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The Argentine Foreign Debt Default and Restructuring

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ABSTRACT

For almost three decades, Argentina's foreign debt was one of the main concerns of economic policy in the country. Despite this, both the record amount of the defaulted debt and the novel characteristics of its restructuring in 2005 surprised many observers. In this Policy Brief we comment on some aspects of the issue that seem to be more relevant for present discussions. We also assess three frequently mentioned arguments about the Argentine foreign debt and default and comment on the role of the IMF.

RESUMEN

Durante casi tres décadas, la deuda externa de Argentina fue una de las principales preocupaciones de la política económica en el país. A pesar de ello, tanto el monto sin precedentes de la deuda que cayó en default, como las características novedosas de su reestructuración en 2005 sorprendieron a muchos observadores. En este Policy Brief se consideran algunos aspectos de la cuestión, que parecen ser más relevantes para las discusiones actuales. Además, se evalúan tres argumentos mencionados con frecuencia acerca de la deuda externa argentina y del default, y se plantean también algunos comentarios relativos al papel jugado por el FMI.

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The Argentine Foreign Debt Default and Restructuring

For almost three decades, Argentina's foreign debt was one of the main concerns of economic policy in the country. Despite this, both the record amount of the defaulted debt and the novel characteristics of its restructuring surprised many observers. We have analyzed the Argentine foreign debt problem, the default of part of the public debt in 2001 and the restructuring process in a number of papers, particularly in Damill, Frenkel and Rapetti (2010)[2]. In what follows we comment on some aspects of the issue that seem to be more relevant for present discussions. We start by briefly assessing three frequently mentioned arguments about the Argentine foreign debt and default and commenting on the role of the IMF.

Debt Intolerance

Let us first consider the argument that takes the Argentinean experience as an example of "debt intolerance." Some economists include Argentina in a grouping of countries that carry an "original sin" of being serial defaulters and consequently suffer from debt intolerance. The extraordinary emphasis that the debt intolerance approach puts on both the remote past and rigid institutional features takes the focus away from what is the most fruitful perspective in an international comparative analysis of the external debt problem: the different policies followed by the countries in their processes of financial integration into the global system. In our analyses of the Argentine foreign debt we have paid special attention to the economic policies that framed Argentina's external debt growth since the 1970s. We conclude that there is no supporting evidence for the "debt intolerance approach". We show that by the end of the seventies the country had built up an intolerable debt burden. The origin of the external debt problem was not a remote "original sin" but a more recent original policy mistake—essentially, the combination of capital account opening, a fixed nominal exchange rate and an appreciated real exchange rate. That original policy mistake was repeated again in the nineties.

Fiscal Profligacy

The second argument we criticize is the one that takes the Argentine case as an example of how uncontrolled public spending is the main cause of the crisis and default. This is probably the most common, yet false, image of the Argentine case.
A detailed examination of the fiscal accounts shows that the cumulative effects of the interest rate rise, which followed the increase in the country risk premium due to contagion after the Asian and Russian crises, caused the adverse public debt dynamics in the last quarter of the nineties . Interest rates on Argentine public debt rose more than in many other countries in the region. The interest payment item was the main factor explaining the increase in the fiscal deficit in the 1998-2001 period leading up to the default. Indeed, the fiscal deficit increased despite a significant rise in the surplus in the primary balance. In addition, the deficit of the pension system following the social security reform of 1994, partly privatizing the public system, also contributed to the increase in the fiscal deficit. The fall in the public pension system receipts also resulted from the recession and the employment contraction that started in mid-1998. In other words, the rise in the country risk premium and the interest rate can be associated with the fragile external accounts or, alternatively, with the evolution of public finances, or with both, as the investment fund analysts and the risk rating agencies actually wrote in their reports. However, even if the uncertainties regarding public debt sustainability weighed significantly in the investors'

2 Damill, M., R. Frenkel and M. Rapetti "The Argentinean Debt: History, Default and Restructuring" in Herman, B., J. A. Ocampo and S. Spiegel (eds.) *Overcoming Developing Country Debt Crises*. Oxford University Press, Initiative for Policy Dialogue Series. 2010.

assessments, this should not overshadow the original source of the rise in public deficits and debt in the late nineties.[3] The main source was not mistaken but exogenously chosen expenditure and tax policy, but rather the compounded effects of inherent fragility of the external accounts and their vulnerability to the contagion of crises of confidence elsewhere.

