



# Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts"

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July 2, 2010

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

R41029

## Summary

In December 2001, following an extended period of economic and political instability, Argentina suffered a severe financial crisis, leading to the largest default on sovereign debt in history. It was widely recognized that Argentina faced an untenable debt situation that was in need of restructuring. In 2005, after prolonged, contentious, and unsuccessful attempts to find a mutually acceptable solution with its creditors, Argentina abandoned the negotiation process and made a one-time unilateral offer on terms highly unfavorable to the creditors. Although 76% of creditors accepted the offer, a diverse group of "holdouts" opted instead for litigation in hopes of achieving a better settlement in the future. Although Argentina succeeded in reducing much of its sovereign debt, its unorthodox methods left it ostracized from international credit markets for a decade and triggered legislative action and sanctions in the United States.

Argentina still owes private creditors \$20 billion in defaulted debt and \$10 billion in past-due interest, as well as \$6.2 billion to Paris Club countries. Of the disputed privately held debt, U.S. investors hold approximately \$3 billion. The more activist investor groups have lobbied Congress to pressure Argentina to reopen debt negotiations. Some Members of Congress have introduced punitive legislation in both the 110<sup>th</sup> and 111<sup>th</sup> Congress, but to date it has not received any legislative action. Nearly five years after the original debt workout, however, a confluence of circumstances has persuaded Argentina to restructure the holdout debt, particularly the need to secure long-term public financing.

On April 30, 2010, Argentina announced a new \$18.3 billion offer to exchange new bonds and cash for defaulted bonds held by the "holdouts." The exchange ran from May 3 to June 22, 2010. Two distinct offers were made, one for retail (small) investors, the other for institutional (large) investors. At settlement on August 2, 2010, retail investors will receive replacement bonds for the full face value of the defaulted bonds they currently hold. Past due interest will be paid in cash. Institutional investors will receive a discount bond equal to a 66.3% reduction in the face value of the defaulted debt they currently hold. Past due interest will be covered by a separate seven-year "Global" bond. Interest rates vary depending on the bond. Both groups of investors will receive a GDP-linked security called a warrant that provides for additional payments should the Argentine economy grow at rates higher than anticipated and stipulated in the prospectus.

The 2010 offer drew sufficient support to retire most of the remaining defaulted debt. Analysts estimate 66% of bondholders participated, leading to a total participation rate of 92% for the 2001 default, if the 76% tendered in the 2005 workout is included. Historically, a greater than 90% threshold of participation has allowed countries to eventually return to the international capital markets. The \$6.2 billion of bonds not exchanged are held largely by a group of Italian retail investors and various institutional "vulture" funds, which continue to litigate. Court reactions to these holdouts are not easy to predict, but technically any judgments against Argentina would still be in place for untendered defaulted bonds. It remains to be seen, and opinions vary, as to whether Argentina will be able to address these bondholders in some way that will allow for a return to the international capital markets in the near future.

If there is a legacy to the Argentine case, it may be in the changes to bond contracts that seek to improve outcomes for creditors. One option is the use of collective action clauses (CACs), now standard for sovereign debt, which require all creditors to bargain collectively, with a compulsory majority decision applicable to all bondholders. It is no coincidence that both the 2005 and 2010 Argentine exchanges are governed by CACs.

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## **Introduction and Recent Developments**

In December 2001, following an extended period of economic and political instability, Argentina suffered a severe financial crisis, leading to the largest default on sovereign debt in history. In 2005, after prolonged, contentious, and unsuccessful attempts to find a mutually acceptable solution to restructuring the debt, Argentina abandoned the negotiation process and made a one-time unilateral offer. The terms were highly unfavorable to creditors, but 76% accepted the offer. A diverse group of "holdouts," however, opted to litigate instead. Argentina owed these private creditors \$20 billion in defaulted debt and \$10 billion in past-due interest. It is also in arrears to the United States and other governments on \$6.2 billion in loans. Although Argentina succeeded in reducing its debt burden, its unorthodox methods have left it ostracized from international credit markets for a decade and triggered legislative action and sanctions in the United States.

The lingering effects of the debt default became a legacy problem for Argentina, but in October 2009, the Argentine government decided to restructure the remaining holdout debt. Argentina made the necessary filings at the U.S. Securities and Exchange Commission (SEC) and its European and Japanese counterparts for a debt exchange. A formal offer was made on April 30, with bondholders given a seven-week period from May 3 to June 22, 2010, to exchange their bonds. Taking into consideration all aspects of the offer, financial analysts valued the new discount bonds at 48-51 cents on the dollar, compared to 60 cents for the 2005 exchange.

Argentina offered \$18.3 billion in new bonds to cover defaulted bond principal and interest. At the close of the exchange, 66% of bondholders accepted the exchange, totaling \$12.1 billion. The other 34% or \$6.2 billion worth of bonds was not tendered, including \$4.5 billion estimated to be held by so-called "vulture funds." These bondholders continue to litigate. It remains to be seen if Argentina is able to address remaining holdouts and achieve its ultimate goal of settling the default permanently and reentering the international credit markets.

## **Background to the Current Debt Restructuring**

Argentina's 2001 debt crisis resulted from many factors. For the most part, Argentina fell victim to its own economic policies, but these were compounded by questionable lending and policy advice by the International Monetary Fund (IMF), a global recession, and international credit markets determined to chase high-yielding debt with inadequate regard to risk. Together, these factors propelled Argentina toward a position of unsustainable debt that ended in an unprecedented default and restructuring scheme.

