A victory by default?

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The successful restructuring of Argentina's debts has set a painful new benchmark for creditors

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IN 1902, after Venezuela defaulted on its sovereign debt, German, British and Italian gunboats blockaded the country's ports until the government paid up. In 1881, after the Ottoman empire failed to honour its obligations, European powers simply seized Ottoman customs houses and helped themselves to their due. The options available to more than 500,000 aggrieved creditors of the Republic of Argentina, which defaulted on bonds worth $81 billion in December 2001, were more limited. After much bluff and bluster, a large majority of them meekly surrendered their claims before a deadline on February 25th, in exchange for new bonds worth roughly 35 cents on the dollar.

The giant debt swap is epic in scale. It involves 152 varieties of paper denominated in six currencies and governed by eight jurisdictions. These bonds will now be exchangeable for three new issues. More importantly, the swap carries important lessons for emerging-market creditors and debtors alike. Bondholder groups think it a travesty. But on March 1st, Néstor Kirchner, Argentina's president, declared the restructuring a triumph, claiming "at least 70-75%" of bondholders had accepted it. His economy minister, Roberto Lavagna, announced two days later that the provisional take-up was

76%.

Even in a default, there is money to be made. So-called "vulture" funds pick over the non-performing bonds discarded by disheartened investors. In the summer of 2002, a few months after Argentina stopped honouring its debts, a brave buyer could have purchased a distressed bond in the secondary market for 20 cents on the dollar or less. On February 25th, he could have swapped it for crisp peso-denominated paper worth 35 to 37 cents: a tidy annualised return of 25% or more.

Not every vulture will settle for such quick pickings. The more patient among them will hold out for their full pound of flesh in the courts. They take their inspiration from Elliott Associates, an American hedge fund that spent $11.8m on distressed Peruvian debt and, after four years in the courts, forced the government to settle in 2000 for almost $56m. According to Manmohan Singh, an economist at the International Monetary Fund (IMF), the annualised returns from successful litigation can be more than 300%. Paradoxically, the higher the acceptance rate for a debt deal, the better for the refusniks: governments are more likely to settle with a small minority than with an army of litigants.

Elliott Associates did not seize Peruvian customs houses. Instead, it threatened to dip into the payments Peru made to other creditors through Euroclear, a settlements system based in Belgium. That legal avenue has since been closed, but other strategies will be tested, including a class-action lawsuit in New York. That said, litigants are likely to be more of a nuisance than a real threat to Argentina. "Vultures" is perhaps too grand a term for them. To a sovereign borrower, they are no more than mosquitoes who, as Mr Singh suggests, can draw enough blood to quadruple in size, but not enough to do real damage.

If litigation is more an irritant than a deterrent to sovereign defaulters, why should they ever repay anything? Several hard-pressed governments may be asking themselves the same question. "Restructuring was formerly a taboo word, now it's a topic of open conversation," says Walter Molano, of BCP Securities. The "haircut" inflicted on bondholders—the proportion of debt that Mr Kirchner has successfully written off—sets a new standard. In other restructurings, creditors have had to accept either a cut in principal, a lengthening of maturity or a reduction in interest payments. Argentina has achieved all three.

Could Argentina afford to pay more? It managed a government budget surplus which, before interest payments, was around 4% of GDP last year, and its foreign-exchange reserves increased to more than $19 billion. With this money it could have sweetened its offer, perhaps by as much as 3 or 4 cents on the dollar, reckons Vladimir Werning of J.P. Morgan. But the government would have been unwise, he concedes, to do much more, committing itself to pay more in the future when it does not know how much money it will have.

Kirchner's swap shop 1

Argentina's public debt, $bn

	Dec 2003*	Post-swap†
Bonds eligible for the swap	104.1	36.2
BODENs‡	18.5	19.4
Provincial guaranteed bonds	9.7	10.5
IMF loans	15.5	13.8
Other multilateral loans	16.7	15.1
Guaranteed loans	14.1	15.0
Other loans	7.6	7.6
Short-term debt	2.5	3.2
Total debt	**188.6**	**120.8**

Hold-outs	-	20.8

*Corrected for the effects of peso-ification
†Assuming 80% participation
‡Bonds compensating banks for peso-ification
Sources: AGM; Ministry of Economy; *The Economist*

Even after the swap, Argentina's debt will be more than $120 billion (see chart 1). Indeed, the 152 varieties of bonds eligible for the exchange amounted to just 55% of its total debt last year. It owes $13.8 billion to the IMF and another $15 billion to other multilateral institutions, such as the World Bank. During its economic crisis the federal government shouldered the debts of the provincial governments and stuffed the country's banks and pension funds full of bonds, called BODENs, which were then forcibly converted to pesos.

