

**New York State Senate Public Hearing**  
**“Argentine Debt and New York Impact”**

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**Argentina: The Unending Saga On Debt**

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**1. Introduction and Background**

Argentina has a long history of macroeconomic instability that included large fluctuations in the rates of growth, recurrent balance of payments and debt crises and very high and unstable rates of inflation. This instability affected the ability to grow over time, as real GDP per capita in 2009 was only 31% higher than thirty years earlier, compared with an increase of 67% for the advanced economies, 260% for the NICs, and almost 4 times for Developing Asia. The most recent cycles include a rapid expansion during most of the nineties followed by a deep crisis in 2001-2002 and a period of rapid growth from 2003 until 2008. This ended with the big recession in 2009, and continued debt problems.

In the period 2001-02 there was an unprecedented increase in poverty and unemployment, a traumatic devaluation, a large balance of payments crisis, and a massive default on public sector debt. The recovery from the 2001-02 crises was very strong, as the economy quickly moved to a path of rapid growth, and improved most of its social indicators. Over the period 2003-09 GDP per capita increased by 50 percent, after surpassing the previous record levels of 1998. From 2003 and until 2007 the country managed to reduce its macroeconomic vulnerability, in large part explained by the sharp reduction in debt service payments during the default and after their unilateral resolution in 2005. The restructuring of the government debt in 2005 was successful in reducing the burden of the debt on the cash position of the public finances, as it extended the maturity, and lowered the nominal value and the interest payments on the bonds; the external accounts moved into a surplus helped by a benign world scenario; and the banking system left behind its serious crisis.

In more recent years external conditions weakened, and in conjunction with serious conflicts between government and different sectors of production, particularly farmers, output decelerated, and entered into a recession for the first time since 2002. Government expenditure continued to increase particularly in the form of subsidies across the economy, while public sector surpluses moved to deficits, and financing shrunk. In response, the government took increasingly non-market oriented actions, and seized assets, first from private pension plans, and then from the autonomous Central Bank, after firing its president. Argentina has now come out with a proposal to settle its massive debt in arrears with private creditors- US\$20 billion, although the terms of this proposal remain subject to controversy, and there are serious questions about the degree of acceptance by bond-holders.

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The economy is now faced with the serious challenge of sustaining growth. It is experiencing high rates of inflation by regional and world standards; investment has declined particularly originating from abroad; and the country is facing growing bottlenecks. In addition there are important challenges if the government decides to unwind numerous subsidies and some price controls to eliminate distortions that affect the business climate and investment.

In these circumstances the macro-outlook looks negative, as the economy is expected to continue to face obstacles to growth even with higher world prices, and international perceptions about the country remain broadly adverse, even though with some optimism associated with the debt negotiation announcements. The peso is claimed by the government to be competitive, although in the last two years it has appreciated in real terms, when measured against the private unofficial measurements of inflation (Inflation is seriously underreported by the official statistical office). In addition, the country has returned to fiscal deficits, particularly when including the imbalances of the provincial governments. Finally, external accounts have weakened, as private capital outflows over the last two years have been enormous. There are serious doubts as to how the government will find a way to get out of the rigid controls and low investments in infrastructure, about the strategy for economic integration to the world economy, about the approach to Paris Club debt and the debt holdouts, and about the business climate that has been keeping foreign investment low.

## **2. Economic Background in the last twenty years**

The “Convertibility Plan” in the early 1990s was a response to the hyperinflation of the late eighties and was a comprehensive program that combined stabilization and structural reforms, in order to move Argentina to a path of long-term growth after many years of economic stagnation, and based on a fixed exchange rate. The program was very effective in bringing down inflation, and Argentina enjoyed in the one of the lowest rates of inflation in the world. There was also a quick recovery in economic activity. Investment was one of the engines of growth, but it was increasingly financed from abroad.

During the Convertibility years Argentina experienced an increase in public debt, as the fiscal deficit increased, revenues from privatization declined, and the economy stopped growing. The stock of gross public debt rose from 30% of GDP in 1993 to 54% in 2001. While the debt burden did not appear to be large, it was difficult to roll over because Argentina did not have a deep domestic capital market with large institutional investors. The country was thus dependant on the international capital markets, which worked well when the markets were bullish, but became a problem when investors became bearish about the viability of the Argentine currency board.

