

THE FAILURE OF DEBT-BASED DEVELOPMENT: LESSONS FROM ARGENTINA

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In this article I discuss the lessons one can learn from Argentina's recent debt restructuring and the possible rules and practices of future restructurings. But I will also briefly describe the long and extremely problematic Argentine debt history, which started in 1824, to show the failure of the debt-based economic development model. I conclude that, regardless of any pyrrhic victory obtained from the restructuring process and the willingness of the international financial markets to lend new money, Argentina should not incur additional public debt.

Lessons from the Restructuring Process

Legal Inclination toward Sovereign Debtors

The overall rulings of the U.S. courts regarding the numerous claims filed by bondholders against Argentina have so far favored the sovereign debtor. Even though the U.S. courts have issued various judgments against Argentina, there has not been any effective enforcement of those judgments. The U.S. courts have always found a way to reject all legal arguments presented by the holdouts, so bondholders have so far not been able to collect on their judgments. For example, in one of the latest attempts by the holdouts to attach assets (filed after the bonds were tendered by the bondholders but before the exchange offer was implemented in early 2005), the U.S. Court of Appeals for the Second Circuit, on May 15, 2006, did not rule in favor of Argentina on legal grounds but rather on political considerations. The judges, in *E. M. Limited v. the Republic of Argentina*, said that the exchange offer was necessary for Argentina's well being, and

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for that reason they confirmed the judgment from the district court. In Argentina the Supreme Court ruled against the rights of the bondholders to collect in accordance with their original terms, arguing that the existence of an emergency justified limiting property rights.

From the foregoing, it appears that (1) the level of actual protection given by New York law and jurisdiction regarding sovereign bonds is not sufficient to protect creditor rights, and (2) Argentine courts too often accommodate the needs of the government rather than the private property rights of citizens.

In Europe the luck of the holdouts has been no better than in the United States. The Italian courts have rejected the claims filed by the Italian bondholders, and the German courts have not condemned Argentina, giving the government precious time to advance with the restructuring proposal.

Another interesting aspect of Argentina's restructuring process is that the favorable reaction from the courts had the support of the clearinghouses of debt-related securities and other financial institutions. The clearinghouses, in particular, are agencies of crucial importance because they are the places where eventual attachments against Argentina's assets might materialize. For instance, the Belgian parliament—with jurisdiction over Euroclear, one of the principal European clearinghouses—approved a law to exempt Euroclear from possible attachments from holdouts of payments made by Argentina and its agents.

Argentina's favorable treatment from the courts was not anticipated because in the recent past the courts had usually protected the rights of creditors. Today holdouts do not appear to have weapons powerful enough to threaten sovereign debtors or to affect the restructuring process. Of course the saga has not ended, and the holdouts still might try to attach the proceeds of new debt securities issued in the international capital markets or some other asset, and eventually may succeed in the long run. But if recent history is any indication, the courts may keep the future balance in favor of sovereign debtors.

Are Statutory Mechanisms Needed to Regulate the Restructuring?

The lack of success of the holdouts to collect on their judgments brings into question two important purposes of the sovereign debt restructuring mechanism (SDRM) promoted by the International Monetary Fund: (1) avoiding attacks from the holdouts against the restructuring when it is occurring, and (2) giving debtors the

possibility of binding dissenting bondholders if a determined majority of the bondholders participated in the exchange. The first purpose was to be reached by having some sort of stay against judicial claims, while the second purpose was to be realized through collective action clauses (CACs).¹

In practice, judges have imposed a stay because they have been reluctant to issue preliminary injunctions and enforce eventual judgments against Argentina. With regard to the holdouts, they have had little success in dealing with Argentina, which has refused to even recognize that portion of the debt—much less to discuss the issue with the IMF or with the private creditors. This lack of progress implies that the second purpose (avoiding problems with the holdouts) may be reached without the statutory regime and directly by fact (keeping that portion unpaid indefinitely).

What about the Use of Collective Action Clauses?

In the Argentine case, CACs might not be necessary because the majority of bondholders and the sovereign debtor may, in practice, neutralize the dissenting minority. The importance attributed to CACs should try to match the problem they try to solve. If the problem turns out to be not significant (or much less significant than originally thought), then the importance of CACs should not be overestimated.

The collective action issue was not a problem with the Argentine restructuring. Thus, there was no need for reliance in CACs. Nevertheless, they could have some value in order to give the sovereign debtor and the “hold-ins” an additional level of comfort after the restructuring—provided the qualified majorities are reached. This level of comfort would mean a definitive closure to the judicial claims (because the hold-outs would be formally bound by the agreements between the debtor and the hold-ins) and a more transparent framework for discussions with the IMF and other members of the official community (because there would be no unpaid private creditors left).

Lack of Coordination and of a Clear Message from the Official Sector

The members of the IMF did not have a common view about how to best deal with Argentina. Some important members, such as Japan and Italy, supported not approving any new lending to Argentina.