The Social Cost of the Default

We also question the view that the default was the main factor responsible for Argentina's deep economic crisis in the early part of the twenty first century and its high social cost. Our analyses show that the abrupt contraction in the activity and employment levels began, to a great extent, before the default, i.e., while the government subjected the country to big efforts to keep the debt servicing on track. The collapse of activity and employment was a consequence of the generalized rush to buy external assets and the resulting liquidity crunch. And then in the first quarter of 2002, the real devaluation owing to the sharp fall in the peso exchange rate added another contractionary effect. However, the default also turned out to be one of the conditions that enabled the recovery that took place soon after. This was not only due to the positive fiscal effect of the payments suspension, but also a consequence of having freed the economic policy from the need to continuously issue signals aimed at facilitating the rollover of the debt obligations. It allowed the implementation of a pragmatic macroeconomic policy, focused on the stabilization of the exchange market and the quick recovery of fiscal revenues, which became feasible when no further new private or multilateral external fresh funds were needed. The success of this policy provided the base for the recovery.

The Role of the IMF

It is striking that Argentina's crisis and the massive default took place in a country that for a long time was considered a Washington Consensus success. Almost until the end of the nineties, the IMF and most of the financial market analysts considered Argentina as one of the cases following macroeconomic policy and structural reforms appropriate for the era of financial globalization. In our view, the IMF's advice was actually not helpful. In fact, the IMF's commitment to the "convertibility regime" – particularly, the rescue package granted to the country at the end of 2000 and extended in 2001—generated criticisms and conflicts within the institution and motivated a special investigation of the convertibility regime period by the Fund's Independent Evaluation Office. The relationship between Argentina and the IMF was very different in the period following the default. The debt restructuring took place in the context of a conflictive relationship between the IMF and the country. The most unusual feature in this process was that the IMF did not participate in the design and management of the debt restructuring. Neither did the organization audit the government's financial projections that justified the call for very deep dept reduction to achieve sustainability. The importance of this novelty is highlighted both by the record amount of debt that was restructured and by the unprecedented haircut, one of the highest in the debt restructuring history of the recent globalization period.

The macroeconomic evolution in the nineties

The basic plot of the macroeconomic story of the late nineties was quite simple. The negative financial turnaround in the foreign environment experienced in 1997-1998, after the East Asian and Russian crises, found the Argentine economy with a significant and growing current account deficit, a

3 On this respect, see for instance our Policy Brief nº 62, "Fiscal austerity in a financial trap: the agonic years of the Convertibility Regime in Argentina", CEDES, 2012 (http://www.itf.org.ar).

considerably appreciated currency and a visible lack of policy instruments to deal with these problems, given the rigidities of the adopted macroeconomic policy rule. In these conditions the country-risk premium jumped upwards and the access to foreign funds became more and more problematic. The subsequently increased interest burden had a negative impact on all borrowers, including the public sector.

Because of the fixed exchange rate and dependence of monetary conditions on the balance of payments, fiscal policies had to bear the burden of the adjustment to the new situation. The government argued that furthering fiscal discipline would strengthen confidence, and consequently the risk premium would fall, bringing interest rates down. As a result, domestic expenditure would recover pushing the economy out of the recession. Lower interest rates and an increased GDP would, in turn, reestablish a balanced budget, thus closing a virtuous circle. Fernando de la Rúa's administration in 2000 borrowed this entire argument from Carlos Menem's administration which had preceded it, and the IMF gave its seal of approval. All of them failed.

The entire macroeconomic story of the late nineties is about this failure. Despite the strong adjustment in the primary balance of the public sector the virtuous circle was never attained. Even worse, the increases in taxes and the cuts in public expenditures reinforced the recessionary trend, thus feeding the negative expectations that prevented realizing the highly anticipated fall in the country-risk premium. Fiscal policy alone was impotent to compensate for the strong macroeconomic imbalances, which laid somewhere else, i.e., in the external sector of the economy. Under this self-destructive fiscal policy orientation, the economy got trapped into a vicious circle for several years, and suffered from the longest recession since the First World War.

The Bailout of the Financial System

The suspension of the service payments on a part of the public debt was declared on December 24, 2001. The measure initially affected 61.8 billion dollars in public bonds and another 8 billion dollars in diverse liabilities, out of a total debt of 144.5 billion dollars. The rest—mainly debt with multilateral organizations (32.4 billion dollars) and recently issued guaranteed loans (42.3 billion dollars)—remained as performing debt.

The devaluation of the peso that followed had a strong impact on the economy, given the important dollarization of contracts inherited from the convertibility period. The government interventions beginning in early 2002 aimed both to reduce the wealth transfer from debtors to creditors and avoid the collapse that would have resulted from being unable to fulfill domestic contracts set in US dollars. The official intervention intended to manage the "distribution of losses". In many cases the intervention meant that parts of the losses were absorbed by the State by issuing new debt.

