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ARGENTINA'S DEBT AND THE DECLINE OF THE IMF

More than three years after defaulting on its debt, the Argentine Government has proposed a bond exchange which would see its investors losing about 70% of their initial investments. Whatever the exact outcome of the operation, it already illustrates the weaknesses of the contractual approach to handling sovereign defaults. Given the coordination problems faced by private investors, the Argentine authorities were able to refuse any constructive and sincere negotiation. However, the scope for resisting such an non-cooperative strategy is in fact limited: the threat of court action was over-estimated and no arbiter or institutional monitor has emerged able of replacing the IMF. The absence of a binding link between private renegotiation and multilateral instruments for policy monitoring considerably reduces the leverage of the Fund on the overall process. This confirms the relative decline of the IMF in the new "international financial architecture". Furthermore, if the contractual approach may attain its objectives for "small" defaults, then several accidents as occurred in Argentina could well lead to a dead-end, requiring more institutional and political responses.

A significant debate has been taking place since the Asian crisis concerning the restructuring of sovereign debt, i.e. debts by governments rather than private agents.[1] Specifically, the methods inherited from the 1980s crisis, which were organised around the IMF, no longer function in a world of globalised, disintermediated capital markets. However, the definition of new procedures faces several obstacles. First, private agents strongly resist the adoption of rules that would be exposed to intervention by public and multilateral institutions. Second, problems of information and of coordination among investors have become considerably more difficult to solve, while collective decision-making is limited by the principle of contract integrity. This is a major factor, as minority investors opposed to restructuring agreements regularly threaten to enter litigation in the commercial courts of the financial markets in which bonds have been issued, mainly New York and London. They may then win legal exemption from the concessions made by other investors, which obviously undermines the principle, in the long term, of negotiated settlements.

Two main proposal have structured the debate.[2] On the one hand, in 2001, the IMF formulated the idea of a "bankruptcy court" for sovereign states – the so-called "Krueger proposal".[3] This body would have fixed a set of constraining rules relating to the representation of actors and the negotiation process. Above all, it could have imposed agreements which were voted by a qualified majority (75% of debt-holders) on recalcitrant investors: resorting to law courts would have been blocked. This highly structured project, however, was not found convincing and in April 2003, the G7 governments, the private financial sector and a number of large emerging countries agreed on an alternative method, based on "Collective Action Clauses" (CACS).

The underlying idea is to adapt the negotiating practices commonly used in resolving international disputes between major private companies (financial and industrial) to the restructuring of sovereign debt. This involves rather informal rules, associated with amicable settlements or private arbitration, that avoid public intervention as much as possible. Such procedures nowadays play an increasing role when

1. See "The Ecuadorian Crisis and the International Financial Architecture", *La Lettre du CEPII*, No 188, March 2000, available at <www.cepii.fr>.
2. See "Sovereign Debt Crises and Multilateral Action Following the Rejection of the Krueger Proposal", *La Lettre du CEPII*, June 2003, available at <www.cepii.fr>.
3. IMF (2002), "The Design of the Sovereign Debt Restructuring Mechanism – Further Consideration", prepared by the Legal and Policy Development and Review Department, 27 November.

conflicts are related to direct investment or, to some extent, within the WTO.[4] In the case of sovereign debt restructuring, the main effect of adopting CACs is that no *a priori* negotiating rule is to be imposed upon the parties: a lot of confidence is thus placed in their clear interests and their "good faith"; while the risks of parasitic behaviour by minority investors should be controlled ultimately by qualified majority voting within each bond issue. And if ever major problems arise, cases are to be taken to court in the markets of issue. At best, a "Code of Good Practice" could complement these principles and guide actors, for example, on issues of mutual information.[5] Problems are thus to be solved pragmatically and at a lower cost than in the IMF-controlled process, where underlying problems of collective action would have been be settled *ex ante*, through mandatory rules. These include the coordination between different classes of investors, the verification of parties' "good faith", equitable burden sharing and the control of litigation risks.

