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Argentina's Sovereign Debt Restructuring

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Summary

In December 2001, after four years of deepening recession, impending financial crisis, and mounting social unrest, Argentina's government suddenly collapsed and ceased all payments on its debt. Argentina has failed to pay before, but this time it registered the largest sovereign default in history. Total public debt grew from 62% of GDP in late 2001 to a record-breaking and unsustainable 164% following default and devaluation in early 2002. Argentina faced restructuring over $100 billion of debt owed to domestic and international bondholders, including $10-15 billion of bonds held by U.S. investors. After an extended and contentious "negotiation" period, Argentina exchanged new bonds for the old on June 2, 2005. The results were unprecedented, with the offer garnering a 76% participation rate (far below the more standard 90%) and paying only 26%-30% of the debt's net present value to most bondholders (nearly half the historical minimum of 50%).

Sovereign defaults are typically worked out in what amounts to a consensual understanding between creditors and debtors, with the assistance of the IMF in setting macroeconomic targets that form the basis for a mutual understanding of a country's ability to repay. In this case, Argentina argued that its debt was simply too big to repay and rebuffed both private creditors, and at times, the IMF, even "suspending" its agreement at one point.

In the end, a mutually agreeable resolution failed to materialize, leading to a default that was not only unprecedented for its lengthy resolution (over three years), low recovery rate (30% of NPV), and large residual holdout (24% of creditors), but for the process that stretched (creditors would say flaunted) the guidelines of sovereign debt negotiations. This applied to both informal negotiation guidelines understood to be in play by bondholders, and a more formal understanding as embodied in the IMF's policy of lending into private arrears. Other countries may look to Argentina as a model for reneging on sovereign debt, but the cost of Argentina's financial collapse in long-term social and economic terms has been devastating. For investment firms and individual holders of Argentina's debt, the huge loss taken on the default is also a highly negative precedent.

Since the debt restructuring, Argentina has repaid the $9.8 billion it owed the International Monetary Fund (IMF) and seeks to normalize relations with the private international financial markets. Still, there is outstanding litigation against Argentina by the 24% of bondholders who refused to accept the restructuring, and re-engaging the international capital markets has had only limited success. Litigants' lack of success when faced with a determined defaulting country has already led to the adoption of collective action clauses as standard provisions in emerging market debt and the Argentine default will continue to have widespread implications not only for creditors, but for Argentina's long-term financial sustainability, developing country debt markets, guidelines for future sovereign debt restructurings, and IMF policies. In support of U.S. congressional interest in developing country financial crises, this report analyzes Argentina's debt restructuring. It will not be updated.

Contents

A Summary of Argentina's Sovereign Debt 1

Resolving Sovereign Defaults 4

Argentina's Debt Restructuring Strategy 7
    The Dubai Proposal 8
    The "Final" Buenos Aires Offer 9
    IMF Program "Suspension" 10
    Concluding the Restructuring Agreement 11

Outlook and Implications 13
    Argentina 13
    The IMF 14
    U.S. Policy 15
    Emerging Markets and Debt Restructurings 16

List of Figures

Figure 1. Global Distribution of Argentine Debt to Be Restructured 3

List of Tables

Table 1. Argentina's Sovereign Debt 2
Table 2. Argentina: Selected Economic Indicators 4

Argentina's Sovereign Debt Restructuring

In December 2001, after four years of deepening recession, impending financial crisis, and mounting social unrest, Argentina's government suddenly collapsed and ceased all payments on its debt.[1] Argentina has failed to pay before, but this time it registered the largest sovereign default in history.[2] Total public debt grew from 62% of GDP in late 2001 to a record-breaking and unsustainable 164% following default and devaluation in early 2002. Argentina faced restructuring over $100 billion of debt owed to domestic and international bondholders, including $10-15 billion of bonds held by U.S. investors.[3] After an extended and contentious "negotiation" period, Argentina exchanged new bonds for the old on June 2, 2005. The results were unprecedented, with the offer garnering a 76% participation rate (far below the more standard 90%) and paying only 26%-30% of the debt's net present value to most bondholders (nearly half the historical minimum of 50%).

Since the debt restructuring, Argentina has also repaid the $9.8 billion it owed the International Monetary Fund (IMF) and seeks to normalize relations with the private international financial markets. Still, there is outstanding litigation against Argentina by the 24% of bondholders who refused to accept the restructuring, and re-engaging the international capital markets has had only limited success. The Argentine default will continue to have widespread implications not only for creditors, but for Argentina's long-term financial sustainability, developing country debt markets, guidelines for future sovereign debt restructurings, and IMF policies. In support of U.S. congressional interest in developing country financial crises, this report analyzes Argentina's debt restructuring. It will not be updated.

A Summary of Argentina's Sovereign Debt

Prior to the debt restructuring, the Argentine government owed $194.6 billion in bonds and loans, a vast amount by any measure. The debt portfolio can be classified into three categories based on how the debt was managed (see **Table 1**).

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[1] For details, see CRS Report RS21072, *The Financial Crisis in Argentina*, by (name redacted), and also, Blustein, Paul. *And the Money Kept Rolling In (And Out): Wall Street, the IMF, and the Bankrupting of Argentina*. New York: Public Affairs. 2005.

[2] In fact, from 1824 to1999, Argentina's sovereign debt was "either in default or undergoing restructuring a quarter of the time" and it has had at times by far the lowest Institutional Investor rating of all major emerging market economies. Reinhart, Carmen M., Kenneth S. Rogoff, and Miguel A. Savastano. Debt Intolerance. *Brookings Papers on Economic Activity*. William C. Brainard and George L. Perry, eds. Washington, D.C. 2003. pp. 6-7.

[3] Debt restructuring implies a formal change in the contractual arrangements of the debt, such as reducing the face value of the debt and issuing new bonds with lower interest rates and longer maturities — usually at a sizable loss to bondholders.

