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SHOULD ARGENTINA PAY ITS BOND HOLDERS?

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A dozen years ago, Argentina engaged in the world's largest sovereign debt default. The issue is still being litigated and appears to be close to the end game. World financial markets will be significantly affected by the ultimate resolution of this conflict.

For more than two centuries, the U.S. Government has been able to borrow money to finance its operations more inexpensively than any other entity on the planet. Alexander Hamilton, the primary architect of the U.S. financial system and the first Secretary of the Treasury, understood that a government that built a reputation for absolute financial integrity would be able to bring great benefits to its people.

At the time of the formation of the Republic, Hamilton made the bold move of having the U.S. Government assume the debts, largely left over from the Revolutionary War, of what had been the sovereign states of America and then quickly prove that he could service them in full by setting up a competent tax collection (largely tariff) system.

Despite today's record deficits, few doubt that push-come-to-shove the U.S. will make good to its bondholders. In addition to its ability to tax an economy that produces more than a fifth of the world's GDP, the government continues to own a third of the land in the U.S. and has trillions of dollars of other assets that it could sell if the need be.

While the U.S. spent two centuries building a reputation for paying its debts, Argentina has spent the last two centuries doing the opposite. Both countries were blessed with a huge swath of very fertile, well watered land and many natural resources; and both countries were populated with largely literate immigrants from Europe – but politically they chose very different paths.

A hundred years ago, Argentina, like the U.S., was one of the ten wealthiest countries on earth on a per capita basis. But whereas the U.S. occasionally dabbled with limited light socialism, Argentina went full bore for Fascist/socialist policies and institutions, where the rule of law was and is too often ignored.

So Argentina, formerly a free and prosperous country, has fallen to number 73 in real per capita income according to the World Bank, fallen to 102 out of 176 countries in Transparency International's corruption index, fallen to 124 out of a 185 in the World Bank's cost of "Doing Business", and fallen to 127 out of a 144 countries in the Economic Freedom of the World Index. The current government under Cristina Fernandez de Kirchner, rather than trying to reverse course, continues to become more economically and politically repressive.

In December 2001, Argentina engaged in the largest sovereign debt default in history. In 2005, Argentina abandoned the negotiation process and gave the bond holders a very unfavorable take-it-or-leave-it offer. A majority of the creditors, believing they had little choice, took the offer of an exchange of bonds. In 2010, another group of debtors agreed to accept an exchange for some bonds after the price had been driven down by statements from government officials, but there is still a significant group of creditors holding out for full payment, whose claims are roughly 15 billion dollars (principal and interest).

This group of creditors has been litigating the issue in the New York courts and has received a number of favorable rulings. The reason the issue is fought in the New York courts is that both parties had agreed that New York law would be applied and that New York courts would have jurisdiction in case of a dispute. This is common practice when countries seek to issue bonds and seek U.S. buyers.

The group of holdout investors is led by Paul Singer's Elliott Management and its Cayman-incorporated funds. Such funds are pre-eminent in the resolution of non-performing sovereign debt.

Argentina sets unenviable records in many ways:

- the most frequent sovereign defaulter;
- as noted, the largest default ever in 2001;
- the lowest participation ever in a voluntary restructuring, other than political pariah countries;
- and the longest time spent in default.

The Kirchner regime adopted a take-it-or-leave-it, cram-down approach to private creditors, after paying off the IMF early and in full. Bilateral debts and arbitration awards remain unpaid, along with private creditors who did not participate in the restructuring.

The impasse with private creditors has lasted unusually long, now approaching twelve years. The Kirchner regime consciously and deliberately structured its affairs to evade the judgments and collection actions that follow from an unresolved default. They moved accounts and assets from jurisdictions where judgments might be enforced, and for some years have channeled most foreign payments through the accounts of their central bank at the Bank for International Settlement (BIS) in Basel, sheltering behind the Swiss immunity of that institution.

Despite many attempts, including the almost comical arrest of the Argentine Navy's ceremonial sail flagship in Ghana, few assets have been seized by creditors. The Kirchner regime has taken apparent pride in this and has turned a weakness into a virtue by declaring a policy of "disindebtedness."

With access to international borrowing largely cut off by unpaid creditors (although the World Bank and InterAmerican Development bank still lend), most government borrowing has been funded by intra-government notes issued to the central bank and the public pension agency. Private pension funds were nationalized in 2008 to expand the public agency's funding capacity. It was recently reported that public debt in the hands of private holders has fallen to 13 percent of GDP from a high of 105 percent. The majority of the central bank's assets are now virtually interest-free loans to the state.

