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The IMF Should Be Involved in the Emerging-Market Debt Restructuring Process[1]

— Argentina's Sovereign Debt Resolution —

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1. Introduction

In December 2001, Argentina defaulted on US$81 billion of external sovereign bonds owed to private creditors. It also suspended payments on its US$4.5 billion debt to official bilateral creditors, but remained current on its approximately US$30 billion debt owed to multilateral financial institutions such as the International Monetary Fund and the World Bank. In September 2003, Argentina unilaterally announced a debt restructuring plan, proposing a nominal debt reduction of 75 percent with no payment on past due interest on defaulted debt. Since then, Argentina has continued to refuse to negotiate with private creditors, and has taken steps to launch a set of new bond issues in exchange for defaulted bonds in the near future. If the delayed interest payment of over US$20 billion is included, the total amount of debt owed by Argentina to private creditors is more than US$100 billion, which is two-thirds of Argentina's total debt of US$150 billion.

Argentina's accumulation of external debt was the result of its failure in macroeconomic policy, which can be traced back to the adoption of a quasi-currency board known as the Convertibility Plan in 1991, under which the peso was pegged at parity with the US dollar. The Convertibility Plan worked well at the beginning, but became unsustainable because of its inherent inflexibility and unattended fiscal imbalances, especially in the second half of the 1990s. While the primary responsibility lay with Argentina, the IMF (that continued to provide financial assistance to Argentina in the 1990s) also made mistakes leading up to the financial crisis in 2001. According to a recent report by the IMF's Independent Evaluation Office, "conditionality was weak, and Argentina's failure to comply with it was repeatedly accommodated." It also says

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that "IMF surveillance failed to highlight the growing vulnerabilities in the authorities' choice of policies and the IMF erred by supporting inadequate policies too long."[2]

When a country restructures its sovereign debt, it is a prerequisite that it meet conditionality under the IMF's standby agreement, and strictly observe the IMF's rules concerning debt restructuring. Argentina has not met key elements of macroeconomic conditionality, such as setting a primary budget surplus target, and has failed to comply with the IMF's debt restructuring rules. This paper discusses the need to strengthen the IMF's policy of lending into sovereign external payment arrears to private creditors for sovereign debt restructuring in relation to Argentina's debt issue.

2. Change in Emerging-market Finance, Resolution of Sovereign Debt Restructuring

The market environment of emerging-market economies changed considerably in the early 1990s. First, reflecting financial globalization, private capital flows to emerging market economies increased dramatically in the form of equity investment, foreign direct investment, and non-bank flows (including bond issues). There was a fundamental shift towards private finance, as official flows became stagnant and emerging-market economies became increasingly dependant upon private-capital flows.[3] Second, private-capital flows in the form of bonds increased while bank loans decreased, after a massive conversion of bank loans into bonds was initiated by the Brady plan in the early 1990s. Private creditors to sovereign debtors diversified, from institutional investors to numerous retail investors.

Due to these changes, a new approach towards the restructuring of sovereign debt became necessary. When sovereign borrowers were dependant upon banks, negotiations to restructure sovereign debt were held between a debtor and a steering committee representing a limited number of bank creditors, most of which were operating internationally. Communication between those involved was relatively easy, and serious inter-creditor equity issues did not arise as a result. When considered necessary, banks could agree to maintain short-term trade lines, and at times provided new money to fill financial gaps.

The situation changed dramatically when bond investors (including retail investors) became creditors, replacing bank creditors. For debtors, communication with creditors has generally become difficult. For a diverse group of creditors holding an array of financial instruments driven by different investment considerations, it has become extremely difficult to consolidate their interests, which lie within different legal systems.

After the occurrence of a number of financial crises, the IMF, the G7, and other official bodies have engaged in discussions on how to prevent and resolve crises. The

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[2] IMF Independent Evaluation Office report of June 30, 2004, "Evaluation of the Role of the IMF in Argentina, 1991–2001".

[3] Emerging-market economies' external financing (Institute of International Finance):

(Billions of dollars)	2002	2003	2004*	2005*
Net Private Flows	125	213	226	229
Net Official Flows	–6	–22	–20	–27

* Forecast

publication of program documents by the IMF and its members has served an important role in improving information disclosure and transparency, but the mechanism to prevent and resolve crises has been slow to adapt to changes in the international capital markets. For instance, it is only recently that collective action clauses (CACs) in sovereign bond issues became standard practice, after Mexico and Brazil included them in their bond issues in the New York market in 2003.[4]

It is essential to establish a flexible framework and rules in the resolution of sovereign debt issues, to cope with the increasingly complex market situation brought about by securitization. It is also important to have a common understanding on the roles and responsibilities of those involved, such as debtor governments, their creditors, and the IMF.