In the long run

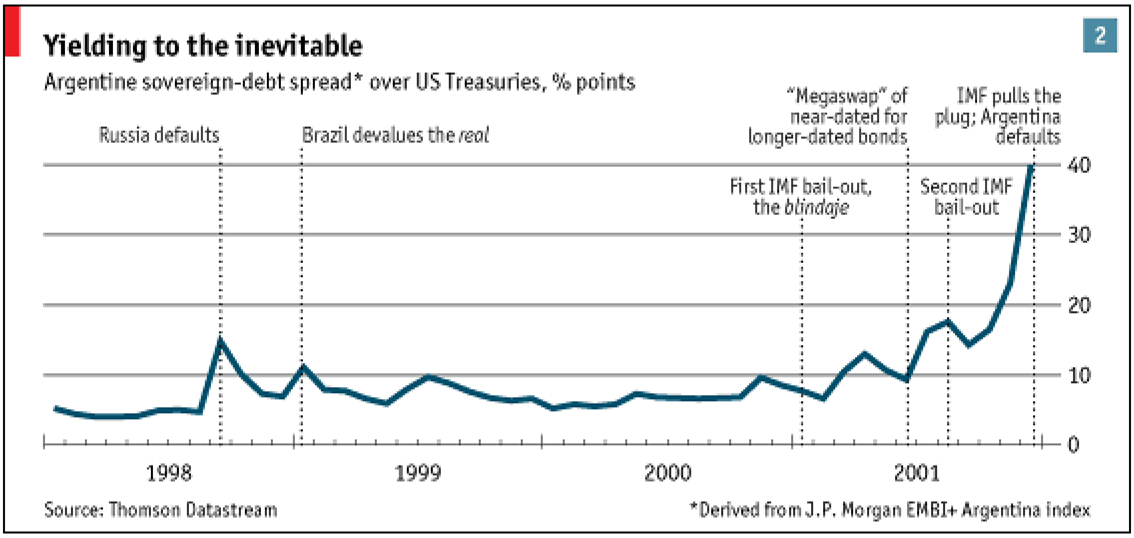
At around 75% of GDP, Argentina's debt ratio remains higher than the 52% carried by its neighbour Brazil. But the interest burden on Argentina's debts is now much lighter (a coupon of 2-5% in the first ten years, compared with 10% in Brazil) and the maturities much longer than the market would normally accept. No big Latin American government has ever fully repaid a 30-year bond; Argentina has offered a 42-year bond.

Standard & Poor's, a credit rating agency, has said it will upgrade Argentina to B- after a successful debt swap, a rating shared by Ecuador, Suriname and Lebanon. Tax revenues are quite buoyant at present, but may sag when soya prices inevitably ebb and capacity constraints bite. The budget surpluses that Argentina requires are not too onerous at first, but sustaining them may be difficult. The country needs fiscal stamina, not budgetary heroics, if its debt ratio is to fall.

Argentina defaulted so heavily because it defaulted so late. Its descent into default, devaluation and destitution is vividly recounted in a new book by Paul Blustein (see article). Far from being too ready to flout its obligations, he concludes, Argentina was too reluctant to do so. Domingo Cavallo, a messianic politician who returned as finance minister in 2001, would not countenance default. "Who could conceive such a destructive idea for a country, and be bold enough to propose it?" he wrote in the *Financial Times*.

Mr Cavallo had made his name with his 1991 "convertibility" plan, which killed Argentina's chronic hyperinflation. The plan removed all scope for monetary mischief by pegging the peso to the dollar, and making the currencies freely interchangeable. But Argentina's "monetary self-denial", as Mr Blustein calls it, coexisted uneasily with its financial self-indulgence. The Argentine government sold unprecedented amounts of bonds to foreign investors, accounting at its peak for more than a quarter of all emerging-market issuance. Its public debt increased from 35% of GDP at the end of 1994 to 64% at the end of 2001, nearly all of it denominated in dollars.

