. According to President Kirchner at the opening of the 2004 congressional session in Argentina:

"We know that the debt is a central problem, but we will not pay it any price. This is not a question of dogma or capriciousness….it is a question of a cold and rational reading of the numbers and of the economic situation."

Bondholders' pessimism about the probability of an acceptable restructuring offer is reflected in the relatively low price of Argentina's defaulted bonds. The price of its widely traded global 2008 bonds is currently trading at about 26 cents in the dollar, the lowest level since March 2003. The slow progress in the debt talks is a main reason why some creditors in Europe and in the United States are taking Argentina to court over the debt.

So far the tactic of playing chicken with the Fund has worked and helped to make President Kirchner extraordinarily popular at home. However, the threat of default on obligations falling due with the IMF has seriously disrupted Argentina's relations with the international community. The tendency to fling insults from Buenos Aires when such tactics meet inevitable resistance does not give the impression of a government negotiating, as IMF rules require, in good faith. The IMF's First Deputy Managing Director Anne Krueger, who called on Argentina to be more constructive in its debt talks, has been accused of undermining the country's relationship with the IMF by her sometimes sharp criticism of Argentine policymaking.

Amid these bitter negotiations between Argentina and its creditors, concern has grown among the Fund's shareholder countries that Argentina is not keeping its part of the deal. At the end of the IMF Executive Board meeting to approve the first review of the Argentina's performance under the Standby Arrangement, eight of the 24 members abstained on the vote – the traditional means of expressing dissent within the Fund. The abstainers included the United Kingdom, Italy and Japan. The G-7, which dominates the Fund's board, almost always votes together and this decision marked a rare breaking of ranks. The United States, which generally leads the G-7, voted in favour of the disbursement. Directors cited the Argentine authorities' continued verbal attacks on their bondholders, on the IMF, and on Krueger personally, as reason to withhold support for releasing the latest tranche of the loan.

4. Moving Ahead

The IMF already has substantial support outstanding to Argentina, nearly $12.5 billion. This amounts to almost 595 percent of quota, compared with a normal limit of 300 percent. As a result of default, Argentina is receiving a substantial flow of "exceptional financing," estimated at more than US$13 billion in interest and principal repayments that it is not making to its private creditors. By lending into arrears, the Fund (on behalf of the international community) recognizes the need for official support in the present circumstances, but is also putting its own credibility at risk.

Even with the best of fiscal adjustment efforts, Argentina's outlook over the next few years appears difficult. At the same time, Argentina financing needs are very large - at an average of US$18 billion (12 percent of GDP) in 2004-2006 and over US$20 billion (10 percent of GDP) in 2007-2010 – in relation to obligations falling due on existing debt held by the private sector and bilateral creditors. In addition, prospects are poor for Argentina regaining voluntary market access in the near future. Thus, in the best of circumstances, Argentina will need the support from the IMF for some time.

Accordingly, it would seem reasonable and desirable for the Fund to extend sufficient credit to Argentina to finance the rollover of repayments that are coming to the Fund, provided that the authorities are making good faith efforts to restructure sovereign debt. Otherwise, the IMF is reinforcing the signal that lending to emerging market countries is inherently risky because of the significantly asymmetric negotiating position that external private creditors have at the restructuring table.

The vote on the second review of Argentina's Fund-supported program in late March 2004 will provide another test of how far the United States is willing to maintain its support for Argentina, especially if the government refuses to take a more conciliatory stance in the debt restructuring. If the United States relinquishes support, Argentina must either soften its stance with bondholders or risk going into a dangerous default with the IMF. An Argentine default on its IMF debt would put a stop to this game of chicken because it would force the member governments that are net donors to recognize the losses on their own books. In the United States, such an event would undoubtedly spark congressional debate about the IMF, similar to the Meltzer Commission report in the late 1990s. The G-7 would then need to come up with a credible financing plan for offsetting a potential Argentine default to the Fund.

It is quite evident that Argentina's experience provides a compelling case for making the sovereign debt restructuring process more orderly, more predictable, and more rapid. There is also a strong case that steps to address collective action problems created by the threat of holdout litigation could help to improve the restructuring process. It would be a tragedy if the international community does not capitalize on the work already done in thinking through the problems that arise in a sovereign debt restructuring. The debate began with the G-10's 1996 report on Sovereign Liquidity Crises and gained prominence with the IMF's proposed new statutory bankruptcy regime in 2002.

Argentina has demanded that private creditors accept a 75 percent write-down in the value of defaulted debt; bondholders are asking for a 35 percent write-down. A proactive strategy is needed to bridge this dialogue of the deaf and bring Argentina and its creditors to the table (Truman, 2004). The IMF is well placed and quite capable of achieving this substantive engagement. In the tradition of Roubini and Setser (2004), the IMF should create a code that lays out the broad principles that are open to multiple interpretations (good faith, fair burden sharing, and comparability of treatment) and seeks to balance the interests of creditors and debtors. While the Fund should not specify all details, the code should set out at least two aspects (i) the basic principles that would guide the restructuring process; and (ii) a roadmap for reform for how to move from default to a successful restructuring. This requires setting out the roles, responsibilities and modes of interaction between Argentina, its existing creditors (private investors, the Paris Club, the IMF and other multilaterals) and potential sources of new financing (the IMF, World Bank and IDB). The Fund would then publicly pronounce on Argentina's formal offer, within the context of Argentina's external debt sustainability and program objectives.

Such an approach would help bridge the gap between the IMF's requirement of "good faith" negotiations and bondholders concerns about "fairness." At the same time, it is incumbent upon the G-7 to support the Fund in this initiative, if the Group is to seriously address its responsibility for the health and stability of the international financial system and for improving global financial governance.

In conclusion, the present acrimony in Argentina's sovereign debt restructuring process has been a source of disquiet to the international community, raising the stakes of a standoff and potential default to the IMF. It also weighs heavily on the Argentine economy and makes the task of stabilization all the more difficult. Time is certainly not on anyone's side, and forging a way forward is an urgent necessity. We must ensure, however, that any proposed solution is viable, credible and serves the best interests of the Argentine people.

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