

After Argentina

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Argentina has finally restructured its foreign debt. Its credit rating is up, and its debt is back in the index. The new bonds are trading roughly in line with Brazil and Uruguay's, just above 400 basis points over treasuries for instruments of comparable duration. Argentina is raising new money from foreign investors. Earlier in the summer of 2005, it reopened a domestic dollar issue to accommodate excess foreign demand. Argentina and the International Monetary Fund (IMF) are on again. They might even sign a new disbursing program after the fall 2005 congressional elections. Like a bad dream, the 2001 default is fading into the night after three years of brisk growth and impressive fiscal management—even as the usual nabobs natter on about structural reform and unhappy bondholders.

Has the biggest sovereign debt default in history passed without answering the urgent legal and policy questions it posed, and with barely a ripple in the global financial markets? So far, pretty much. Which is not to say that the episode is over or that it has been unimportant.

Before its foreign bond exchange, Argentina owed about \$82 billion in principal and \$20 billion in past due interest. Hundreds of thousands of creditors held 150 kinds of defaulted instruments issued in six currencies under the laws of eight jurisdictions. Creditors owed just over 76 percent of the total, or \$62

billion in principal, got \$35 billion in new performing bonds. Other performing debt at the time of the exchange included over \$40 billion in domestic and about \$30 billion in multi-lateral obligations. Argentina left behind almost \$25 billion in defaulted principal and interest.

The scale of Argentina's operation is a multiple of earlier bond restructurings: Russia exchanged on the order of \$30 billion, Ecuador \$6 billion, Uruguay \$5 billion, Ukraine \$3 billion, and Pakistan under \$1 billion. These and other crises spread anxiety about the international system's ability to manage financial globalization. The trauma and drama of Argentina's debt default in 2001 seemed to validate this anxiety. Overnight, Argentina's middle class plunged into poverty, and Italian retirees lost their savings. With so many lives and so much money at stake, expectations ran high that Argentina's restructuring would instantly change the world of emerging-market sovereign debt.

The high stakes may help explain the unusually contentious tone of the debt exchange. All involved felt profoundly aggrieved even as they disagreed vigorously on whom to blame. Foreign investors blamed a succession of Argentine governments and the IMF; Argentine politicians blamed one another, the foreign investors, and the IMF; the IMF blamed Argentine politicians, the markets, and G-7 fecklessness; and the Argentine public blamed all of the above.

Just as soon as the Argentine government announced the results of its tender on March 18, 2005, editorial pages worldwide heralded a new era for sovereign debt, for the emerging markets, and occasionally for international finance. Their views on Argentina's lessons were as disparate as they were definite. Some said the exchange would close the markets to middle-income countries. To others, it reaffirmed the markets' resilience. Some claimed it proved the need for statutory sovereign bankruptcy. Others said it clearly discredited the idea. Most spoke too soon.

By the time the deal settled in June 2005, it had confirmed many presumptions about emerging-market debt and shattered none. So far, lawsuits have not yielded a penny for the creditors. They failed to stop the exchange or dent Argentina's recovery. Bondholders failed to stick together; the markets failed to

banish a defaulter; and the official sector failed to change the outcome.¹ Even documentation for the new securities breaks little new ground. Smaller restructurings that came before might look more revolutionary for introducing the tools, such as aggregated collective action clauses, that Argentina adapted on such a vast scale.

The real lessons of Argentina's restructuring so far are more subtle and complex than the surrounding commentary. The default and the exchange were both points in a longer financial restructuring process that began before the default and will go on for years after the exchange. Argentina's unorthodox debt management immediately before and after the default is partly responsible for the outcome of the exchange. With \$25 billion in defaulted debt still outstanding, Argentina's most important innovations may well be ahead.

The default and the passage of time shifted bargaining leverage to the debtor. Already overextended in Argentina by the time of the default, the IMF had little financial or political capital left for policy activism postcollapse. If anything, it innovated by omission. But private creditors failed to fill the resulting policy gap to enhance their own position. For Argentina, restructuring external debt was bound up with allocating losses from the financial crisis and political realignment after 2001. Its government committed to deliver a deal on its own terms, and it generally succeeded. Will this encourage others to default or to pursue punitive restructurings? What recourse is left for the creditors? And what, if anything, can the official sector do after Argentina to project a constructive vision of sovereign restructurings?

PROLOGUE: DOMESTIC DEBT AND OTHER GYMNASTICS

Argentina's latest round of troubles began after Russia defaulted and Brazil devalued in 1998–99 (Mussa 2002). Its "convertibility" regime—the one-to-one peg of the Argentine peso to the US dollar—helped defeat hyperinflation in the early 1990s but required sustained access to external financing. Argentina ran perennial budget deficits. The dollar was high, commodity prices low. As markets closed and exports collapsed, the government turned to official lenders, domestic banks, and pension funds to finance its budget and trade deficits.

