

## Argentina v. Holdouts: The Real Costs of Default and Benefits of Settlement

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On July 3, the most venerable of the Pan-American organizations, the Organization of American States (OAS), met in Washington to discuss the conflict between Argentina and the "holdouts" (known in official and popular language as "vulture funds") with regard to the restructuring of foreign debt of Argentina that originated from the default of 2001. The result was predictable, even in the presence of a court ruling endorsed by the Supreme Court of the United States requiring that Argentina pay the "holdouts" (at the same time "pari passu") as the holders of bonds restructured in 2005 and 2010. There was unanimity on the part of the Latin American members and the Caribbean in support of the Argentine and an abstention by the United States. Argentina claims that it cannot fulfill the obligations imposed by the US courts, for economic and national legal reasons.

Beyond the complex legal aspects in connection to this case, what does Argentina attain with these actions? At the OAS, Argentina managed to get declaratory support, in addition to the endorsement provided by the G-77 and other fora. The declaration involved no cost for other countries in the region. If the Argentine Government was to observe the facts and not be blinded by the rhetoric, it would notice that no other countries (excluding those that are in a state of conflict or post-conflict) are in a situation equivalent to that of Argentina. All countries, to the extent they borrow in international markets, are meeting their obligations within the framework of the laws that they have accepted for their debts. In addition, they recognize the relevant rules and the competent authorities that will settle their eventual disputes. An interesting observation relates to the fact that the ratings of the sovereign obligations of other countries have not shown any degree of contagion, and no other major debtor is following in the footsteps of Argentina. There are thoughtful proposals for the reform of financial system to deal with debt difficulties and defaults, but that is relevant to the future.

What would Argentina lose if it did not negotiate with the plaintiffs within the framework of the Court ruling against the country? Although the government talks of external actions against it and the need to defend its sovereign rights, what Argentina is putting at risk is the economic future of virtually all Argentines. Unfortunately, its recent declarations give the impression of a lack of clear objectives, beyond the ideological reassurance to its close followers. If Argentina does not reach a satisfactory agreement for both parties it would face many economic problems. To understand these problems, it is important to review the current situation of the country.

### **Current Economic Conditions**

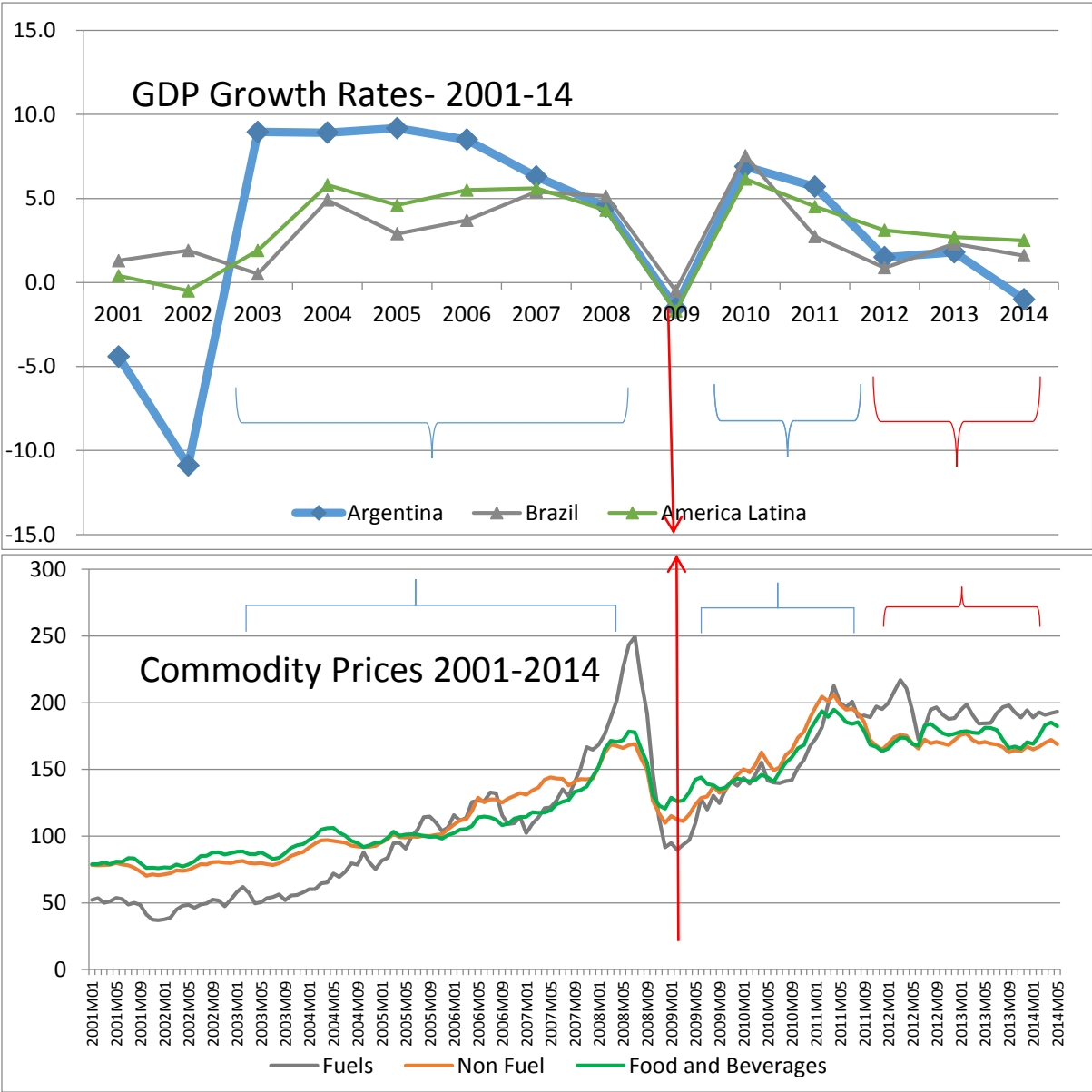
The Argentine government has claimed in a systematic fashion that it followed a successful growth and development model that brought considerable prosperity to the Argentines. In practice, Argentina grew

