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Argentina's Sovereign Debt Restructuring

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Summary

In December 2001, after four years of deepening recession and mounting social unrest, Argentina's government collapsed and ceased all debt payments. Argentina has failed to pay before, but this time it registered the largest sovereign default in history. Argentina must restructure over \$100 billion owed to domestic and foreign bondholders, including \$10 billion held by U.S. investors. A final offer made in June 2004 amounted to a 75% reduction in the net present value of this debt, and although an improved offer is expected by year-end, it is still the largest proposed write-down in the history of sovereign restructurings, which foreign bondholders have rejected.

Regardless of how Argentina's debt is finally resolved, it will likely represent an unprecedented loss for bondholders. This will have widespread repercussions not only for creditors, but for Argentina's long-term financial sustainability, developing country debt markets, guidelines for future sovereign debt restructurings, and the International Monetary Fund (IMF). All of these issues have been the subject of congressional hearings focused on evaluating the causes and ongoing repercussions of Argentina's financial crisis.

Argentina must settle with foreign bondholders if it is to return to the sovereign debt market, which will be necessary for financing investment in long-term growth. Argentina has made a reasoned case that its debt is simply too big to repay; nonetheless, the default is not only unprecedented for its low recovery rate, but also for the process that has stretched (creditors would say flaunted) the guidelines of sovereign debt negotiations. This applies to both informal negotiation guidelines understood to be in play by bondholders, and a more formal understanding as embodied in the IMF's policy of lending into private arrears.

Argentina's experience raises important questions in at least three major policy areas: country decisions to default on debt, codes of conduct for emerging market debt restructurings; and the role of the IMF in helping resolve financial crises. Although other countries may look to Argentina as a model for renegeing on sovereign debt, the cost of Argentina's financial collapse in long-term social and economic terms has been devastating. For investment firms and other holders of emerging market debt, there is no denying that the huge loss taken on a default like Argentina's is a highly negative precedent.

The fact that debt workouts are being completed, even if not always smoothly or in a timely fashion, may suggest that the "market system with IMF assistance" approach is still preferable to taking another shot at reinventing the international financial architecture, including creating some type of sovereign bankruptcy option. But should the Argentine case fail to be resolved to the mutual satisfaction of all parties, it could reinvigorate interest in a systematic and internationally recognized debt restructuring system, because as Argentina has shown, once insolvency occurs and debt becomes far too large to manage, there may be little incentive for countries to work with the existing unenforceable system in finding a quick and consensual solution. This report will be updated periodically.

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Argentina's Sovereign Debt Restructuring

In December 2001, after four years of deepening recession and mounting social unrest, Argentina's government collapsed and ceased all debt payments.¹ Argentina has failed to pay before, but this time it registered the largest sovereign default in history.² Argentina's total public debt grew from 63% of GDP in late 2001 to a record-breaking and unsustainable 150% following default and devaluation in early 2002. Argentina must restructure over \$100 billion owed to domestic and international bondholders, including \$10 billion of bonds held by U.S. investors.

When a country defaults, resolving its financing shortfall entails adopting policy changes, obtaining official emergency financial assistance from the International Monetary Fund (IMF), and undertaking debt restructuring.³ Nearly three years after the default, the first two are in place to some degree, but Argentina has yet to finalize a debt restructuring agreement. Regardless of how Argentina's debt is finally resolved, it will likely represent an unprecedented loss for bondholders. This will have widespread repercussions not only for creditors, but for Argentina's long-term financial sustainability, developing country debt markets, guidelines for future sovereign debt restructurings, and the IMF. The U.S. Congress has held numerous hearings to evaluate the causes and ongoing repercussions of Argentina's financial crisis. This report analyzes Argentina's debt situation in support of this interest and will be updated periodically.

A Summary of Argentina's Sovereign Debt

The Argentine government owes \$195.5 billion in bonds and loans, a vast amount by any measure. The debt portfolio can be classified into three categories defining how the debt will be managed (see **Table 1**). First, *performing debt*, is debt being serviced, or not in arrears. Second, *non-performing debt not to be restructured* is debt that is not part of the current restructuring effort, but is not being serviced. Third, *non-performing debt to be restructured* comprises the multitude of bonds

¹ For more on the crisis, see CRS Report RS21072, *The Financial Crisis in Argentina*, and CRS Report RL31582, *The Argentine Financial Crisis: A Chronology of Events*, by J. F. Hornbeck.

² Indeed, from 1824 to 1999, Argentina's sovereign debt was "either in default or undergoing restructuring a quarter of the time" and it has by far the lowest Institutional Investor rating of all major emerging market economies. Reinhart, Carmen M. Kenneth S. Rogoff, and Miguel A. Savastano. *Debt Intolerance. Brookings Papers on Economic Activity*. William C. Brainard and George L. Perry, eds. Washington, D.C. 2003. pp. 6-7.

³ Debt restructuring implies a formal change in the contractual arrangements of the debt, such as reducing the face value of the debt and issuing new bonds with lower interest rates and longer maturities — usually at a sizable cost to bondholders.

subject to the current restructuring efforts. This third category can be further disaggregated into principal and so-called past due interest (PDI), or interest that has accrued, and is still accruing, but has not been paid. PDI in sovereign debt workouts historically has been repaid in full, either up front, or as a new bond issue separate from the principal due (often referred to as a PDI bond). How PDI is handled is an important part of the debt picture for any sovereign debt default.