3. Changes in IMF Policy on Lending into Arrears

In 1989, the IMF established its policy on lending into arrears to private creditors in relation to sovereign debt issues. Before then, arrears to private creditors were not tolerated. At the onset of a number of debt crises in the 1980s, IMF-supported programs required the elimination of existing arrears and the non-accumulation of new arrears during the program period, provided that a large majority (critical mass) of bank creditors supported a restructuring package under the IMF program.

Under the terms of the 1989 decision, non-tolerance of temporary arrears to commercial banks was modified. Under certain circumstances, the IMF is permitted to lend into arrears to bank-creditors to support a member's economic programs when there is a firm indication that the member and its creditors are willing to negotiate in good faith on a restructuring plan.

Under the 1999 modification, the scope of the IMF's policy on lending into governments' external arrears was broadened to encompass arrears on international sovereign bonds. The 1999 policy specified that IMF lending into arrears can be granted when prompt IMF support is essential for the success of a member's adjustment program, and when that member is making good-faith efforts to reach a collaborative agreement with its creditors.

Under the terms of the 2002 policy, the form of substantive dialogue is left to debtors and creditors, but the debtor is expected to: engage in early dialogue after the debtor judges that the debt has become unsustainable; share relevant non-confidential information with all creditors on a timely basis; and provide creditors with an early opportunity to participate in the design of the restructuring strategy and in the design of individual instruments.

If a representative creditor committee has been established on a timely basis, additional guiding principles include the need to: establish a collective framework for negotiation with a steering committee; share confidential information with the committee when necessary; agree on the suspension of litigation by creditors

[4] When the payment terms of bonds must be changed, a majority of bond-holders can do so if CACs are included in the bond contract. The active use of CACs in international bond issues coincided with the IMF's decision to withdraw the SDRM proposal in 2003.

represented in the committee during negotiations, and have reasonable costs of the creditors' legal and financial advisors borne by the debtor.

The IMF has repeatedly stated that debt negotiations are to be conducted between a debtor and its creditors, and that the IMF should not be involved in such negotiations. When the IMF and private investors are creditors, the IMF customarily enjoys preferred creditor status, superior to that of private investors. The IMF helps support member countries' economies through macroeconomic policies, and acts as the lender of last resort. As the most knowledgeable and experienced institution in a member's economy, the IMF is in the best position to help resolve financial issues when a member country falls into difficulties. Since the IMF established the guiding principles for the resolution of debt, it should be more actively involved in their implementation, by actively participating in debt negotiations.

4. Argentina's Debt Issue and the Role of the IMF

Major events since Argentina defaulted on its sovereign debt in December 2001 are summarized as follows.

2001-2002: Under increasingly difficult economic and political circumstances, the government completed domestic restructuring with resident creditors by December 2001, but failed to restructure external debt and defaulted at the end of 2001. Government representatives met creditors in the United States, Europe, and Japan between the end of 2002 and the beginning of 2003, but nothing material came out of these meetings, due to difficulties in securing a political consensus.

2003: President Kirchner took office in May 2003, and the government created the Creditors Consultative Group in June, appointing US, European, and Japanese financial institutions as members, but no debt negotiations were conducted. On September 20, the IMF's board approved a three-year standby agreement for US$13.3 billion for Argentina. Three days after that, at the IMF's annual meeting in Dubai, Argentina proposed a debt restructuring plan with a nominal debt reduction of 75 percent of its US$81 billion sovereign debt owed to private creditors. Creditor groups immediately rejected this proposal.

2004: In January, Argentina-bondholder groups from around the world formed the Global Committee of Argentina Bondholders (GCAB), representing holders of approximately US$38 billion in bond principal claims, which is about 75 percent of the total principal amount of defaulted bonds held outside of Argentina. Bondholders consist of more than half-a-million retail investors, and more than 100 institutions, banks, partnerships, and committees. The GCAB has repeatedly proposed formal negotiations to Argentina, but has been unsuccessful up to now. On June 1, Argentina publicly declared that it would take steps to offer new bonds in exchange for defaulted debt in the near future. The government indicated that the exchange offer will mature in 30–42 years, with a nominal debt reduction of 75 percent. Argentina filed documents with the US Securities and Exchange Commission in June, which is a necessary procedure to launch an exchange offer later this year.