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<sup>1</sup> The opinions expressed here are those of the author and do not necessarily reflect those of Centennial Group Latin America or Inter-American Dialogue.

rapidly during the first years of the administration of Presidents Nestor and subsequently Cristina Fernandez de Kirchner, but as Figure 1 indicates, it was clearly linked to the recovery process from the very traumatic recession the country suffered in the early 2000s, and the sharp increase in commodity prices (the main source of Argentine Exports). In fact, as was the case with other countries in the region, especially other emerging countries, a significant proportion of the GDP growth observed in recent years is explained by changes in terms of trade. In the specific case of Latin America, one third of economic growth can be explained by these changes. As observed in Figure 1, GDP growth was high when commodity prices (particularly for non-fuel commodities) were rising, and the rate of growth became negative or declined when prices declined, or more recently, remained stagnant.

**Figure 1: Argentina and Others GDP growth and Commodity Prices**

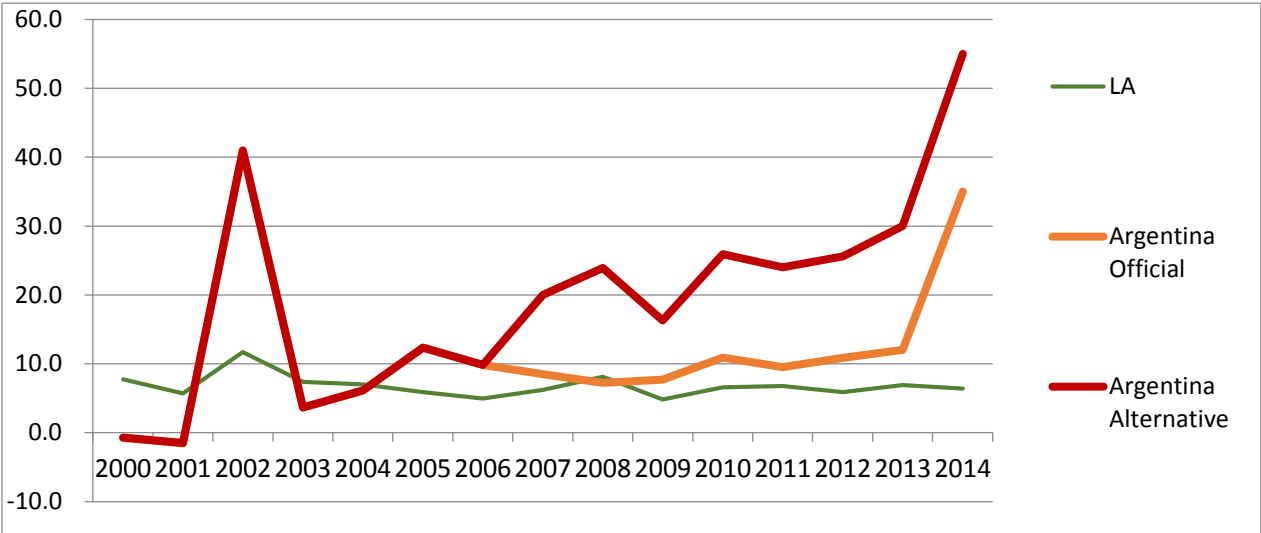


Sources: IMF, World Bank and authors estimates

The slowdown in GDP has been particularly steep in more recent years, as has been the case in other countries of the region, but particularly in Brazil, Argentina’s main trading partner. However, the decline in growth in Argentina and the more recent recession that has emerged in 2014 and has been even reflected by official statistics goes beyond that of its trading partners.

The decline in output has been accompanied by an acceleration of inflation. The Argentine Statistical Office has revised the numbers on inflation, which had been underreported in the past, and the official numbers show a jump in inflation so far in 2014. Alternative measures, which were capturing a considerably higher rate of inflation in the past, continue to show significant divergences in 2014, with a projected rate above 50 percent for the year, the second highest in the region, even considering the existence of price controls on some strategic items and a tighter monetary policy since early 2014.