Table 1. Argentina's Sovereign Debt
(\$ billions)

Debt Category	Amount	Percent
Performing Debt:	84.7	43.3
International Financial Institutions (IMF, World Bank)	(32.7)	
BODENs*	(26.8)	
Guaranteed Loans	(12.9)	
Provincial Bonds	(10.0)	
Other	(2.3)	
Non-Performing Debt Not to Be Restructured:	6.7	3.4
Bilateral (including Paris Club)	(4.8)	
Commercial (mostly banks)	(1.4)	
Past Due Interest (PDI)	(0.5)	
Non-Performing Debt to Be Restructured:	104.1	53.3
Principal	(81.2)	
Past Due Interest (PDI) (through June 2004)	(22.9)	
Total Public Debt	195.5	

Data Source: Government of Argentina and Credit Suisse First Boston. *Bonos del Gobierno Nacional — National Government Bonds.

Performing debt includes all debt owed to the international financial institutions (IFIs); BODENs, or bonds issued to compensate banks and depositors for the peso devaluation; guaranteed loans for sovereign debt previously restructured during the final attempts to avoid default in 2001; and provincial debt that the federal government assumed after the crisis. Except for the obligations owed to international organizations, most of this debt is held by Argentines and has been fully “pesified.” This means that the non-IFI bondholders already reduced their claims, when in 2001 their bonds were restructured, and again in 2002, when their dollar-denominated bonds were converted to devalued pesos (pesified).⁴

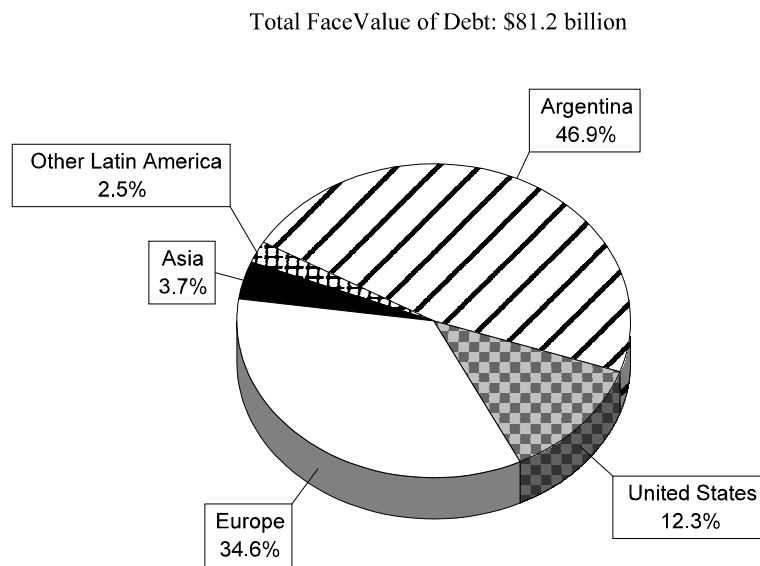
The Argentine government has reasoned that both the IFIs, which have continued to lend to Argentina, and those creditors who participated in the “voluntary” restructuring and “pesification” of debt, should not be further penalized because they have been actively engaged in helping Argentina solve its financial problems. In fact, there seems to be little room for restructuring this debt without reigniting a crisis. Defaulting on the IFIs is not a realistic option. Their debt is considered “senior” to all other and is always repaid in full, except under the rarest of circumstances. Such a default would place Argentina in a small group of countries completely shut off from external capital. Nor has Argentina much room to

⁴ Credit Suisse First Boston. *Emerging Markets Daily Latin America*. March 7, 2003, p. 2.

restructure most of the domestically held BODENs. Many were placed with depositors and financial institutions, under some government pressure, so a default or write down could jeopardize the banking system. Restructuring BODENs held by public sector pensions would be politically unfeasible for similar reasons.⁵

This leaves two categories of non-performing debt that are left to take the brunt of the debt write-down. The smaller of the two is \$6.7 billion, mostly bilateral debt owed directly to countries (Paris Club) and some commercial bank loans. This debt is not being serviced nor currently restructured and its status is undetermined. The important figures for understanding the debt workout are those summarized in the third group, *non-performing debt to be restructured*. This involves \$81.2 billion worth of bonds at nominal or face value that Argentina has not honored since the December 2001 default. In addition, accruing interest is estimated to be \$22.9 billion as of June 2004, which may hit \$25 billion by 2005.⁶ Therefore, for purposes of discussion in this report, the total value of the restructured debt to be evaluated is \$104.1 billion (\$81.2 + \$22.9 billion), or only 53% of total public debt.

Figure 1. Global Distribution of Argentine Debt to Be Restructured



Source: CRS from Global Committee of Argentine Bondholders

Countries worldwide invested in Argentina's bonds. As seen in **Figure 1**, Argentines are the most exposed, owning 47% of the total face value of debt to be restructured (not including interest), mostly held by pension funds and banks. Second in order are the European retail (private) investors who hold 35% of the bond debt concentrated in Italy, Switzerland, and Germany. U.S. money manager,

⁵ Gallagher, Lacey. *Argentina Debt Restructuring: Past or Future?* Credit Suisse First Boston. August 20, 2003. pp. 13,15, and 23.

⁶ Global Committee of Argentina Bondholders (GCAB). *Roadshow Presentation*. July 2004. This document may be found at [<http://www.gcab.org>].

insurance, and institutional accounts hold 12% of the debt or \$10 billion, including funds that have purchased highly discounted debt on the secondary market. The last 6% is held by Asian and Latin American creditors. Bonds were issued in seven foreign currencies, mostly in the U.S. dollar, Yen, Euro, Lira, and Deutsche Mark.