Towards the end of the nineties the convertibility regime faced significant challenges because of a marked deterioration in economic performance. The Brazilian crisis of 1998 had a major negative impact on Argentina. Other countries abandoned their peg, but that effect was magnified when Brazil, Argentina’s main trading partner, devalued in 1999. The government made desperate efforts to avoid a currency and debt crisis, but did not respond well to the crisis. In June 2001 it structured a large swap of debt known as the *Megacanje* (Mega-exchange) that attempted to reduce significantly the financial requirements for the forthcoming years. The efforts failed, as political support for the required fiscal measures waned due to the expectation of a bail-out without additional efforts. Eventually Argentina defaulted and devalued. The Argentine crisis was the worst in Argentina’s recent history and among the deepest in emerging markets. GDP per capita fell by 25% in just 4 years, while the rate of unemployment reached an unprecedented level of 25% of the labor force.

The crisis in Argentina was extremely traumatic, but the country recovered. While the financial system had been hampered, the capital stock, which had been modernized, remained intact and provided a major source of potential economic growth. The recovery was surprisingly strong and sustained over time, and the economy managed to return to growth, after a turning point for economic activity towards mid-2002. The economy started to recover, taking advantage of the low domestic costs in dollar terms, as most wages had remained very stable due to the large increase in unemployment. The recovery was also helped by a significant improvement in the international environment. GDP grew at an average rate of 8.5% during the six years ended in 2008, with sharp increases in investment that reached 22% of GDP. Domestic savings exceeded that amount, giving rise to current account surpluses of some 2% of GDP, and reflected in a large accumulation of international reserves, which reached US\$46 billion.

The fiscal accounts improved markedly early during this period, as the government managed to control wages and pensions, despite the increases in domestic prices while tax revenues increased thanks to the introduction of export taxes allowing the government to start running fiscal surpluses. These developments led to the perception that Argentina was entering a new stage and entailed a new economic paradigm. However, inflation accelerated and became the second highest in Latin America.

Eventually, the Argentine economy slowed down in line with the rest of the region and the world. Actually, Argentina, according to independent estimates, saw a decline of 2.0% in GDP in 2009. This decline was only exceeded by those experienced by Mexico (6.5%) and Venezuela (2.5%) among the larger countries in the region. Macroeconomic policies have weakened considerably in the last two years or so. Fiscal policy became expansionary on account of a rapid increase in domestic expenditure, reflecting wage and subsidy increases, the first well in excess of productivity growth, and the second increasing further the distortions that have plagued the Argentine economy. The weakening fiscal position of the provinces and other sub-national governments has also contributed to this situation, repeating episodes of the past. A long standing conflict with farmers over taxation, and a decline in export prices further contributed to the mounting problems of the Argentine treasury, even as the debt relief resulting from the unilateral debt restructuring helped improve the fiscal position of Argentina.

The initial fiscal position allowed reserves to accumulate and the peso to appreciate in real effective terms, but in more recent times this accumulation stopped. Regarding the exchange rate it has appreciated in real terms relative to the US dollar and more recently with respect to the Euro, but this has been mitigated by the appreciation of the Brazilian Real.

After imposing a unilateral solution to its debt problems (see below), the government of Argentina took what at the mildest could be described as heterodox actions to obtain financing, in the absence of adequate financing from the markets. The first source of financing was the government of Venezuela, which charged very high interest rates on its loans, but the underlying conditions caused strong rejections in Argentina, and resulted in the end of this financing. Subsequently the government arbitrarily seized the assets of the Private Pension Plans, and merged the public and private systems in 2008, and further eroded the confidence in the integrity of the Argentine capital markets. Finally in recent months the government sought to capture significant amounts of the country's foreign reserves, as described below. This resulted in a serious conflict with the President of the Central Bank, his eventual departure, and further efforts by the government to seize foreign reserves.

At present two other key problems persist: investment has declined and, excluding construction is very low due to macroeconomic inconsistencies. The freeze of utility tariffs and other critical prices has

adversely affected the views about Argentine policies abroad and the willingness of private investors to undertake new investments in infrastructure. In addition, many companies started demands in the ICISD (CIADI in Spanish) that represent an important financial contingency in the future. The Central Bank now views inflation as a structural issue, thus excluding any monetary view of inflation. The current account surplus remains reasonably strong even with fiscal fragility, because of a lack of incentives for new investment both domestically and abroad. The business climate reflects all the problems noted.

### **3. The Ease of Doing Business in Argentina**

Argentina has a good standing among Latin American and other emerging countries in terms of its per capita income and other development indicators, as reflected in the Human Development Index (HDI), developed by the UNDP. The HDI indicator combines per capita income, levels of education, and longevity, as broad indicators of well being. Within the overall rankings, Argentina is ranked 49 out of 182, only behind Chile among the larger Latin American countries. The relative position has eroded over the years, but still remains high. Its relative position in Per Capita Income on the basis of Purchasing Power Parity is about one third down from the top: 60 out of 182, again very respectable relative to other countries in the developing world, but a far cry from the levels held forty or fifty years ago.