**Figure 2: Rates of Inflation 2000-2014**

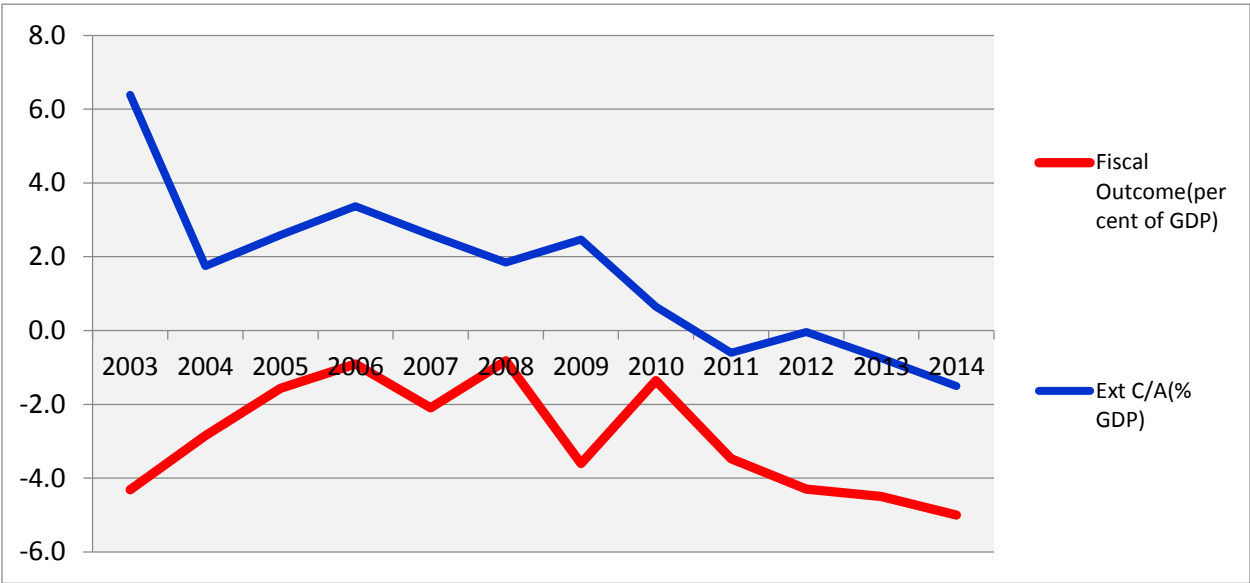


**Sources: Official data, World Bank, IMF, “Inflacion Verdadera”, and own estimates**

The deteriorating performance of the Argentine economy mirrors the weakening of the macroeconomic stance, previously hidden by favorable external conditions and the limited payment of interest obligations to foreign creditors, accounted for widespread arrears and sharp cuts in interest rates on restructured debt. Specifically, the current account of the balance of payments has moved from a large positive position to a negative position in recent years because of the weaker exports and high imports, even as interest payments were effectively cut in half . As a consequence, the fiscal deficit, which had been improving in line with exports through 2008, has declined ever since, with the only exception in 2010, when commodity prices rose sharply. As prices stagnated (See Figure1) and imports remained at record levels, in part because of a decline in fuel production, the public sector deficit is expected to reach 5 percent of GDP in 2014, as illustrated in Figure 3. As a consequence public sector debt, which had been declining as a proportion of GDP through 2008, started rising again and may reach between 45 and 50 percent in 2014. This value is still low by international standards but may increase to the extent that Argentina continues to face difficulties in obtaining foreign financing at reasonable interest rates.

Argentina has seen a collapse in foreign direct investment (FDI), which is currently only a shadow of previous years. FDI, which had reached levels equivalent to 8 percent of GDP in the 1990s, has tended to decline ever since. The ratio of FDI to GDP averaged 2.1 percent during the decade 2003 and 2012 but with a downward trend. In 