Recovering Defaulted Sovereign Debt

When a country becomes insolvent and defaults on its debt, a general framework for analyzing its options points to three critical responses. First, the country must adjust policies. This includes correcting fiscal and current account deficits, as well as structural imbalances, which in Argentina's case involve the banking sector, utility regulation, and federal-provincial fiscal relations. Second, emergency IMF financing is needed. Third, debt must be restructured to achieve longer-term financial sustainability.⁷

As seen in **Table 2**, Argentina has dealt with the first issue in part by making dramatic fiscal adjustments. With the return of robust economic growth, increased taxes, and reduced expenditures, Argentina is now running a large primary budget surplus, defined as the surplus that exists after all public expenditures have been met except for interest on debt. This surplus is a direct measure of a country's fiscal capacity to service its debt, and theoretically, is available entirely for debt service. The correction of the current account balance from deficit to surplus points to the reversal of borrowing abroad and the generation of foreign exchange available to repay foreign obligations and rebuild international reserves.

Table 2. Argentina: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005
Real GDP Growth (%)	-3.4	-0.8	-4.4	-10.9	8.9	7.0	4.0
Current Account Balance (% of GDP)	-4.2	-3.1	-1.6	13.8	9.3	7.4	4.3
Primary Budget Surplus (% of GDP)	-0.8	0.4	-1.3	0.9	2.8	4.5	3.9
International Reserves (\$ billion)	27.1	26.9	14.9	10.5	14.1	18.5	19.6
Debt (% of GDP)	47.4	50.8	62.5	150.6	146.7	140.0	130.0
Poverty Rate (%)	27.1	29.7	35.4	53.0	54.7	—	—
Per Capita GDP (\$ 000)	7.8	7.7	7.2	2.7	3.3	3.8	3.7

Data Source: IMF. *Second Review Under the Stand-by Arrangement and Requests for Modification and Waiver of Performance Criteria*. March 12, 2004. p. 24 and Credit Suisse First Boston. Primary surplus is for consolidated (federal and provincial) accounts. 2005 data are projections.

⁷ Roubini, Nouriel and Brad Setser. *Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies*. Institute for International Economics. Washington, D.C. August 2004. p. 119.

Since 2002, indicators point to Argentina's strengthening capacity to repay debt, particularly the robust growth in GDP and the primary surplus. But, ability and willingness to service debt are two different issues. Argentina insists that not all residual financial resources available for debt should be so used. The country's massive economic downturn resulted in a 50% poverty rate, with real per capita GDP falling back to levels of 30 years ago. Social programs and domestic investment are also deemed critical for its economic recovery and political stability. It becomes a serious political (some would say moral) decision to decide what percentage of public resources should be spent on social programs versus debt reduction, a decision that also hinges on a defaulting country's bargaining power.

Second, Argentina has an ongoing relationship with the IMF, which with the strong support of the United States, has continued while in default to private creditors. The IMF provides emergency financing subject to policy adjustments. While making corrections to fiscal policies is almost unavoidable when insolvent, it is far more difficult to make deeper structural reforms. IMF lending typically is done with a clear understanding that such challenging reforms will be accomplished. The IMF cannot dictate policy, but theoretically it can exert leverage by having the option not to lend — a point of some contention in the IMF-Argentine relationship.

The IMF also has a role to play in the third major challenge, restructuring the debt. Although it does not participate directly in debt restructuring negotiations, the IMF can continue to lend to a country in default. Specifically, IMF policy allows "Fund lending into sovereign arrears to external private creditors...in circumstances in which: (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and is making a *good faith* effort to reach a *collaborative agreement* with its creditors."⁸ The IMF obviously has an influential role in encouraging negotiations to move forward through its program conditions, and as a creditor.

When, in December 2001, Argentina halted the final attempts to avert a default, it faced a massive restructuring problem with bondholders from throughout the world. While it was widely understood that Argentina would not be able to repay its debt in full, the question remains, what amount (and conditions) would satisfy both creditors and the Argentine government?

Countries in default reach a voluntary agreement with creditors or risk costly, prolonged, litigation and ostracization from financial markets. Litigation is the least preferred method given that recovering sovereign assets is nearly impossible. There are no formal rule books for how to proceed, but all parties are best served by avoiding a protracted and confrontational negotiation. Negotiations may take the form of formal meetings between creditor committees and government groups, less formal consultation arrangements, or some combination. The process can be lengthy,

⁸ *IMF Board Discusses the Good-Faith Criterion Under the Fund Policy on Lending into Arrears to Private Creditors*. Public Information Notice No. 02/107. September 24, 2002 and *Fund Policy on Lending into Arrears to Private Creditors — Further Consideration of the Good Faith Criterion*. July, 30, 2002. pp. 6, 15, and 19-20.

but historically has resulted usually in a timely agreement with a 90% or more bondholder participation rate, although Argentina is clearly the exception. Widely accepted basic guidelines suggest that creditors should be treated equally in terms of taking losses, although domestic and foreign debt tend to be treated differently, and that the government in default should make every reasonable effort to pay as much as it can. These generalities obviously allow for a great deal of leeway in specific debt negotiations.⁹