In 2001, three years into a recession, Argentina's hopes

for economic growth looked increasingly fanciful absent drastic, painful policy change. That year the government launched three operations that tried and failed to solve its debt problem (Republic of Argentina 2005a). In February, it swapped about \$4 billion in external bonds, extending near-term maturities. The famous mega-exchange in June pushed off maturities on over \$30 billion at the cost of increasing Argentina's foreign-currency, foreign-law debt stock and raising the spreads to levels that undermined market confidence.

The third exchange was more unusual. In November 2001, Argentina offered to swap about \$42 billion in foreign bonds for loans governed by Argentine law and secured by dedicated tax revenues. The exit instrument was designed to

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appeal to Argentine financial institutions that had come to hold about 40 percent of the government's foreign bonds. (Russia's default and punitive restructuring of its treasury bills had made foreign investors briefly wary of domestic-law debt.) The exchange dramatically reduced Argentina's foreign-law debt and helped partially to segregate investors with different preferences into different instruments.

The swap did not prevent default on Argentina's foreign bonds, which came on Christmas Eve in 2001 after the IMF refused further disbursements. Convertibility collapsed, and the peso fell to a quarter of its precrisis value. After weeks of riots and a succession of presidents, Argentina enacted emergency measures that led to more dramatic changes in its debt stock. It converted into pesos all public and private domestic-law debt, including the loans resulting from the November exchange. These loans continued to perform throughout the default episode, albeit in pesos and at even lower interest rates. The government then proceeded to issue over \$20 billion in dollar- and peso-denominated domestic-law debt (primarily the Boden bonds) to compensate domestic constituencies for damage from the crisis. The Boden paid low interest rates, and only a small portion of them traded. Those that traded became a favorite among foreign investors, who calculated that the

¹ The official sector comprises the IMF, World Bank, regional development banks, G-7 and G-10 governments, and the group of bilateral creditors that meet in the Paris Club.

government would not default on the obligation that now formed much of the capital in the Argentine banking system.

The net result was a radical transformation of Argentina's debt stock. Before the November 2001 exchange, December 2001 default, and February 2002 "pesification," almost 70 percent (nearly all the debt owed to private creditors) was in performing foreign-currency, foreign-law bonds. A year later, these bonds represented just over a third of the total and were mostly in default, trading at some 20 cents on the dollar. Performing debt comprised almost \$40 billion in domestic-law instruments and over \$30 billion in debt to multilateral institutions. Foreign bonds regained some of their share in mid-2003, when Argentine pension funds that had rejected pesification of their guaranteed loans were forced to revert to their defaulted global bonds.

The identity of Argentina's creditors also changed over time, most dramatically in the past three years. In the mid-1990s, Argentina borrowed chiefly from foreign institutional investors. As the recession wore on and institutional interest wore thin, Argentina tapped unprecedented numbers of European, and to a lesser extent Asian, retail investors. In the run-up to the crisis, it turned to multilateral and captive domestic institutions. After the default, compensation bonds expanded the holdings of domestic creditors. Meanwhile, speculative investors—mostly foreign institutions—began to buy performing domestic debt and soon defaulted foreign bonds.

These changes, some driven by the markets and others by Argentine policies, helped shape the debt exchange in 2005.

THE OFFER: DUBAI TERMS FOR ALL

Argentina first broached the restructuring terms with its creditors at the IMF/World Bank Annual Meetings in Dubai in September 2003, almost two years after the default. The "Dubai Terms" set a political benchmark for the government—75 percent debt reduction and no recognition of past due interest (potentially 90 percent in present value terms at market discount rates).

The creditors were outraged. Three months after Dubai, disparate investor groups united under the umbrella of the Global Committee of Argentina Bondholders (GCAB) to pool negotiating leverage and demand a better deal. The committee claimed to represent about \$40 billion in US, European, and Japanese creditors. It joined forces with another group representing Argentine nationals.

Several GCAB members sought to represent retail investors in Europe and Asia. These investors generally were not repeat players and knew little about emerging-market debt.

Many individuals bought Argentine bonds for their retirement accounts from European and Japanese banks. After the default, Argentina and its institutional creditors found it hard to predict retail behavior.

GCAB unveiled its own "Dubai Terms" in response to a slightly improved proposal from Argentina in June 2004, valued at about 20 cents on the dollar (GCAB 2004). Creditor demands included full recognition of past due interest and recovery values over 60 cents on the dollar. One Wall Street analyst wrote that the group was "repeating the government's strategy in Dubai: to present something that will hardly help in the very same negotiation process" (*Deutsche Bank*, July 13, 2004). These polar opposite positions set the tone for the remainder of Argentina's restructuring, as competing road shows grew increasingly strident.

