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## Default and Debt Swap in Argentina: Kirchner's fair Haircut Matthias Bickel

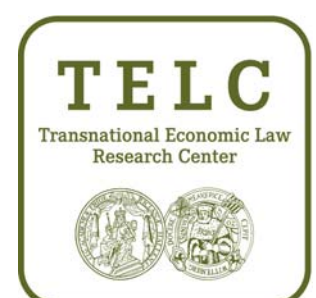
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## Default and Debt Swap in Argentina: Kirchner's fair Haircut

Argentina's debt swap was successfully concluded on 25 February 2005. Since 14 January creditors had the chance to swap their old bonds on which Argentina had defaulted in December 2001. This swap was the greatest such deal in the history of world trade. Despite Argentina's promise to restructure the sovereign external debt within four months, the Minister of Economic Affairs, Roberto Lavagna, launched the take-it-or-leave-it offer as recently as early January 2005, after a period of three years of negotiations. Within the scope of the debt swap Argentina offered its creditors 16 different bonds denominated in four currencies. In comparison to the defaulted bonds, the new bonds possess a longer maturity and yield a lower interest rate. But the main concern was the inherent haircut. The creditors would have only seen a return of around 30 percent of their capital contributions. On 25 February, 76.1 percent of the creditors accepted the deal. The Argentinean Republic was capable of swapping 62.6 billion US-Dollars of sovereign debt for 35.2 billion US-Dollars of new bonds. The new government bonds will be placed on 1 April 2005. In the following, five crucial questions will be answered.

(1) **Why do countries bankrupt, and will investors return after default?** The paradigm of international finance that states never declare

themselves bankrupt is simply false. The means of handling a default situation have merely changed. In 1902, after Venezuela defaulted on a sovereign bond, the British and the Germans sent gunboats to the harbour of Caracas to force the Venezuelan Government to honour its liabilities. The Anglo-German blockade ended in 1903. In the case of Argentina, the default in 2001 was not the first time that the Argentinean Republic did not pay its bill. In 1824, Baring Brothers placed the first public loan, issued by Buenos Aires, on which Argentina defaulted in 1828. At this time it took 29 years to find an agreement between the creditors and their debtor.

The investment climate improved between 1862 and 1875. Argentinean securities, such as government-guaranteed railroad company bonds, were sold again at the stock exchange in London. The high capital demand of the 1880s led to a lending boom. In particular, a great amount of funds was needed to build up the Argentinean railroad system. Low interest rates in Australia, Canada, the United Kingdom and the United States provoked investors to transfer their capital to Argentina. In 1890, Argentina defaulted for the second time. High capital inflow prior to the default not only accelerated investment, but also increased consumption. Then, despite a rise in exports, Argentina was unable to increase its export earnings. When the Bank of England tightened its monetary policy, inves-

tors pulled out their capital and Argentina had to adapt its current account balance without having the option of further lending. The default resulted in a global financial and economic crisis, known as the Baring crisis.

In 1931, the Argentinean Republic defaulted only partly on a sovereign bond. At this time the United States had displaced Great Britain as the main supplier of foreign capital. The decade before the 1930s debt crisis was on the one hand distinguished by intense capital inflows, and on the other hand by the excessive accumulation of external debt. By the mid-1930s a decline of output forced the United States to cut foreign lending. This exogenous shock resulted in bank failures and a decline of Argentinean exports. Scarce liquidity caused a run on the pound which led to downward pressures on the British currency. After the implementation of a tight monetary policy in Great Britain had failed, the pound was allowed to float freely. An appreciation of the British currency provided an additional incentive for Argentina to advance its export earnings, and made repayment of its foreign debt denominated in sterling more difficult. Although 62 percent of Latin American debt had remained in default by 1945, the British government granted Argentina a 40 million US-Dollars loan to honour its short-term debt.