Argentina's actions are not considered to be working along the lines of the IMF policy on lending into arrears: first, the government has not made a good-faith effort to reach a collaborative agreement with creditors; second, the government has not shared with all creditors, information on assumptions affecting debt sustainability; and third, the government has not recognized the formation of a creditors' committee. Under the circumstances, only the IMF can take decisive action with the member government.

The following is a summary of the private sector's viewpoints with regard to the IMF's recent actions in connection with its standby to Argentina.

(1) IMF Standby and Argentina's Proposal

A question arises from the fact that Argentina announced a unilateral debt reduction proposal immediately after its agreement with the IMF on the standby agreement. What was discussed and agreed between Argentina and the IMF in reference to the private sector is not known. Argentina stated in its letter of intent addressed to the IMF (dated September 10, 2003), that the government believes that "collaborative dialogue with creditors and its commitment to treat all creditor groups in a fair and equitable manner will help to secure a high participation rate in the eventual restructuring." On the basis of a proper interpretation of the lending into arrears policy, private creditors expected that the IMF would agree to the standby when it appeared that Argentina would in good faith try to reach a collaborative agreement with its private creditors, but things did not move in that direction.

(2) IMF Board Approved the First Review

In the first review meeting in January this year, the IMF's board approved a disbursement of US$334 million under the standby agreement. This decision was made even though there was no prospect of negotiations commencing between Argentina and its creditors, which it had committed. If the policy on lending into arrears had been applied more strictly, the first review would not have been approved.

(3) Second and Third Reviews, and the Next Step

The second review was approved by the IMF's board in March, since Argentina had met the conditions under the standby agreement, and also had declared in its letter of intent addressed to the IMF that it would negotiate with private creditors (including GCAB).[5] The third review, originally scheduled to take place in June, was postponed until the end of this year because Argentina failed to meet such conditions as the primary budget surplus target for 2005 and because negotiations with private creditors had not been conducted despite Argentina's promises at the second review.

While the relationship between Argentina and the IMF is at a delicate stage, IMF managing director, Rodrigo de Rato, met President Kirchner in Buenos Aires on August 31, 2004. According to the IMF's press release, Mr. Rato stated that, to attract new investments necessary to sustain growth and reduce poverty for the benefit of all its citizens, "there are two particularly important and inter-twined elements: the completion

[5] "The authorities have indicated their willingness to negotiate with private creditors with the aim of reaching a collaborative agreement. They have committed to meaningful negotiations with all representative creditor groups, including the GCAB." (IMF Argentina Second Review Under the Stand-by Arrangement and Requests for Modification and Waiver of Performance Criteria, March 12, 2004.)

of a comprehensive, sustainable restructuring of Argentina's sovereign debt to private creditors, and a supporting medium-term fiscal framework." These are legitimate requests by the IMF to a member government. The press reported that Mr. Rato touched upon the question of the acceptance rate by private creditors necessary for a successful exchange offer. This will become a significant issue if Argentina launches an exchange offer in the near future.

5. Conclusion

As emerging-market economies grow faster than advanced economies, their borrowing requirements will remain strong. As financial globalization deepens, private capital flows will continue to grow, while net official flows will continue to dwindle. Sovereign debtors of emerging market economies will continue to depend upon international capital markets for the resources needed to finance domestic projects. Under the circumstances, it is important to strengthen the international financial system for emerging-market economies, particularly in crisis prevention and resolution.

From the private creditors' perspective, three points are essential to resolve a financial crisis in a member country. First, there must be a strong IMF package for the member, supported by the IMF's surveillance and conditionality under an IMF standby agreement. Second, to resolve the external debt issue, timely and constructive negotiations between the debtor and its creditors (or a steering committee representing them) are essential. Third, in order for the restructuring package agreed between the debtor and a representative of creditors to be successful, it must be approved by a large majority of its creditors.

For these three points to work, two foundations need to be in place. First, timely, transparent information on emerging-market economies needs to be disseminated to creditors. Second, the IMF must develop comprehensive guiding principles by expanding the current lending into arrears policy to help promote orderly, expeditious sovereign debt restructuring. In this respect, the IMF should conduct three-way discussions between member governments, representative creditors and itself. The guiding principles should be market-oriented, but discussions conducted on the SDRM in March 2002, and on the subsequent code of conduct, will provide a useful basis for further discussions.

As an international financial institution, the IMF maintains a neutral stance to its members and its private creditors. In this capacity, it should closely monitor and actively participate in a member's restructuring negotiation process and, when necessary, take decisive action based upon the guidelines set forth by it, to achieve its ultimate objective of maintaining international financial stability.

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