Sovereign debt workouts typically involve issuing new debt for old, under more lenient conditions that allow a country to eventually recover its financial standing in the international community. Recovery rates have varied, depending on the circumstances of each case. Since 1990, for example, a sample of nine Latin American sovereign debt restructurings indicates that the reduction in the nominal value of the debt (referred to as “the haircut”) ranged from 0% to 45%, with an unweighted average of between 35%-40% (considerably more generous than Argentina’s proposed 75% reduction, see below).¹⁰

Clearly there is room for different resolutions, but the important goal to achieve is Argentina’s long-term debt sustainability. This may be defined as an overall debt burden being “consistent with the country’s overall capacity to make payments.”¹¹ The concept implies that the debt payment schedule must be reduced, smoothed out, and extended so that the country can afford payments under reasonable economic assumptions. It is in the creditors’ interest to get a country to pay as much as possible within this constraint. To ignore it is to risk a future default and starting over again.

Argentina’s Debt Restructuring Strategy

Argentina’s default was unprecedented in size, leading to highly complex and contentious debt restructuring negotiations. Significantly, because only 53% of Argentina’s debt is carrying the burden of restructuring, the write-down will have to be huge for Argentina to achieve its debt sustainability goals. Notwithstanding Argentina’s predicament, creditors argued that Argentina was not absolved of its responsibility to negotiate and devise a restructuring plan that would allow Argentina to reduce its overall debt, treat multiple creditors in a nondiscriminatory fashion, and minimize the potential for lengthy and costly law suits. Having 152 bonds denominated in seven currencies and governed by the laws of eight legal jurisdictions greatly complicated the task. For example, debt falling under British and Japanese law operates under collective-action clauses, which makes for relatively easier resolution by allowing a majority of bondholders to make binding decisions for all. Collective-action clauses do not apply to debt governed by U.S., German, or Italian

⁹ Roubini and Setser. *Bailouts or Bail-Ins?*, pp. 167 and 174 and GCAB, pp. 12-13.

¹⁰ Global Committee of Argentina Bondholders. *Roadshow Presentation*. July 2004.

¹¹ Roubini and Setser, *Bailouts or Bail-Ins?*, pp. 20 and 172. The authors note that in addition to the debt size, important factors include the coupon rate, a country’s ability to adjust policies, and the amount of debt issued short-term and in foreign currencies.

law. The result has been multiple class-action and individual law suits filed in the United States and European countries.¹²

Argentina initially juggled its debt dilemma by putting off private bondholders while negotiating with the IMF. In fact, bondholders did not have their first significant meeting with Argentine authorities until March 2003, 15 months after the crisis began. It was at that time that Argentina intimated that not all debt would be treated equally, with foreign bondholders probably having to take the largest debt write down. Details of Argentina's offer to foreign bondholders, however, would not be made available for another six months. While negotiations with creditors remained stalled, on September 10, 2003, Argentina entered into a new controversial three-year \$12.6 billion IMF stand-by arrangement, replacing a seven-month interim arrangement that had just expired. Following tense negotiations, the IMF, with strong support from the United States, acquiesced to what some characterized as a "soft" agreement with Argentina after it had failed to make a \$2.9 billion payment, making it technically in arrears with the IMF for one day.¹³

The IMF agreement was a necessary first step to take before formal negotiations with private bondholders could begin because it provided the policy framework that would guide the country's economic recovery. Importantly, this included accepting Argentina's formal offer to the IMF to commit to only a 3% primary fiscal surplus and only for 2004, although it would devote slightly less than that to actual debt payments.¹⁴ The IMF interpreted this effectively as a "floor" on Argentina's commitments to debt service, but in retrospect, creditors correctly saw it as more of long-term "ceiling" that signaled they should expect a larger write down of debt than initially anticipated. At this point, it was less clear whether IMF lending would help ensure that a timely and collaborative debt restructuring process could take place.

The Dubai Proposal

Shortly after the IMF program was in place, Argentina turned to bondholders, making an initial offer on September 22, 2003 at the World Economic Forum meeting held in Dubai, the United Arab Emirates. Although lacking in detail, it was widely interpreted as an offer to pay 25 cents on the dollar of the principal value of the debt, with no recognition of past due interest, an unprecedented stand. On a net present value (NPV) basis, financial institutions estimated this to be a 90% rather than 75% reduction in the value of the bonds.¹⁵ Argentina argued from the outset that

¹² Pruitt, Angela. Argentina's Debt Workout Is Complex. *The Wall Street Journal*, March 12, 2003. p. B9C.

¹³ Munter, Paivi. Argentina Disappoints. *Financial Times*, September 17, 2003. p. 51.

¹⁴ *Latin American Weekly Report*. September 7, 2004. p. 5. By comparison, Brazil has operated with a 4.25% (or higher) primary surplus in recent years to deal with its large sovereign debt.