First, *performing debt* refers to debt that continued to be serviced, or was never in arrears. Second, *non-performing debt yet to be restructured* refers to debt not included in the restructuring effort, but that has not been serviced either. Third, *restructured non-performing debt* comprises the multitude of bonds that were subject to the restructuring offer. This third category included principal and so-called past due interest (PDI), or interest that accrued, but had not been paid. Historically, PDI in sovereign debt workouts has been repaid in full, either up front, or as a new bond issue separate from the principal due (often referred to as a PDI bond). How PDI is handled is an important part of any sovereign debt restructuring.

Table 1. Argentina's Sovereign Debt
(prior to the June 2, 2005 restructuring)
($ billions)

Debt Category	Amount	Percent
Performing Debt:	**84.7**	43.6
International Financial Institutions (IMF, World Bank)	(32.7)	
BODENs*	(26.8)	
Guaranteed Loans	(12.9)	
Provincial Bonds	(10.0)	
Other	(2.3)	
Non-Performing Debt Yet to Be Restructured:	**6.7**	3.4
Bilateral (including Paris Club)	(4.8)	
Commercial (mostly banks)	(1.4)	
Past Due Interest (PDI)	(0.5)	
Restructured Non-Performing Debt:	***103.2***	**53.0**
Principal	*(81.8)*	
Past Due Interest (PDI) (through June 2004)	*(21.4)*	
Total Public Debt	**194.6**	

Data Source: Government of Argentina and various news sources. *Bonos del Gobierno Nacional - National Government Bonds.

Performing debt included all debt owed to the international financial institutions (IFIs); BODENs, or bonds issued to compensate banks and depositors for the peso devaluation; guaranteed loans for sovereign debt previously restructured during the final attempts to avoid default in 2001; and provincial debt that the federal government assumed after the crisis. Except for the obligations owed to international organizations, most of this debt was held by Argentines and has been fully "pesified." This means that the non-IFI bondholders already reduced their claims, when in 2001 their bonds were restructured, and again in 2002, when their dollar-denominated bonds were converted to devalued pesos (pesified).[4]

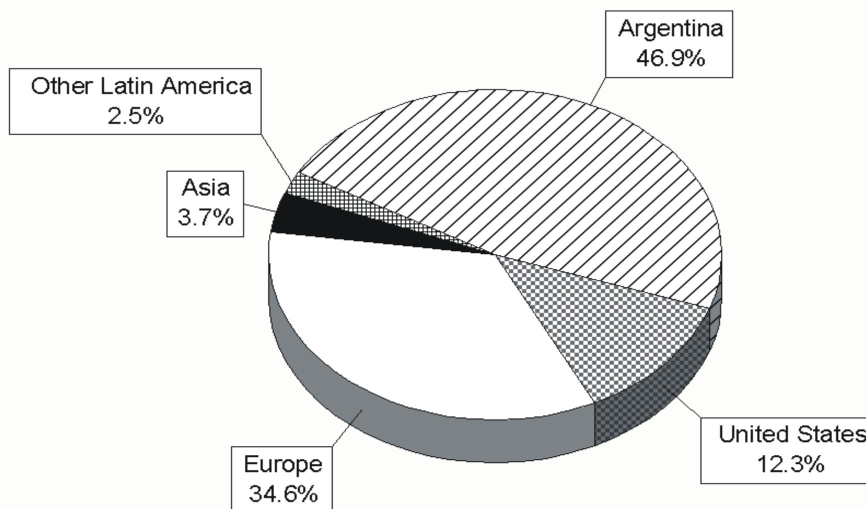
The government of Argentina reasoned that both the IFIs, which continued to lend to Argentina, and those creditors who participated in the "voluntary" restructuring and "pesification" of debt, should not have been further penalized because they were actively engaged in helping Argentina solve its financial problems. In fact, there was little room for restructuring this debt without reigniting a crisis. Defaulting on the IFIs was not a realistic option. Their debt is considered "senior"

[4] Credit Suisse First Boston. *Emerging Markets Daily Latin America*. March 7, 2003, p. 2.

to all other and is always repaid in full, except under the rarest of circumstances. Such a default would have placed Argentina in a small group of countries completely shut off from external capital. Nor was there much room to restructure most of the domestically held BODENs. Many were placed with depositors and financial institutions, under some government pressure, so a default or write-down could have jeopardized the banking system. Restructuring BODENs held by public sector pension funds would have been politically unfeasible for similar reasons.[5]

This left two categories of non-performing debt that had to take the brunt of the write-down. The smaller of the two was $6.7 billion of mostly bilateral debt owed directly to countries (Paris Club) and some commercial bank loans. Argentina has yet to deal with the Paris Club. The important figures for understanding the debt workout are those summarized in the third group, *restructured non-performing debt*. This involves $81.8 billion worth of bonds at nominal or face value that Argentina did not honor after the December 2001 default and accrued interest of $21.4 billion. Therefore, for purposes of discussion in this report, the total value of the restructured debt to be evaluated is $103.2 billion ($81.8 + $21.4 billion), or only 53% of total public debt.

Figure 1. Global Distribution of Argentine Debt to Be Restructured



Source: CRS from Global Committee of Argentine Bondholders

Much of the debt subject to restructuring, unlike the performing debt, was held by foreign private parties. As seen in **Figure 1**, Argentines were still the most heavily exposed, owning 47% of the total face value. Second in order were the European retail (private) investors who held 35% of the bonds concentrated in Switzerland, Italy, and Germany. U.S. money manager, insurance, and institutional

[5] Gallagher, Lacey. *Argentina Debt Restructuring: Past or Future?* Credit Suisse First Boston. August 20, 2003. pp. 13,15, and 23.

accounts held 12% of the debt or $10-15 billion, including funds that purchased highly discounted debt on the secondary market. The last 6% was held by Asian and Latin American creditors. Bonds were issued in seven foreign currencies, mostly in the U.S. dollar, yen, euro, lira, and deutsche mark.