The main source of the new indebtedness came from the intervention in the financial system, which involved a 14.4 billion dollar rise in public debt. In February 2002, the government decided to compel the conversion of all foreign-currency bank deposits into pesos at a rate of 1.4 pesos per dollar. Bank credits denominated in foreign currency were converted into pesos at a rate of one peso per dollar. This measure was aimed at avoiding generalized bankruptcies in the private sector. The "asymmetric pesification" of credits and deposits caused a significant loss in banks' net worth that was compensated by the government.

Considering the different measures and effects derived from the management of the convertibility collapse and the declaration of default, between December 2001 and December 2003 the gross public debt stock increased by about 28.2 billion dollars (23% of 2003 GDP). By the end of 2003, Argentina's total public debt reached 179 billion dollars (146% of 2003 GDP).

The Public Debt Swap

In the second half of 2003 the first official steps for the restructuring of the defaulted debt were taken. In September, after reaching an agreement with the IMF, the government took advantage of the annual meeting of the IMF and the World Bank in Dubai to make public the main guidelines and the agenda of their restructuring proposal.

The "Dubai proposal" established that Argentina would offer uniform treatment to every holder of its bonds issued up to December 2001, while still fully servicing its multilateral debt and the guaranteed loans issued in 2001. The government thus recognized a defaulted stock of bonds of about 87 billion dollars. This amount left aside an important volume of past due interest. A 75% haircut was to be imposed on the bonds, according to which new bonds would be issued in a swap that would leave the equivalent of a maximum amount of bonds of about 21.8 billion dollars. Three bonds, called Par, Quasi-Par and Discount, were announced. Although the detailed characteristics of the instruments were not published at the time, their outlines were clear. The Par would preserve the nominal value of the original debt but would have longer maturity and a lower interest rate than the other two. The other two bonds would entail nominal haircuts. The haircut corresponding to the Discount bond would be higher than the haircut of the Quasi-Par. The new bonds would also incorporate mechanisms—which would be specified later on—to reward the bondholders with a coupon tied to the economic rate of growth. The sustainability of the proposal was said to be consistent with a target for the primary surplus that had been recently agreed upon with the IMF (2.4% of GDP for the central government and 3% for the consolidated public sector). The government announced that it expected to maintain that target in the long run.

In June 2004, a few months after the finance ministers of the Group of 7 manifested that Argentina should accelerate the restructuring process and issue "good faith" signals, the government made public a new proposal in Buenos Aires. It was a second offer that aimed to get closer to the creditors' positions. The eligible debt was the same as the one defined in Dubai, although it was now measured at 81.8 billion dollars. In exchange for that defaulted debt stock, new bonds would be issued for a total of 38.5 billion dollars, in case the level of acceptance of the swap was lower than 70%, and for 41.8 billion dollars in case the level of acceptance was higher than the 70% benchmark. This offer involved a substantial improvement if compared to the 21.8 billion dollars to be issued according to the Dubai proposal. The swap would comprise only the capital of the defaulted bonds while the past due interests would not be recognized; i.e. liabilities amounting to 81.8 billion dollars would be exchanged for new bonds amounting to 38.5 or 41.8 billion dollars, depending on the level of acceptance.

The swap started on January 14, 2005. Six weeks later, the restructuring operation was closed. On May 3, 2005, the government announced that acceptance of its offer had reached 76.15% of the debt in default. This meant that 62.3 billion dollars of the old bonds would be exchanged for about 35.3 billion dollars of new instruments plus the corresponding GDP growth-linked coupons. The maximum amount of the issuing would be 15 billion dollars in the case of the Par bonds, 8.33 billion dollars in the case of the Quasi-Par bonds and about 11.9 billion dollars in the case of the Discount bonds.

The government expressed satisfaction at the swap's outcome. The operation signified the reduction in the public debt stock by about 67.3 billion dollars and attenuated the public finances' exposure to the exchange risk, since around 44% of the new bonds were denominated in local currency.

Macroeconomic Policy and Performance after Devaluation and Default

The abrupt fall in output and employment continued after the end of the convertibility regime, but for only a very short period. Certainly, in opposition to most opinions and beliefs—including those of the IMF's officials—the traumatic episodes that brought the convertibility regime to an end were not followed by a deeper depression. Moreover, an extraordinary quick recovery started only one quarter after the devaluation and default. The GDP recovery started soon after the exchange rate depreciation (around three months later, as can be seen in the available monthly activity indicators).