¹⁵ The net present value (NPV) of an investment considers the time value of money at an assumed discount rate. The present value of cash outflows (funds loaned) is compared to the present value of cash inflows (principal and interest payments) over the life of the
(continued...)

this was consistent with the 3% primary surplus target, a controversial position given that strong economic growth would support a much larger surplus. By December 2003, even the IMF began to suggest that Argentina could muster a higher primary surplus and make good on a greater portion of its defaulted debt.¹⁶

The Dubai proposal met with immediate resistance from creditor groups, their governments, and the IMF. Initial speculation that the offer was only a bargaining ploy soon gave way to a sense that Argentina was sincere and unlikely to change its position. Bondholder groups immediately rejected the Dubai offer and the IMF delayed the first quarterly IMF program review over the lack of movement on debt negotiations. IMF reviews are required for a country to remain in good standing and receive the next disbursement of funds. Great Britain, Italy, Japan and other members representing 35% of IMF votes then registered their dissatisfaction formally. In a highly unusual move, they abstained from what is typically a pro forma vote to continue lending to a country that has met its economic targets.¹⁷

Nonetheless, Argentina had enough votes to survive the first IMF review, but the second was also problematic because of a \$3.1 billion payment due on March 9, 2004. Argentina continued to meet its macroeconomic targets as set out in the IMF arrangement, but the IMF pressured Argentina over its lack of “good faith” effort in debt restructuring negotiations and its failure to make headway on microeconomic reforms, especially in utility pricing, banking regulation, and restructuring the provincial-federal fiscal arrangement that had contributed to the crisis in the first place. The IMF also required that Argentina negotiate a final debt agreement acceptable to at least 80% of the bondholders by September 2004.¹⁸ Capitalizing on the seemingly strong leverage that the IMF wielded at that point, some creditor groups openly refused to continue discussions with the Argentine debt consultation groups, while others won injunctions in U.S. courts to have liens placed on Argentine-owned property in the United States. Undaunted by these actions, Argentina countered by announcing that it would refuse to make the \$3.1 billion IMF payment unless it was assured that the IMF would approve the second review and the related disbursement of funds needed to cover that payment.¹⁹

This action presented an unusual standoff and highlighted not only the fact that a large debtor, like Argentina, wields its own leverage against lenders, but that the IMF, with \$15 billion invested in Argentina, had its own interests at stake in keeping Argentina from falling into arrears. To the extent that this was a motivating factor

¹⁵ (...continued)

investment. The loss is the NPV difference between what would be paid on the initial bonds compared to what would be received from the replacement bonds at lower yields and longer maturities.

¹⁶ Latin American Brazil and Southern Cone Report. *IMF Reprises Role of Villain in Argentina*. December 23, 2003. p. 12.

¹⁷ Dow Jones Newswires. *Big Abstentions in IMF Vote Put Argentina Under Pressure*. January 29, 2004.

¹⁸ Reuters News. *IMF Gives Argentina Debt Ultimatum*. March 7, 2004.

¹⁹ Thomson, Adam. Argentina on the Edge. *The Financial Times*. March 8, 2004. p. 17.

for IMF actions, it worked against private bondholders who had hoped that the IMF stand-by arrangement would be an effective inducement for Argentina to improve its debt restructuring offer. In the end, a compromise was reached in which Argentina agreed to negotiate formally with all creditors, but it did not change its fundamental offer with respect to the depth of the debt write down nor increasing Argentine resources beyond the 3% primary budget surplus. The IMF was heavily criticized in the press and by investment firms for failing to deal more strictly with Argentina, which again became the central issue of the third review scheduled for June 2004.

The “Final” Buenos Aires Offer

Argentina began seemingly earnest negotiations with bondholder groups in April 2004, but bondholders again contested this process. In the middle of a series of meetings, which bondholders characterized more as presentations than negotiations, Argentina unexpectedly canceled further talks and tabled its final offer on June 1, 2004. A formal filing was made with the U.S. Securities and Exchange Commission (SEC) on June 10, outlining the provisions of this agreement. Bondholders rejected this “unilateral” offer even before it could be fully analyzed, arguing that Argentina had failed once more to live up to its IMF-imposed commitment to make “a good faith effort to reach a collaborative agreement.”

The Buenos Aires offer differed mainly by recognizing past due interest through the end of June 2004, provided at least 70% of the bondholders agreed to the arrangement. If less than 70% acquiesced, the offer would proceed in any case, but PDI would be recognized only through December 31, 2003. Many features of the Dubai proposal were retained so that the debt write off would still amount to 75% of outstanding debt, but on a present value rather than nominal basis. This arrangement would still allow President Kirchner to save face by claiming a 75% write down in debt, while improving the offer to bondholders considerably over the Dubai proposal. The huge loss to bondholders, however, would still be unprecedented.

Argentina presented the offer as final and anticipated issuing \$43.2 billion dollars in new bonds, assuming a minimum 70% participation rate (details will vary with a smaller participation rate). A menu was offered of three options, with fully capitalized PDI distributed as part of the discount and quasi-par bond offers, carrying various interest rates. Discount and par bonds would be governed by international law, the quasi-par bonds by Argentine law; all would have collective action clauses.²⁰

- *Discount bond (\$19.9 billion)* — existing bonds would be exchanged for new U.S. dollar-denominated 30-year bonds with a 63% reduction (discount) in principal value carrying a 4.15% coupon interest rate for the first five years, 4.88% for years 6-10, and 8.51% for the remainder, with a 20-year grace period on capital payments (goal — debt and debt service reduction);

²⁰ SEC. Form 18-K/A. *Annual Report of the Republic of Argentina*. Filed June 10, 2004 and Gallagher, Lacey. *Argentina: What’s New in the 18-K. Emerging Markets Sovereign Strategy Daily*. Credit Suisse First Boston. June 15, 2004.