In the end, GCAB did not move, and Argentina moved some. In January 2005, the government offered a final menu of par, discount, and quasi-par bonds that the markets valued slightly above 30 cents on the dollar. It included instruments linked to Argentina's future economic growth and added a small amount of cash by backdating the exchange to December 2003. During this period, the authorities sustained budget surpluses unprecedented by Argentine standards, as the economy grew by over 8 percent. This economic performance both made Argentina a more attractive credit and seemed to validate creditor contentions that it could pay more.

But the biggest change took place in the markets. In the 15 months since the Dubai meetings, spreads on emerging-market debt fell dramatically as global investment capital searched for yields. Interest rates in the United States, Europe, and Japan were at historic lows. What might have looked like an outrageous offer in 2003 looked more attractive using 2005 discount rates. GCAB's institutional constituents were quietly peeling off; some began buying up defaulted debt from retail investors who had lost patience. In the end, most institutions appear to have tendered in the exchange. Even as Italian retail leaders publicly denounced what they called Argentina's cram-down, billions of dollars in Italian retail holdings were tendering or selling to participating funds. The largest single pool of retail claims, representing over \$1 billion in German and Austrian investments, accepted Argentina's offer two hours before the deadline.

What had looked like the new dawn of creditor organization seemed to fizzle overnight. GCAB's website fell silent—it posted no reaction to the exchange. True to the atomistic stereotype, sovereign bondholders could not hold a coalition. Each acted in its own self-interest; most came to see Argentina's offer as an opportunity for short-term gain or at least a chance to cut their losses. For now, the sovereign debtor seemed to hold all the cards.

LITIGATION: BONDS IN LIMBO

In one sense, any transaction of over \$80 billion that demands unprecedented debt relief and attracts over three-quarters of the creditors is a triumph. Argentina's was all the more impressive because it proceeded against the background of thousands of creditor lawsuits, most in Argentina but also dozens in New York and over 100 in Europe.

The conventional wisdom before Argentina's default was that getting a judgment against a government was much easier than collecting on it. Since the Brady exchanges of the 1990s, a steady undercurrent to this wisdom had emerged arguing that litigation might yet become a potent creditor weapon. This reasoning held that once sovereign debt took the form of tradable bonds rather than relationship-driven bank loans, a default would send thousands of bondholders storming the courts to demand 100 cents on the dollar. A rush to the courthouse would jam up negotiations, delay the country's recovery, and inflict greater losses on the creditor collective.

Until Argentina, the most prominent and successful holdouts² sued on loans, not bonds (as in *Elliott Associates v. Peru*). Rather than block restructuring, they sought to profit from its success. A country that has restored its payment capacity could better afford to pay ransom; moreover, its return to the global markets created offshore payment streams that litigants could target. Most puzzling perhaps was the fact that cooperating creditors seemed unfazed by the holdouts. They saw payments to the holdouts as a modest tax on the restructuring that kept the threat of enforcement real, perhaps deterring the debtor from defaulting on the margins. At the same time, the still-considerable risk, hassle, and expense of sovereign debt litigation deterred emulators.

Several times Argentina looked like it might challenge conventional wisdom, as many of its bondholders did go to court in large numbers (Republic of Argentina 2005a). Several bondholders secured judgments and at various stages tried to stop the exchange offer. A fund owned by the Dart family, well-known for its holdout litigation prowess, got a judgment for \$725 million. The remaining individual judgments represented a tiny fraction of the debt—about \$15 million all told. Then the New York District Court certified a class action against Argentina, which could have reached \$4 billion in claims. But none of this seemed to matter as Argentina marched on with its \$62 billion exchange. Lawsuits seemed

² Holdouts are creditors who refuse to participate in a debt restructuring. Some hold out for better restructuring terms; others refuse to participate in any collective restructuring and sue for full payment.

powerless to stop it, and in the words of the presiding judge in New York, "not only have they not yielded a hundred cents on the dollar, they have not yielded one cent on the dollar."

The march suddenly stalled on March 21, 2005, when NML Capital Ltd., an offshore fund with connections to Elliott Associates, moved to seize the defaulted bonds that Argentina had accepted for the exchange.³ NML argued that the bonds, which were ostensibly locked up in custodial accounts in New York⁴ for Argentina's benefit, were assets of the debtor that had market value and could be sold to satisfy a future judgment. Because the bonds' market value was a fraction of their face value, NML initially succeeded in freezing \$7 billion in bonds tendered by participating creditors to pay its own \$360 million claim. Other holdouts, including the Darts, shortly joined NML.