### **The 2001 Financial Crisis**

Argentina's 2001 financial crisis had its roots in a history of untamed fiscal policy, the Achilles' heel of Argentine economic strategy for most of the 20<sup>th</sup> century. Argentina has long relied on fiscal largesse as a basic policy tool, covering its shortfalls by printing currency or relying on more creative alternatives to expand the money supply. This approach to fiscal governance, as would be expected, led to recurring bouts of high inflation and indebtedness, typically followed by temporary efforts to stabilize prices. At the end of the 20<sup>th</sup> century, such a policy culminated

with the hyperinflation of 1989-90, toppling the Alfonsín government and bringing Carlos Menem to the presidency along with his well-known minister of economy, Domingo Cavallo.<sup>1</sup>

The Menem-Cavallo cure for chronic inflation was the now infamous “convertibility plan.” Enacted on April 1, 1991, it set the stage for the crisis that would emerge a decade later. The plan legally guaranteed the convertibility of pesos to dollars at a one-to-one fixed rate and limited the printing of additional currency only to amounts supported by its reserve position (which could fluctuate with the amount of dollars entering or leaving the country). Upholding this promise, however, required that monetary and fiscal policies also be constrained—the money supply could not be expanded to cover deficits. Therefore, to preserve this system, deficits either had to be eliminated or financed through debt.

At first convertibility worked well; it forced fiscal and monetary discipline on the government, which combined with strong economic growth, reduced inflation and debt service. Cracks in Argentina’s economic policy, however, soon began to appear. The main problem was that fiscal deficits were not contained at either the provincial or national levels to thresholds required to support the convertibility plan. By 1993, debt began to grow, compounded by the practice of rolling it over. From 1995 to 2001, the debt service ratio grew from 30% to 66%.<sup>2</sup> The Argentine peso soon became greatly overvalued, reducing Argentina’s competitiveness and ability to export, with predictable declines in public revenue.

Fiscal balances further deteriorated with a strengthening dollar (to which the peso was linked), competitive devaluations by its major regional trading partners (most importantly Brazil), and falling commodity prices. Argentina was already entering a four-year recession when the global downturn arrived in 1999, causing public revenue to fall further. The weaknesses of the convertibility plan’s strict policy constraints were now exposed. It has been likened to a straitjacket precisely because the Argentine government had no policy room to address the recession. The convertibility plan, by definition, prohibited devaluing the peso to increase exports, and excessive debt eliminated the option for a fiscal stimulus to counter the economic downturn. The third option, reducing government spending, only guaranteed a deeper recession. By this point, there was already little chance of Argentina avoiding financial disaster.<sup>3</sup>

In retrospect, it is also clear that in addition to Argentina’s policy choices and an increasingly hostile global economy, actions by the international community were complicit in deepening the severity of Argentina’s financial crisis. Global credit markets lent generously to Argentina, even after risk factors began to rise to worrisome levels. Investment bank and credit agency reports overstated Argentina’s strengths.<sup>4</sup> Also, the IMF agreed to numerous lending arrangements made

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<sup>1</sup> Gerardo della Paolera, Maria Alejandra Irigoin, and Carlos G. Bózzoli, “Passing the Buck: Monetary and Fiscal Policies,” in *A New Economic History of Argentina*, ed. Gerardo della Paolera and Alan M. Taylor (Cambridge: Cambridge University Press, 2003), pp. 72-74. Inflation hit a high of nearly 200% per month in 1990 and as noted by these and other authors, high inflation is costly. It reduces the real value of money with the resulting loss of purchasing power equivalent to a large “inflation tax” on society as a whole.

<sup>2</sup> *Ibid.*, and CRS Report RS21072, *The Financial Crisis in Argentina*, by J. F. Hornbeck. Debt service ratio = public sector debt/exports.

<sup>3</sup> *Ibid.*, pp. 2-4. Argentina required a more, not less, competitive exchange rate to attract foreign currency needed for debt service. As long as the peso was pegged to an appreciating dollar, this was not possible, and with the addition of a procyclical fiscal policy, Argentina eventually was unable to cover its debt obligations.

<sup>4</sup> Paul Blustein, *And the Money Kept Rolling in (And Out): Wall Street, The IMF, and the Bankrupting of Argentina*. (New York: Public Affairs, 2005), pp. 5-8, 31-35, 198-200.

between 1991 and 2001 based on promised changes in Argentine policies and economic assumptions and projections that ranged from being overly optimistic to unrealistic. U.S. policies for much of the time could not be divorced from those of the IMF. Without the IMF, the convertibility plan would have collapsed much sooner. By its own admission, the IMF made repeated mistakes in surveillance, conditionality, and economic analysis that resulted in lending too much for too long into an untenable situation. Many economists would later argue that Argentina would have been better off had the IMF ended its support and pushed for debt restructuring much earlier.<sup>5</sup>

Notwithstanding the many factors that compounded Argentina's financial problems, the government's economic policies were the major cause of the economic crisis. Faced with the unsustainable situation described above, and falling international credibility, Argentina was unable to roll over its debt. Financial panic and political unrest ensued. On December 20, 2001, President de la Rúa resigned and six days later, a new government defaulted on Argentina's sovereign debt. Soon thereafter the government abandoned the convertibility plan and devalued the peso. The Argentine default left the government in arrears with a number of international creditors. Argentina owed private investors bonds with a face value of \$81.8 billion, the Paris Club countries \$6.2 billion,<sup>6</sup> and the IMF \$9.8 billion. Addressing the large private-sector debt was Argentina's most pressing problem, which was undertaken in a highly unusual manner.

## **The Debt Restructuring of 2005**

The severe financial crisis hit Argentina hard. Between capital flight and the large peso devaluation, much of the country's wealth evaporated nearly overnight. Poverty and unemployment skyrocketed, leading to street protests and political unrest. As Argentina turned to address its debt problem, it argued that bondholders would have to share in the misery that affected the whole country, and that the government had a moral duty to ensure this outcome. It was, as many argued, a matter of equity that the write-down on bonds be historically high, particularly given that continued lending from the IMF, investment banks, and foreign governments at a time when it was clear that Argentina faced an impending crisis had only compounded the financial problems. Perhaps most importantly, Argentina was simply in no position to repay such massive debt.<sup>7</sup>

A sovereign default means the government is no longer willing or able to pay the debt it has incurred in the international markets. Sovereign defaults occur periodically and are typically worked out in what amounts to a consensual understanding between creditors and debtors. This type of understanding usually takes the form of a debt restructuring, which involves a formal and legal change in the contractual arrangements of the debt, such as reducing the face value of the

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<sup>5</sup> The dominant view at the IMF, despite some strong internal opposition, was that the IMF could not abandon Argentina for fear of being viewed as the cause of its economic collapse. Ibid, pp. 100-106, 134, 140-41, 157 and CRS Report RL32637, *Argentina's Sovereign Debt Restructuring*, by J. F. Hornbeck.