- *Par bond (\$15 billion)* — existing bonds would be exchanged for new U.S. dollar-denominated 35-year bonds at face (par) value, hence no reduction in principal. Coupon interest rates would be 2.08% for the first five years, 2.5% for years 6-15, 3.75% for years 16-25; 5.25% for the remainder, with a 25-year grace period on capital payment (goal — debt service reduction), and
- *Quasi-par bond (\$8.3 billion)* — existing bonds would be exchanged for new peso-denominated 42-year bonds with an undefined reduction in principal, a coupon interest rate of 5.57% (later estimated at 3.6-4.0%), and a 32-year grace period on capital payment (goal — reduction in debt and debt service).

In addition, GDP-linked payments were attached to all bonds. Specifically, if in any given year real GDP growth exceeds 3% (3.9% in 2005) in constant peso terms, 5% of all additional growth would be directed toward increased coupon payments for all three bonds, with an additional 5% to be used for bond buy backs. Computing the dollar valuation of this incentive is a complicated and partially speculative effort and the plan is clearly predicated on strong and sustained growth of the Argentine economy, which cannot be guaranteed indefinitely.²¹

The financial community criticized the new bond terms on a number of technical grounds that diminished investor response. First, the 42-year bonds would far exceed standard 30-year maturities used for sovereign restructurings. Second, the structure of the maturities with 20-year grace periods on repayment of principal would effectively subordinate largely foreign-owned bonds to domestically held debt that is not being restructured and that would be paid off first. Third, PDI would not be recognized as a separate bond issue, but as part of the discount and quasi-par bond offerings, and so would not be clearly linked to the original debt instruments.²²

The timing of the offer was also critical, coming before the June 2004 IMF review. Argentina needed to represent itself as making good faith negotiations with creditors in order to remain in good standing with the IMF. While the June offer was undeniably more generous than the Dubai proposal, creditor groups, led by the Global Committee of Argentine Bondholders (GCAB), complained that it was a unilateral proposal presented as a final ultimatum and lobbied to have Argentina declared in breach of IMF conditions. They also returned to the courts and responded with a counter proposal that would shorten maturities, include a down payment, and raise the overall recovery rate from 25% to 55-60% of the original debt value.²³ This action was based on the robust growth of the Argentine economy that the GCAB argued should allow for higher payments on debt.

²¹ Ibid, p. 2.

²² Ibid.

²³ The GCAB reportedly represents 75% of foreign bondholders. See [<http://www.gcab.org>].

IMF Program “Suspension”

The IMF has a policy of remaining neutral in debt negotiations, but through its review process, effectively serves as an arbiter between Argentina and its bondholders, whose respective assumptions regarding Argentina’s ability to repay creditors appeared to be irreconcilable. The IMF and any leverage it had was sidelined in August 2004, however, when Argentina announced it would “suspend” its IMF agreement, thereby giving up temporarily access to further lending.²⁴ It was clear at that point that Argentina was out of compliance with the IMF arrangement, including the commitment to enter into “good faith” negotiations with creditors. Argentina was effectively playing off against each other the three pillars of crisis resolution (policy adjustment, IMF financing, and debt restructuring). It reasoned that, for the short term, it needed the time and freedom from IMF conditionality to finish negotiations with creditors more than it needed IMF financing.

In addition, Argentina requested, and was granted on September 17, 2004, an extension by the IMF on payments amounting to \$1.1 billion of some \$2.5 billion due in the final quarter of 2004, further relieving it of IMF pressure. Argentina pledged, nonetheless, to stay current with its other IMF payments, which should not be a burden given its improved international reserves position.²⁵

The delayed IMF review ignited a debate over whether it would improve or diminish Argentina’s leverage with international creditors. Argentina has argued that its best chances for working out a deal with bondholders lies with completing its offer by year end 2004, at which point it could then re-engage the IMF. Creditors have argued to the contrary, that without IMF leverage, a debt workout is unlikely. Although the IMF reiterated a call for Argentina “to decisively address all the outstanding structural issues of their program, and to complete a comprehensive and sustainable debt restructuring,”²⁶ it is far from clear that a program suspension and debt payment extension will provide the incentives for Argentina to push through on these commitments.

Concluding the Restructuring Agreement

Argentina announced on October 12, 2004 that it would formally “launch” its final offer to bondholders on November 15, 2004, once it received SEC approval. At the same time, the Argentine government also convinced five of its largest domestic pension funds holding nearly 20% of the bonds to accept an offer, laying the groundwork for building what it hopes to advertise as “an acceptable” 70%

²⁴ Argentina has used this term and it can be said that both the review process and IMF disbursements have been “suspended,” but the agreement technically is still in effect and Argentina can restart the review process when it is ready, as has been the case with IMF arrangements in the past.

²⁵ These are so-called “expectation basis payments,” which may be rolled over for one year. See IMF. *IMF Executive Board Extends Argentina’s Repayment Expectations and Argentina: Projected Payments to the IMF*. On Argentina page at [<http://www.imf.org>].

²⁶ Ibid.

participation rate.²⁷ This tactic may prove to be a risky gamble, particularly if it is poorly received by foreign bondholders and they decide to push through on their threat to test their legal recourse to the limit. Such an action could then take the international financial system into a new chapter of sovereign restructurings.