Argentina's lawyers argued among other things that the bonds did not belong to Argentina but to the tendering holders, that the bonds could not be Argentina's assets and liabilities at the same time, that if Argentina ever came to hold the bonds they would have no value because it would cancel them immediately, and that the government would sooner scrap the entire \$62 billion deal than go forward without the frozen bonds. The creditors pointed out that nothing in

Argentina's crisis seems to suggest that default shifts the balance of power in favor of the debtor absent official intervention.

Argentina's contracts required it to cancel the bonds or to stop the exchange. Since Argentina would come to hold the bonds sooner or later, the court should prevent the government from destroying them and instead make it turn the bonds over to the creditors.

The trial court eventually ruled in Argentina's favor but kept the bonds frozen for two months while the creditors appealed. The federal appeals court in New York upheld the decision in a terse summary order that stressed the trial judge's discretion to deny remedies that might pose a risk to the overall debt exchange, which, in turn, was important to Argentina.⁵

³ See *NML Capital, Ltd., et al. v. Republic of Argentina*, hearing transcript, March 29, 2005, United States District Court for the Southern District of New York.

⁴ Argentina contested the bonds' precise location.

⁵ See *EM Ltd. et al. v. The Republic of Argentina*, summary order, May 23, 2005, United States Court of Appeals for the Second Circuit, New York.

The order may not be cited as precedent, but it reveals something about judicial thinking. Surely most large-scale sovereign debt restructurings are important for the debtor country. And in this case, “risk to the exchange” was at least to some extent a function of Argentina’s refusal to proceed while some bonds were frozen. If future judges use similar reasoning, preclosing challenges look increasingly remote.

Some observers expressed dismay at the appellate court’s decision to let the exchange go forward on procedural grounds (the scope of the trial court’s discretion). The ruling is frustrating for its failure to resolve the substantive legal issues whose seriousness the judges acknowledged. Nevertheless, the court’s critics are unduly harsh. Every policy entity involved in Argentina’s debt default was trying to have its cake and eat it too. For example, the IMF seemed to call both for polite negotiations and for a sustainable debt profile, yet it refused to pass judgment on Argentina’s payment capacity. The US executive branch continued to affirm the sanctity of contracts while pursuing their renegotiation and to insist on a solution that was free-market yet also polite and sustainable—all the while trying to keep up good relations with Argentina. Why should the court, which had clear procedural grounds for punting, make new law and volunteer to take the blame for a failed exchange, when all other responsible institutions seemed to wash their hands of Argentina? Given the opening, the judges handed the hot potato right back to the IMF and the G-7.

Of course the real aim of the NML maneuver was not so much to hoard defaulted paper but to pressure Argentina to settle at the risk of jeopardizing the restructuring. The problem for the illiquid debtor—which Argentina turned into a legal argument of sorts—is that paying off one creditor in full before the closing encourages (nay, entitles) every other creditor to demand the same and turns the restructuring into a first-come first-served asset grab. Waiting until after the closing may encourage more holdouts the next time (few governments expect a next time on their watch) but at least would reduce current claimants to a more manageable pool. Even in GCAB’s assessment of Argentina’s finances, the government could not pay all its creditors in full upfront.

Domestic bankruptcy laws are designed to preempt a disorderly grab race for the debtor’s limited assets. These laws do not apply to sovereign governments. Argentina’s bond exchange seems to reaffirm the view that each sovereign debtor fashions its own regime for allocating assets among its creditors.

After letting the restructuring go forward, the trial judge certified a new batch of class actions—all but certain to yield more judgments but no money for the creditors. They might not appreciate the irony.

DOCUMENTATION: A SHIFT IN TONE

Some bondholders had sued to stop Argentina’s offer on the grounds that it would use “exit consents”—ask tendering creditors to amend the old instruments to make them illiquid and even harder to enforce. Ecuador was the first to import the technique from corporate restructurings as part of its 1999 Brady bond exchange. Since then, creditors have fought exit consents as unfairly coercive and have succeeded in raising the voting threshold for exit consents in many issues.

The litigants turned out to be wrong. Argentina did not use exit consents, nor did it specify a minimum participation threshold to make its exchange effective. This approach was not an olive branch to its creditors. It might have reflected partly the reality of a mammoth exchange with so many diverse creditor constituencies, including unpredictable retail. It also reflected the government’s message since Dubai: Once it had decided how much it could afford to pay, its ultimate threat to nonparticipating creditors was refusal to pay or to improve the terms. An exchange that relies on exit consents, which require threshold participation, by definition has an element of consent. An exchange driven by the debtor’s promise to stiff nonparticipants prioritizes debt relief over near-term market access.

