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Changing Rules of the Game of Global Finance: Glimpses from a Sovereign Debt Restructuring Episode

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Abstract:

Sovereign debt restructuring refers to debt workout procedures for sovereigns which involve reduction in the nominal value of the old debt instruments when the debt burden of a country becomes unsustainable. Debt restructuring is required in any debtor-creditor relationship since any financial contract has to take the possibility of default into account. As far as corporations are concerned, the idea that the debt burden of the corporations may become unsustainable and in which case it may require restructuring is not new. Corporations in the US have access to legal remedies if they want to restructure their debts or go for liquidation. But when it comes to sovereigns, the international financial architecture lacks any mechanism to take care of the "debt overhang" of sovereigns.

Literature in this area has tried to model the incentives which would lead the sovereign debtor towards repayment. The two main incentives are direct punishments (such as trade embargoes) and reputation concerns (fear of loss of access to international capital markets). The basic assumption in all these models is that creditors only have limited powers to enforce repayments since the sovereign debtor cannot be ordered to repay by the courts of the creditors' country of origin because of the sovereign immunity laws. The focus of this paper is on the recently concluded Argentine debt restructuring where the sovereign debtor was forced to make repayments to the "vulture funds" after an order for repayment was passed by the US courts, thus making the assumption of non-enforceability of sovereign debt untenable. This is a real threat because 70% of the sovereign bond documentation is under the US law at present and many debt restructuring exercises are on in countries around the globe.

The paper also looks at two different sovereign debt crisis resolution episodes from history – the first one is the Barings' Crisis of 1890 when Britain was the centre of international finance and the other episode is from the inter-war period when USA had overtaken Britain. The attempt is to see if history has some lessons to offer for an orderly debt workout.

Keywords: debt overhang, default, sovereign debt restructuring, repayment, vulture funds.

1.1: Introduction

Sovereign debt restructuring refers to debt workout procedures for sovereigns which involve reduction in the face (nominal) value of the old debt instruments when the debt burden of a country becomes unsustainable. A restructuring of debt is done through an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a legal process. It is not the same as debt rescheduling which implies lengthening of maturities of the old debt. Debt restructuring is required in any debtor-creditor relationship since any financial contract has to take the possibility of default into account. If banks were to know that all money which they have lent were to come back to them for sure, then the whole theory of asymmetric information which is a part of many models of monetary economics would become irrelevant. As far as corporations are concerned, the idea that the debt burden of the corporations may become unsustainable and in which case they may require a restructuring is not new. Corporations in the US do have access to Chapter 11 of the US Bankruptcy code if they want to restructure their debts. They can also liquidate their firms by taking the aid of Chapter 7 in the same code. But when it comes to sovereigns, the international financial architecture lacks any mechanism to take care of the 'debt overhang' of sovereigns (Krugman, 1988) though the idea of an international law for governing sovereign debt is centuries old : *"When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor"* (Smith, 1776).

Early literature in the area tried to model the incentives which would lead the sovereign debtor towards repayment (Eaton and Gersowitz, 1981; Eaton, Gersowitz and Stiglitz, 1986). The two major mechanisms identified in the literature which would lead sovereign debtors towards repayment were direct punishments (such as trade embargoes) and reputational concerns ("willingness to pay" defaults could lead to loss of access to international capital markets) (Bulow and Rogoff, 1989; Eaton and Fernandez, 1995). **The basic assumption in all these models was that creditors only have limited powers to *enforce* repayments since the sovereign debtor could not be ordered to repay by the courts of the country of origin of the creditors because of the sovereign immunity laws.** The assumption persists even in the recent literature - "The defining feature of sovereign debt is the limited mechanisms for enforcement" (Aguiar and Amador, 2013).So, according to the theoretical literature the "binding constraint on debt repayments" would be "willingness to pay" of the sovereign