<sup>6</sup> The Paris Club is a voluntary, informal group of 19 creditor nations who have agreed to act with a common approach to negotiate debt relief for developing countries unable to meet their external obligations. Members of the Paris Club agree to restructure and/or reduce official debt owed to them on a case-by-case basis, provided certain conditions are met. See, CRS Report RS21482, *The Paris Club and International Debt Relief*, by Martin A. Weiss.

<sup>7</sup> Juan Pablo Bohoslavsky and Kunibert Raffer, "¿Qué Hacer con los Reclamos de los Acreedores Holdouts?," *Economía*, January 24, 2008 and Universidad de Buenos Aires. Plan Fénix. *La Argentina y su Deuda Externa: En Defensa de los Intereses Nacionales*. July 2004. <http://www.econ.uba.ar/planfenix>.

obligations, issuing new bonds with lower interest rates and longer maturities, and capitalizing overdue interest, usually at a sizable loss to bondholders. Historically, a "successful restructuring" typically has had a 90% or greater participation rate (there are always some holdouts) by offering no less than 50% on the net present value of the debt. Usually, this process unfolds 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 its debt.<sup>8</sup>

Argentina began the debt restructuring process in 2002, negotiating with the IMF and investors for three years to find a solution that it felt was commensurate with its deeply diminished economic and social reality. Facing a huge debt burden, Argentina adopted a hard line toward all parties, insisting on a large write-down of principal for private creditors and postponing action on Paris Club and IMF debt. After years of negotiation, which were criticized by both sides, Argentina eventually determined that it had reached an impasse with creditors and decided to act on its own. It suspended its agreement with the IMF and filed for a one-time unilateral offer with the SEC to settle with private creditors. The Argentine legislature codified this commitment with the so-called "Lock Law" (*Ley Cerrojo*), which prohibited the government from reopening the exchange or making any kind of future offer on better terms. This action served the dual purpose of ensuring participating bondholders that they would not lose out on any better deal in the future and prodding a relatively higher participation rate than might otherwise have been the case.<sup>9</sup>

On January 14, 2005, Argentina opened the bond exchange for six weeks hoping to reach a final settlement on the \$81.8 billion face value of debt plus \$21.4 billion of past due interest (PDI). The default was unprecedented for its size (\$103.2 billion), lengthy resolution (over three years), low recovery rate (30% on a net present value basis, including PDI), and large residual holdout (24% of creditors). Bondholders and the IMF criticized Argentina for engaging in a process that stretched (creditors would argue flaunted) the accepted guidelines of sovereign debt negotiations. Nonetheless, of the \$81.8 billion face value of debt, \$62.2 was exchanged for \$35.2 billion of new bonds. The Argentine government, however, was unable to settle the matter fully because \$19.6 billion of bonds (24% of eligible securities) were not tendered and remained in dispute along with accrued interest, \$6.2 billion of Paris Club arrears, and \$9.8 billion of IMF debt.<sup>10</sup>

Argentina has addressed this remaining debt in one of two ways. In 2006, it decided to repay in full the \$9.8 billion owed to the IMF, relieving the government of any pressure to follow IMF policy constraints. Alternatively, Argentina has so far declined to restructure or repay debt owed to the Paris Club countries or holdouts. Holdout creditors have pursued litigation to force repayment, with the resulting judgments and attachment orders effectively precluding Argentina from borrowing in the international capital markets until the defaulted bonds are repaid or restructured.<sup>11</sup> For years, neither of these responses affected Argentina's determination to deviate

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<sup>8</sup> For examples of five developing country defaults (Ecuador, Pakistan, Russia, Ukraine, and Uruguay) that had participation rates of 93%-98%, see Marcus Miller and Dania Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," *The World Economy*, vol. 30, no. 10 (October 2007), p. 1497.

<sup>9</sup> The Republic of Argentina, *Registration Statement No. 333-163784*, Securities and Exchange Commission, Washington D.C., April 9, 2010, p. 4. This document also contains Argentina's view of the crisis and 2005 exchange.

<sup>10</sup> CRS Report RL32637, *Argentina's Sovereign Debt Restructuring*, by J. F. Hornbeck. p. 11-13 and Fitch Ratings. *Argentina: Rapprochement with Creditors and Sovereign Ratings*. Special Report. November 19, 2009, p. 2.

<sup>11</sup> Argentina's international bonds were issued under eight different jurisdictions, including New York and a number of foreign countries. Some 38% of the untendered bonds were denominated in U.S. dollars. Those issued under the jurisdiction of the State of New York are subject to U.S. law. Miller and Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," pp. 1492-1493, 1496, and 1502.

from its policy of “financial independence.” Strong economic growth until the 2008 global financial crisis and reliance on various stop-gap measures (details below) to meet financing gaps have allowed Argentina to rebuff attempts at forced resolution.

Argentina made a first effort to restructure the remaining defaulted debt in September 2008. As President, Cristina Fernández de Kirchner announced that Argentina would seek to repay the Paris Club debt out of its approximately \$47 billion of international reserves and signed an agreement with a three-bank consortium (Barclays Capital, Deutsche Bank, and Citibank) to consider their offer to renegotiate with private holdout creditors. The simultaneous onset of the global financial crisis, however, put an end to the potential deal and any hope of meeting short-term financing needs with international borrowing.<sup>12</sup>

## **U.S. Responses to Argentina's Debt Repudiation**

Argentina owes approximately \$29 billion of bond principal and interest arrears to private investors and \$6.2 billion of loans to Paris Club countries, including nearly \$500 million in arrears to the United States.<sup>13</sup> Private bondholders, the United States Government, and Members of Congress have all taken actions to encourage Argentina to repay these debts.

