Argentina:
An Object Lesson for International Economic Policymakers

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Subcommittee on International Trade and Finance of the
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by

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I appear before the subcommittee wearing two hats. First, as Director of the Gailliot

Center for Public Policy and a Professor of Economics at Carnegie Mellon University. Second, as leader of the Negotiation Team for the Argentine Bond Restructuring Agency plc (ABRA).

ABRA is the largest creditor in the Argentine debt restructuring. It holds approximately $1.2 billion nominal amount of Argentina bonds and the interests of an estimated 30-40,000 retail investors in Germany, Austria, Switzerland and the Netherlands.

ABRA was one of the three founders and is a member of the Steering Committee of the Global Committee of Argentina Bondholders (GCAB) which represents directly holders of more than $37 billion nominal amount of bonds or more than 2/3 of the $53 billion Argentine debt held by foreign investors. All major constituencies of Argentina's foreign bondholders are represented, both geographically and by type of investor. Italy, Germany, Austria, Japan and the United States dominate. Retail and institutional investors share power to match their equal shares of Argentina's debt.

Argentina and the Capital Markets: An Egregious Example

A developing nation of 38 million people, insignificant in the world economy and largely dependent on agricultural exports, was able to borrow an extraordinary $100 billion in the capital markets. It became the largest debtor in the emerging world with 25% of the global total. The most sophisticated global hedge funds and professional portfolio managers along with the most naïve Japanese farmers and Italian pensioners readily purchased these promises to pay without any regard to the debtor's capacity to pay. The

creditworthiness of the borrower was irrelevant. It was the bailout policies of the Clinton Administration in the 1990's that had socialized the risks and privatized the returns from emerging market lending.

In 1995 in Mexico, Lawrence Summers, then US Treasury undersecretary gave life to a financial anomaly: an asset with a high rate of return and with an unwritten AAA guarantee from G7 governments via IMF bailouts. The natural laws of the risk/return trade-off were contravened. The demand was explosive. Annual bond issuance by Latin American governments instantly quadrupled from $9 billion to $37 billion.

Bailouts grew with borrowing. The $50 billion package for Mexico was promised to be a one-time event. Instead, there followed in swift succession: in 1997, Thailand for $17 billion, Indonesia for $34 billion and Korea for $57 billion; in 1998, Russia for $16 billion and Brazil for $42 billion; and in 2000 Turkey for $10 billion and Argentina for $20 billion. Loss largely bypassed the private sector that, with the exception of Russia, did not write off a single dollar on sovereign lending to large emerging nations. A quarter trillion dollars in risk was shifted from the balance sheets of private creditors to official ledgers.

In 1996, the Group of Ten took note of the moral hazard inherent in bailouts with a promise that they would act to "discourage expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector". But as time went on, an overriding but unspoken U.S. Treasury policy, without legislative

endorsement, held that development in emerging economies was a global public good and that a high flow of affordable funding to these markets, beyond official capability, must be encouraged at all costs.

Even as the IMF was warning the Argentine government behind closed doors that its fiscal policy was unsustainable, the Fund continued to support the nation publicly. In five years starting in 1995, bondholders doubled their investment from $50 billion to $100 billion.

By 2000, G7 taxpayers were staring at a long list of payouts down the road. Excesses were finally halted by the Bush Administration in December 2001 when the IMF stood by and a clearly insolvent Argentina was allowed to default on its massive debt to the private sector.

Argentina and the IMF: A Tiger by the Tail

The economist John Maynard Keynes once wrote that if you owe the bank 100 pounds, you have a problem. If you owe the bank 1 million pounds, the bank has a problem.

Just as past bailout policy had allowed Argentina to dominate emerging bond markets with $100 billion debt to the private sector, it permitted Argentina to accumulate $30 billion of debt to the official sector and to hold a disproportionate share of official lending.

It is the IMF's third largest debtor with 15% of the Fund's portfolio. It is the second largest borrower at the Inter-American Development Bank with 17% of loans outstanding. It is the World Bank's fifth largest exposure with 7% of total risk.

Nothing is more feared by the multilateral agencies than default. It not only threatens their capital structure but, even more dangerous, calls into question the long-held posture that official loans are riskless and, consequently, have no cost to donor country taxpayers. As then Secretary of Treasury Robert Rubin stated to Congress when he requested the $18 billion appropriation for the IMF in 1998: "It does not cost one dime".

Default to any of the International Financial Institutions by a major borrower opens a Pandora's box of policy issues. Why are the multilateral agencies providing funds at subsidized interest rates to developing borrowers that enjoy full access to the capital markets? What are the costs and risks for G7 taxpayers? What has been the effectiveness of past efforts? Why are the costs of participation in these institutions not accounted for in the U.S. budget? When new funding is requested, Congress will be called upon to scrutinize the merits and costs of International Financial Institution programs relative to competing uses of scarce public monies.

Twice in the past two years, Argentina has successfully played the default card. To combat IMF conditions of reform, the Argentine government halted payments to the World Bank and Inter-American Development Bank in late 2002. Similarly, in September 2003, Argentina defaulted to the IMF for a day until an agreement on the

government's terms was signed.

The Emerging World is Watching

Lending to governments is a tricky business. We no longer live in an era where the governments of private sector lenders send the navy to collect on their bad loans. There is no collateral; no security; no ability to enforce the contract; and no ability to seize assets. The only rational reason to pay is that there is more to gain from paying than from not paying.

Argentina has made a preemptive decision. Payments to the country's lenders are now deemed discretionary expenditure, not fixed obligations. Government-sponsored posters of ragged children crystallize a new concept: the "social debt" to provide a better quality of life for citizens takes priority over the financial debt to the nation's creditors.

If Argentina even comes close to imposing the 90% debt reduction it currently is demanding (a level of relief that has not been obtained by even the poorest African nations), how can Latin American leaders or any developing country politician justify to their electorates stringent fiscal efforts to honor obligations to foreign lenders? Why not schools and hospitals instead of repaying rich foreigners? The resulting defaults will cascade through the international capital markets.

At the beginning of this statement, it was noted that ABRA was the largest creditor in the Argentine debt restructuring. I misspoke. The debt held by the IMF is a 13 time

multiple. In order to qualify for IMF loans, the rules of the Fund require governments in default to the private sector to demonstrate “good faith efforts” to restructure their debt. Is it not a conflict of interest to ask this agency to rule on a debtor’s good faith toward what are, in essence, competing creditors at a time when its own balance sheet is threatened?

Every month that Argentina delays its restructuring, it saves $700 million in accumulating interest. Since the default in December 2001, this adds up to more than $20 billion. Instead of relying upon exhortation and a vague and subjective standard of “good faith”, the IMF should create automatic financial incentives that encourage governments to restructure defaulted foreign debt without delay. As a condition of desirable Fund loans that carry highly subsidized interest rates and no repayment for 3 years, the IMF should require an accelerated 5% monthly prepayment until the country comes to terms with its private creditors.

The Argentine crisis is the creature of a misguided international financial policy. When the expectation of bailouts no longer intervenes, market forces will limit the debt a government can accumulate and the IMF will no longer be at the mercy of its large borrowers.