debtor and not its "ability to pay" (Eaton and Gersowitz, 1981). Sovereign debt crisis resolution in developing countries became difficult after some major institutional changes which took place in the 1990's. Firstly, a process of financial disintermediation was in place after the advent of the Brady bonds from the early 1990's onwards. So, countries moved mostly from bank finance to bond finance as their preferred source. This increased the volatility in the emerging markets as the structure of the bonds markets may become dispersed (Argentina is a case in point) so much so that it becomes difficult to identify the lender. Secondly, from the 1990's onwards, the developing countries also saw a surge in capital inflows which was unrelated to their current needs of trade and investment. There were also changes in the sovereign immunity laws in the US and UK in the late 1970's. The sovereigns do not enjoy absolute immunity from litigation attempts by their commercial creditors in the US as they did earlier in history. Also, the problem of debt restructuring no more remained a problem of a debtor-creditor negotiation. It became an inter-creditor negotiation issue.

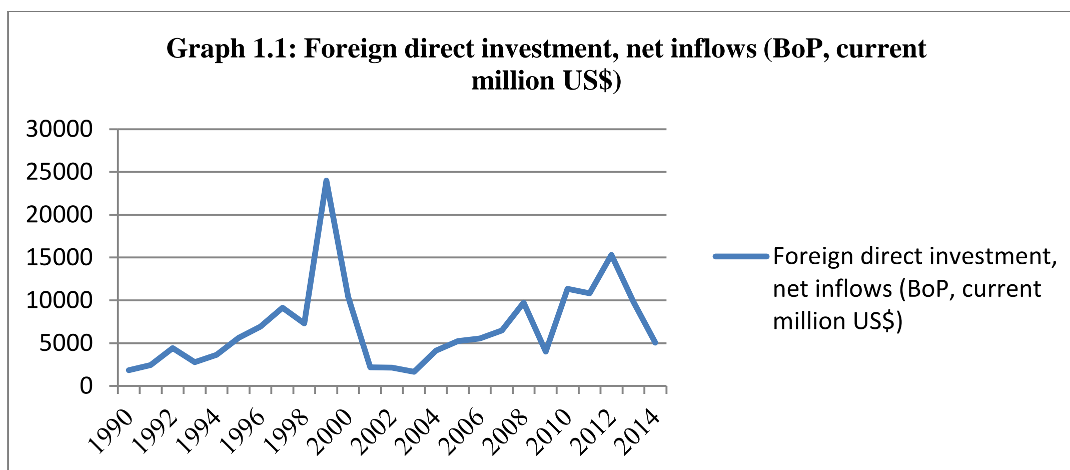
I have tried to study the Argentine episode at greater length focussing mainly on the judicial interpretation of the infamous "pari passu" clause which sounded the death knell for an orderly debt workout in Argentina. I shall also look at what economic implications this decision has for future restructurings given the fact that the viability of some of the key assumptions of the theoretical models is in question now. I would also go back into history to see how sovereign debt crises were resolved *then* and would try to answer the following question – Can history guide us towards a "good faith" and orderly debt workout? I look at two different episodes from history under two different hegemonic regimes – the first one is the Barings' Crisis of 1890 when Britain was the centre of international finance and the other episode is from the inter-war period when America had taken over the role of the hegemon after the demise of the gold standard era.