In earlier exchanges, including Uruguay and the Argentine province of Mendoza, participating creditors amended the old bonds to withdraw the issuer’s sovereign immunity waiver with respect to the new bonds to protect new payments. Because Argentina chose to forego exit consents, it could not shield the new bonds in this way from lawsuits on the old.⁶

Argentina took a different approach to intercreditor equity. The “most favored creditor” (MFC) clause, which sought to assure participating creditors that holdouts would not get a better deal, was probably the most important and most controversial innovation in Argentina’s new bond contracts (box 1).

Similar language has appeared in corporate workouts and in sovereign workouts involving commercial banks (Buchheit 2002). Argentina also used a similar device in the domestic swap shortly before the default. The structure of the MFC clause recalls other devices designed to level the playing field among creditors, such as the negative pledge clause or the sharing clause in syndicated loans. The borrower promises not to favor some creditors over others of equal rank and to distribute any new value proportionately among similarly situated creditors. Argentina’s initial version of the clause had

⁶Like Uruguay before it, Argentina got incremental protection by using a trust instead of a fiscal agency structure.

Box 1 Most Favored Creditor Clause

"[I]f at any time on or prior to December 31, 2014, the Republic voluntarily makes an offer to purchase or exchange (a "Future Exchange Offer") or solicits consents to amend (a "Future Amendment Process") any outstanding Non-Performing Securities, each Holder of Securities shall have the right, for a period of 30 calendar days following the announcement of any such Future Exchange Offer or Future Amendment Process, to exchange any of such Holder's Securities for (as applicable): (i) the consideration in cash or in kind received by holders of Non-Performing Securities in connection with any such Future Exchange Offer, or (ii) debt obligations having terms substantially the same as those resulting from any such Future Amendment Process. . . ."

Source: Republic of Argentina (2005b).

covered private settlement as well as new offers, and it might have barred disproportionate recovery for litigants. The final version of the clause omitted the word "settlement," potentially opening the door to holdout payments and issuer buybacks.

Public statements by some investors suggest that the MFC clause might have done more to alarm than to reassure them. Its perceived loopholes no doubt motivated the government in early February to pass a domestic law that raised the bar for reopening the exchange or settling with nonparticipating creditors on the side. This inflation of commitment devices—the government tying its own hands to show the markets it means what it says—is oddly evocative of the defunct convertibility regime. For now, it is clear that the government is determined not to pay the holdouts. It is anyone's guess whether and when this latest law might go the way of convertibility.

If the law stands, it might increase on the margins the government's vulnerability to legal challenge. First, holdouts will surely argue that the law amounts to a legal act formally subordinating the old debt to the new in violation of the *pari passu* (equal ranking) covenant in the old bonds. The question of whether creditors could use the *pari passu* clause to attack Argentina's new payments was raised and deferred in the Southern District of New York in 2004. Without the law, Argentina might have argued that the new bonds did not effect legal subordination—merely disproportionate payment.

Some have also argued that the law amounts to expropriation within the meaning of Argentina's bilateral investment treaties and is subject to challenge before the World Bank's International Centre for Settlement of Investment Disputes

(ICSID). If the claimants succeed in proving expropriation (none have on similar claims), it is far from clear that enforcing an ICSID award would be any easier than collecting on a New York judgment. The government's recent promise to flout other ICSID rulings is not encouraging.

In sum, the results of Argentina's efforts at intercreditor equity remain uncertain. For now, bond documentation is a secondary constraint to domestic politics and domestic legislation. It will come into play if and when Argentina brings itself to overcome these domestic factors and reach out to the holdouts.

In other respects, Argentina's documentation is progressive but not revolutionary (Republic of Argentina 2005a). Its new bonds include collective action clauses pioneered by Mexico in 2003, which have since become standard in emerging-market sovereign bonds. Most importantly, Argentina became the first government since Uruguay to include aggregated voting provisions in its shelf registration statement. Should Argentina choose to amend its debt documentation, it may proceed issue by issue, with 75 percent of the aggregate principal amount outstanding required to amend key terms. Alternatively, it could amend key terms in multiple issues with the approval of 85 percent of the aggregate principal amount outstanding and two-thirds of the principal outstanding under every affected issue. If it fails to secure the approval of any single issue, the amendment does not take effect with respect to that issue, although the affirmative votes count toward the 85 percent threshold.⁷ Bonds held by entities directly or indirectly owned or controlled by Argentina, including state-owned banks and pension funds, are ineligible to vote.