2013 FDI was only the equivalent of 0.2 percent of GDP, the lowest in the last twenty years and mainly reflecting the reinvestment of profits by local foreign companies as they had serious impediments to the remittance of their profits. Moreover, on the basis of official data, Argentine private assets abroad have increased by 100 billion \$US and reached a level of more than 200 billion \$US in the last ten years, mostly reflecting continued capital flights in the face of increasing uncertainties about economic policies in the country. As the current account weakened and the capital account showed net outflows, net international reserves declined by one third to about 30 billion \$US.

**Figure 3: External Current Account and Public Sector Deficit (In percent of GDP)**



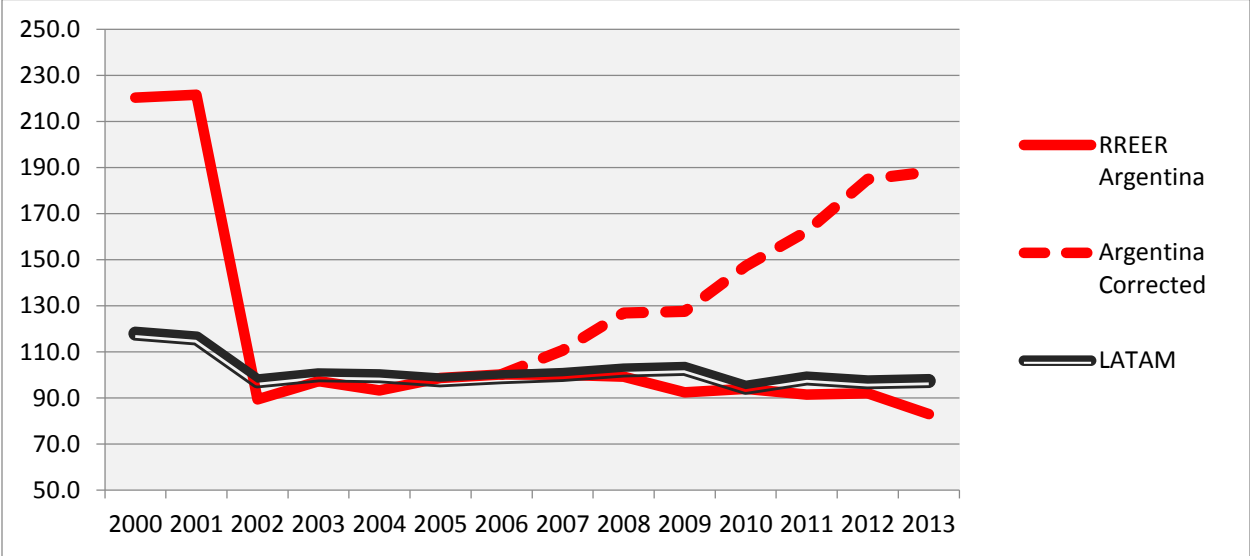
**Sources: World Bank, IMF and Official data**

The situation has become complicated by the increasing restrictiveness of the exchange and trade system, which has made transactions with the rest of the world cumbersome and very costly to local firms and individuals. Moreover, the currency in real effective terms (i.e. the exchange rate with respect to Argentina’s trading partners, adjusted for the differential rates of inflation) has appreciated significantly well beyond the official estimates. If the unofficial rate of inflation is used to calculate the effective real exchange rate there has been a sustained loss of competitiveness, eroding the initial gains that had taken place in 2002. Although the peso was allowed to depreciate by about 20 percent in the early part of the year 2014, cumulative inflation so far this year has been in excess of that percentage, and the peso remains too high by any indicator, certainly much more appreciated than the broadly quoted parallel (blue) exchange rate.