1.2: Argentina's Attempts at Debt Restructuring

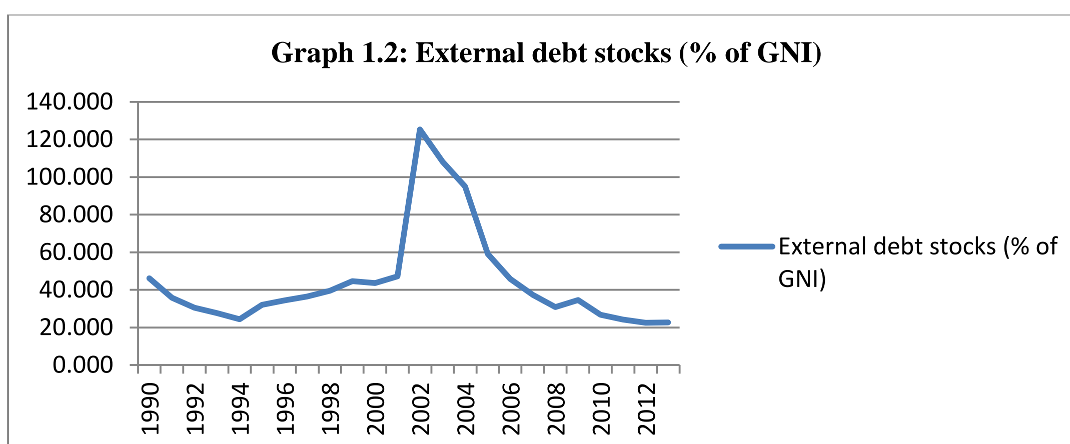
Argentina resorted to a hard currency peg (a currency board arrangement) in 1991 to solve the inflation problem. The currency board arrangement was an extreme form of a fixed exchange rate regime wherein the country adopted "an explicit legislative commitment" to fix the nominal exchange rate at a certain parity with the US dollar (1 peso = 1 US dollar). The Central Bank of the country was permitted to issue the domestic currency only on the condition that it was backed by an equivalent purchase of US dollars (Frenkel and Rapetti,

2010). The name "convertibility" was earned because pesos could be exchanged for dollars one-to-one with the backing of the legislature. The idea was that such a hard currency peg would reduce the future inflationary expectations of the agents in the economy and would make the actions of the government sound more credible. What the convertibility programme did in effect was to make the imbalances in the balance of payments adjust through output and employment changes rather than through changes in prices. This was because any addition to the foreign exchange reserves had to be balanced by an equal expansion of the monetary base of the economy and that led to an increase in output and employment. Similarly, any contraction of the foreign exchange reserves had to be balanced by an equal contraction of the monetary base that led to a reduction in the output and employment in the economy (Frenkel and Rapetti, 2010).

The convertibility programme was able to instil confidence among the market participants and the inflationary expectations in the economy went down. This led to a drastic decline in the inflation rate in the economy in the 1990s. The country attracted huge inflows of capital after the convertibility programme was implemented (Graph 1.1) and this swelled the foreign exchange reserves of the country. There were three important reasons for this surge in the capital inflows into the country – a decrease in the interest rates in the US in the early 1990s, the increase in price stability in the country after the adoption of the convertibility programme and the incentives given to the private investors by the large scale deregulation of the economy under the convertibility programme. The increase in the capital inflows led to a surge in liquidity in the economy. This caused a reduction in the interest rates that led to a rise in the aggregate demand and employment in the economy. The expansion of aggregate demand led to an increase in the prices of non-tradables that caused a real exchange rate appreciation. The real exchange rate might also have appreciated due to the presence of inertial inflation. The inertia in inflation arose due to the indexation of wage contracts and the indexation of many non-tradables like housing rents, school fees and mortgage payments (Frenkel and Rapetti, 2010). These led to the worsening of the current account balance which, in turn, increased the need for external financing that further boosted the accumulation of debts in the economy in the latter half of the 1990s (Graph 1.2).



Source: World Development Indicators, World Bank.