### **Private Sector Responses**

In the eyes of institutional creditors, the 2005 Argentine restructuring set a precedent that could not be condoned, even though a majority of bondholders accepted the terms. Although Argentina continues to argue that the restructuring was a negotiated solution, it was not a mutually agreed one. Bondholders had to accept or reject the offer with the alternative being no restitution at all. Some holdouts sought legal remedies in the United States and other countries, as well as at the World Bank's International Center for the Settlement of Investment Disputes (ICSID). In the United States, 158 suits have been filed, 18 of which are class actions. There are an additional 34 proceedings underway at the ICSID brought by investors under numerous bilateral investment treaties (BITs). Awards have been rendered in eight ICSID cases totaling \$913 million, but none have been “executed upon.”<sup>14</sup> U.S. creditors argued that Argentina had not fulfilled its obligations under either the bond contracts or its bilateral investment treaty with the United States.

Because many bonds in the hands of holdouts are still being traded, ownership is difficult to track. They were originally marketed in local country currencies: 58% in Euros, 38% in U.S. dollars, 2% in Argentine pesos, and the remaining 2% in other currencies. U.S. ownership is still estimated at approximately \$3 billion. Funds that have brought suit against Argentina in U.S. courts have made claims on \$2-3 billion of principal.<sup>15</sup> Because most of these funds are legally organized in countries known for their lack of financial transparency, it is difficult to state with certainty the nationality of ownership.<sup>16</sup>

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<sup>12</sup> Jude Webber, “Argentina Mulls Delay to \$6.7 billion Debt Repayment,” *Financial Times*, October 11, 2008.

<sup>13</sup> Paris Club debt as of June 2010 may be closer to \$7.0 billion with accrued interest, and \$7.5 billion if penalties are added.

<sup>14</sup> The Republic of Argentina, *Registration Statement No. 333-163784*, Securities and Exchange Commission, Washington DC, April 9, 2010, p. 11, and Prospectus, April 27, 2010, pp. 59-60.

<sup>15</sup> Correspondence with U.S. Department of State, January 12, 2010.

<sup>16</sup> A few funds are legally incorporated in the United States, the rest in the Cayman Islands, British Overseas (continued...)



Depending on the owner of the bonds, the goal of the litigation strategy differs. Institutional funds representing corporate and investment banks generally seek improved terms on the exchange. Funds representing retail (individual) investors, mostly European, also have held out for a better settlement. Hedge funds and so-called "vulture funds," which purchase risky assets in the secondary market at highly discounted prices, typically sue for full recovery. They may represent as much as \$4.2 billion of defaulted bonds.<sup>17</sup> Their "holdout" strategy can be highly profitable for investors with patience, realizing capital gains on undervalued bonds, often purchased after the default, and potentially receiving full restitution of interest and principal if the holdouts dwindle to a sufficiently small percentage of the total unresolved debt.<sup>18</sup>

Litigation has not resolved any claims, but has applied considerable leverage on Argentina. It has produced \$8.6 billion in legal judgments and attachment orders from U.S. courts, which has precluded Argentina from raising funds in the international credit markets.<sup>19</sup> For example, approximately \$105 million of Argentina's Central Bank reserves are frozen in the Federal Reserve Bank of New York and another \$2 billion of global bonds backing guaranteed loans are on hold at the Depository Trust Company.<sup>20</sup> On January 12, 2010, a U.S. judge froze \$1.7 million of Argentine central bank reserves held at the Federal Reserve Bank of New York because the Fernández government attempted to use them to guarantee payment of debt coming due in 2010, thereby making them eligible for attachment (see below).

Because the Argentine government did not recognize any creditor groups as negotiating partners, the hedge and "vulture" funds have also served as one form of admittedly imperfect investor coordination. While they bring greater pressure to bear on Argentina because of their collective action, their prolonged delaying tactics in seeking full restitution can clash with other investors wishing to pursue a settlement strategy.<sup>21</sup>

## **U.S. Government Responses**

With Argentina's default on Paris Club debt, including nearly \$500 million owed to the United States government, a number of sanctions have been invoked automatically as defined in U.S. law. U.S. agencies are prohibited from lending to a country that is in arrears on its debt to the U.S. government including the Export-Import Bank, Overseas Private Investment Corporation, and the U.S. Trade and Development Agency. The U.S. military is prohibited from offering Foreign Military Financing, exercising the Excess Defense Articles through 505 Drawdown authority, or fully using the Global Peacekeeping Operations Initiative funding. In addition, all foreign

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Territories, Turks and Caicos, British Virgin Islands, Switzerland, and Luxembourg. *Main Judgments and Pre-Judgment Claims Against the Argentine Republic*, provided by the Embassy of Argentina, December 2009.

<sup>17</sup> Discussion with FitchRating, June 11, 2010.

<sup>18</sup> Miller and Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," p. 1497.

<sup>19</sup> There are 158 judgments against Argentina and many include attachment orders in which the courts can seize funds from any future debt that might be issued by Argentina, effectively prohibiting access to the international credit markets. A list of claims against Argentina is summarized in, *Main Judgments and Pre-Judgment Claims Against the Argentine Republic*, provided by the Embassy of Argentina, December 2009.

<sup>20</sup> Correspondence from U.S. Department of State, January 12, 2010.