Resolving Sovereign Defaults

When a country becomes insolvent and defaults on its debt, a general framework for analyzing its options points to three critical responses. First, the country must adjust policies. This includes correcting fiscal and current account deficits, as well as structural imbalances, which in Argentina's case involved the banking sector, utility regulation, and federal-provincial fiscal relations. Second, emergency financing is needed. Third, debt must be restructured to achieve long-term financial sustainability.[6] Traditionally, the IMF has played a decisive role in all three.

Table 2. Argentina: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005
Real GDP Growth (%)	-3.4	-0.8	-4.4	-10.9	8.8	9.0	9.2
Primary Budget Surplus (% of GDP)	-0.8	0.4	-1.3	0.6	3.0	5.1	3.7
Current Account Balance (% of GDP)	-4.2	-3.1	-1.4	8.5	7.4	3.0	1.5
Gross International Reserves ($ billion)	27.1	26.9	14.9	10.5	14.1	19.6	20.7
Debt (% of GDP)	47.4	50.8	62.2	164.2	144.5	133.9	80.0
Poverty Rate (%)	27.1	29.7	35.4	53.0	54.7	—	—
Per Capita GDP ($ 000)	7.8	7.7	7.4	2.8	3.4	4.1	4.3

Data Source: IMF. *Argentina: Staff Report for the 2005 Article IV Consultation.* May 31, 2005. p. 38&40, and news accounts. Primary surplus is for consolidated (federal and provincial) accounts.

First, as seen in **Table 2**, Argentina dealt with the fiscal adjustment by increasing taxes and reducing expenditures, which combined with the return of robust economic growth in mid-2002, allowed Argentina to move toward large primary budget surpluses. This is the surplus that exists after all public expenditures have been met except for interest on debt. The primary surplus is a direct measure of a country's fiscal capacity to service its debt, and theoretically, is available entirely for debt service. It may be increased by raising taxes or reducing spending in other areas of the budget. The correction of the current account balance from deficit to surplus points to the reversal of borrowing abroad and the generation of foreign exchange available to repay foreign obligations and rebuild international reserves.

[6] Roubini, Nouriel and Brad Setser. *Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies*. Institute for International Economics. Washington, D.C. August 2004. p. 119.

Structural adjustments proved to be more elusive. Usually the IMF helps define the macroeconomic framework for achieving these policy adjustments. As a third party, the IMF can lend credibility to the targets, from which both debtors and creditors should be able to develop "realistic expectations" regarding the debt workout.[7] The IMF cannot dictate policy, but theoretically, it can exert leverage through its lending authority. With the IMF involved in setting policy goals, the hardship linked to adjustments (especially fiscal) may be politically more palatable for the debtor country if promoted as necessary measures to achieve long-term recovery, rather than simply appeasing creditor demands for greater repayment. In addition, creditors may be more accepting of the implied recovery rate on debt.

Second, the IMF is the last source of emergency financing for a country in default. Specifically, IMF policy allows "Fund lending into sovereign arrears to external private creditors...in circumstances in which: (a) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (b) the member is pursuing appropriate policies and is making a *good faith* effort to reach a *collaborative agreement* with its creditors."[8] IMF assistance provides breathing room for a financially troubled country as it attempts to recover.

Third, the IMF also has a role to play in restructuring the debt. Although it does not participate directly in debt restructuring negotiations, by setting the policy adjustment guidelines and providing emergency financing, the IMF acts as an "official arbiter" and obviously has an influential role in encouraging consensual and expeditious negotiations. It also has interest in a quick resolution as a creditor, and in the case of Argentina, was one of the largest.

The major dispute between the Argentine government and its creditors involved differing perceptions of the country's ability versus willingness to service its debt. Argentina insisted that not all residual financial resources available for debt (the primary surplus) should be so used. The country's massive economic downturn resulted in a 50% poverty rate, with real per capita GDP retreating to levels not seen for 30 years. Argentina deemed social programs and domestic investment critical for its economic recovery and political stability. Under these circumstances, it is a serious political (some would say moral) decision to determine the percentage of public resources that should be spent on social programs versus debt reduction, a decision that also hinges on a defaulting country's bargaining power.[9]

This is where Argentina and its creditors were unable to come to terms. While it was widely understood that Argentina would not be able to repay its debt in full,

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[7] Roubini, Nouriel and Brad Setser. The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions, and the Argentine Episode. *Journal of Restructuring Finance*. Vol.1, No. 1. 2004. p. 181.

[8] *IMF Board Discusses the Good-Faith Criterion Under the Fund Policy on Lending into Arrears to Private Creditors*. Public Information Notice No. 02/107. September 24, 2002 and *Fund Policy on Lending into Arrears to Private Creditors — Further Consideration of the Good Faith Criterion*. July, 30, 2002. pp. 6, 15, and 19-20.

[9] For a sympathetic view of Argentina's dilemma, see Roubini, and Setser, *The Reform of the Sovereign Debt Restructuring Process*, p. 182.

the question remained, what amount (and conditions) would satisfy both creditors and the Argentine government? This problem was never satisfactorily resolved in part because the traditional arbitration role of the IMF was compromised.

Countries in default come to an agreement with creditors or, like Argentina, risk costly, prolonged litigation and ostracization from financial markets. There are no formal rule books for how to proceed, but all parties are usually best served by avoiding a protracted and confrontational negotiation. Negotiations may include formal meetings between creditor committees and government advisory groups, less formal consultation arrangements, or even less structured communications. Part of the process is assessing the market value of the defaulted debt, one important benchmark.