¹Under a CAC, if a qualified majority of the bondholders approve the debtor proposals, they are binding on all bondholders.

Other members, particularly the United States, favored a more lenient approach. International politics has played an important role in the reasons for these decisions. The lack of coordination to uniformly condemn Argentina and the bold support from the United States gave Argentina precious time to maneuver, carry on its debt proposals, and obtain consent from the bondholders. Even though the IMF did not lend new money, it may not avoid the fact that the private financial community considers that the Fund had a complicit role in the outcome of the restructuring because the Fund renewed some financial programs—even though Argentina failed to comply with specific conditions that had been agreed upon. This circumstance strengthened Argentina's position and weakened the position of the creditors.

Moral Hazard

The IMF and other members of the official community remained concerned about the problem of moral hazard. In cases with debt overhang, official lenders have been reluctant to organize bailout plans in favor of the debtors and creditors. The refusal of the IMF to grant new loans to Argentina at the end of 2001 and throughout the restructuring process has sent a strong message.

Restructuring without Public Money

The lack of public money has not prevented the restructuring from taking place. In fact, the restructuring was accompanied by net payments from Argentina to the official community, mainly the IMF. This implies that the traditional mechanism to compel the debtors to negotiate in good faith with the private creditors may have no effect. This understanding, however, is not absolute because the IMF did some rollovers of certain payments. The official sector needs to think of other methods if it wants to compel sovereign debtors to negotiate.

Lack of Coordination among Bondholders

There is also lack of coordination among bondholders. There are different kind of bondholders, such as high-net worth individuals, personal savers, hedge-funds, pension funds, financial institutions, and vulture funds that acquire the bonds at different prices and with different holding expectations and strategies. You will not see the same attitude toward the restructuring offer from an investor who bought the bonds at high levels and kept them up to the exchange offer as from an investor who bought after the default. Most likely the former bondholder would be less inclined to participate in an offer with a "haircut" of 70 percent than the latter. Each group, and

eventually each bondholder, pursues its own self-interest, which may conflict with the self-interest of others. Therefore, investors react differently to restructuring proposals and may not maintain coalitions sustainable over time. Consequently it is difficult for them to oppose those proposals effectively.

Discussion on the Payment Capacity

In addition to the discussion of what the financial community calls “willingness to pay” (the degree of—or lack of—enthusiasm of the debtor to pay the debt), there is the usual discussion about the payment capacity of the sovereign debtor (the same happens in the private sector). In the case of Argentina, the country’s payment capacity was very limited because of the severe economic crisis. There is also the question of how to reallocate public revenues—for example, shifting funds from infrastructure investment to repaying the public debt. But that issue has more to do with willingness to pay than with the capacity to pay.

Argentina’s lack of financial resources gave the government space to maneuver and eventually it came up successfully. One could argue that with a larger payment capacity the markets may have rejected Argentina’s offer. But if the sovereign debtor is not willing to increase its offer sufficiently, then the markets will be in trouble—unless the courts and the official sector do something different. And even so, that may prove to be ineffective given the fact that the sovereign debtor may cancel its credits with the IMF, as Argentina did at the end of 2005, and avoid IMF conditions and dealings, as well as avoid all possible attachments on its assets by not having assets attachable abroad.

Favorable Perspectives of Argentina Returning to the Debt Market

Argentina has received some placement proposals from the investment banking community, but is Argentina ready to return to the global capital markets? Its country risk is close to that of Brazil, which has a good level of creditworthiness in the emerging market group. In the past a defaulting sovereign state would need to pass through a long period before it could borrow again. In the present, those periods are much shorter. Of course, Argentina’s fiscal, economic, and financial record in the post-default era matter most. The better the post-default record is the more chances there are to return to the capital markets.

A country’s present performance may be more important than its

past performance. The interest rate will reflect the default, but countries that do well find ways to handle it. This does not mean that I favor new and more public debt. In fact, I strongly oppose it.

Argentina's Addiction to Debt

Argentina's debt problems are not new. As I will explain, Argentina is a country that should not incur public debt (with the exception to refinance a portion of the principal payments). To this end, I have proposed that the Federal Constitution should contain a formal and express prohibition, ideally with no exceptions, at least regarding the public debt as it has been incurred lately (mainly to finance current public expenses). The debt history of Argentina shows that any time there was a period of global liquidity and Argentina contracted debt, which was accompanied by compliments from the international community regarding the policies carried on by the various Argentine governments, it incurred costly economic and social crises. In particular, there were five main debt events: three involved a default on the foreign debt, and all ended in turmoil and crisis.

The First Default

The first default occurred in the 1820s. The City of London, at that time the financial capital of the world, enjoyed a liquidity boom. In Latin America, simultaneously, the patriot armies needed financial resources for the independence wars against Spain, Chile, Colombia, Peru, and Brazil. The province of Buenos Aires (Argentina was not even a country yet) took huge international loans governed by British law and jurisdiction, because British investors were eager to invest in new places. The economic situation of these territories deteriorated and all defaulted. The province of Buenos Aires declared default on its loans in 1828 (only four years after the date of the loan). The debt crisis was accompanied by an economic and political crisis, including the fall of the government. The default lasted 29 years.