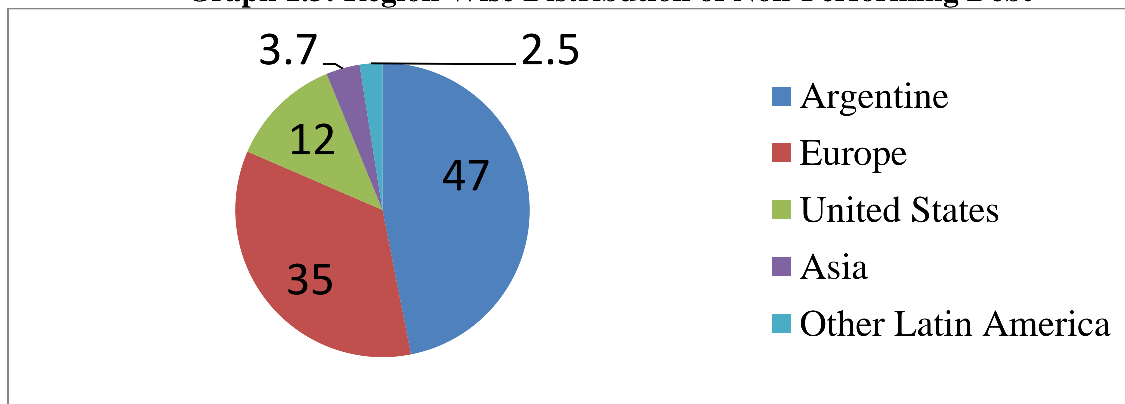
Source: International Debt Statistics, World Bank.

The rise in external indebtedness significantly increased the fragility of the economy. This led to a weakening of the credibility in the economy's management of the exchange rate system. The risk premium rose with the increase in the probability of an exchange rate devaluation causing a rise in the domestic interest rate. The economy thus became vulnerable to speculative attacks against its currency and faced a banking and currency crisis after two exogenous shocks in the late 1990s – the Asian and the Russian crisis. The country eventually defaulted on its external debt in 2001. The period of "euphoria" had added significantly to the debt burden of Argentina and most of that debt was held in the hands of the public sector.

There was no doubt in the fact that such a large debt burden was unsustainable and sooner or later it would require a restructuring. Unfortunately, the restructuring exercise could not take place pre-emptively. This debt stock was later restructured in 2005 and 2010 after Argentina defaulted on payments that were due to its private foreign creditors. The Kirchner government that came to power in 2003 decided to save the resources of the country from being wasted on servicing debt and utilise the savings on increased social sector spending.

Restructuring of debt in Argentina was not a simple exercise due to two important reasons-first, because the government had issued 152 bonds denominated in 7 currencies and governed by multiple jurisdictions by the time of the default (Thornbeck, 2004) which made the negotiation process extremely difficult and second, because the domestic banks in Argentina were holding a lot of the government issued bonds as their assets. Any decline in the face value of such bonds could destroy the intermediation channels in Argentina. The region wise distribution of non-performing debt which was to be restructured in 2005 was as follows-

Graph 1.3: Region Wise Distribution of Non-Performing Debt



Source: Hornbeck, 2004.

The majority of the debt which was to be restructured in 2005 and later on in 2010 was held by domestic creditors (Graph 1.3). This consisted of common people of Argentina, the pension fund holders and other retail investors who had invested their lives' savings in buying their country's bonds which are considered to be the most risk free asset in any country. The next big segment of bondholders consisted of European (majorly Italian) retail investors who were again investors with marginal savings. An IMF study puts the number of retail investors affected in the 2005 restructuring exercise to be around 6,00,000 -4,50,000 Italians, 35,000 Japanese and 1,50,000 Germans and Central Europeans (Das, Papaioannou and Trebesch, IMF Working Paper,2012). It is interesting to note here that the major threat to this restructuring exercise came eventually from the minority of the bondholders (holdouts from the United States). The attempt at restructurings both in 2005 and 2010 were aimed at bilaterally negotiating with the private creditors in "good faith" in the hope that there would not be any holdouts; but this was not to happen. The details of the restructuring exercise for 2005 are as follows-

Post-default restructuring: 66 US$ and Ar peso denominated bonds exchanged for 5 US$ and Ar peso denominated bonds.

Total Duration: 42 months

Haircut: 76.8 %

Participation Rate: 76% (others were holdouts who litigated)

Creditor Structure: Dispersed

(Source: Das, Papaioannou and Trebesch, IMF Working Paper, 2012).