The recovery was precisely triggered by the sudden change in the relative prices in favor of the tradable goods sectors. In the beginning of this phase the recovery was led by the local production of previously imported goods. Apart from the shift in relative prices, the quick economic recovery that followed the crisis was also a consequence of a set of policies that, still with flaws and ambiguities, aimed at recovering the basic macroeconomic equilibria.

Many of the policies that played important roles in this stage faced opposition from the IMF. Firstly, the imposition of exchange controls: this measure compelled the exporters to liquidate in the local market a considerable part of the international currency generated by their exports and also restricted capital outflows. Secondly, the establishment of taxes on exports: this absorbed part of the devaluation's favorable effect on the exporters' incomes and significantly contributed to the recovery of fiscal equilibrium; it also attenuated the impact of the devaluation on domestic prices and, consequently, on real wages. Thirdly, a flexible monetary policy: this initially enabled assistance to banks in the crisis phase and afterwards contributed to the recovery of money demand, thus helping the recovery. Fourthly, when the foreign exchange market started to show an excess supply of international currency, exchange rate policy attempted to stop the peso from appreciating through the intervention of the Central Bank (and of the Treasury later on).

The IMF particularly insisted on a freely floating peso. For a short period the government adopted this regime. Once the exchange rate was free to float, however, the parity rose abruptly, reaching levels close to 4 pesos per dollar. Reintroduction of exchange controls followed, which was crucial to contain the exchange rate overshooting. The government managed to stabilize the nominal exchange rate by mid-2002 by compelling the exporters to liquidate the international currency in the local exchange market and by limiting the currency outflows.

Soon after, when the exchange rate was stabilized, the demand for pesos started to recover and the exchange market began to show an excess supply of dollars. The end of the exchange rate overshooting put a check on the rise in the domestic prices. The freezing of public utilities rates, as well as the high unemployment (which kept nominal wages from rising) also contributed to slow the rise in prices.

The improvement in the consolidated public sector global balance that took place between 2001 and 2004 was equivalent to 10 percentage points of GDP. This result passed from a global deficit of 5.6% of GDP in 2001 to a 4.5% surplus in 2004.

Which factors explain the adjustment in the fiscal cash flow results? Forty percent of it derives from an improvement in the provinces balances. This improvement comes from the increase in tax collection facilitated by the recovery and the rise in nominal prices, together with the restraint in expenditure. Meanwhile, 60% of the six-points-adjustment in the national public sector's budget is explained by the improvement in the primary balance (+3.7% of GDP). The contraction of interest payments, basically resulting from the default on the sovereign debt, accounts for the rest (-2.4% of GDP).

The rise in the national primary surplus is mainly explained by an improvement in tax revenues (+4.7% of GDP). It is interesting to observe that although the receipts from traditional taxes such as the VAT and the incomes tax rose significantly, they did not increase substantially when measured as a proportion of GDP. Between 2001 and 2004 they increased by 1.2% of GDP taken together. The tax on exports is the item that mostly explains the rise in tax revenues. The soy and derivatives industry generated almost one half of the taxes on exports.

Hence, the public sector absorbed part of the effect of the devaluation on the profitability of the tradable goods sector, and also benefited from the high prices reached by some of the exportable goods, such as soy and oil. The contribution made by the tax on financial operations established in 2001 was also very relevant. The increase in the collection of this tax explains 30% of the improvement in total tax receipts.

The interest payments on the public debt passed from representing almost 4% of GDP in 2001 to only 1.4% in 2004 (without taking into account the accrued interest on the debt in default).

However, the fiscal effects of the suspension of part of the debt service payments are significantly higher than what is shown in the mentioned account. It can be estimated that the amount of interest on the public debt—valued at the 2004 exchange rate—would have represented, in that year, between 9 and 11 percent of GDP. This is approximately equivalent to one half of the total tax collection of that year. Paying that amount would have certainly been incompatible with the economic recovery. As was pointed out above, a crucial aspect of the fiscal financial vulnerability derived from the extremely high proportion of debt in foreign currency, with the consequent exposure to the impact of exchange rate variation. The substantial exchange rate depreciation in 2002 would have had a harsh impact on the public sector's financial equilibrium. Taking this into account, it can be said that the payment suspension and the following debt restructuring enabled a considerable amount of fiscal savings—either measured in domestic currency or as a proportion of GDP.

However, the most important effect of the default and the end of the convertibility regime was regaining the instruments of macroeconomic policy. This was of crucial importance in moving the economy out of the abysmal situation generated by the agony and the final collapse of the convertibility regime.