Russia's default in August 1998 deprived Argentina of such ready access to foreign capital (see chart 2). Then Brazil's devaluation five months later destroyed Argentina's competitiveness in foreign markets. The country was stuck with twin deficits, a trade gap and a budget gap, that foreigners were less and less willing to finance. To right itself, the Argentine economy needed to regain competitiveness. Since the exchange rate could not fall, prices and wages had to instead. As recession took hold, peso prices edged downwards, tax revenues faltered and Argentina's dollar debts grew harder to repay.



With a weak hand, Argentina refused to fold, but kept raising the stakes. It took on a $15 billion loan from the IMF, known as the *blindaje* or "armour", at the start of 2001 and a second $8 billion bail-out that summer. It completed its notorious "megaswap" of near-dated securities for longer-dated, higher-yielding bonds in June 2001, buying itself a little time.

Long before the event itself, it was clear that Argentina had to default on someone. As the last year of dollar-peso convertibility wore on, everyone jockeyed to make sure that someone would not be them. Gerardo della Paolera, of the American University of Paris, and Alan Taylor, of the University of California, have described the "fiscal war of attrition" that ensued*. Foreign investors moved their money out; the unions took to the streets, to forestall a raid on their pensions or a cut in their wages; the provincial governors kept up their spending, going so far as to issue their own scrip to fund it; eventually, depositors pulled their money out of the banks.

Bang, crash, wallop

In the end, Argentina defaulted on everyone. It stopped servicing its bonds, domestic and international; it cut wages and raided pension funds; it foisted its bad IOUs on to one side of the banks' balance sheets, then made a grab for the deposits on the other side, putting a freeze on withdrawals. It forcibly converted dollar deposits into pesos at one exchange rate; dollar loans at another. For the banks, this "asymmetric peso-ification" was every bit as painful as it sounds.

Must default be this messy? If the process were painless, governments would resort to it more often. Creditors would then be less willing to lend and bond finance would be more expensive. The sheer disorderliness of a default ensures that governments do not resort to it lightly.

A period of exile from capital markets is only the most obvious consequence of default. The legacy of financial disarray is more insidious. "Default", write Carmen Reinhart, Kenneth Rogoff and Miguel Savastano—three current or former IMF economists—"can become a way of life."** The more often default occurs, the less a defaulter has to lose, hence the more likely it will default again.

As a consequence, serial defaulters struggle to "tolerate" debt levels that other economies manage quite comfortably. Their credit rating begins to suffer even at relatively low levels of debt. The authors estimate Argentina's safe threshold of external debt at just 15% of

GDP. Although a country's financial tendons may heal suspiciously quickly, they are permanently weakened each time they snap.

To default is natural

Andrew Haldane, of the Bank of England, and Mark Kruger, of the Bank of Canada, argue that “default is a natural feature of the market mechanism”†. Default and debt go together like risk and return. Argentine bonds offered higher yields than American Treasuries precisely because their promise to repay was not as secure. True, a more orderly system of payments standstills and debt workouts might marginally raise the incidence of default. But it would also raise the recovery rate for creditors. The two effects might cancel each other out. Default should be avoided at some cost, but not, they write, “at all costs”.

Reluctant to default, Argentina has been painfully slow to restructure its debts. Its standoff with creditors has been confrontational, drawn out and poisonous. When national governments go bust, there is no impartial bankruptcy court that can resolve their differences with creditors. But in previous defaults, the IMF has served as a close surrogate, note Nouriel Roubini and Brad Setser, authors of an admirably thorough book on debt restructuring††. In return for a loan, the Fund asks for a given amount of fiscal effort from its ward, which indirectly determines how much money the debtor can set aside for its creditors. The Fund, as its governors put it in an April 2000 communiqué, “should not micromanage the details” of a deal. But, some say, it should nonetheless offer its best guess of the country's ability to pay.

This time the Fund kept its guesses to itself. It did not set any fiscal targets for Argentina beyond 2004 and ventured no opinion on Argentina's capacity to repay its debts. Messrs Roubini and Setser accuse the Fund and its main shareholders in the capitals of the rich world of coming close to abdicating their traditional roles.