This second approach, which is contractual in its nature, has now been generalised: during the first three quarters of 2003, 90.3% of new, sovereign issues included a CAC.[6] This is a success which extends the positive record of a series of the small-scale restructurings, undertaken since 1998 along similar principles (for the Ukraine, Pakistan, Ecuador, Uruguay).[7] Lastly, discussions launched by the *Banque de France* in particular should lead shortly to the adoption of an indicative Code of Good Conduct by the main actors.[8] This is presented as an additional step in the progressive consolidation of the CAC regime.

The Argentine Affair

Enter at this point the highly conflictual restructuring of Argentine debt, in the wake of the default in December 2001.[9] Though the Argentine case had been an implicit reference in the IMF proposal, the preference then given to the CAC-based, contractual method led to its marginalisation: this episode was seen as too special for any general lessons to be drawn from it. The economic and political crisis of 2002 was unprecedented, while failure by the IMF in preventing it was also exceptional. These problems were compounded by the record level of debt involved ($103 billion), as well as its extreme complexity, in both legal terms and in terms of the number of debt-holders and their interests (see Box).

Box – The Structure of Argentine Debt

The total debt volume runs to $182 billion, of which $103 billion are affected by the present restructuring proposal (including $156 billion in interest arrears accumulated since December 2001). The remainder is mainly made up of multilateral and internal debt, which cannot be restructured.

Outstanding liabilities are spread across seven currencies (50% in dollars, 34% in euros), eight laws and several jurisdictions: in particular 50% comes under New York law with no CACs, 19% under British law with CACs, and 11% under Argentine law. The Brady Bonds, which were issued in the wake of the 1980s debt crisis, account for 6.5% of the total.

38.4% of bond liabilities are held by Argentinians (notably banks and pension funds), 9% by American investment funds and 31% by German, Swiss, and above all Italian small bondholders (15.6% of total liabilities, held by 400,000 savers).

Overall, institutional investors hold 56.4% of outstanding debts and private individuals 43.5%.

Twenty-one associations representing investors have been created, to begin with on a national basis: four associations in Germany, five in Argentina and five in Italy, etc.

Thereafter, a consolidation process, though informal, arose the *Global Committee of Argentina Bondholders* (GCAB, <www.gcab.org>), which represents 500,000 individuals along with about 100 banks and institutional investors, holding more than $39 billion in bonds altogether. This committee, which is not recognised by the Argentine authorities as a key negotiating party, opposes the swap offer made in January-February 2005.

The novelty today is that more than three years after the default, a restructuring procedure may succeed in the coming weeks: investors are now being invited by the Argentine authorities to swap (in New York) the 152 former bond issues for three types of sovereign bonds offered by the Argentine Republic. Interest payments would then restart immediately, but investors would lose between 68% and 75% of their initial investment.

The principle of such an exchange, as an exit strategy from default, has been accepted for a long time. That said, the conditions put forward by the Argentine authorities and above all the absence of any negotiations with private investors are based on strong assumptions. It cannot be ruled out that numerous bondholders will refuse to participate in the exchange, which would worsen the financial imbroglio: when the offer expires on 23 February next, a significant share of the debt would then remain unsettled, even though the Argentine government has repeated that it will make no further proposals: it has even voted a law to tie its hands. The validity of the entire operation would then be contested,

4. For example, the International Centre for Settlement of Investment Disputes, which is linked to the World Bank, and the WTO Dispute Settlement Body.
5. N. Roubini & B. Setser (2003) suggest that the taking into account of good conduct rules by US judges could progressively allow these principles to be integrated into jurisprudence. See, *Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform*, IFRI (Paris), 9 March.
6. As opposed to 20.9% in 2002; *Global Financial Stability Report*, IMF, September 2004.
7. P. Chuham & F. Sturzenegger (2003), "*Default Episodes in the 1980s and 1990s: What We Have Learned*", mimeo, World Bank and University di Tella, November.
8. B. Couillant & P.-F. Weber (2002), "Towards a voluntary Code of good conduct for Sovereign Debt Restructuring", *Financial Stability Review*, Banque de France, June.
9. "Can the Argentine Peso Resist Competition from the Dollar?", *La Lettre du CEPII*, No 209, February 2002, available at <www.cepii.fr>.

as would the value of the new and former stocks, and indeed the conditions for a progressive return by Argentina to the primary capital markets.

