Argentina: A G20 Nation Dealing with Vultures

The series of events that led the International Swaps and Derivatives Association to classify Argentina's recent debt problems as a 'default' is a valuable opportunity for achieving the global political consensus conducive to the implementation of a set of rules that makes sovereign debt restructurings more efficient and equitable, believes **Martin Guzman**

More than 12 years ago, Argentina defaulted on its sovereign debt for the last time. The default occurred in the middle of a devastating economic and social crisis – that was accompanied by a devaluation of the domestic currency and a freezing of people's deposits in the banking system. The country had been in a severe recession for three years prior to these events. By the end of the recession, the poverty rate had achieved a historical maximum of 57.5 percent, the rate of unemployment had climbed to 20.8 percent, and the annual Gross Domestic Product fell by 11 percent in 2002. The elected president resigned in December 2001, amid violent protests that claimed the lives of 39 civilians. Clearly, the country was not in a position to honour its debts.

Economic Reforms and the Legacy of Structural Problems

A set of economic reforms undertaken in the early 1990s encouraged and supported by the so-called Washington Consensus, reforms that would supposedly enrich the country, had led to a rapid growth in sovereign debt. These reforms included liberalisation of (domestic and external) financial and trade relations, and the privatisation of public enterprises. Another central element was the imposition of a currency board, a Convertibility system that fixed the value of the Argentine peso to the value of the US dollar, at a one-to-one parity. By 1998, Argentina was the poster child of the International Monetary Fund (IMF). In October 1998, its president was invited to give a speech on the Argentina's successful experience at the joint Annual Meeting of the Board of Governors of the IMF and the World Bank.

The experiment proved to be a massive failure. The country did not become richer, and it left a legacy of structural problems. Trade reforms were conducive to large-scale destruction of jobs in the industrial sector. In a country with a significant proportion of unskilled workers, the implications were exclusion from the markets for many, more income inequality, and less opportunities for the losers – with effects in terms of social behaviour difficult and expensive to undue, that still persist.

Another legacy was the need of normalising the country's situation with its creditors. There were two rounds of negotiation, in 2005 and 2010. By the end of the second round, 92.4 percent of the creditors had accepted the new terms. The restructuring included a large haircut of 66 percent, and a novel element, the GDP indexed bonds, which would pay more if the country grew more. Argentina's economy soared since 2003 (annual GDP growth was higher than eight percent since then until the global financial crisis that erupted in 2008), and creditors benefitted from this rebound.

Out of the 7.6 percent who did not accept the new terms, a fraction of them were not good-faith creditors. They were not investors that had lent to Argentina. Instead, they were vulture funds. They bought bonds that were already in default at a huge discount in the secondary markets. Then, they sued the country, claiming full payment on the defaulted bonds, plus interest – interest that also included a compensation for risk. This *modus operandi* was not new: they had already successfully followed it in Peru and several African countries in distress.

Griesafault and its Aftermath

Argentina's debt had been issued under the jurisdiction of New York – as the majority of debt securities in the world. Judge Thomas Griesa of the Southern District of New York came up with a peculiar interpretation of *pari passu*, a standard contractual clause intended to ensure that all claimants are treated equally. He considered that if Argentina paid in full what owed to the creditors that had accepted the restructuring, it also had to pay in full what the vultures were claiming. The restructured creditors would not receive a single dollar if Argentina did not pay the vultures in these terms. The consequence was that on July 31, these creditors did not receive the payments that Argentina deposited in the Bank of New York Mellon a few days before. This was the first time in history that a country was willing and capable of paying its debts, but was blocked by a judge from doing it – a situation that elsewhere has been defined as a Griesafault.

The International Swaps and Derivatives Association (ISDA) classified the event as a default. Defining the event as such is not innocuous, as it activates payments on Credit Default Swaps (CDS). Interestingly, Elliot Management, the hedge fund headed by Paul Singer whose subsidiary NML Capital is one of the vulture funds suing Argentina, is a member of the ISDA Committee judging the nature of the event.

Negative Consequences

The event has negative consequences for Argentina, for the US judicial system, and for the functioning of international debt markets – more negative for the global economy than for Argentina. For Argentina, it delays the end of the restructuring process, further impeding access to international credit markets. It also creates other inefficiencies that are difficult to quantify – by not obeying Griesa's ruling, the country could be in contempt with the US Justice.

The expected costs of obeying the rule would have been larger. The exchange bonds received by creditors that accepted the restructuring contain a legal clause, RUFO (that stands for Right upon Future Offers), included to protect creditors that participated in the restructuring. The clause states that if Argentina pays any holdout creditor more than what it pays to them, they have the right to obtain the same better terms – this clause expires on December 31. By paying the vultures (who would obtain a total return of 6,000 percent under these terms), the country could have had to pay up to $1,400 billion to the other creditors – about a third of the country's annual GDP, an impossibility that would have led to another default.

The competence of the US judiciary is being damaged. The government of the United States had filed a brief before the appeals court made its decision, claiming that the decision would encourage countries to issue their debts outside the jurisdiction of New York, and that "it would have a detrimental effect on the systemic role of the US dollar".

The ruling severely distorts the functioning of international credit markets. It encourages usurious behaviour and creates a moral hazard problem. Any creditor would have incentives not to participate in restructurings, making fresh starts impossible. The IMF, in a paper released last year, had warned that the decision could "exacerbate the risk undermining the sovereign debt restructuring process". Anticipating this situation, sovereigns' incentives to borrow would also decrease, with negative consequences for global efficiency and stability.

Luckily, the United Nations is supporting the establishment of mechanisms for the restructuring of sovereign debts – an initiative that has received strong support of the most prominent economists in the field, including two Nobel laureates. The International Capital Market Association has also recently revised and updated the collective action clauses (clauses that state that if a pre-specified percentage of the debtors accept a restructuring, the other creditors are compelled to accept it as well) and the interpretation of the *pari passu* clause for sovereign debt securities, in order to finish with the distortive vulture funds' business.

The Way Forward

The challenge for Argentina and its creditors is to find a way to execute the payments that have already been made, and those that will be made in the coming months. Argentina's government is now proposing an alternative mechanism. A recently passed law will allow creditors to exchange the bonds issued under the New York jurisdiction for other bonds with the same terms issued under the jurisdiction of Argentina or France, to execute the payments with no interference of Judge Griesa's ruling. Some creditors have anticipated that they would take the deal.

The Griesafault should not create panic. Markets are smart enough to distinguish ordinary defaults from Griesafaults. Domestic corporate interest rates have not reacted to the event. The country's main macroeconomic problems are not the consequence of the Griesafault, but the consequence of other more fundamental factors – the recent times of high output and consumption growth are gone. The country did not administrate the boom optimally in order to stabilise the consumption of the society over long periods of time. Bottlenecks in the energy sector are evident, and the market endogenous adjustments are resulting in high inflation and a continuous depreciation of the domestic currency, while international reserves keep decreasing. In an international context significantly less favourable than during the last decade, these problems will be difficult to overcome, making more likely a scenario of persistent lower economic growth with lower consumption capacity.

This event, we hope, will end up being a valuable opportunity for achieving the global political consensus conducive to the implementation of a set of rules that makes sovereign debt restructurings more efficient and equitable. The vulture funds business undermines global economic, political, and social stability. It is a negative sum game that should be terminated.

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