However, domestic and foreign investors in Argentina confront serious problems when seeking to do business, and thus in engaging in new investments. Thus the business climate is much worse than implied by its income and general welfare. These issues are described below in the second set of tables presented in this section. The World Bank in its 2009 edition of its Annual Publication *Doing Business* reviews specific aspects of carrying out business in most countries of the world. The publication provides a comprehensive review of business practices around the world and covers 182 countries. The ranking for Argentina is low. Colombia is in the first quartile and Chile and Mexico are in the top of the second quartile. Argentina is placed in position 118, ahead of Brazil and Venezuela, but well below others.

The placement of Argentina is low also in the worldwide ranking in the lists on competitiveness, corruption perception and economic freedom. It is placed below the middle of each ranking, ahead of the bulk of less developed countries, but well behind the strong performers in the world economy. Argentina ranks high in education, training, and health. On this basis the prospects for Argentina could be brighter than looking at the ranking noted above. However the general deterioration in Argentina's standing, and the poor business climate dominate the rankings overall.

### **4. Public Debt Issues**

#### **a. The Public Debt Restructuring**

In 2005, three years after declaring default and following a long and conflictive process, creditors accepted Argentina's unilateral debt restructuring offer, but the acceptance rate was one of the lowest on record. The government made the final offer at the beginning of 2005. In the end there was 76.1% participation level. There were 80.8 billion dollars of debt eligible for the debt. The offer reduced the number of bonds to just three types of, plus the GDP warrant, with a 66% haircut in nominal value for the discount bonds. The present values of the different new bonds were the same. In the end the acceptance reached about US\$61 billion, with virtually no negotiation with (mainly foreign) creditors, and entailed reductions of more than two-thirds in their present value relative to the time of issue.

Bondholders holding about US\$19 billion did not accept the arrangement. They were effectively shunned by the Argentine authorities, who have not serviced that debt or taken any initiative to attain a settlement with the creditors, as described below. In particular Congress passed the *ley cerrojo* (or padlock law in English), precluding the Government from reopening negotiations with those creditors that did not accept or were left out from the offer made by Argentina at the time. This highly nationalistic and exclusionary policy pushed by the Government and without real precedent in recent debt default and negotiation history. A significant proportion of those left-out creditors are Japanese, Italian and German bondholders.

The unilateral settlement by Argentina set a new model about how to negotiate a debt restructuring. In contrast to Ecuador, Russia and other cases, Argentina dealt with the issue without engaging into a real negotiation. It ignored the recommendations from the IMF, and the G-7. It did not sit down with the creditors to discuss the macro-projections nor to discuss alternative structures that might have suited them better. It did not pay attention to the suggestions of the advisor banks. And yet it got its way. Certainly the combination of good luck and toughness worked in the Argentine case to generate a large level of participation. Argentina got a slanted deal, as it reduced the nominal debt in default in half and as it extended the maturities significantly at very favorable interest rates.

Fortunately, emerging countries did not follow Argentina toward default, with the exception of Ecuador. However, the Argentine restructuring has raised serious questions about the international financial order, about the mechanisms to deal with default, about how to ensure inter-creditors equity and burden sharing between domestic and foreign bondholders, and about private and official creditors. In addition, it raised questions about the usefulness of issuing sovereign debts under foreign law, especially as foreign courts, including in the US, have been almost powerless to enforce their rulings asking sovereign countries to make the payments to the bondholders.

#### **b. The Burden of Public Debt**

The total stock of Argentine public sector debt that is published by the Ministry of the Economy is estimated at some US\$170 billion, which is equivalent to roughly 55% of GDP. There are a number of features that complicate an evaluation of the actual debt burden and the challenges that Argentina faces in terms of debt management. The amount tends to overestimate the actual debt, as there is a stock of US\$ 50 billion of intra-public sector debt, most of it with the Central Bank and the now public sector social security system, which represents roughly 30% of the total debt and 17% of GDP.

The debt should be also adjusted for the value of the growth warrants (adjustments to returns based on growth performance) attached to the 2005 bonds. These warrants entail about US\$ 4 billion in contingent liabilities. While some analysts heavily discount the value of the bonds that are not being serviced, in light of the current disputes, this adjustment is not taken into account in these estimates. In addition, the estimates do not include the effect of the under-reporting of inflation on debt which has entailed a confiscation of part of the domestic currency denominated debt. In the end, the value of public debt amounts to some 40% of GDP, a sharp decline from the 120% of GDP registered in 2004 and even higher in previous years. The debt burden associated with this figure places Argentina with a smaller public sector debt than countries that a much better credit rating and where debt is not a major concern such as Uruguay, Brazil or Colombia. When foreign reserves (adjusted for Central Bank liabilities) are taken in to account, with a value of some 7-10% of GDP, the burden is even smaller. In fact, this level of debt begs the question about the link between Argentina's ability and willingness to pay.