Investment firms are speculating that Argentina may amend its final offer to garner a higher participation rate. The main enhancement would be to include an effective issue date of January 2004 on the new bonds. The year's interest would effectively amount to a up-front cash payment intended to increase bondholder participation. Assuming a cash advance, GDP-linked clause, and a 70% participation rate, one estimate places the recovery value for non-retail foreign bondholders to be 29.5% to 31.5%, higher than the earlier 25% recovery value. Investor groups recognize the political cost of raising the offer further, but given that it still represents a historically low recovery rate, and that Argentina's fiscal capacity could support a larger effort, foreign bondholders are unwilling to accept even this offer.²⁸

Outlook and Implications

As Argentina approaches the final stages of its sovereign debt restructuring, the results could range from a reasonably high participation rate that might be viewed as a success, to a complete breakdown in Argentine-investor relations and even a break with the IMF. The second case would leave all parties the worse off. Congressional hearings for years have focused on the IMF, the financial crises of the last decade, and more recently the dire consequences of the Argentine default to consider policy options that might help avoid such a dire outcome. Congress has expressed concern over effects on U.S. investors and has focused on the destabilizing effects that large financial crises can have on the international financial system, as well as, developing countries and their relations with the United States. A financially unstable Argentina, for example, raises the prospect of a politically unstable South America that may include a backlash against the United States.²⁹ Financial crises and sovereign defaults are also costly, not only for creditors, but for the societies that must make amends, which can mean years of economic hardship.

²⁷ This rate is still very low and probably not high enough to reopen the capital markets to Argentina anytime soon.

²⁸ Credit Suisse First Boston. Argentina: Getting Ready for the Updated Offer. *Emerging Markets Sovereign Strategy Focus*. October 15, 2004. pp. 6-7.

²⁹ Senator Evan Bayh raised the concern over anti-Americanism in hearings on February 28, 2002 as chair of the Senate Subcommittee on International Trade and Finance of the Committee on Banking, Housing, and Urban Affairs. Antonio Estrany y Gendre, former Undersecretary for International Economic Relations of Argentina, in a presentation at the Center for Strategic and International Studies in Washington D.C. on October 6, 2004, supported this concern in noting that there has been a strong correlation between the drop in support for the United States in Argentina with its rising economic hardship since the crisis began. Broader concerns raised here were echoed by Senator Chuck Hagel when he chaired hearings before the Senate Subcommittee on International Trade and Finance on March 10, 2004.

Over the past decade, multiple financial crises in Latin America, Asia, and the Middle East demonstrated that circumstances vary and that one solution does not fit all cases. Many were resolved as well as could be expected, others less so. Argentina, however, is a clear case of failure and so enormously instructive. Argentina's debt ballooned beyond sustainability and the IMF, with U.S. support, continued to lend into insolvency. The subsequent debt workout became adversarial, protracted, and undiplomatic, and Argentina, in turn, experienced an unprecedented economic setback that will test the fabric of its social and political life for years to come. There is also some doubt, despite the experience of the past decade, how to formulate a better strategy if this situation were to arise again. Future congressional hearings may find interest in some or all of the following issues spun off from this catastrophe.³⁰

Argentina

Argentina must settle with foreign bondholders if it is to return to the sovereign debt market, but it appears determined to stick to its hardline approach of committing no more than 3% of its primary budget surplus to finance a long-term debt restructuring, resulting in a 70-75% debt write-off on a net present value basis. It hopes to finalize such an offer by year-end 2004 and attract as many as 70% of the bondholders, with the remainder left to fend through the court system. If all of the domestically held debt were to be restructured, this would mean that Argentina would only have to convince 43% of the foreign bondholders to achieve the historically low target of a 70% participation rate. It is far from clear, given the resistance of foreign bondholders, that such an unprecedented outcome will materialize, or whether it would portend a precedent setting solution from a broader policy perspective.

Argentina has made a reasoned case that its debt is simply too big to repay, and combined with its lack of progress on structural economic reforms, there is also reason to believe the economy may have trouble achieving levels of prolonged growth in output and revenue needed to achieve sustainability without a huge write-down in its debt. Nonetheless, the default is not only unprecedented for having the lowest recovery rate in history, but for the process that has stretched (creditors would say flaunted) the guidelines of sovereign debt negotiations. This applies to both informal negotiation guidelines understood to be in play by bondholders, and a more formal understanding as embodied in the IMF's policy of lending into private arrears.

Argentina's experience raises more questions than it answers in three major policy areas: country decisions to default on debt; codes of conduct for emerging market debt restructurings; and the role of the IMF in helping resolve financial crises. Although other countries may look to Argentina as a model for reneging on vast amounts of sovereign debt, the cost of Argentina's financial collapse in long-term social and economic terms has been devastating. Looking ahead under the best scenario, Argentina faces years of foreign debt repayments while it tries to rebuild an economy with 50% poverty and 14% unemployment rates, high crime, and political unrest.

³⁰ If one were to include the entire universe of issues related to the international financial architecture and the economics of bailouts, this discussion would be far longer.

Still, if other developing countries find themselves in a hopeless debt situation, they could view Argentina as one model to emulate. For investment firms and other holders of emerging market debt, such a thought reinforces their belief that Argentina's default is a highly negative precedent. Argentina's negotiating tactics have also been vilified. But the repercussions do not end there. Finding the external financing needed for Argentina's future investment and growth will be difficult. It will be years before Argentina can access the sovereign debt market, and the cost to borrow will likely remain very high even then. In the meantime, it is a test of IMF policy to see how long Argentina can depend on IMF rollovers as a major financing tool (it has had an arrangement with Argentina virtually continually since 1985).

