

Argentina's Debt: the Good, the Bad and the Ugly

Miguel Kiguel

Former Under Secretary of Finance and Chief Advisor to the Minister of the Economy, Argentina; Former President, Banco Hipotecario; Director, Econviews; Professor, Universidad Torcuato Di Tella

The saga of Argentina's debt includes many myths, mysteries and challenges. In 2005, four years after the default at the end of 2001, the government managed to restructure the debt with a large 66 percent haircut. Two years later, the credit spreads measured by the Emerging Market Bond Index (EMBI) had dropped from over 6000 basis points (bps) in 2005 to just 200bps in 2007, similar to the levels of Brazil. This was the good part, when markets seemed to have forgiven the sins of the past and gave Argentina the benefit of the doubt. Argentina was perceived to have had left its debt problems behind and that going forward, it would be a credit worthy country.

One myth is that Argentina's haircut in its 2005 debt restructuring was huge. In fact, it ended up being not as large as was thought, mainly because the government included in its offer a warrant linked to GDP growth that allowed the exchange bondholders to receive extra payments if the economy were to grow more than 3.25 percent per annum. This ended up being very costly for Argentina and a good deal for the bondholders. Investors attached almost no value to the warrant at the time of the exchange, but they received the equivalent of over 30 percent of the face value of the defaulted bonds (in other words, almost as much as they received in new bonds and hence the overall haircut ended up being less than 40 percent). This was clearly a poor policy decision which raises questions on how to design GDP warrants in future sovereign debt restructurings.

One of the mysteries is how Argentina managed to achieve a 78 percent acceptance of an offer that, at the time, looked extremely harsh. There are at least two explanations. First, when the initial

offer was presented in early 2005 in Doha, the actual value was estimated at \$18, implying an 82 percent haircut. By the time the exchange offer was actually launched at the end of 2005, the same offer was valued at around \$33, mainly thanks to significant tightening of the spreads of emerging market sovereign bonds. The second reason was that investors felt they had few options to get paid if they rejected the offer.

One important lesson from the Argentine debt restructuring is that creditors do not have many levers to collect funds from a sovereign country that does not want to pay. A country can get away with a lot and avoid sanctions for quite a long time. The vulture funds, or the "Elliots" of this world, have been litigating against Argentina, trying to attach assets for more than eight years to no avail until very recently. Argentina had no access to international financial markets and was forced to hide its assets (primarily using the Bank of International Settlements) to avoid attachments, but to the extent that Argentina could abstain from borrowing abroad made it difficult for foreign creditors to collect from the country.

The good times did not last very long. Argentina made two important policy mistakes that eventually proved to be very costly. First, it manipulated the consumer price index to erode the value of the local currency-indexed debt, a decision that many investors viewed as a "technical default". Second, it stayed away from the international financial markets, as part of a policy decision of debt reduction which in practice implied that the government was not going to issue new debt.

This second decision meant that debt service (both principal and interest) had to be met with



international reserves in a situation in which there was no lender of last resort (the IMF was not an option). This concept of debt reduction was “extreme” and difficult to maintain in years in which the government was running fiscal deficits or in which it faced large principal payment obligations in foreign currencies. It would have been more reasonable to state an objective of reducing the debt to GDP ratio over time or to change the profile of the debt (increasing the share of local currency). Debt became a political target and there was a view by the authorities that issuing debt amounted to a return of the demonized nineties. Instead, they preferred to rely on an inflation tax or on reducing the stock of international reserves.

The reluctance to issue debt made the economy extremely vulnerable. While the strategy was viable in good times when reserves were rising, it was potentially risky in periods when reserves were dropping. This was the bad part that eventually materialized and lasted from mid-2007 to 2011, when Argentine spreads increased relative to those of Brazil and became closer to those of Venezuela.

We are now facing the ugly part of the debt saga as the situation took a turn for the worst following a number of adverse events. First, the external situation became more complicated in 2011, due to the Greek *de facto* involuntary debt restructuring. Then in 2012, Argentina’s policy decision to nationalize the oil company Yacimientos Petrolíferos Fiscales (YPF) without any payment to Repsol, and the forceful conversion of some provincial dollar debt (pesification) issued under domestic legislation added to fears.

Two issues complicated the situation further. First, back in October 2012, the New York Court of Appeals in the U.S. ratified a lower court ruling that required Argentina to pay \$1.3 billion to the bondholders of defaulted bonds (mainly vulture funds), either voluntarily and directly to the creditors, or alternatively by forcefully attaching a proportion of the funds that Argentina was transferred for the payments of the performing bonds. This decision, which at the moment has been appealed and

a ruling is still pending, implies that there could be a new default on Argentina’s debt. In contrast to the 2001 default, it would not reflect insolvency or lack of funds but instead reflect an unwillingness to settle with holdouts.

Following the October ruling, Argentine credit spreads increased dramatically, especially the credit default swap (CDS) which reached 3,500 bps, as the market anticipated a high risk of default in the bonds issued under foreign legislation. The effect on the domestic legislation bonds was much smaller, as the market believes that they have a smaller credit risk.

The second complication was the large drop in international reserves, from a peak of \$52 billion in mid-2011 to \$37 billion more recently. This drop in reserves led to the imposition of strict foreign exchange controls in 2011, which in turn led to the emergence of a parallel exchange rate. The spread on Argentina’s sovereign bonds has increased dramatically in 2013, averaging 60 percent, putting pressure on reserves and forcing the government to tighten controls even further.

The twin credit and foreign exchange spreads are complicating macroeconomic management, especially because in the absence of a major change in policies, it is difficult to reverse the fall in international reserves while the current environment is negatively affecting investment and growth. This ugly phase is bringing back memories of balance of payments or debt crises, although in previous occasions they occurred in periods in which commodity prices collapsed or when emerging markets were facing debt crises, neither of which is the case nowadays.

It seems clear that Argentina currently faces important challenges. The outlook for improving the credit spreads depends in part on the eventual outcome of the legal battle in New York, but equally important is the approach on debt management. Argentina needs to come to terms with the difficulties generated by its resistance to not issue foreign currency debt when it is obvious that it needs dollars to continue servicing its debt.

It also needs to recognize that the current spreads in the parallel exchange market are accelerating the losses in reserves as leakages are affecting official trade flows and firms are reluctant to bring financial flows at the official exchange rate when there is a high risk of depreciation of the currency.

The paradox is that Argentina's debt problems take place in a country that is solvent and most macroeconomic fundamentals are still reasonable. Net public sector debt amounts to only 18 percent of GDP, and foreign currency debt issued with the private sector (excluding multilateral organizations) represents less than 10 percent of GDP. In addition, much of that debt is long-term, implying that financial requirements in any given year are not very large.

In addition to the low debt burden, Argentina has small fiscal and current account deficits of 2.5 and 1.0 percent of GDP, respectively. These levels compare well with other Latin American countries such as Brazil, Colombia and Uruguay.

How can one then explain that Argentina's credit spreads are one of the largest among emerging markets? The explanation lies in the twin spreads and the persistent fall in reserves which are directly related to distrust of the market mechanism to address macroeconomic problems by strict government intervention. This time it is policy, not fundamentals, that explain the twin spreads, and if they are not changed, the spreads are not going to disappear.