## **5. Current Relations with Creditors**

**Relations with the Paris Club.** Argentina stopped paying its obligations to the Paris Club countries at the time of its declaration of default. The debt to the Paris Club, of about US\$7 billion, remains broadly in arrears. For a significant period there were no official discussions about the process of repayment. Argentina has frequently indicated that it seeks to repay its obligations to the Paris Club, but this proposed course of action is controversial in Argentina and among creditors, who lost trust in the willingness of Argentina to pay. This is further complicated because of the Paris Club practice that debt relief is usually provided in the context of an IMF program, which is claimed to be unacceptable by the authorities. The relations with official creditors and investors have remained bitter, because of the confrontational approach of the authorities, and unstable legislative and regulatory conditions. The failure to reach an agreement with the Paris Club severely restricts limits official financial from credit agencies. At the moment, official creditor agencies have circumvented the ban on credit to Argentina, as they have lent to existing official energy-related trust funds.

**Relations with IFIs.** The Argentine government has reduced the intensity of relations with the Bretton Woods institutions, and particularly with the IMF, where relations are distant. After virtually uninterrupted financial (lending) relations between the IMF and the country, all obligations were repaid in early 2006. At present Argentina considers it unviable and unnecessary to approach the IMF for use of its financial resources. The role of the Inter-American Development Bank is being preserved, while promoting more regionally-oriented efforts, specifically those of CAF, and the incipient Banco del Sur. To the extent that conditions may change in the future, and depending on the severity of these changes it is plausible that Argentina may require IMF assistance.

**Relations with Private Creditors.** A universe amounting to almost US\$30 billion, including accrued interest, of the hold-outs of the previous restructuring is not being paid. Argentina has fended off the legal efforts of the bond-holders that did not participate in the restructuring of 2005 but it cannot raise money directly in international markets, which constitutes a serious impediment. There is no easy prediction other than that the *status quo* will be maintained. The Argentine Congress in November 2009 suspended the “padlock law” which had prohibited restructuring of debt held by creditors that did not accept the restructuring offer concluded by the Argentine government in 2005, as noted above.

The unrecognized (hold-out) creditors hold obligations for roughly 24% of the original debt, and represent more than half of Argentina’s foreign lenders. Since 2005, these creditors and the purchasers of bonds in the secondary market have been in persistent conflict with the Argentine government. While the holdouts have not obtained payments so far, they have successfully won over 100 lawsuits against Argentina requiring the country to pay what it owes. Additionally, the Argentine government has not raised money in international capital markets because of the clear fear of attachment of assets, and transferred foreign reserves to the BIS. This is further complicated by the arrears the Paris Club.

Arrears to private and public creditors constitute about one fourth of total public debt, on the basis of nominal corrected values. On account of this, plus considerable uncertainties about the rule of law regarding contracts, Argentina’s sovereign rating is B-, or six levels below investment grade. Only two countries in the region have a lower rating- Ecuador and Nicaragua. Furthermore Argentina is the only member of the select G-20 that is this low in the ratings and in addition is in arrears to the Paris Club.

## **6. The Central Bank, the management of reserves, and the BIS**

In recent months the Argentine Government sought to seize part of the International Reserves of the Central Bank, with the proclaimed aim of securing public debt payments. The request was against the legislation that establishes the autonomy of the Central Bank. The President of the Central Bank viewed this correctly as an attack on the financial integrity of the country. The government then deposed him by decree, and appointed a new President, while remaining in conflict with the Argentine Congress on account of this situation. The government action was meant to appropriate resources for politically motivated spending. But more importantly, it was the inevitable consequence of actions to protect the assets of Argentina from legal action by external creditors, since default was declared eight years ago.

As the country climbed out from the recession the Central Bank was able to start accumulating reserves from previously low levels. However, instead of using the opportunity to start debt negotiations, the Central Bank moved its reserves, mainly held at the Federal Reserve Bank of New York, to the Bank of International Settlements (BIS). Located in Basel, and associated with most Central Banks, it bases its deserved prestige on developing, coordinating, and helping implement regulations aimed at strengthening and stabilizing banking systems. It also acts as depository for some of the foreign reserves of many central banks, because of its prudent management, although paying low interest rates.