The process can be lengthy and in some respects may resemble more of an exchange of views than a true negotiation. Historically this has resulted in timely resolutions and a greater than 90% bondholder participation rate, with Argentina clearly being the exception. Widely accepted basic guidelines suggest that creditors should be treated equally in terms of taking losses, although domestic and foreign debt tend to be treated differently, and that the government in default should make every reasonable effort to pay as much as it can. These generalities obviously allow for a great deal of leeway for interpretation in individual debt negotiations.[10]

Sovereign debt workouts typically involve issuing new debt for old, under more lenient conditions that allow a country eventually to recover its financial standing in the international community. Recovery rates have varied, depending on the circumstances of each case. Since 1990, for example, a sample of nine Latin American sovereign debt restructurings indicates that the reduction in the value of the debt (often referred to as "the haircut") ranged from 0% to 45%, with an unweighted average of between 35%-40% (considerably more generous than Argentina's final offer of a 70%-74% reduction, see below).[11]

Clearly there is room for different resolutions, but the important goal to achieve for Argentina was long-term debt sustainability. This may be defined as an overall debt burden being "consistent with the country's overall capacity to make payments."[12] The concept implies that the debt payment schedule must be reduced, smoothed out, and extended so that the country can afford payments under reasonable economic assumptions. It is in the creditors' interest to get a country to pay as much as possible within this constraint. To ignore it is to risk a future default and starting over again.

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[10] Roubini and Setser. *Bailouts or Bail-Ins?*, pp. 167 and 174 and Global Committee of Argentina Bondholders (GCAB). *Roadshow Presentation*. July 2004. pp. 12-13. This document may be found at [http://www.gcab.org]. pp. 12-13.

[11] Ibid., GCAB.

[12] Roubini and Setser, *Bailouts or Bail-Ins?*, pp. 20 and 172. The authors note that in addition to the debt size, important factors include the coupon rate, a country's ability to adjust policies, and the amount of debt issued short-term and in foreign currencies.

Argentina's Debt Restructuring Strategy

Argentina's default was unprecedented in size, leading to a highly complex and contentious debt restructuring process. Significantly, because only 53% of Argentina's debt carried the burden of restructuring, the write-down had to be huge for Argentina to achieve its debt sustainability goals. Notwithstanding Argentina's predicament, creditors argued that Argentina was not absolved of its responsibility to negotiate and devise a restructuring plan that would allow Argentina to reduce its overall debt, treat multiple creditors in a nondiscriminatory fashion, and minimize the potential for lengthy and costly law suits.

Restructuring over 100 bonds denominated in seven currencies and governed by the laws of eight legal jurisdictions greatly complicated the task. For example, debt falling under British and Japanese law operates under collective-action clauses, which makes for relatively easier resolution by allowing a majority of bondholders to make binding decisions for all. Collective-action clauses did not apply to debt governed by U.S. (New York), German, or Italian law. The result was multiple class-action and individual law suits filed in the United States and European countries.[13]

Argentina initially juggled its debt dilemma by putting off private bondholders to negotiate with the IMF. In fact, bondholders did not have their first real contact with Argentine authorities until March 2003, 15 months after the crisis began. At that time, Argentina intimated that all debt would not be treated equally, with foreign bondholders expected to take the largest debt write-down. Details of Argentina's offer, however, would not surface for another six months. While negotiations with creditors remained stalled, on September 10, 2003, Argentina entered into a new controversial three-year $12.6 billion IMF stand-by arrangement, replacing a recently expired seven-month interim arrangement. Following tense negotiations, the IMF, with strong support from the United States, acquiesced to what some characterized as a "soft" agreement with Argentina after it missed a $2.9 billion payment, putting it technically in arrears with the IMF for one day.[14]

The IMF agreement provided the necessary policy framework for formal negotiations with private bondholders to begin. Importantly, this framework was limited, and included accepting Argentina's formal offer to commit to a primary fiscal surplus of 3% of GDP for 2004, although it would devote slightly less than that to actual debt payments.[15] The IMF interpreted this effectively as a minimum for Argentina's commitments to debt service, but in retrospect, creditors correctly saw it as more of long-term maximum that signaled they should expect a larger debt write-down than initially anticipated. In setting what many viewed as a low primary surplus target, the IMF lost credibility with creditors, who thereafter cast doubt on

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[13] Pruitt, Angela. Argentina's Debt Workout Is Complex. *The Wall Street Journal*, March 12, 2003. p. B9C.

[14] Munter, Paivi. Argentina Disappoints. *Financial Times*, September 17, 2003. p. 51.

[15] *Latin American Weekly Report*. September 7, 2004. p. 5. By comparison, Brazil has operated with a 4.25% (or higher) primary surplus in recent years to deal with its large sovereign debt.

the IMF's ability to serve as a catalyst for a timely and collaborative debt restructuring process.

The Dubai Proposal

Shortly after the IMF program was in place, Argentina turned to bondholders, making an initial offer on September 22, 2003 at the IMF-World Bank Annual Meetings held in Dubai, the United Arab Emirates. It was widely interpreted as an offer to pay 25 cents on the dollar of the principal value of the debt, with no recognition of past due interest, an unprecedented stand. On a net present value (NPV) basis, financial institutions estimated this to be a 90% rather than 75% reduction in the value of the bonds.[16] Argentina argued from the outset that this was consistent with the 3% primary surplus target, a controversial position given that strong economic growth supported a much larger surplus. By December 2003, even the IMF recognized that Argentina could muster a higher primary surplus and make good on a greater portion of its defaulted debt.[17]

The Dubai proposal met with resistence from creditor groups, their governments, and the IMF. Initial speculation that the offer was only a bargaining ploy soon gave way to a sense that Argentina was sincere and unlikely to change its position. Bondholder groups immediately rejected the Dubai offer and the IMF delayed the first quarterly IMF program review over the lack of movement on debt negotiations. IMF reviews are required for a country to remain in good standing and to receive the next disbursement of funds. Great Britain, Italy, Japan and other members representing 35% of IMF votes then registered their dissatisfaction formally. In a highly unusual move, they abstained from what is typically a pro forma vote to continue lending to a country that has met its economic targets.[18]

Nonetheless, Argentina had enough votes to survive the first IMF review, but the second was also problematic because of a $3.1 billion payment due to the IMF on March 9, 2004. Argentina continued to meet its macroeconomic targets as set out in the IMF arrangement, but the IMF pressured Argentina over its lack of "good faith" effort in debt restructuring negotiations and its failure to make headway on microeconomic reforms, especially on utility pricing, banking regulation, and restructuring the provincial-federal fiscal arrangement that had contributed to the

[16] The net present value (NPV) of an investment considers the time value of money at an assumed discount rate. The present value of cash outflows (funds loaned) is compared to the present value of cash inflows (principal and interest payments) over the life of the investment. The loss is the NPV difference between what would be paid on the initial bonds compared to what would be received from the replacement bonds at lower yields and longer maturities.