Aggregated voting makes sense when it can be conducted across a significant portion of a country's debt stock. Because Argentina's was the first comprehensive debt exchange since Uruguay's, it was the first opportunity for a sovereign issuer since then to bring its debt stock within the aggregation framework. Adapting recent contractual reforms across \$35 billion in bonds with nary a protest from the markets is an impressive achievement and a milestone for the asset class (box 2).

WHAT IS NEXT FOR ARGENTINA AND THE WORLD

Immediately after the offer expired, Argentina's government pronounced the default episode over: Argentina had emerged victorious from the ashes of crisis. Some market participants and editorial observers took a more sour view, though they

⁷ For example, had Argentina's defaulted bonds contained similar aggregated collective action clauses, issues in which NML and the Darts had bought controlling positions would have dropped out of the restructuring.

Box 2 Bottom Fishers Save the Day

By the mid-1990s, it had become fashionable to criticize a certain kind of emerging-market investor—one that buys distressed debt at pennies on the dollar in the hope of collecting a fabulous return. The bottom fisher and the maverick litigant were all the same in this view and equally threatening to the system since both would disrupt orderly workouts.

In fact, the litigant has turned out to be a small and distinct subspecies of the bottom fisher. He does buy low—so low that he can afford to invest in pressing a claim and chasing phantom sovereign assets around the world for years. With the stark exception of the NML incident, which may or may not be repeated in light of the appellate court ruling, the litigant typically lies low until the restructuring is complete. He wants every other creditor to accept deep debt reduction, maximizing the country's residual payment capacity and clearing the field of competition. Beyond being a high-skill specialty sport, maverick litigation is self-limiting. While it is plausible for a country to pay \$100 million or maybe even \$1 billion quietly to get rid of the stalking nuisance, payment on the order of \$25 billion seems improbable.

In contrast, the average bottom fisher wants to get the maximum recovery for minimum effort, preferably over a short period. He may be an exemplary collective actor—content to join in the chorus pressing the debtor for a better deal and glad to share the proceeds with others who help secure that deal. The last thing he wants is a protracted stalemate. The two-month settlement delay following NML's March 2005 intervention in Argentina is precisely the sort of thing that upsets the bottom fisher's calculus and adds to his costs.

To the extent Argentina's offering was a success, bottom fishers deserve part of the credit. Some bought Argentine bonds at 17 cents in 2002 and happily tendered in an exchange worth nearly double in 2005. Most probably bought in the closing weeks. They created a market where European retail investors could sell billions of dollars in defaulted bonds. Individuals traumatized by their foray into high-risk investing sold at a discount from exchange values. They might have saved money and tendered a week later—if they had the stomach to ride out the NML incident. They might have stayed out. In the end, the bottom fishers pocketed the difference and assured the high level of participation in Argentina's exchange.

too saw the exchange as an endpoint—proving that sovereign debtors could trample creditor rights with impunity and exuberance. Both conclusions seem premature.

No other sovereign restructuring has left behind anything close to \$25 billion in holdouts. Argentina cannot and will not pay them all in full. What these creditors can do to Argentina and what Argentina can do about them is far from clear.

More litigation could bring doctrinal and policy shifts. Because Argentina privatized most of its economy in the 1990s, the government has few commercial assets available to satisfy its creditors. As before, creditors will likely target offshore payments to or from Argentina when it issues new bonds. For example, a US court could find that the exchange or, more likely, Argentina's domestic law violated the *pari passu* clause in the defaulted bonds. The remedy might include an injunction against payments on the new bonds or some form of *pro rata* distribution.

Even if legally sound, such a ruling would raise critical policy concerns—it could turn the world's largest payments systems into collection agencies. Recent Belgian court decisions that had the same effect prompted a law to shield Euroclear from injunctions. Early in the latest round of lawsuits against Argentina, the US Treasury, the Federal Reserve Bank

of New York, and the New York Clearing House all intervened on Argentina's side on the *pari passu* issue, suggesting they will not let it be resolved in a policy vacuum. But inasmuch as Argentina's domestic law hurts its case against *pari passu* enforcement, it also takes away a key legal argument for the supporting agencies. The fact that few if any other countries have enacted such laws also diminishes the systemic importance of Argentina's case and the policy impetus for intervention.

If creditors succeed with ICSID arbitration, governments might start pressing for new provisions in bilateral investment treaties to address sovereign debt default and restructuring. For example, Uruguay's treaty with the United States specifically shields it from expropriation claims by holdout creditors who had been outvoted using collective action clauses in Uruguay's bonds. It is the only example of this approach to date.

Recent calls for new limits on foreign sovereign immunity might gain momentum if Argentina flouts both court and ICSID rulings, and especially if other countries follow its example.