In 1982, Argentina again declared a

debt moratorium. The anti-communist military junta (1976-83) increased the outstanding external debt from eight to 43 billion US-Dollars. Both the advantageous economic factors prior the debt crisis, and the Falklands war (1982) led again to heavy borrowing. The first oil shock in 1973-74 caused an increase in international lending. Oil-importing countries planned to balance their current account deficits by borrowing from oil-exporting countries which had a current account surplus at their command. The second oil shock in 1979-80 more or less mirrored the effects of the first one: inflation escalated, oil importer's current accounts turned negative, and the world economy went into recession. Anti-inflationary policies in developed countries, especially a rise in interest rates, intensified Argentina's ability to service her debts. The volume of exports shrank due to a downturn in global demand, and the Andean republic was incapable of financing its current account deficit by sharply reducing its imports.

At the beginning of 1986, the Argentinean minister for economic affairs, Juan Vital Sourrouille (1985-89) had to decide whether to install a tight monetary and fiscal policy to fight inflation, or to implement expansionary monetary and fiscal policies with the goal of boosting output and labour markets. Political pressure urged him to choose the latter. In April 1986, the fixed exchange rate system was

displaced by a crawling peg. Monetary control was relaxed, which led to an increase in inflation and capital flight. Neither the Austral Plan (1985), neoliberal reforms (1987), nor the Plan Primavera (1988) were capable of preventing the final collapse of the Argentinean economy in July 1989. Hyperinflation reached a peak of 5.000 percent, and unsuccessful attempts of the central bank to strengthen the Peso resulted in an unintended subsidy of capital flight, since big companies purchased the US-Dollars sold by the bank with the aim of transferring them abroad. Argentina was again no longer in the position to service its foreign liabilities.

Two conclusions can be drawn: first, countries bankrupt because their financial systems are not yet able to treat exogenous shocks efficiently. For instance, a terms of trade shock, e.g. a deterioration of competitiveness, induces the necessity to adjust the current account balance. This goal could inter alia be reached by cutting imports or by expanding exports, since a current account deficit must be financed. If these options cannot be realized, countries are often tempted to incur debts. In case growth slows down and the ratio of interest payments to the volume of exports exceeds the export growth rate, a peck of trouble is not far off. Second, capital markets are afflicted with amnesia. Indeed, it will take some years until investors return, but as long as a country's economic indicators look

good, investors will do so.

**(2) Could Argentina have paid more, and is the deal really unfair?**

Most of the creditors are angry about Argentina's recent debt swap offer since the country achieved growth rates of around nine percent over the last two years, and creditors take these as indicators of economic recovery. Receiving a negative return on investment accompanied by a loss of up to 70 percent of investment is anything but a cash cow. Nowhere near enough, since those who have accepted the deal must wait until 2038 to get their new bonds (which bear lower interest rates) mobilised. How much have creditors in a comparable situation gotten back? First of all, it has to be pointed out that the Argentinean 2005 debt swap was the biggest such swap in the history of world trade. After Russia defaulted in December 1998 (20.2 billion US-Dollars), and again in June 1999 (6.4 billion US-Dollars), the restructured value of the defaulted bonds amounted to 35 and 36 percent respectively when the debt was rolled over in August 2000. The Ecuadorian example (2.9 billion US-Dollars) showed similar figures: investors received 33 percent of their capital contribution in August 2000. There are also instances where creditors retrieved up to 65 percent. But the accumulated value of the Pakistani bonds reached only 0.3 billion US-Dollars. Empirical data indicates that the higher the original value of the defaulted

bonds, the lower the restructured value.