There were many novel features in the debt swap agreement of the 2005 restructuring. The debt restructuring which was being done under the Peronist government of Nestor Kirchner came down heavily on the practice of capitalizing past due interest and increasing the overall debt burden. So, the deal included the provision that Argentina would not recognise the past due interest for the period between December 2001 and December 2003 (Sturzenegger and Zettelmeyer, 2006). The other interesting part of the deal was that the newly restructured bonds were GDP linked which means interest payments on these bonds would be conditional on the growth of the economy. The conditions were the following – "GDP had to be higher than the stipulated trend; growth in the previous year had to be larger than 3 percent; and the total payments made by the facility could never be larger than 48 cents on the dollar" (Sturzenegger and Zettelmeyer, 2006). The agreement also carried a stick feature – the Kirchner government passed a new law – the *Ley Cerrojo* (The "Lock Law"). This law forbade the government from reopening any additional exchanges in the future for the bondholders who refuse to abide by the 2005 terms of the exchange. This was also the first debt restructuring exercise in Argentina which had made use of the collective action clauses[1] (CAC's). The use of CAC's in the US law was permitted after 2003 when they were used by Mexico for the first time. After the restructuring exercise in 2005, the Argentine government took another historic step by making the debt renegotiation process completely bilateral – it cleared all its IMF dues and made its restructuring deal free from IMF surveillance. The IMF program was suspended in August 2004 and full payment was made on IMF dues in 2006.

The 2010 debt restructuring exercise was an attempt by the Cristina Kirchner government to carry forward the process of honouring the sovereign debtor's payment commitments which

[1] These are clauses which are added in a debt contract. In the event of a need for a debt restructuring, these clauses kick in as follows- If 75 % of the creditors have agreed for a restructuring of the debt burden of the sovereign debtor, the minority creditors are also roped in irrespective of their wishes.

was started in 2005. The Cristina Kirchner government had to repeal the Lock Law which it had enacted in 2005 to enable another debt swap in 2010. The main reason behind opening another debt swap was that the government wanted to rope in the holdouts to avoid the much litigation which had started coming up after 2005 in courts across the globe against Argentina. The terms of agreement which were offered in the 2010 debt swap were almost same as that in 2005. This was due to a law which the Argentine government had passed in 2009 – the RUFO clause. The RUFO (Rights upon Future Offers) clause barred the government from giving bondholders who had filed lawsuits any favourable treatment than what was offered to those who have not done so. This law were to have important implications later for Argentina in 2014. The result of the debt swap was encouraging since it did rope in some holdouts and the participation rate for both 2005 and 2010 exchange combined came out to be 91.3%. The minority creditors who still did not agree to abide by the terms of the agreement were majorly hedge funds who had deep pockets and could fight cases against what they called the "rogue debtor". This can be clearly observed from the details about the participation in the debt swap as mentioned in the table below –

Table 1.1: Participation in the 2010 Debt Swap

	Participants	Non-Participants	Total
Main non-litigants	8.6	0.0	8.6
Italian Retail Investors	3.3	1.0	4.3
Litigants (Hedge funds)	0.0	4.4	4.4
Others	0.5	0.6	1.1
Total	12.4	6.0	18.4

Source: Hornbeck, 2013. All figures are in US billion $.

The hedge funds who owned 4.4 billion $ of Argentine bonds were the major non-participants in the 2010 debt swap. A group of hedge funds in America had formed an organisation in the early 2000's to advance their interests. This group was known as American Task Force Argentina (ATFA). NML, a Cayman-islands based subsidiary of Elliot Funds Limited was a major force behind this grouping. Paul Singer owns Elliot Funds and using his political clout among the Republicans in the US, the ATFA spent around 6.7

million US $ in lobbying from 2007 to June 2015 (Source: Embassy of Argentina in the United States). All kinds of arm twisting measures have been tried against Argentina by these hedge funds throughout the restructuring period and even after that - ranging from seizing Argentinian assets in the central bank, capturing a ship on foreign soil and attempting to capture the President's plane. These actions were *eerie* reminders to the world of the days of 'gunboat diplomacy'. Imperialism reached an unrivalled ferocity after the US court's eventual decision in favour of the hedge funds on which I shall focus now.