This policy worked without obvious disadvantage during the commodity-led boom that followed the default, but is now coming undone as uncontrolled government spending and bad policies overwhelm the previous fiscal and trade surpluses – out of which the debt could have easily been paid. The greatest single problem is an interaction between price controls on energy, which, over a decade, have led to a precipitous decline in exploration and production, combined with massive subsidies on public transport and various forms of energy. In the last several years, both energy imports and the volume of subsidies have exploded.

This problem has been aggravated by the regime's handling of the country's largest petroleum company, YPF. Privatized in the 1990s with majority ownership going to the Spanish firm Repsol, a large chunk of the company's shares were sold by Repsol to friends of Nestor Kirchner to "localize" ownership. The purchase was nearly 100 percent financed with bank loans and seller financing.

To help its new shareholder pay the loans, YPF's dividend payout was raised to nearly 100 percent, which severely inhibited investment in the country's key "Vaca Muerta" shale oil field. In 2012, Nestor's widow, now the country's president, was desperate because energy production was falling due to underinvestment, and then expropriated without compensation Repsol's majority stake in YPF. YPF recently signed a deal with Chevron to move forward with Vaca Muerta, effectively replacing one foreign controlling entity with another, but on terms less favorable.

Due to the dire impact of energy policy on the trade surplus, the regime applied severe currency controls and has haphazardly moved into a multiple-rate system. This has intensified public desire for various hedges, such as an increased demand for imported automobiles, etc. The controls are personally managed by a Secretary of Domestic Trade, Guillermo Moreno, who also manages the price controls that made domestic energy production uneconomic. Companies must negotiate with him to obtain currency for capital and raw material imports, which has adversely affected the supply of inputs for production.

Moreno is alleged to be behind the systematic underreporting of inflation, which has earned Argentina the first-ever censure of a member by the IMF. The Argentine government claims inflation near 10 percent, while many knowledgeable economists – including many well regarded Argentine economists – place it nearer 25 percent. Conversely, growth has been materially overstated, which has ironically been costly for the country because the debt rescheduling with private creditors included a GDP warrant, on which billions have now been paid. On the other hand, the government cheated largely domestic holders of inflation-linked bonds.

Government subsidies to consumers now exceed 4 percent of GDP. Foreign debt service is only about 2 percent of GDP, which would not increase by much if Argentina honored and negotiated a payout of the dishonored debts it is avoiding. Obviously these choices are made purely on the basis of near-term political expedience.

The headline news this year in the battle with creditors is that the U.S. courts have to date ruled in favor of the hold-out bond holders. The Argentine government has vowed to defy any ruling against it. Third parties, like holders of restructured bonds, have entered the battle on Argentina's side, as has the French government. The latter claim that a ruling in favor of the hold-out bond holders would destroy the consensual process of sovereign debt restructuring. The argument lacks merit. It is Argentina that has uniquely defied restructuring conventions, including ignoring the fact that the terms of the old bonds prevent a cram-down.

The ultimate outcome of the Argentine case is important for precedents it might set. The hold-out bond holders are, of course, waging the extended legal battle for their own profit. But it is important for the sake of everyone else that the hold-out bond holders ultimately win. For financial markets, like all markets, to work properly, the rule of law must be upheld. If governments, whether they are Argentina, Greece or Detroit, are allowed to stiff bond holders, investors are going to be much more reluctant to buy government debt – or at least will demand much higher risk premiums.

If governments have less access to inexpensive capital, then their citizens will suffer. It is particularly dangerous for the citizens of poor or middle-income countries to have governments who treat bond holders poorly. Global bond investors have many alternatives, and they are not going to sit quietly and have their feathers plucked.

Assume an Argentine town needs a new sewer system, which, being a long-lived asset providing benefits over many years, should be appropriately funded through debt financing. But, as a result of the actions of the Argentine government in ignoring the rights of bond holders, the town is now denied access to the debt markets (at least at reasonable cost), and the people in that town will be forced to live in an unhealthy situation or to shoulder an increased tax burden that may cause real hardship.

Politicians, who like to demagogue and act like they are hurting rich bond holders, are actually increasing the stock of misery of their own constituents.

Those who attempt to hold debtors to their own promises and follow the rule of law should not be vilified, but praised – for they are the non-intentional heroes who make the system work for everyone's betterment.

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