<sup>21</sup> Amrita Dhillon, Javier García-Fronti, Sayantan Ghosal and Marcus Miller, "Debt Restructuring and Economic Recovery: Analysing the Argentine Swap," *The World Economy*, vol. 29, no. 4 (April 2006), pp. 392-393.

assistance is prohibited except for International Military Education and Training funding and certain programs related to countering terrorism and trafficking in narcotics or persons.<sup>22</sup>

## **Legislative Responses**

In Congress, some Members have responded to U.S. creditor concerns with the introduction of punitive legislation against Argentina. The Judgment Evading Foreign States Accountability Act of 2009 (H.R. 2493) was introduced in the 111<sup>th</sup> Congress on May 19, 2009, and driven in part by the American Task Force Argentina (ATFA), a private lobby group representing various constituents, including hedge and “vulture funds.”<sup>23</sup> The bill cites Argentina’s decision to ignore judgments against its actions as detrimental to U.S. investors and undermining the United States legal system. The bill’s stated goal is to protect future investors by motivating those countries identified as “judgment evading foreign states” to “raise their standards of behavior.” It would deprive such states and any state-owned corporations from issuing debt in the U.S. capital markets and would require that any future debt offerings carry written warnings that they have failed to satisfy outstanding judgments against them. The bill would also require that any request for bilateral or multilateral assistance be accompanied by a statement identifying the country as a “judgment evading state.” To date, Congress has not acted on this bill.

Despite lack of congressional action on H.R. 2493, the Government of Argentina has expressed a strong reaction against it, in part because it is directed at the actions of a single country and viewed from Argentina, amounts to a threat of imposing economic sanctions. The Argentine embassy has indicated that passage of such a bill could lead to a deterioration of bilateral relations, although there has been relatively little attention paid to the legislation in general.

## **Restructuring Sovereign Debt**

A sovereign debt restructuring is a complicated matter and in Argentina’s case the government faced three core and interrelated issues in attempting to form a strategy to (1) negotiate a solution with private debt holdouts; (2) repay or reschedule Paris Club debt; and (3) reengage the IMF. It was widely believed that a successful conclusion for Argentina was unlikely without meeting all three goals to some degree, in part because they are interrelated. First, the Paris Club generally does not entertain a sovereign debt restructuring proposal without the debtor country undergoing an Article IV review of its economy (standard practice for all IMF country members), and having an IMF lending program in place. Among other goals, the Article IV review provides one presumably unbiased assessment of Argentina’s economic health and ability to repay its debt, although Argentina has been particularly distrustful of the institution since the 2001 crisis. The IMF, however, usually does not consider a formal program until the “holdout” creditors have been offered a proposal.

The IMF review can be important in part because it can affect a country’s borrowing rates. There was, however little hope for a clean IMF review for Argentina at this time. Among other issues, the IMF has registered grave concerns over the politicization of Argentina’s economic data

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<sup>22</sup> Correspondence from U.S. Department of State, January 12, 2010.

<sup>23</sup> *Ibid.*, and Mark Weisbrot, “Vulture Funds Lobby Against Argentina,” *America Latina en Movimiento*, August 6, 2009. <http://alainet.org/index.phtml>

reporting. The national office of statistics, Instituto Nacional de Estadística y Censos (INDEC), has been criticized in particular for understating national inflation rates.<sup>24</sup> The discrepancy can be seen in the **Appendix**. By underreporting increases in price levels, the Argentine government can reduce public sector costs by, for example, having lower inflation-based price adjustments where applicable and borrowing domestically at artificially lower nominal interest rates. Correcting data reporting is important for making a valid assessment of Argentina's ability to pay future debt obligations. The IMF is unlikely to provide a fully positive review of Argentina if this problem is not corrected.

These issues raised two important questions: was Argentina willing to accede in whole or in part to these requirements, and if so, what is the sequence that would make the most sense to ensure that all three conditions are met? As it turned out, Argentina skirted the entire issue, moving ahead with the bond exchange without an IMF review and promising to deal with the Paris Club at some future date.

For Argentina, a "successful" restructuring requires a sufficiently large participation rate to eliminate most of the existing judgments and attachment orders. Argentina expects, with no guarantee, that such an outcome will lead to renewed access to the international credit markets. Historically, sovereign debt workouts that involve a 90% voluntary participation rate or higher have been able to achieve this goal. A participation rate of 60% or higher of the holdout group would allow for the total participation rate, including the 2005 participants, to reach this threshold.

## **Argentina's Debt Profile and Rationale for Restructuring (Again)**

As may be seen in **Table 1**, the portion of "holdout" debt plus that owed to the Paris Club represents 21% of Argentina's total public sector debt. For eight years, Argentina has been unable or unwilling to find a solution that would restructure this portion of debt, but circumstances have changed. Argentina has both the political will and financial incentives to negotiate a final solution to its long-outstanding debt issue.

There are three major incentives for Argentina to resolve its outstanding debt issues. First, in the medium to long run, Argentina, like many countries, will need to borrow in the international capital markets. Although its financing gap for FY2010 is reportedly covered, the steep decline in 2009 fiscal revenue relative to expenditures points to a deteriorating fiscal position. The fiscal balance has fallen from a surplus of 1.4% of gross domestic product (GDP) in 2008 to a deficit of -0.7% of GDP in 2009 (see **Appendix**). By initiating a restructuring process in 2010, when financial requirements are not an immediate threat, Argentina has the time to make the political and financial arguments for reengaging the international credit markets at reasonable rates.<sup>25</sup>

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<sup>24</sup> Helen Parsons, Carola Sandy, and Igor Arsenin, *Argentina: Rising Tide Lifts All Boats*, Credit Suisse, New York, NY, September 17, 2009, p. 1.

<sup>25</sup> The official Argentine position stresses that the need for financing is not the major incentive for restructuring its debt, but fiscal reality argues to the contrary. Ministerio de Economía y Finanzas Públicas. *Boudou Explicó en Diputados los Alcances de la Suspensión de la Ley Cerrojo*. October 28, 2009.