[17] Latin American Brazil and Southern Cone Report. *IMF Reprises Role of Villain in Argentina*. December 23, 2003. p. 12.

[18] Dow Jones Newswires. *Big Abstentions in IMF Vote Put Argentina Under Pressure*. January 29, 2004.

crisis in the first place. The IMF also required that Argentina negotiate a final debt agreement acceptable to at least 80% of the bondholders by September 2004.[19]

Despite IMF pressure, creditors complained that Argentina continued to meet with them only on its own terms, effectively "dictating" its position rather than offering an exchange of terms. Many meetings were held in Buenos Aires, which increased creditor costs and ran counter to historical precedent. In response, many refused to meet with the Argentine debt consultation groups; others pressed for injunctions in U.S. courts to have liens placed on Argentine-owned property in the United States. Argentina also took a hard stand with the IMF, declaring it would refuse to make the scheduled $3.1 billion payment unless it could be assured that the IMF would approve the second review and the related disbursement of funds needed to cover that payment.[20]

These events led to an unusual standoff and highlighted not only the fact that a large debtor, like Argentina, wields its own leverage against lenders, but that the IMF, with $15 billion invested in Argentina, had its own interests at stake in keeping Argentina from falling into arrears. To the extent that this was a motivating factor for IMF actions, it worked against private bondholders who had hoped that the IMF stand-by arrangement would be an effective inducement for Argentina to improve its debt restructuring offer. In the end, a compromise was reached in which Argentina agreed to negotiate formally with all creditors, but it did not change its fundamental offer with respect to the depth of the debt write-down or increasing its financial commitment beyond the 3% primary budget surplus. The IMF was criticized in the press and by investment firms for failing to deal more strictly with Argentina, which again became the central issue of the third review scheduled for June 2004.

The "Final" Buenos Aires Offer

Argentina began seemingly earnest negotiations with bondholder groups in April 2004, but bondholders again contested this process. In the middle of a series of meetings, which bondholders again characterized more as presentations than negotiations, Argentina unexpectedly canceled further talks and tabled its final offer on June 1, 2004. A formal 18-K/A filing was made with the U.S. Securities and Exchange Commission (SEC) on June 10, outlining the provisions of this agreement.[21] Bondholders rejected this "unilateral" offer even before it could be fully analyzed, arguing that Argentina had failed once more to live up to its IMF-imposed commitment to make "a good faith effort to reach a collaborative agreement."

The Buenos Aires offer differed by recognizing past due interest through the end of December 2001, provided at least 70% of the bondholders agreed to the arrangement. In addition, GDP-linked payments were attached to all bonds, which

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[19] Reuters News. *IMF Gives Argentina Debt Ultimatum*. March 7, 2004.

[20] Thomson, Adam. Argentina on the Edge. *The Financial Times*. March 8, 2004. p. 17.

[21] SEC. Form 18-K/A. *Annual Report of the Republic of Argentina*. Filed June 10, 2004 and Gallagher, Lacey. Argentina: What's New in the 18-K. *Emerging Markets Sovereign Strategy Daily*. Credit Suisse First Boston. June 15, 2004.

stipulated that Argentina would increase payments should economic growth exceed predetermined baselines. This provision was predicated on strong and sustained growth of the Argentine economy, which could not be guaranteed, and in any case, bondholder groups found it to be a marginal increase at best and unattractive for those unwilling or unable to wait years for the full valuation of this option to be realized.[22]

Many features of the Dubai proposal were retained so that the debt write off still amounted to 75% of outstanding debt, but on a present value rather than nominal basis. This arrangement would have allowed President Kirchner to save face by still claiming a 75% write-down in debt, while improving the offer to bondholders considerably over the Dubai proposal. The huge loss to bondholders, however, would still have been unprecedented, and the offer was widely rejected.

The timing of the offer was also interesting, coming before the June 2004 IMF review. Argentina needed to represent itself as making good faith negotiations with creditors in order to remain in good standing with the IMF. While the June offer was undeniably more generous than the Dubai proposal, creditor groups, led by the Global Committee of Argentine Bondholders (GCAB), complained that it was a unilateral proposal presented as a final ultimatum and lobbied to have Argentina declared in breech of IMF conditions. They also returned to the courts and responded with a counter proposal that would have: 1) shortened maturities; 2) included a down payment; and 3) raised the overall recovery rate from 25% to 55-60% of the original debt value.[23] This action was based on the robust growth of the Argentine economy that the GCAB argued should allow for higher payments on debt.

IMF Program "Suspension"

The IMF has a policy of remaining neutral in debt negotiations, but through its review process, effectively served as an arbiter between Argentina and its bondholders, whose respective assumptions regarding Argentina's ability to repay creditors proved irreconcilable. The IMF and any leverage it had was sidelined in August 2004, however, when Argentina announced it would "suspend" its IMF agreement, thereby giving up temporarily access to further borrowing.[24] It was clear at that point that Argentina was out of compliance with the IMF arrangement, including the commitment to enter into "good faith" negotiations with creditors. Argentina was effectively playing off against each other the three pillars of crisis resolution (policy adjustment, IMF financing, and debt restructuring). It reasoned that, for the short term, it needed the time and freedom from IMF conditionality to finish negotiations with creditors more than it needed IMF financing.

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[22] Ibid, p. 2.

[23] GCAB reportedly represented 75% of foreign bondholders. See [http://www.gcab.org].