With the aid of debt swapping, the amount of Argentinean sovereign debt will decrease from 190 (December 2004) to 72 billion US-Dollars (March 2005). Therewith, the ratio of foreign external debt to the GDP equals a moderate 72 percent. Just to service the interest payments on the restructured debt, the Argentinean economy will have to reach a primary surplus of almost four percent of the GDP within the next few decades. This burden is already at an almost unacceptable level. One has also to bear in mind that the Argentinean economy shrank by around 20 percent during the most severe years of the crisis (1999-2002). If the Argentinean economy was forced to repay its debts in full, not only would the probability of defaulting again in the near future remain high, but repayment would also take place at the expense of the Argentinean population, which suffered terribly during the years of depression. Surely, a debtor should pay his debts, but extraordinary circumstances call for exceptional measures. In addition, the present value of the defaulted bonds prior to the debt swap was determined by the bond market, and was not significantly different from the 70 percent haircut offered by the Argentinean Republic. Taking into consideration the extent of the liabilities and the impact and severity of the crisis, Kirchner's debt swap cannot be regarded as an un-

fair deal.

**(3) What will happen to the holdouts?** Not all creditors accepted the debt swap. Those who refused to write off about 70 percent of their investment still own bonds amounting to around 20 billion US-Dollars of nominal value. Most small investors, including retailers, have either swapped their bonds at the very last minute, or have sold them to investment banks or to more sophisticated financiers. In the preliminary stages of the bargain, credit associations, such as the Global Committee of Argentine Bondholders (GCAB), or national groups like AARA and ADAPD, urged creditors not to accept the deal. The success of the swap originates from Kirchner's strategy not to draw back. Shortly before 25 February, the Argentinean Senate even approved a law which forbade any further negotiations with the holdouts. In any case the principle of non-discrimination will be applicable if the holdouts manage to achieve a more advantageous deal, i.e. creditors who have swapped their bonds will receive the same payment as those who did not yet accept the take-it-or-leave-it-offer. On the one hand this debt restructuring principle makes a more advantageous achievement less likely. But on the other hand it will be easier for the Argentinean government to negotiate with a smaller group of litigants due to the high acceptance rate. The only way of getting a better payment consists of filing an action.

But this approach is linked with high expenses and will take its time. The Italian Central Bank for instance recently initiated an investigation into the behaviour of Italian Banks. This comes against the background of these financial intermediaries having recommended the purchase of Argentinean bonds while having themselves already started to remove these papers from their own portfolios. Accordingly, a claim could be filed against banks which have demonstrably failed to comply with their duty of care.

**(4) Why does the IMF not get a haircut?** Paying back debt to a multilateral organisation is a *conditio sine qua non* for any sovereign debtor. Even so, if default occurs, the option of renegotiating the credit agreement remains. However, the IMF will in any case be repaid in full. Precisely because institutions such as the IMF or the World Bank also lend to countries which are isolated from international capital markets, their claims must be senior. The credit lines are linked with a close to risk-free interest rate. This is the reason why the IMF is often referred to as “lender of the last resort”. If the IMF would participate in the loss of a default, its goal of safeguarding the global financial system would be undermined. The Fund merely intends to prevent defaults by lending to sovereign creditors who are illiquid, but not yet insolvent. In this vein the IMF has prevented defaults inter alia in Mexico, Turkey and Brazil. Conse-

quently, the International Monetary Fund made a decisive contribution to protect creditors from suffering an investment loss that had surely come about without a lender of last resort.

**(5) Will the Argentinean example affect the honouring of emerging market debt?** An incentive to purchase emerging market bonds results from the higher interest rate. These coupons are not only designed to this purpose, since capital is most needed in emerging countries due to strong growth, but also because creditors are paid a risk premium. Emerging market debtors’ incentive to repay their liabilities will not at all be negatively affected by the Argentinean default. A sovereign debtor cannot pick and choose whether to pay back its debts or not without a solid justification, a severe economic and financial crisis, for example. Bearing in mind that Argentina went through the worst recession ever with a 20 percent fall in output, rising unemployment rates of up to 21 percent, and a decline in living standards of 20 percent, the conclusion to be drawn from the Argentinean tragedy is obvious: default is very costly, and no sovereign debtor would ever be happy to declare himself bankrupt.

As the debt swap was finally successful, the IMF has promised to restart negotiations about the suspended credit line, and Standard & Poor’s announced to upgrade Argentina’s new bonds to a “B-“. According to

this, the Argentinean crisis has come to an end: it's time to tango again.

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