**Table I. Argentina: Total Public Sector Debt, December 31, 2009**

(in \$ billions)

Debt Category	Amount	Percent
<b>Performing Debt:</b>	<b>133.9</b>	<b>79.0%</b>
Bonds and Bills	91.2	
Loans and Other	42.7	
Other	0.5	
<b>Nonperforming Debt:</b>		
<b>Private ("holdout"):</b>	<b>29.2</b>	<b>17.3%</b>
Falling Due	5.2	
Past Due:		
Principal	15.0	
Interest	9.0	
<b>Paris Club:</b>	<b>6.2</b>	<b>3.7%</b>
Principal	5.1	
Interest	1.1	
<b>Total Public Sector Debt</b>	<b>169.8</b>	<b>100.0%</b>
Total Public Debt/GDP	59.4%	

**Source:** Institute of International Finance and Government of Argentina, Ministry of Economy and Public Finances.

Second, opportunities for ad hoc financing are limited. In the absence of access to international capital markets, Argentina has met its financial needs by placing debt with domestic government agencies, restructuring domestically held debt, selling bonds directly to the government of Venezuela, and nationalizing private pension funds. In a recent example, on December 14, 2009, President Fernandez attempted to create a \$6.6 billion Bicentennial Fund for Stability and Debt Reduction. The fund would have set aside money to guarantee early repayment for debt coming due in 2010. While on the surface it may seem to reinforce Argentina's commitment to meet its debt service, it presented numerous problems because the commitment would have been financed from Central Bank reserves, which the government would purchase with 10-year government bonds. In addition to undermining the independence of the Central Bank, this strategy would have diminished Argentina's international reserve position and allowed the government to defer difficult decisions on fiscal adjustment.<sup>26</sup>

Using Central Bank reserves to guarantee debt payments is an unusual move and was challenged by both the president of the Central Bank of Argentina, who refused to transfer the funds, and the Argentine Congress. President Fernández responded with a presidential decree dismissing the Central Bank president and he resigned his position on January 29, 2010. Nonetheless, the Argentine courts suspended application of the presidential decree to finance the Bicentennial

<sup>26</sup> International Monetary Fund, *Global Markets Monitor*, Washington, D.C., December 16, 2009, p. 4.

Fund, deciding that the congress must vote on the matter. President Fernández later rescinded the original decree, replacing it with two others in an attempt to avoid a constitutional problem in using Central Bank reserves to guarantee Argentine multilateral and private sector obligations coming due.<sup>27</sup>

Third, market conditions initially favored placing debt, encouraging Argentina to move ahead with the bond restructuring. Interest rates were low by historical standards and liquidity high. These conditions changed with the debt problems that emerged in the Euro zone, causing yields to rise, making the exchange more difficult, and precluding Argentina from selling any new debt as it had planned. The bond exchange process, however, was already well underway.

By some measures, Argentina is also in better financial shape to address repudiated debt than it was during the 2001 crisis or the 2005 restructuring. Argentina has a positive current account balance and has increased its international reserves from \$10.4 billion in 2002 to \$47.5 billion in 2009. During the 2003-2008 economic recovery, Argentina had an average annual growth rate of 8.5% and the increased revenues have until recently allowed it to maintain a primary surplus of 2.8% or higher (for detailed data, see **Appendix**). The primary surplus reflects the fiscal surplus after non-debt expenditures have been paid, and so is a measure of resources available exclusively for debt service. Because of the global financial crisis, however, the primary surplus fell to 1.2% of GDP in 2009, levels inadequate to reduce Argentina's total public debt, and its medium-term fiscal capacity remains in question unless it is able to return to the credit markets.

## The 2010 Exchange

In 2009, Argentina began the initial process of setting up a new bond exchange, taking three important steps: (1) President Cristina Fernández de Kirchner lent full support for the deal; (2) on November 18, 2009, the Argentine legislature suspended that portion of the 2005 law that prohibited reopening a debt restructuring offer; and (3) in December 2009, the Argentine government filed a preliminary prospectus with the SEC, which approved Argentina's request to issue new bonds. On April 15, 2010, the minister of economy announced the key features of the proposed bond deal. A formal offer was made on April 30, 2010. An early tender for institutional investors opened May 3-12, 2010, while the general submission ran from June 7-22, 2010. The final settlement date is scheduled for August 2, 2010.

The exchange was structured to provide two different offers, one for small retail investors, defined as those holding less than \$50,000 of defaulted bonds, and a second for institutional investors, or those holding amounts greater than \$50,000, a feature also present in the 2005 exchange. The retail investors were made a more generous offer to entice their support in order to ensure a minimally acceptable overall participation rate.

The bond exchange addresses two aspects of outstanding debt. First, the face (or par) value of the bond. This term refers to the stated value on the bond when it was issued. Second, past due interest (PDI), or the unpaid interest that has accrued since the default. In each case, both retail and institutional investors receive a bond in exchange for the defaulted debt, cash or a separate "Global" bond for PDI, and a separate GDP-linked security called a warrant that provides for

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<sup>27</sup> Jude Webber, "Argentina Debt Battle Intensifies," *Financial Times*, January 11, 2009, p. 3 and Volkel, Christian, "Government Appeals Against Suspension of Argentine Debt Payment Fund," *IHS Global Insight*, February 8, 2010.

additional payments under certain circumstances (see **Table 2** for a summary of the bond characteristics).

**Table 2. Terms of Argentina 2010 Bond Exchange**

Bond Characteristic	Retail Investors	Institutional Investors
Bond Type	Par Bond (pays full face value)	Discount Bond (66.3% reduction from face value)
Amount	Up to \$2.0 billion	Up to \$16.3 billion
Maturity Date	December 31, 2038	December 31, 2033
Annual Interest Rate	2.5%-5.25% increasing over time	8.28%
Past Due Interest (PDI)	cash payment	Separate 2017 Global bonds @ 8.75%
GDP-linked warrant	yes, expiring by December 15, 2035	yes, expiring by December 15, 2035
2005 GDP Warrant Payments	no	no
Bank Commission	0.4%	0.4%

**Source:** Securities and Exchange Commission, *Amendment #5 to Argentina 18-K*, filed April 19, 2010, and *Prospectus Directive* filed April 27, 2010, pp. 11, 33-42, and 106-112.

