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Lessons from Argentine crisis

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As Argentina's soccer hero Lionel Messi sent his fellow countrymen into rapturous heights, an American Supreme Court's decision plunged the country into abysmal depth of a debt crisis.

On June 17, a US Supreme Court judge rejected Argentina's appeal against a lower court decision and ordered payment of US\$1.3 billion, the full value of bonds of to the US based creditors. The decision was the culmination of a ten-year legal battle against the "hold-out creditors", who rejected the re-structuring terms and conditions of the defaulted loan repayment in 2002.

Argentina's President Cristina Fernandez de Kirchner described the creditors as vultures. She however had to put up a brave show as Argentina was marching from one victory to another in Brazil. She announced that she would not negotiate with the hold-out creditors wanting their full pound of flesh.

A worried IMF

Everyone, however, was aware of a likely major disaster, waiting to happen. If the court order is carried through, Argentina will have no funds to meet the June 30 installment due to be paid to those who had accepted restructuring terms.

The International Monetary Fund (IMF) is worried that failure to honor the US legal order would have "broader systemic implications". The IMF concern is the US Supreme Court decision would act as a precedent and it would encourage more US creditors to hold out in future restructurings of any sovereign debt. The IMF has been involved in similar restructuring of loans to countries which are currently in trouble.

Promptly, Standard and Poor's (S&P) cut the Argentina's credit rating by two notches from "CCC+" to "CCC-". Already, Argentina is unable to raise funds on the international market since its 2001-02 debt default.

The rating agency's latest cut is the unkindest cut of all: the "limited capacity to pay the plaintiff creditors while servicing its current debt".

No stranger to debt crisis

Argentina, South America's third-largest economy (population: 41 million; GDP: US\$484.6 billion; and GDP per capita US\$18,608), has the dubious distinction of committing the biggest debt default in world history.

Argentina had a checkered past with dictatorships and democracy alternating during the last century. Although some order was restored in the late 1990s, persistent excessive fiscal spending, inflation, capital outflows and corruption contributed to unprecedented growth in public debt, most of which was held by foreigners. The IMF helped to rescue the economy with loans. As Argentina failed to service the debt, IMF extended payment schedules as well.

The crisis got intensified when the IMF refused in late December 2001 to release part of a loan, citing Argentina's failure to reach previously agreed-upon budget deficit targets. Argentina faced biggest default of all times: US\$100 billion. External debt reached the peak: 143 percent of GDP.

Restructuring of defaulted loans took place to save Argentina from disaster. About 8 percent of the US based creditors/hedge funds refused to accept the terms. The other 92 percent holding the defaulted debt agreed to write off two-thirds of their pre-crisis value. The write-off gave breathing time to Argentina.

Thanks to farm exports of wheat and soya beans in the next few years, Argentina paid back US\$150 billion to its creditors. The debt level fell: 40 percent of GDP.

Pacific situation

Among Pacific island countries (PICs), Marshall Islands (external debt: 120 percent of GDP) has been graded as "high risk" by multilateral lending agencies including Asian Development Bank (ADB). Two PICs are rated as medium risk: Samoa (66 percent) and Tonga (41 percent). None of the PICs except Fiji is exposed in any significant degree to overseas private sector creditors

Fiji's external debt level is less than 20 percent of GDP. It is not eligible for concessional loans from World Bank and ADB. Due to increasing exposure to overseas private sector loans, ratio of multilateral loans to external debt declined: from 47 percent in 2005 to 18.4 percent in 2012.

For avoiding loans with conditionalities from IMF and ADB, Fiji resorted to issuing international bonds: first in 2006 for US\$150 million and the second in 2011 for US\$250 million. The overseas private sector institutions are dominant creditors. After fully meeting its obligations for the first bond issue, Fiji is currently meeting the interest obligations for the second one.

The latest news is Argentina has asked US judge to issue a stay of his ruling against the country as it seeks to negotiate the hedge funds. That is the only way out.

The lesson for PICs is clear. Borrowing in the international market is not free from risks. All private lenders, overseas or domestic, are motivated by greed.