AFP

The barber of Buenos Aires

If the Fund has remained remarkably hands-off, it is perhaps because its hands are not entirely clean. After twice lending money to Argentina in 2001, the IMF is now itself one of the country's biggest creditors, anxious to be repaid. In September 2003, it agreed to a new programme, which, in effect, rolls over the billions Argentina still owes as they come due. This should have helped it chivvy Argentina towards a deal. But Mr Kirchner was in no mood to be chivvied. First, he threatened to default on the Fund. Then, last summer, he suspended the September 2003 agreement, deciding that the IMF's money was not worth the accompanying hen-pecking.

In such situations, the Fund is only as strong as its biggest shareholders want it to be. Having sided against the Fund in its quarrels with Mr Kirchner in 2003, the American government's stance will again be crucial in the months ahead. The IMF must decide whether to give its blessing to the debt exchange, and what to demand of Argentina in return for rolling over its debts, $5.5 billion of which falls due this year. To call the Fund a pawn of the American Treasury is “an exaggeration,” says Mr Blustein, “but not an inordinate one.”

How quickly will investors shrug off this encounter with emerging-market risk? Many already have. Gross bond sales are strong, and the premium over American Treasuries of J.P. Morgan's index of emerging-market bonds (the EMBI Global) is just 3.35%—around a ten-year low.

Indeed, capital markets appear to have a remarkably short memory. Argentina has defaulted on its foreign debts five times in the past 175 years; Brazil seven times; and Venezuela nine times. A debtor can default no more than once, unless a creditor is willing to forgive and forget. Amnesia sometimes sets in remarkably quickly. The bad loans that Argentina inherited from the debt crisis of the 1980s were written down in 1992. Just three years later, Argentina was carrying more foreign debt, both in absolute terms and relative to the size of its GDP, than it had in 1991.

J.P. Morgan has announced that Argentina's weight in the EMBI Global will rise from 1.9% to about 2.7% once the latest debt swap is declared a success. The index weights countries according to how much debt they have issued. Thus any fund manager tracking the index must, in effect, lend more to the countries borrowing the most. In the heady days before its default, when Argentina accounted for 23.3% of the index on average, the perversity of this incentive was manifest. Purists will protest that bond prices, like all prices, are set at the margin. As long as the marginal investor is willing to bet against the index, prices will not be distorted. But such brave investors may be in short supply.

Against the grain

Mohamed El-Erian, an emerging-market specialist at PIMCO, an American fund manager, is one. He quietly eased his firm's money out of Argentina a year before the default. Cleaving tight to the index, he says, is about "personal risk management", not asset risk management. In other words, a fund manager who does badly when the index falters is unlikely to lose his job. Departing from the index and then underperforming is a sure way to get fired. This is why so few other managers walked away from Argentina earlier.

With real interest rates still so meagre in mature markets, investors are chasing yield even into territories they formerly scorned. But emerging markets remain chronically vulnerable to sudden drop-offs in capital flows. Last spring, for example, when the markets realised American interest rates were about to turn, a yearlong rally in emerging-market bonds was undone in a matter of weeks.

In theory, capital should flow from where it is abundant to where it is scarce. But Argentina's downfall demonstrates the dangers of relying too much on this dynamic. In the 1990s, Argentina tried to borrow its way back to the *belle époque* it enjoyed prior to 1914, when decades of foreign investment, anchored by a rigid monetary standard, built the railways and boulevards that still distinguish the country from its neighbours in the minds of its citizens. The embrace of the international bond markets in the 1990s lulled Argentina into thinking it had left the periphery of global capitalism and joined its centre.

Other developing countries appear under no such illusions. For all the fear that Argentina's default may have set a precedent, many of its peers seem to have drawn the opposite lesson from this sorry saga. In recent years emerging-market countries as a whole have been net exporters of capital. They have offset generous private inflows with the prudent accumulation of foreign reserves. With these war chests at their disposal, countries can insure themselves against the sudden reversals of market sentiment to which they are still vulnerable. Emerging markets may enjoy the benefit of recurrent exuberance; they never get the benefit of the doubt.

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*Gaucho banking redux. NBER working paper 9457

**Debt intolerance. NBER working paper 9908

†Bank of Canada Review, Winter 2001-2002

††Bailouts or bail-ins? IIE, 2004