The total value of the new securities offered is \$18.3 billion, \$17.6 billion to cover principal and \$0.7 billion to cover unpaid interest accrued as of December 21, 2001, the point of default. The total amount covers the face value of defaulted debt, including the heavily discounted (reduced) value of the bonds owed to institutional investors, plus the PDI on bonds owed institutional investors (retail investors will receive cash for PDI, see below). There is a limit of \$2.0 billion of par bonds, there is no limit on the issuance of discount bonds beyond the total \$18.3 billion of total securities as defined in the prospectus.

## Face Value

Retail investors will receive a par bond to compensate them for the full face value of the defaulted bonds they hold. Institutional investors, by comparison, will receive a discount bond reflecting a 66.3% reduction in the face value of the defaulted bonds they hold. In each case, new bonds will be issued in exchange for the old ones, with the discount bond for institutional investors maturing in 2033 and carrying an annual interest rate of 8.28%. Par bonds for retail investors will mature in 2038, and carry a sliding annual interest rate beginning with 2.5% for the first 9½ years, 3.75% for the next 10 years, and 5.25% for the final 9½ years. Interest is paid semi-annually.

## Past Due Interest

At settlement, retail investors will be paid PDI in cash, covering interest from December 31, 2003, up to September 30, 2009. PDI for institutional investors will be covered by a par "Global" bond maturing in 2017 with interest paid in semi-annual payments, carrying an interest rate of 8.75%. It will cover interest from December 31, 2003, through December 30, 2009.

## GDP-Linked Warrants

Both retail and institutional investors receive GDP warrants, which are securities that may be traded separately from the bonds to which they are attached. A warrant is a promise to make a particular offer under certain circumstances, often issued in connection to bonds to make them more attractive to investors. In this case, Argentina promises to make additional payments on the new bonds in the event that the Argentine economy grows faster than a predetermined and stated rate for any given year, as defined in the prospectus. The warrant is meant to compensate for bonds outstanding in December 2001 and interest accrued to December 30, 2001, but payment in any given year is based on better than expected economic performance in the previous year.

From a budgeting perspective, higher than anticipated economic growth tends to generate higher than expected revenues. Argentina is effectively promising to use some of these resources to increase payments to bondholders, should economic conditions allow. This feature turned out to be particularly attractive for the 2005 exchange because Argentina emerged from its crisis with six years of very high economic growth (see **Appendix**), well above projected rates. It remains to be seen if this trend can be repeated.

Investors had hoped that the new deal would include the equivalent of past payments on warrants issued in the 2005 exchange, arguing that like past due interest, they were entitled to compensation from Argentina's better-than-expected fiscal position arising from very strong past economic growth. Argentina decided not to include such payments, reasoning that in rejecting the 2005 deal, the holdouts had declined to participate in that growth. Although market speculation had suggested that the absence of this provision might reduce the participation rate, Argentina was able to exceed its stated goal of a 60% participation rate.

## Valuation

In the arcane world of bond valuation, analysts estimate the value of the exchange for discount bonds at between 48 and 51 cents per dollar value of the bond. These numbers compare unfavorably with the 60 cents on the dollar valuation of the 2005 exchange, which included a better than expected performance because of GDP-linked warrants.<sup>28</sup> Analysts estimate that inclusion of past payments of GDP warrants would have added 7 cents on the dollar to the offer. The defaulted bonds traded in the market recently in a range of 48-50 cents on the dollar, nearly four times their lowest trade level of 11 cents recorded in September 2008.<sup>29</sup>

## Participation

The bond exchange closed on June 22, 2010. Argentina has not released the formal results of the exchange, but early analysis reveals that of the \$18.3 billion of new bonds offered, 66% of bondholders (\$12.1 billion) participated, leaving 34% (\$6.2 billion) preferring to continue litigation efforts before the Southern District Court of New York and the World Bank's ICSID. A preliminary breakdown appears in **Table 2**. Argentina advertised that a "successful" exchange would be one that exceeded a 60% participation rate because it would allow for a total

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<sup>28</sup> Igor Arsenin and Carola Sandy, *Argentina's Debt Swap Offer: Good Enough*, Credit Suisse, New York, April 15, 2010, p. 1.

<sup>29</sup> International Monetary Fund, *Global Markets Monitor*, April 16, 2010, p. 5.

participation rate, including the 2005 exchange, of over 90% of defaulted debt. This threshold has historically been accepted as adequate to allow for a defaulting country eventually to place debt in the international markets at an acceptable interest rate.

**Table 3. Participation in Argentine 2010 Bond Exchange (\$ billions)**

	Participants	Non-Participants	Total
Main Non-Litigants	8.5	0.0	8.5
Italian Retail Investors	3.2	1.1	4.3
Litigants (vulture funds)	0.0	4.5	4.5
Others	0.4	0.6	1.0
Total	12.1	6.2	18.3

**Source:** International Monetary Fund, *Global Markets Monitor*, June 24, 2010, p. 6.

In Argentina's case, the 66% participation rate for the current exchange allows for a total participation rate of 92% of total defaulted debt, including the 2005 exchange participants. The remaining \$6.2 billion of untendered bonds, however, could continue to present a problem for Argentina, particularly given the attachment orders that remain in place that would allow confiscation of any new international bond offer. Argentina may have at least three options to address this problem. First, Argentina can ignore the remaining holdouts and test the courts in a future bond sale in the international market. Second, Argentina could attempt a follow-on swap to convince holdouts to participate, which seems unlikely. Third, Argentina could settle with remaining holdouts. Argentina is also still in arrears with the Paris Club, which could affect market sentiment for a new debt placement. Argentina may have to address this debt in order to sell bonds as yields that would be commensurate with its budgetary expectations.