Four Lessons

Whatever the outcome, four main lessons may be learnt from this experience, which underline the fragility of the present rules. They actually concern the key points on which the "CACs vs Bankruptcy Court" debate stumbled.

✦ The organisation and coordination of private investors are indeed problematic. Using the method employed in the 19th century,[10] 21 committees of bondholders have actually been formed, but the definition of a common position, followed by the delegation of the power of negotiation have remained impossible. Among other things, this problem reflects the cleavage between the small German, Japanese and especially Italian bondholders (400,000), who bought stocks at par, and specialised investment funds which generally acquired them after default, at a heavily discounted price. The conditions offered by the Argentine government thus imply significant gains for the latter, while the former will suffer substantial losses: coordination between these two groups was bound to be difficult. From a tactical point of view, the main beneficiary however is the Argentine government: it refused to recognise the legitimacy of even the most important committees (especially the GCAB which represents debt of nearly $39 billion) and it did not hold negotiations in proper form. In the end, the government was thus able to impose a "take it or leave it" strategy, which may have reflect a tacit alliance with the US investment funds.[11]

✦ The notion that any defaulting country will enter into constructive negotiations has thus been invalidated. Furthermore, nothing suggests that this is specific to Argentina: the combination of sovereign default, a deep social crisis and an explosive political system could arise elsewhere. More generally, other "major" defaults, with significant redistributive effects, both internally and externally, could again incite debtors to adopt non-cooperative strategies. As the history of the 1930s showed, rational behaviour under adverse circumstances may lead a sovereign borrower to refuse negotiation or to repudiate its debt.[12] After World War II, financial multilateralism indeed aimed to contain, within a set of strong rules, the risks incurred by a failure of collective action. This was to provide a solid financial basis for economic integration, be it in terms of exchange rates, trade and later financial integration.

✦ Furthermore, the means available within the contractual framework to counter non-cooperative strategies have proved to be quite fragile, to say the least. In particular, the threat of legal action, which has been much discussed in recent years, seems to have been overestimated.[13] This also applies to an alternative, little-discussed approach, whereby bond exchanges are vetted by the local market regulator, in this case New York. This seems to have been a more effective instrument for regulating negotiations, in London and Paris, before 1914, than was the threat of legal proceedings. However, no such mechanism has yet re-emerged.

✦ Lastly, the role and the means of the IMF are thrown into doubt, because the Fund has had practically no hold on the Argentine debt restructuring process. For three years, the IMF called upon the Argentine authorities to "negotiate in good faith", threatening to suspend credits disbursements in case of refusal. None of this has had any effect. In September 2004, the Argentinians even decided to suspend their IMF agreement until after the bond exchange. And, after February 23, if the Fund were to state that the number of bonds brought to the exchange is too small to validate the overall operation, the practical consequences of such a declaration might be quite limited. The most likely impact is, in fact, that the Argentinians will continue to ignore the Fund.

The main consequence of this episode is therefore that rules as regards sovereign debt restructuring are now far removed from past regimes, which were centred on multilateral rules (albeit loose ones). However, the "soft" rules of private finance, founded on precedent and good faith, have in no way proved their effectiveness. In essence, the restructuring process has not shifted to bilateral negotiation, but instead to a logic dominated by unilateral, non-negotiable proposals. The Argentine episode thus asks whether, in the future, "light", contractual rules of negotiation, which are also fragile and open to failure, will be enough in the case of large sovereign default. The most likely answer is that this approach may succeed when debts are neither too important nor too complex. Conversely, substantial defaults in the future are likely to see further, serious problems emerge. The major risk would be the contagion of several defaults in rapid succession, as occurred in the early 1980s. Failure to tackle them effectively would imperil the survival of international capital markets, at least within their existing perimeter 7 – unless a bankruptcy-type procedure, as envisioned by the IMF, were to reinvented on the spot.