Among the more subtle effects, settlement delay from the NML lawsuit may discourage certain investors—those who trade actively—from participating in defaulted debt exchanges

and possibly in other transactions that might be targeted by holdout litigants. These investors may stay out altogether or, more likely, may demand a higher return in exchange for the perceived rise in settlement risk. A change in the behavior of a pivotal investor group could affect the terms and outcome of a future exchange. On the other hand, broader market conditions, such as the abundance of capital searching for yield, might well drown out any effects of this altered risk perception.

But the next act in Argentina's restructuring drama probably will not be in court. It will unfold in the coming months as Argentina tries to negotiate its refinancing agreement with the IMF. Less than a year after it had walked away from its last IMF program, the government signaled a desire to reengage. Argentina sent representatives to Washington even before closing the debt exchange. Negotiations have been contentious. Argentina and the IMF have argued over structural conditionality (taxes, banks, and utilities) and more recently over monetary policy, but the fate of the holdout creditors has weighed on the talks from the start.

In this respect, the encounter is tricky for the Fund and its shareholders. The official sector has tried hard to keep its distance from Argentina's bond restructuring operation but

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has found it equally hard to avoid the appearance of complicity in the outcome. Now Argentina has decreed the restructuring done. If the IMF does not accept Argentina's contention that \$25 billion in holdout claims are wholly uncollectable, it might see them as a threat to policy performance, as well as to program financing. If the IMF renews its program without addressing the holdout issue, it will have publicly ratified the exchange result and, by implication, the process Argentina used to obtain it. Yet the IMF's recent history with Argentina limits the alternatives.

The official sector uses three main tools to influence the restructuring of sovereign debt held by private creditors. First, governments that agree to relieve a country's debt in the Paris Club can press the debtor to seek comparable concessions from other creditors. Since Argentina's Paris Club debt is tiny (under \$2 billion) and yet to be restructured, this intervention avenue is not promising. Second, when a country secures a disbursing program from the IMF, it usually agrees to budget targets that frame its debt payment capacity over the life of

the program. In this respect, Argentina's September 2003 IMF program broke with precedent (IMF 2003a). In place of the customary primary budget surplus target, the IMF implied that Argentina must overperform a floor target by the amount it would agree to pay its creditors. The official sector gave up its say over the debtor's payment capacity.

Instead, officials used the third tool—the IMF's policy on lending into arrears, which allowed it to finance a country that was making a good faith effort to reach a collaborative agreement with its creditors (IMF 2002). Argentina's contentious relations with its creditors offered the most serious test of the policy to date. Many argue that the IMF Board made a mockery of the policy by approving disbursements to Argentina despite its refusal to negotiate deal terms with its bondholders. The Argentine authorities point to their meetings with creditors as evidence of good faith. Others question the relevance of a policy on lending into arrears to the case of Argentina, which has seen no net new multilateral lending since the default—program disbursements only partially covered Argentina's repayments to the IMF.

As Argentina's exchange drew near, the IMF Board interpreted its policy to require a comprehensive restructuring that restores debt sustainability. The IMF's debt sustainability analysis has not been published, though the offer terms are reportedly consistent with it. The IMF did not define "comprehensive" (though some Board members volunteered personal views on required participation). It is difficult to accuse Argentina of making an unreasonable offer if the terms were indeed in line with the IMF's own analysis and where over three-quarters of its creditors signed up. But the Fund may argue that 76 percent falls short of comprehensive, since Argentina can neither pay nor wish away \$25 billion in presumptively conscientious objectors. Lending at this level of holdouts, including many retirees, would cause a political, if not a policy, problem. And so, since the exchange has closed and program talks have begun, the Fund and its shareholders have been exhorting the government in general terms to deal with the holdouts.

The Argentine government may yet save the Fund the embarrassment if it allows inflation to get out of hand or fails to meet structural conditionality in its program, such as reforming its tax system, fixing its banks, or settling its differences with domestic utilities. Argentina might even decide to walk away again, since it has a relatively manageable debt service schedule for the next few years against the background of rapidly growing foreign reserves. On the other hand, judging by the fact that the defaulted debt trades at only a slight discount to the new performing bonds, the market expects Argentina to reopen its offer, securing or circumvent-

Box 3 Lending into Arrears

Through most of the 1980s Latin American debt crisis, IMF rules had barred it from lending to countries in payment default to their private creditors. As the commercial bank restructurings wore on, IMF policy had the effect of pressuring sovereign debtors to settle with private creditors to gain access to IMF funds. The IMF economic program at times was held hostage to private negotiations.

In 1989, the IMF Board adopted a new policy that allowed the Fund to lend notwithstanding member arrears to commercial banks. In 1998, after most emerging-market debt had shifted into tradable bonds, and after several countries had trouble servicing those bonds, the IMF extended its policy to permit lending into arrears on bonded debt provided, among other things, that the country was negotiating in good faith with its creditors (IMF 2002).