## Outlook

Argentina has completed the restructuring of the largest and most controversial default on sovereign debt in history, largely on its own terms. There is little disagreement that in 2002 Argentina faced a desperate financial situation that required a radical restructuring of debt, including a large write-off by bondholders. The historical precedent for such an outcome has been set on many occasions. The Argentine debt restructuring framework, however, involved methods, processes, and a deep discount that were notably unprecedented. In addition, although Argentina negotiated for years with creditors under IMF guidelines, it ultimately made a "take it or leave it" offer, with the promise that no better offer would be made to those investors that chose to "hold out" for a better future result.

Argentina kept its promise by offering a new bond exchange that is valued below the 2005 offer. Much of the defaulted debt, however, has been trading on the secondary market, at prices as low as 11 cents on the dollar, so there was opportunity for many institutional investors, including the "vulture funds," to gain on the 2010 exchange valued at between 48 and 51 cents on the dollar, although most if not all apparently declined the offer. The 2010 offer drew sufficient support, however, to retire most of the remaining defaulted debt. Analysts estimate 66% of bondholders participated, leading to a total participation rate of 92% of total 2001 defaulted, if the 76% tendered in the 2005 workout is included.



As was expected by many, one-third of bondholders (\$6.2 billion) did not accept these terms and prefer to let the litigation option play out. Court reactions to these holdouts are not easy to predict, but technically any judgments against Argentina would still be in place for untendered defaulted bonds. It remains to be seen, and opinions vary, as to whether Argentina will be able to address these bondholders in some way that will allow for a return to the international capital markets in the near future.

In the end, Argentina's debt restructuring was costly for all parties, raising a lingering question of whether it represents a new template for debtor countries in the future. For many reasons, it arguably does not. Perhaps the major lesson for Argentina is that a prolonged disregard for fiscal responsibility can have dramatic long-term economic, social, and political consequences. At the financial level, the costs to Argentina have been severe, particularly its inability to access international credit markets. This cost was compounded by Argentina's resorting to creative, but unorthodox financing mechanisms that could not adequately replace conventional financial arrangements indefinitely. If the new debt exchange allows Argentina access to international credit, the bonds likely will carry higher interest rates than those of many other countries. Such a result seems like an undesirable model for other countries contemplating a sovereign default.

The Paris Club so far has also been a loser in this case. The Argentine case demonstrates that national governments may be limited in their efforts to influence a sovereign nation that is determined to delay or deny debt repayment. For the United States, neither sanctions nor legislative proposals have had any noticeable influence on Argentina, and actually may have reinvigorated Argentina's resolve to stay the course of default as long as possible. In the end, it was fiscal necessity and the international markets that appeared to have the greatest leverage on Argentine decision making.

Creditors also clearly suffered, with the exception of those with the patience and willingness to accept the risk of purchasing highly discounted debt in the secondary markets. Creditors as a whole are best served by a quick and mutually-agreed debt workout, which historically has led to better and more equitable terms than those offered by Argentina. The lack of collective action presented a serious problem in this case. The financial markets have since responded in ways that seek to avoid a second occurrence of a prolonged, costly, unilateral workout.

The most important development along these lines is the adoption of collective action clauses (CACs) in sovereign debt contracts. These clauses require minority holdouts to capitulate to a majority-negotiated solution. They have become the "market standard" for sovereign bonds governed by the laws of New York, the jurisdiction under which most foreign debt is placed in the United States, including Argentina's.<sup>30</sup> While it is not possible to compensate most of the original bondholders of defaulted Argentine debt, it is likely that CACs and other bondholder cooperation mechanisms will improve chances for better outcomes in future sovereign debt defaults. CACs may help investors negotiate for better returns and also likely reduce the holdout problem, eliminating role of "vulture" funds, which often trade on the losses of other creditors and employ a strategy that can impede movement toward early resolution. Developments that improve investor coordination and lead to more equitable outcomes may be the major legacy of the Argentine debt crisis. It is no coincidence that both the 2005 and 2010 Argentine exchanges are governed by CACs.

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<sup>30</sup> Michael Waibel, "Opening Pandora's Box: Sovereign Bonds in International Arbitration," *The American Journal of International Law*, vol. 101, no. 4 (October 2007), p. 736.

## Appendix. Argentina: Selected Economic Data, 2000-2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP Growth (%)	-0.8	-4.4	-10.9	8.8	9.0	9.2	8.5	8.7	7.0	0.7
Overall Fiscal Balance (%)	-3.6	-6.8	-2.0	0.9	3.7	2.1	1.9	1.1	1.4	-0.7
Primary Fiscal Balance (%)	0.4	-1.3	0.7	2.8	5.3	4.4	4.0	3.2	3.3	1.5
Inflation Rate INDEC (%) <sup>a</sup>	-0.7	-1.5	41.0	3.7	6.1	12.3	9.8	8.5	7.2	5.5
Inflation Rate others (%)								15.0	25.0	17.0
Current Acct Balance (% GDP)	-3.1	-1.4	8.5	6.3	2.1	2.9	3.6	2.8	2.1	na <sup>b</sup>
International Reserves (\$ bn)	32.5	15.3	10.4	13.8	19.3	27.3	31.2	45.7	46.2	47.5
Public Debt (% GDP)	45.7	53.7	166.4	138.7	127.3	73.9	64.0	56.1	48.8	59.0
International Bond Issues (\$ mn) <sup>c</sup>	13,468	2,711	0	100	200	540	1,896	3,256	65	na <sup>b</sup>

**Source:** United Nations Economic Commission on Latin America and the Caribbean (ECLAC). *Estudio Económico de América Latina y el Caribe 2008-2009*, July 2009 and Government of Argentina, Ministry of Economy and Public Finances (for debt figures).

### Notes

- Instituto Nacional de Estadística y Censos – Argentina's official government statistical office, which has come under criticism for grossly understating inflation rates since 2007. Adjusted inflation rates have been added on the line below to reflect private sector estimates of annual inflation rates since 2007
- na = not available
- Includes sovereign, financial sector, and other commercial debt.

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