[24] Argentina used this term and it may be said that both the review process and IMF disbursements were "suspended," but technically the agreement was still in effect and Argentina knew it could restart the review process, as have other countries in the past.

In addition, Argentina requested, and was granted on September 17, 2004, an extension by the IMF on payments amounting to $1.1 billion of some $2.5 billion due in the final quarter of 2004, further relieving it temporarily of IMF pressure.[25] Argentina pledged, nonetheless, to stay current with its other IMF payments, which was not a burden in 2004 given its improved international reserves position. This strategy, however, could not be continued indefinitely. Argentina needed to conclude an agreement with bondholders that would allow it to deal with the IMF.

Concluding the Restructuring Agreement

After securing SEC approval, Argentina opened the bond exchange on January 14, 2005, allowing a six-week window for bondholders to respond to an offer that was only slightly better than the one made in June 2004. The Argentine government made clear that this would be the only offer and that holdouts risked remaining permanently in default. The Argentine legislature codified the point on February 9, 2005, when it passed a law prohibiting the government from reopening the exchange offer or making any kind of future private settlement. Argentine officials were prepared to accept as little as a 50% participation rate, much below the 90% historical minimum usually strived for, and even farther below the 95-98% standard actually achieved in recent restructurings.[26]

The offer closed on February 25, 2005, and the Government of Argentina announced on March 18, 2005, that 76% of creditors had agreed to the terms. Although the actual settlement was scheduled to occur on April 1, last minute legal efforts by holdout creditors delayed the transfer of bonds and cash payments until June 2, 2005. Of the $81.8 billion face value of bonds, $62.2 was tendered, leaving $19.6 billion (24%) in the hands of holdout groups. A total of $35.2 billion of new bonds was issued to replace $103.2 billion in total debt (including interest), reducing Argentina's debt by $68 billion. An additional $6-7 billion in past due interest (PDI) not recognized by the Argentine government also remains unpaid.

The exchange involved a menu of three securities options, with fully capitalized PDI distributed as part of the discount and quasi-par bond offers, carrying various interest rates. All securities have collective action clauses and were issued in dollar, yen, euro, and peso denominations, subject to the laws of the United States, Japan, Great Britain, and Argentina, respectively. The following details apply:[27]

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[25] These are so-called "expectation basis payments," which may be rolled over for one year. See IMF. *IMF Executive Board Extends Argentina's Repayment Expectations* and *Argentina: Projected Payments to the IMF*. On Argentina page at [http://www.imf.org].

[26] This includes restructurings since 1998 involving Pakistan, Russia, Ukraine, Uruguay, and Ecuador. Porzecanski, Arturo C. From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default. *Chicago Journal of International Law*. Summer 2005. p. 326.

[27] Government of Argentina. *Argentina Announces Results of Successful Exchange Offer*. Press Release. March 18, 2005, Tillotson, Daniel C. *Emerging Market Sovereigns Market Commentary*. Wachovia Securities. January 7, 2005, and Gallagher, Lacey. *Emerging Markets Economics Daily Latin America*. Credit Suisse First Boston. March 21, 2005.

- *Discount bond ($11.9 billion)* — existing bonds exchanged for 30-year bonds with a 66% reduction (discount) in principal value carrying a 4.35% coupon interest rate for the first five years, 5.0% for years 6-10, and 8.52% for the remainder, with a 20-year grace period on capital payments (goal — debt and debt service reduction);

- *Par bond ($15.0 billion)* — existing bonds exchanged for 35-year bonds at face (par) value, hence no reduction in principal. Coupon interest rates are 1.29% for the first five years, 2.5% for years 6-10, 3.75% for years 11-25; 5.25% for the remainder, with a 25-year grace period on capital payment. Retail investors holding less than $50,000 of bonds had priority, (goal — debt service reduction);

- *Quasi-par bond ($8.3 billion)* — existing bonds exchanged for peso-denominated 42-year bonds, indexed to inflation, with a 31% reduction in principal, a coupon interest rate of 5.5%, and a 32-year grace period on capital payment (goal — reduction in debt and debt service); and

- *Detachable GDP-Linked Warrant* — additional payments to be made by the Argentine Government should annual economic growth exceed a predetermined baseline level beginning December 15, 2006, and lasting until 2035. Coupons were detached and began trading separately after 180 days (goal — demonstrate that Argentina was willing to base repayment on economic performance).

Argentina offered a number of other enhancements to broaden bondholder participation. First, the effective issue date for the new bonds was set retroactively to December 31, 2003. The additional interest amounted to an up-front cash payment. Second, a new "most favored creditor" clause promised that if a better offer is made to holdouts, all creditors will be included. Some questioned the appeal of this clause, however, given there was an important "legal loophole" in not explicitly covering out-of-court settlements. Third, "buyback clauses" allowed funds set aside for repayment that go unused because of holdouts to be dedicated to repurchasing outstanding debt. Fourth, the bonds did not include once widely anticipated and controversial "exit consents," which would have required those bondholders agreeing to the offer to also vote to restructure the terms of the original bonds, limiting the rights and recourse of any holdouts to the deal.[28]

Most bondholders recovered between 26%-30% of the net present value of their investment, slightly higher than earlier offers and reflective of market values, but by far the lowest on record for a sovereign default. Peso-denominated bonds had a higher payout. Holdout groups representing nearly $20 billion of debt are pursuing

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[28] Tillotson, *Emerging Market Sovereigns — Market Commentary* and Credit Suisse First Boston. Visit to BA: Debt Deal Terms Unlikely to Change for Now. *Emerging Markets Economics: Argentina*. November 24, 2004. Credit Suisse First Boston and *Emerging Markets Economics Daily Latin America*. January 13, 2005. pp. 2-4.

litigation in the U.S. courts and have threatened binding arbitration before the World Bank's International Centre for Settlement of Investment Disputes (ICSID).[29] They seek full recovery of the outstanding bonds, arguing that Argentina never truly negotiated with them, set an unacceptably low acceptance level, refused to recognize all past due interest, offered an historically low recovery value, and underestimated its ability to pay.[30] Litigation is being considered over the February 9 Argentine law prohibiting reopening of the exchange offer as evidence of expropriation and/or repudiation. The law is being challenged as a violation of the U.S.-Argentina bilateral investment treaty, a tactic that may take years to resolve. Although New York District court has ruled in favor of numerous plaintiffs, there are no financial assets to which to attach their claims.