The following year, the Fund modified the good faith negotiation requirement in response to fears of holdout disruptions. The new policy allowed lending where "(i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors."

The good faith requirement was refined again slightly in 2002 to reflect additional, mostly procedural, principles for engaging with creditors. Even with this improvement, few would hazard the meaning of "good faith" and "collaborative."

Beyond its ambiguity, the good faith requirement ignores the IMF's institutional bias in favor of lending to a country in crisis (Tarullo 2005). This bias is especially strong and justified where a country has met all macroeconomic and structural conditions at the core of its IMF program. Withholding funds based on procedural failings in talks with private creditors would strain IMF credibility.

ing domestic legislative approval sometime after the fall 2005 elections. Mopping up as many holdouts as possible on equal or harsher terms is certainly in Argentina's interest. On the other hand, the domestic political barrier to any new concessions is extremely high. Moreover, reopening the old offer will do nothing to address the most serious litigation threat, which comes from professional holdouts such as NML and the Darts, aiming to recover close to 100 cents on the dollar.

The Argentine experience so far suggests that the good faith iteration of the lending into arrears policy remains flawed. To an outside observer, recent statements indicate a lending standard in disarray. IMF staff are expert at designing macroeconomic and structural reform programs. They have no special expertise in evaluating the quality of a country's dialogue with its creditors. Proxies for good faith and collaboration, such as the level of creditor participation in a debt exchange, are ultimately circular—they simply outsource the good faith determination back to the creditors and ignore any coercion factor that might have affected participation.

In Argentina's case, the Fund appears both compelled and ultimately unable to judge fairness. In the words of IMF staff, "[T]he credibility of the Fund's policy will depend, in part, on a perception that the Fund actively promotes collaborative resolution to debt difficulties that are [sic] seen as being generally fair to all parties" (IMF 2002). When the dust settles years from now, it may well turn out that the outcome of Argentina's exchange was inevitable. For now, few if any participants would call it either collaborative or fair. To avoid losing more institutional credibility, the Fund may be wise to

shelve further public refinement of the policy until after the Argentina episode has played out (box 3).

The last set of unanswered questions in the wake of the exchange concern Argentina's impact on the international financial system. Already some Philippine and Nigerian legislators announced that they would follow Argentina's example and seek an aggressive restructuring of private debt. This could all be grandstanding, a common legislative pastime, or a signal of future defaults. But so far, there have been no painless sovereign defaults—Argentina's was far from it—and so it is probably too early to eulogize the asset class or market discipline in general.

If anything, Argentina's default and restructuring has shown the terrible effects of sovereign default on its people and institutions. The economy collapsed, along with the currency and the banking system; millions of people became desperately poor, as presidents and ministers lost their jobs in rapid succession. This domestic impact, more than the hope of market access or the threat of bondholder litigation, may be the biggest argument against default in the minds of emerging-market politicians. Argentina's experience only reinforces it. It remains to be seen to what extent both debtor and creditor losses from Argentina's default will strengthen the case for preemptive exchanges on the Uruguay model.

On the other hand, Argentina's crisis seems to suggest that default shifts the balance of power in favor of the debtor absent official intervention. Once a government defaults, it must justify resuming payments. For as long as the economy can grow briskly without addressing defaulted government

debt, it is difficult to see why a government would want to engage its creditors. Argentina's postexchange issues have all been governed by Argentine law and used Argentine payment channels; however, considering the limited impact of lawsuits to date, it would be a stretch to attribute this funding strategy to litigation risk. Instead, brisk demand for Russian and Argentine debt casts doubt on the theory that markets punish defaulters. Two years after Uruguay's generous, polite, and preemptive restructuring, the spreads on its debt are embarrassingly close to Argentina's. Good feelings from the markets may not be bankable after all.

Argentina's crisis also has done little so far to validate or discredit the idea of statutory sovereign bankruptcy. The government achieved impressive debt relief without either collective action clauses or bankruptcy. A three-month workout would have been preferable to a three-year one, but it is doubtful that any regime could have compressed the process to three months in a case of this scale and complexity. To the extent creditors had trouble coordinating, Argentina was able to exploit their differences to get more relief and higher participation. The last-minute attack by NML delayed the closing but did not derail the exchange. The disruption seems hardly worth the institutional and political effort it would take to revive the IMF's proposed Sovereign Debt Restructuring Mechanism (SDRM). On the other hand, \$25 billion in holdouts still pose a risk to the outcome.

In the end, it is still too early to tell how Argentina might have changed the world. We may not know for years. For now, the revolution must wait.

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