Deposits held at the BIS enjoy judiciary immunity, and thus cannot be seized by creditors seeking the repayment of their debt. Most Central Banks hold a small proportion of their reserves at the BIS, on average less than 10 percent of their totals. However, Argentina has 80 percent of its reserves (US\$40 billion) at the BIS, thus declaring off limits these assets from bonafide creditors. More than 10 % of assets represent deposits by Argentina, far in excess of any other country. In this sense, the BIS may have a serious conflict of interest: it protects the unwillingness of an official member to negotiate against creditors from many other countries in the BIS. Argentina was not willing to engage with creditors within an established and accepted institutional framework. It is highly disappointing that the otherwise highly reputable BIS is a party to this behavior. A more reasonable and law-and-contract abiding approach would be to open discussions in good faith with official and private creditors to solve existing problems, and thus open the doors to a normalization of relations between Argentina and its creditors.

## **7. Concluding remarks**

After the Argentine government repeatedly indicated its intentions to restore relations with the international financial world, it has come out with a new offer to deal with existing bonds in default. Over the next weeks and months there will be a careful review and most likely a heated debate about the proposed conditions. The tenor of the offer goes beyond the purpose of this presentation and will be reviewed extensively by others during the current hearings of the New York Legislature.

What remains clear is that Argentina needs to restore credibility in its financial dealings with the rest of the world. Notwithstanding rhetoric to the contrary, Argentina is very much affected by domestic political and economic factors as well as the after-effects of the financial crisis. The boom of recent years had been attributed to the pursuit of “the argentine model” and not the world bonanza, and fiscal and tax policies were accordingly pursued very loosely. However, conditions have reversed and productive investment is declining, while recent capital outflows have amounted to at least the tens of billions if not hundreds of billions. Argentina is losing competitiveness; its business environment is ranked extremely low for a country of its past prestige and income, and its infrastructure is in shambles. Moreover, the quality of education and technological readiness are falling behind other members of the Latin American region.

Prospects for sustained economic growth are questionable at best, and with limited margins to deal with Argentina's financing requirements. However, the Government still seems to want a unilateral decision by imposing on a large number of creditors a likely unreasonable offer. Argentina remains a high credit risk in international markets. The country has been acting as a victim, even with reserves well in excess of minimum thresholds, and up to recently, high economic growth. Furthermore, it is the only country in the exclusive G-20 forum in arrears with creditors, particularly from most other G-20 countries.

The list of policy issues to restore Argentine relevance is long, and their solution will need long term vision and pragmatism. However, Argentina would be well advised if they accepted some basic truths:

- Argentina should follow through on G-20 and multilateral commitments, and pursue more forcefully global financial integration and principles of free trade, even if in a long term perspective. The other Latin American members of the G-20, Brazil and Mexico have certainly done so. The debt negotiation should continue in this light.
- The ideological conflict related to foreign debt seems to run mostly on the side of the Argentine authorities. However, the Government needs to understand that if it does not negotiate in good faith, it is depriving creditors and the citizens of other countries as tax payers, of their money. This may be seen as favorable by some in Argentina, but it is certainly a no-go in a world based on cooperation and fairness. Argentina needs to show a serious commitment to negotiation and repayment if it wants to regain economic stability and return to international capital markets.
- Until the Government completes negotiations with its private creditors, the country will continue to face international lawsuits for the nonpayment of its debt to global investors, which continues to grow. Any other solution would be legally unacceptable in court and would only prolong legal aggravation for all parties involved and the possibility of seizure of assets around the world.
- A low take-it-or-leave-it offer (less than 30 cents on the dollar) would not be acceptable, as Argentina is in a much better position than it was four years ago, and previous creditors have benefited from the high yielding growth warrants.

It is clear that a negotiation will need to take into account previous commitments, but in the context of a true negotiation. Alternatively, Argentina's position in the financial world will not be restored, even if the Government wishes to be recognized as a credible partner in world affairs. In the end, the behavior of Argentina has gone against the principles of respect for the law in the countries of issuance and domestically, and has generated a very dangerous precedent for international financial matters.

While Argentina faced a very difficult situation when it declared default almost a decade ago, conditions have changed. A unilateral approach is unacceptable from a legal point of view, and is very costly to creditors. Moreover, the adverse consequences for borrowers are also unambiguous. Other debtors end up paying for the risk that Argentina imposes by association in the asset class. Ironically, Argentina incurs the highest cost, because of the seriously hampered access to domestic and foreign savings with negative consequences for all its people, rich and poor.