10. See in particular P. Mauro & Y. Yafeh (2003), "The Corporation of Foreign Bondholders", *IMF Working Paper*, WP/03/107.
11. In a comparable situation, the default of Ecuadorian debt in 1999 had already led to such a proposal. See *La Lettre du CEPII*, March 2000, *op. cit.*
12. See in particular the first two contributions by B. Eichengreen and P.H. Lindert eds, (1989), *The International Debt Crisis in Historical Perspective*, Cambridge, MIT Press.
13. This hypothesis was put forward by N. Roubini (2002), "Do We Need a New Bankruptcy Regime?", *Brooking Papers on Economic Activity*, 2002(1): 229-255. See also IMF (2004), "*Progress Report to the IMFC on Crisis Resolution*", 28 September.

What Future for the Fund?

These various observations attest to the growing distance which has appeared, over the years, between private debt renegotiations and multilateral instruments for crisis-management. A brief look at history, however, quickly shows that the resolution of sovereign defaults over the whole 20th century was based on two public functions, which have now been greatly weakened.[14] First, a third-party arbiter between the indebted country and the investors sanctioned fairness in burden sharing, as well as the now so-evasive "good faith" criteria in negotiations. Such was indeed the role of the US *Money Doctors*, at the beginning of the century[15], followed by the League of Nations in the 1920s[16] and later the IMF. Then comes the question of the guarantees offered to the investors that the indebted nation will comply with its economic policy commitments, undertaken in exchange for concessions (the extension of debt maturity, the reduction of outstanding debts, etc.). Indeed, if a country follows a "bad" economic policy and defaults again rapidly, earlier concessions would have been of no avail. This was the contribution of conditionality to the restructuring process: the IMF's second, traditional function was to provide some guarantees that commitments would be respected, so as to add credibility to the overall process.

During the 1980s, the IMF was *de facto* in the central position regarding the unfolding of negotiations. And this gave it to ensure the respect of conditionality retrospectively. This power was based on the close links between its function as a third-party arbiter and as an "executive agent" which controlled economic policy implementation.[17] Today, in contrast, these two functions are no longer linked: the IMF's absence from the process of re-negotiation has considerably reduced its capacity to guarantee, even imperfectly, that policy commitments will later be respected. Its official discourse indeed reflects this evolution: increasingly, the emphasis is less on "conditionality" and more on "policy ownership", as the IMF is expected to act as a "catalytic lender", which should provide the market with "signals" and information, i.e. acting in unilateral, non-negotiated ways *vis-à-vis* private actors.

In other words, this multilateral institution is now considerably weakened because it is no longer the operator of a rule-based regime which provides strong guidelines for collective action. The corollary is that the IMF is rapidly transforming itself into a large economic think-tank, associated with a capacity to act as an *un*conditional lender, as it is less and less able to support on the policies followed by borrowing countries. As stated, this derives from the apparent impossibility for establishing strong rules of interaction between private agents and the multilateral agent, i.e. between contractual re-negotiation and economic policy making. The earlier comparison with the 19th century experience of financial globalisation then raises the more general question of whether, now and then, the same factors may explain respectively the decline and the non-existence of multilateral rules.

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14. See J. Sgard, "IMF in Theory: Sovereign Debt, Judicialization and Multilateralism", *CEPII Working Paper*, 2004-21. Information and expertise may be added as a third function within this framework of analysis.
15. M. Flandreau, ed (2003), *Money Doctors: The Experience of International Financial Advising 1850-2000*, London, Routledge.
16. See W. Pauly (1996), "The League of Nations and the Foreshadowing of the International Monetary Fund", *Princeton Essays in International Finance, 2001.*
17. Concretely, up until 1989, the Fund could not lend to a country which had not signed a reconstruction agreement, in the wake of a default. Since then, and especially since 1995, the IMF criterion has become more blurred as it is based on the "good faith" of debtor taking part in negotiation. See IMF (2002), "Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criteria", prepared by the International Capital Markets, Policy and Development and Review Legal Departments, 30 July.

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