Outlook and Implications

Argentina views the debt exchange as a "success," although creditors feel quite differently and holdouts are pursuing legal recourse in hopes that they will eventually be rewarded. Argentina has taken other steps to normalize its financial relations. In January 2006, it made a final $9.8 billion payment to the IMF, clearing its account. In March 2006, the Inter-American Development Bank (IDB) approved a $500 million loan for Argentina, the first loan from an international financial institution (IFI) since the IMF program was suspended in 2004.[31] Argentina is now proceeding with its own economic policy agenda, free from unwanted guidance by the official sector. Although the economy has been growing rapidly, rising inflation and continued lack of progress on structural reforms raise many questions regarding its long-term prognosis.

In hindsight, with the possible exception of some so-called "bottom feeders" who purchase highly discounted debt prior or during defaults, it is hard to identify any real winners in Argentina's financial crisis, raising more questions than answered in four major policy areas: a country's decision to default on debt; the role of the IMF; U.S. policy options; and codes of conduct for developing country debt restructurings.[32] These are issues that Congress has repeatedly explored in hearings on international financial crises.

Argentina

Argentina is living in the shadow of the most costly sovereign default in history. It made a reasoned case that its debt was simply too big to repay, and combined with its lack of progress on structural economic reforms, there was reason to believe that

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[29] For more information, see [http://www.worldbank.org/icsid/].

[30] Global Committee of Argentina Bondholders. *Investor Roadshow Presentation*. January 2005.

[31] Credit Suisse. *Emerging Markets Daily*. March 2, 2006. p. 2

[32] For a useful legal/financial analysis of this issue, see Gelpern, Anna. *After Argentina*. Policy Briefs in International Economics. Institute for International Economics. Washington, D.C. September 2005. p. 7.

the economy would have trouble achieving levels of prolonged growth in output and revenue needed to achieve debt sustainability without a huge write-down. Even after the restructuring, which provided Argentina with significant debt relief, the stock of public debt exceeded 80% of GDP, although debt service has been greatly reduced by the lower interest rates and lengthened maturities of the new bonds.[33] Debt sustainability is still not assured, but has been buttressed by other factors such as continued strong economic performance and tax collection, as well as the beginnings of renewed financial relationships with the international financial markets. The need for sustained fiscal discipline is another key challenge to Argentine public policy.

The default was not only unprecedented for its lengthy resolution (over three years), low recovery rate (30% of NPV), and large residual holdout (24% of creditors), but for the process that stretched (creditors would say flaunted) the guidelines of sovereign debt negotiations. This applies to both broadly understood informal guidelines and a more formal understanding as embodied in the IMF's policy of lending into private arrears. Other countries may look to Argentina as a model for reneging on sovereign debt, but the cost of Argentina's financial collapse in long-term social and economic terms has been devastating. Under the best scenario, Argentina faces decades of foreign debt repayments while it tries to rebuild an economy that has suffered through high levels of poverty, unemployment, and crime.

For investment firms and other holders of developing country debt, the mere thought that others might follow Argentina's example reinforces their belief that such a default is a highly negative precedent. Creditors vilified Argentina's negotiating tactics, but the financial markets appear willing to return to Argentina. It will also be interesting to see if Argentina can avoid any future borrowing from the IMF. It had an IMF arrangement in place continually from 1984 until January 2006, but appears determined to remain free of IMF influence.

The IMF

There are important questions related to IMF decision making. First, an IMF audit of its own actions found that, prior to the crisis, surveillance was ineffective and conditionality weak, while assumptions about economic growth and debt sustainability were overly optimistic. So the Fund lent too much for too long into an untenable situation, thereby hurting more than helping Argentina.[34] The IMF struggled with the difficult task of defining a clear threshold for insolvency — doing so earlier would have helped Argentina. In not cutting Argentina off sooner, the additional IMF lending only increased Argentina's debt problem, displaced other creditor debt for seniority in repayment, and left fewer financial resources to be used in assisting Argentina post-crisis. This severely constrained Argentina's debt workout options.

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[33] By comparison, Brazil is also considered to have a high level of public indebtedness, amounting to slightly over 50% of GDP, but which carries a much higher interest rate.

[34] IMF. *Report on the Evaluation of the Role of the IMF in Argentina, 1991-2001.* June 30, 2004 and *IMF Survey*, New IEO Report: Watchdog Faults Argentina, but also IMF. August 9, 2004. See also Blustein, *And the Money Kept Rolling In,* p. 199 and elsewhere.

Second, although the IMF was virtually assured of being repaid, Argentina repeatedly threatened to default on the Fund, lending the appearance of having undue leverage when it came time for discussing quarterly reviews and IMF debt rollover. Third, the IMF's leverage proved insufficient to persuade Argentina to negotiate a truly consensual understanding with creditors, and so the IMF lost some credibility as the "official arbiter" of debt restructuring. In fact, the IMF was a critical factor in supporting the 3% primary surplus target, a repayment ceiling creditors found unacceptable. Creditors and analysts further criticized the IMF for not weighing in clearly on Argentina's debt repayment capacity.

Fourth, Argentina also demonstrated the now well-known lesson that IMF financial assistance without policy reforms is insufficient to resolve a serious debt problem. Experts on international financial crises, including those at the IMF, understand that IMF lending should be available to countries dedicated to policy reform and with the political will and strength to see the reforms through. In the alternative, investor confidence and their money does not return, and the financial crisis only tends to deepen.[35] In practice, policy reform can be politically difficult, but Argentina presents a clear case where the ultimate costs were much higher for lending too long to a country incapable of achieving it.