The IMF

There are important questions related to IMF decision making. First, even the IMF agrees that it may have hurt more than helped Argentina by lending too much for too long into an untenable situation.³¹ The Fund struggles with defining a clear threshold for identifying insolvency — doing so earlier would have helped Argentina. In not cutting Argentina off sooner, the additional IMF lending only seemed to support Argentina's debt problem, displaced other creditor debt for seniority in repayment, and left fewer financial resources to be used in assisting Argentina post-crisis. This severely constrained Argentina's debt workout options. Second, although the IMF is virtually assured of being repaid, Argentina more than once threatened to default on the Fund, which at least gave the appearance of having undue leverage when it came time to discussing quarterly reviews and rolling over debt.

Third, creditors chide the IMF for failing to completely fulfill its responsibility to uphold guidelines governing lending into private arrears. In fact, the IMF found its leverage insufficient to persuade Argentina to negotiate a consensual agreement with creditors. Also the IMF's role as "official arbiter" was a critical factor in supporting the 3% primary surplus target for Argentina's ability to repay its debt. As this became the de facto maximum repayment effort by Argentina, creditors questioned whether the IMF did not help define the debt repayment ceiling from which Argentina was unwilling to deviate. Fourth, Argentina is also demonstrating how IMF financial assistance without needed policy reforms is insufficient to resolve a serious debt issue. Although the IMF program has been interrupted, Argentina must pay \$4.5 billion in 2005. It will have to restart the IMF program in 2005, which could be a problem if it fails to achieve a "successful" bond restructuring by then.

U.S. Policy

This situation points to an interesting policy dilemma for the United States as well. The United States government, including the Congress, is concerned with the treatment of U.S. investors abroad, but it has not openly advocated intervening on their behalf. Official U.S. response has been limited to its actions through the IMF. In part, this is consistent with a philosophy supporting market solutions, particularly in light of the moral hazard criticism leveled against earlier bailouts. It may also

³¹ IMF. *Report on the Evaluation of the Role of the IMF in Argentina, 1991-2001*. June 30, 2004.

reflect a priority for concerns over international financial stability and IMF liquidity, which may be at odds with supporting the interests of private bondholders. Historically, this too is an interesting outcome. During the Latin American debt crisis of the 1980s, the solvency of U.S. creditors was of paramount concern for the U.S. government and so they had the upper hand in negotiating sovereign restructurings. In the case of Argentina, the pendulum appears to have swung in the opposite direction, and it remains to be seen if this trend continues.³²

Since taking office, the Bush Administration has made clear that the United States would no longer support large sovereign bailouts, but instead allow markets to resolve these financial disruptions. This commitment, however, proved easier to articulate than enforce. Although the Bush Administration did not jump to the bilateral rescue of Argentina as the Clinton Administration had with Mexico in 1995, it has made smaller efforts with Uruguay. More to the case in point, when Argentina repeatedly sought help from the IMF, the United States proved to be one of the strongest voices of support. Therefore, any criticism of the IMF's costly response to Argentina cannot be divorced from U.S. policy, which when faced with a serious developing country financial crisis, was unable to deviate significantly from the course taken by the previous administration.

Emerging Markets and Debt Restructurings

Investors also paid a heavy price in the Argentine default, including those in the United States who may ask what assistance they might get from Congress and the U.S. Treasury in seeing their rights and investments are honored. The official response may be that the high bond spreads on Argentine debt in the year before default provided adequate information to assess the riskiness of this investment. Given this market-based *caveat emptor*, it may be that the U.S. Government is not prepared to adopt an interventionist policy on behalf of private investors.

U.S. bondholders, however, are pushing to have the United States weigh in officially on the restructuring agreement, either through its voice at U.S. Treasury or the IMF. The United States carries much weight at the IMF and can send a strong signal as to whether future Argentine IMF reviews will be supported, albeit at the risk of perhaps another IMF showdown with Argentina. This is the only leverage available to encourage Argentina to change its course, and it is not clear that the United States, other countries, or the IMF will decide to use it. The message that is ultimately sent, however, even if silence, may affect the options that U.S. and other creditors have in dealing with Argentina.

As for sovereign debt restructurings, the process is already changing. The addition of more sophisticated collective action clauses is becoming increasingly common and other changes are being discussed in the financial community to evaluate options for imposing some form of enforced guidelines or code of conduct on countries reluctant to meet their contractual obligations. In addition, the sheer

³² For a discussion of the 1980s debt crisis and the role of banks, governments, and the IMF, see CRS Report RL30449. *Debt and Development in Poor Countries: Rethinking Policy Responses*, by J. F. Hornbeck. March 1, 2000.

amount of lending to emerging economies may simply be reduced, should investors lose confidence in the market dispute settlement process. In the face of repeated debt management failures, this could be a disguised blessing, but may have long-term repercussions for these country's growth and development. As far as designing and creating an international bankruptcy agency, it is on hold after the Sovereign Debt Restructuring Mechanism (SDRM) promoted by the IMF failed to take hold.³³

The fact that debt workouts are being completed, even if not always smoothly or in a timely fashion, may suggest that the "market system with IMF assistance" approach is still preferable to taking another shot at reinventing the international financial architecture, including creating some type of sovereign bankruptcy option. But should the Argentine case fail to be resolved to the mutual satisfaction of all parties, it could reinvigorate interest in a systematic and internationally recognized debt restructuring system, because as Argentina has shown, once insolvency occurs and debt becomes far too large to manage, there may be little incentive for countries to work with the existing unenforceable system in finding a quick and consensual solution.

³³ See CRS Report RL31451. *Managing International Financial Crises: Alternatives to "Bailouts," Hardships, and Contagion*, by Martin W. Weiss and Arlene Wilson.