Avoiding the Default with the Anger of the People

The second debt crisis occurred in 1873. In the previous years Argentina had returned to the international debt markets (after the debt restructuring of 1857) with various bond placements in London. These loans, as in the 1820s, were excessive compared with the country's payment capacity. After a recession in Europe that weakened foreign credit lines and reduced the demand for Argentine exports, Argentina faced a debt crisis. President Avellaneda was under great

pressure to default on the loans. However, in a well-known message to the Congress in 1874, he said Argentina would not default, and the country would pay its debts with “the anger of the people, if necessary” (see Bruno 2004). Eventually, Avellaneda implemented a bold economic reform and avoided the default, but the toll of the crisis was severe.

The Big Crisis of 1890 and Its Debt Roots

The next crisis occurred in the 1880s. Between 1880 and 1890 President Roca and President Juárez Celman carried on important free-market reforms, including a broad opening to foreign capital. During those years, Argentina consolidated its position as the main foreign destination for British investment. As a result, Argentina experienced strong economic development for more than a decade. But the growth was fueled by excessive foreign debt. The federal government, the provinces, and even various cities continuously accessed the financial markets of Great Britain, France, and Germany. Everything exploded in 1890 when the country suffered a devastating crisis (some analysts compared it with the one suffered in 2001, which was extreme), which also included the fall of President Juárez Celman. By the time of the crisis, the debt obligations accounted for nearly 50 percent of the public revenues of the federal government, which was clearly unsustainable. With adjustment and a debt restructuring, President Pellegrini was able to avoid a default. However, as previously, the economy suffered serious damage and an additional restructuring occurred two years later to put the debt repayment on a sustainable course.

The 1982 Debt Crisis

The famous debt crisis of 1982 lasted almost 10 years (the “Lost Decade”). The military regime (1976–83) enjoyed the petrodollar liquidity boom. After almost 50 years, the international markets were again financing the less developed countries. One more time in its debt-addictive history, Argentina contracted a huge amount of indebtedness, this time in the form of bank loans. The foreign debt grew from US\$7 billion in 1976 to US\$45 billion in 1983, while GDP was stagnant. In 1982 the debt crisis exploded and Argentina was left with an unpayable account. The restructuring negotiations concluded with the Brady Plan in 1992.

From the Brady Plan to the Largest Default

Through the Brady plan Argentina obtained certain reductions in its debt obligations. However, only three years after that accord, the

debt already was higher than the pre-Brady levels and nine years after, it was more than the double. As a percentage of GDP, Argentina's debt went from 50 percent in the 1990s to 200 percent in 2001. The excessive levels of indebtedness had a significant influence on the recession that began in 1998 and on the free fall of the economy in 2001. One might argue that the IMF could be held responsible for not properly intervening. For example, many people asked, "Where was the Fund during the huge fiscal deficit and high indebtedness years?" However, a more realistic view, with which I agree, is that it was the Argentine political class—not the IMF—that should be held accountable for Argentina's fiscal irresponsibility.

Conclusion: No More Debt

One could argue that after so many "haircuts" the Argentine debt would be of a minor significance. It is not. The debt is even higher than what it was in 2001, prior to the catastrophe. Due to a more comfortable maturity structure, the payment obligations are not a problem today. Argentina should learn from its debt history, however. The country has every reason to permanently control its debt levels. The government should keep reducing its debt. The prepayment to the IMF made in late 2005 is a good effort toward this end.

The Argentine government should also avoid taking on new debt to finance its current account. The only debt that the government should incur would be for specific projects that have net revenue flows sufficient to pay off the debt. The practice of project finance could be the most appropriate model to use, where the financing is repaid by the future income from the project, plus eventual credit enhancement such as a cash reserve fund or an assignment of specific public revenues, but without recourse to the general revenues of the government.

Despite the fact that the restructuring was successful from the government's standpoint, defaulting should not be an alternative. The debt-overhang that usually precedes defaults, and the debt and economic crises that usually accompany debt-overhangs and defaults, are extremely damaging to the people—damage that is never redeemed by any successful post-default negotiation. Argentine politicians should not forget the proposed constitutional prohibition. Similarly, the official sector, mainly the IMF, should consider discontinuing all financial aid. Also, the developed countries should consider other ways to help. Instead of approving financial support, they should promote freer trade.

The private markets at least now know that financing sovereigns

may be too costly, and one hopes investors will be more prudent. Argentina's future will be brighter if the government incurs no more debt (the markets would finance only the private sector), the IMF does not grant any more "financial help," and the developed countries promote free trade. We should work to get there.

Reference

Bruno, E. A. (2004) *El Default y la Reestructuración de la Deuda*. Buenos Aires, Argentina: Editorial Nueva Mayoría.