Since Argentina's restructuring, the IMF has sought to modify its policies to limit the possibility of repeating such a prolonged and painful debt workout. It seeks to provide clearer rules for: 1) limiting borrowing from the Fund; 2) providing better oversight and monitoring; 3) improving options for policy support without lending; and 4) reevaluating the "good faith criterion" in the context of resolving sovereign debt arrears.[36]

U.S. Policy

The Argentine situation points to the evolution of an interesting policy dilemma for the United States, as well. The United States government, including the Congress, is concerned with the treatment of U.S. investors abroad, but in the case of Argentina, the official U.S. response was limited mostly to communications through the IMF. This is consistent with a philosophy supporting market solutions, particularly in light of the moral hazard criticism made against earlier bailouts. It may also reflect a priority for concerns over international financial stability and IMF liquidity, which may be at odds with supporting the interests of private bondholders. Historically, this too is an interesting outcome.

During the Latin American debt crisis of the 1980s, the solvency of U.S. creditors was of paramount concern for the U.S. government and so they had the upper hand in negotiating sovereign restructurings. By the 1990s, however, Congress in particular began to raise concerns over the large financial assistance provided to

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[35] Eichengreen, Barry. *Financial Crises and What to Do About Them.* New York, Oxford University Press, 2002. pp. 62-63.

[36] See International Monetary Fund. *The Managing Director's Report on Implementing the Fund's Medium-Term Strategy*. April 5, 2006. IMF website, and Taylor, John. Loan Rangers. *Wall Street Journal*, April 19, 2006. p. A12.

financially troubled countries. By the time Argentina defaulted, the pendulum appears to have swung in the opposite direction, with little interest in the official sector, and particularly the United States, directly intervening in debt workouts.[37]

Since taking office, the Bush Administration has made clear that the United States would no longer support large sovereign bailouts, but instead allow markets to resolve these financial disruptions. This commitment, however, proved easier to articulate than enforce. Although the Bush Administration did not jump to the bilateral rescue of Argentina as the Clinton Administration had with Mexico in 1995, it has made smaller efforts with Uruguay, for example. More to the case at hand, when Argentina repeatedly sought help from the IMF, the United States proved to be one of the strongest voices of support, despite the silence emanating from the U.S. Treasury. Therefore, any criticism of the IMF's response to Argentina cannot be divorced from U.S. policy, which when faced with this serious developing country financial crisis, was not in a position to steer the parties away from a costly and prolonged resolution and which has been criticized for its overall lack of leadership.[38]

The U.S. Congress also chose not to exercise its voice strongly, paying more attention to the economic crisis in Argentina than the actual debt restructuring. In the one hearing on Argentina's debt, U.S. investors were afforded little sympathy by Members and witnesses alike, and much more concern was directed at the potential loss of credibility in international financial markets and the role of the IMF. Little doubt was left that the time had passed when official government action would be sanctioned to support U.S. private investors in cases like this.[39]

Emerging Markets and Debt Restructurings

Investors paid a heavy price in the Argentine default, including those in the United States who sought a bigger role from Congress and the U.S. Treasury in seeing that their rights and investments were honored. U.S. bondholders hoped to have the United States weigh in officially on the restructuring agreement, either through its voice at the U.S. Treasury or the IMF. The United States carries much weight at the IMF and can send a strong signal as to whether IMF reviews will be supported. Given the limitations of litigation against sovereigns, this was the primary leverage available to influence Argentina's decisions, and the United States was not perceived as pursuing this option with any zeal. The message sent was that the creditors were on their own to deal with the Argentine government. Some analysts

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[37] For a discussion of the 1980s debt crisis and the role of banks, governments, and the IMF, see CRS Report RL30449. *Debt and Development in Poor Countries: Rethinking Policy Responses*, by (name redacted).

[38] Blustein, *And the Money Kept Rolling In*, p. 157 and Porcecanski, *From Rogue Creditors to Rogue Debtors*, p. 327.

[39] U.S. Congress. Senate. Hearing Before the Subcommittee on International Trade and Finance. Committee on Banking, Housing, and Urban Affairs. One Hundred Eighth Congress. *Argentina's Current Economic and Political Situation, focusing on the Bilateral Relationship Between the United States and Argentina*. March 10, 2004. S. Hrg. 108-879.

have criticized strongly the G-7 countries and the IMF for not weighing in more heavily in support of investors' rights.[40]

As for sovereign debt restructurings, the process is already changing. Given litigants' lack of success when faced with a determined defaulting country, the markets have already adjusted by adopting collective action clauses as standard provisions in emerging market debt. Other changes are being discussed in the financial community to evaluate options for imposing some form of enforced guidelines or code of conduct on countries reluctant to meet their contractual obligations.[41] As far as designing and creating an international bankruptcy agency, there remains little enthusiasm for resurrecting this idea after the Sovereign Debt Restructuring Mechanism (SDRM) promoted by the IMF failed to take hold.[42]

The fact that debt workouts are being completed, even if not always smoothly or in a timely fashion, may suggest that the "market system with IMF assistance" approach is still preferable to again trying to reinvent the international financial architecture with some type of statutory sovereign bankruptcy option. But the Argentine case was not resolved to the mutual satisfaction of all parties, with a quarter of the bondholders opting for costly litigation, despite the uncertainty of outcome. The success of this litigation may yet influence the future of debt workouts, because as Argentina has shown, once insolvency occurs and debt becomes far too large to manage, there may be little incentive for countries to work within the existing unenforceable system in finding a quick and consensual solution, leaving all parties worse off.

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[40] Porzecanski, ibid., pp. 330-32.

[41] For example, the Institute for International Finance, Inc., which represents large financial institutions, has developed principles for "fair" debt restructuring.

[42] For background, see CRS Report RL31451, *Managing International Financial Crises: Alternatives to "Bailouts," Hardships, and Contagion*, by Martin W. Weiss and Arlene Wilson.

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