Finally, Argentina has had a very poor performance in terms of improvements in total factor productivity. This is mainly caused by the low levels of investment and the adverse atmosphere

regarding private investment and innovation, aggravated by weaker educational achievements in the Argentine School system.

**Figure 4: Real Exchange Rate Index (Appreciation, increase)**



**Benefits of Settlement Far Outweigh Consequences of Default**

There has been much controversy about the costs and benefits of an agreement with the “Holdouts” within the settlement of obligations required by the US Courts. The Argentine government has devoted considerable time and effort to explain the costs of settlement, in terms of the difficulties imposed on its fiscal and its balance of payments cash flows. However, a careful observation of the facts as described above provides a very different picture.

1. If the Argentine Government does not settle and falls into serious delays and/or defaults, it would continue getting no meaningful financing at high interest rates. Argentina has made interest payments of somewhat less than 5 billion \$US a year on an external debt of about 115 billion \$US (excluding intercompany debt of about 30 billion \$US and including non-restructured debt of about 10 billion \$US). However, this does reflect the “restructured” low interest rates of 2005-2010 and does not reflect interest obligations in arrears. Considering that debt will need to be refinanced in the next few years and that Argentina has a high premium on its debt, a settlement of the judicial verdict will normalize the relations with foreign creditors. Many may argue about the savings that Argentina could obtain, but the risk premium could quickly fall by 4-5 percentage points. This would reduce the annual interest bill of Argentina (public and private sector) by 4-6 billion \$US a year, compared to the current situation. The relevant amounts, accumulated over several years, far exceed the costs that the government claims the settlement will entail if it regularized its debt.
2. Although Argentina continues being an attractive destination for investment, in many areas such as oil and gas, legal uncertainty make foreign investors reluctant to bring money to the country.

With a resolution of the current judiciary conflict, Argentina could easily receive FDI of at least 5 billion \$US a year (1.2 percent of GDP) and raise investment significantly.

3. Without a resolution to the current legal dispute, Argentines would continue trying to protect their savings and increasing their holdings overseas, where there are estimated assets of about 200 billion \$US. If the drain were to stop through an improvement of expectations and some capital were to return, the impact would also be very important for the prosperity of the country. It is possible to conservatively estimate these flows at 0.5-1 percent of GDP.
4. With low productive investment and stagnant prices for raw materials, the potential for growth would remain at very low levels, approximately 2-3 percent a year, aggravated by the current doubts about economic policies.
5. The degree of uncertainty would continue pushing producer and consumer prices even with a moderately firm, even if imperfect, monetary policy. Volatility will continue in the foreign exchange markets, even if, or because, the government maintained restrictions on access to the Forex market.
6. Fiscal accounts would remain weak, especially because of the revenue that comes from exports.
7. With the distortions and lack of resources, the impact would be particularly harsh for lower income segments which have already suffered the impact of a high inflation rate, though not recognized officially, even after the revision of the price indexes. According to official estimates, poverty in Argentina was in the range of 5 percent of the population, but this does not reflect the true level of food and other consumer items. While data may be subject to controversy, a report from the Argentine Catholic University published in December 2013 estimated that poverty in Argentina is in the range of 25 percent of the population, equivalent to ten million people.
8. A resolution of the current dispute would allow for a faster economic growth rate and more resources for the vulnerable, thus allowing for greater inclusion and the political and economic stability that Argentina so sorely needs.

Some may consider that the view presented here is too pessimistic. However, recent developments such as a decline in production, low investment, high inflation, a marked differential in the foreign exchange market and increasing poverty, suggest that the current government strategy has failed. Therefore, it is crucial that the authorities understand the need to modify their approach, in an effort to avoid adding to the suffering of the Argentine population.