1.3: The Litigation and the "Pari Passu" Clause

NML Capital Ltd. was the frontrunner in litigating against Argentina in US courts. The example which it set was then followed by other creditors so much so that the debt restructuring exercise became what in the literature is called "rush to the courthouse" (Sturzenegger and Zettelmeyer, 2006). The main plaintiff NML's case was heard in the United States District Court (Southern District of New York) by Judge Thomas Griesa. Judge Griesa gave a series of judgements on matters related to the debt restructuring exercise of Argentina but the most remarkable judgement was the one given in November 2012 when Judge Griesa very creatively used the "pari passu" clause (which was present in the agreement of the bonds issued to the holdout creditors) to aid the plaintiffs. This judgement was a landmark judgement which thwarted all the work which had gone into gaining international support for a sovereign bankruptcy regime. I shall look into the judicial interpretation of this clause in greater detail now.

"Pari passu" is a Latin phrase which means 'equal footing'. In 1994, the bonds were issued by the Fiscal Agency Agreement (FAA) in Argentina with the agreement containing this clause. The agreement read as follows – "The Securities will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness . . ." (*NML Capital,Ltd.v. The Republic of Argentina*, No. 12-105 (2d Cir. 2012))

The initial ruling by Judge Griesa's court was upheld by the Court of Appeals for the Second Circuit. The Court of Appeals observed that " ..the combination of Argentina's executive declarations and legislative enactments have ensured that plaintiffs' beneficial interests do *not* remain direct, unconditional, unsecured and unsubordinated obligations of the Republic

and that any claims that may arise from the Republic's restructured debt *do* have priority in Argentinian courts over claims arising out of the Republic's unstructured debt. Thus we have little difficulty concluding that Argentina breached the *pari passu* Clause of the FAA" (*NML Capital,Ltd.v. The Republic of Argentina*, No. 12-105 (2d Cir. 2012)). This ruling certainly overlooked the facts of the matter in the case because the restructured bondholders had taken deep haircuts to get "priority" over claims compared to other unstructured creditors. There was no mention of this fact in the judgement of the Court of Appeals. After getting approval from the Court of Appeals regarding the breach of the "pari passu" clause, the task was left for Judge Griesa's court to decide appropriate punishment for the "rogue debtor" and also to explain the terms of payments to the bondholders. Judge Griesa awarded an injunction to the Republic of Argentina in the case and ruled that "The Republic accordingly is permanently ORDERED to specifically perform its obligations to NML under Paragraph 1(c) of the FAA as follows:

Whenever the Republic pays any amount due under terms of the bonds or other obligations issued pursuant to the Republic's 2005 or 2010 Exchange Offers, or any subsequent exchange of or substitution for the 2005 and 2010 Exchange Offers that may occur in the future (collectively, the "Exchange Bonds"), the Republic shall concurrently or in advance make a "Ratable Payment" (as defined below) to NML." (*NML Capital, LTD., v. Republic of Argentina*, United States District Court, Southern District of New York). The court explained the idea of "Ratable Payment" as follows – "if 100% of what is currently due to the exchange bondholders *is paid*, then 100% of what is currently due to plaintiffs must also be paid" (*NML Capital, LTD., v. Republic of Argentina*, United States District Court, Southern District of New York).

Although the breach of the "pari passu" clause does not merit an injunction, Judge Griesa had his own reasons for ordering an injunction. As he said in the ruling – "In accepting the exchange offers of thirty cents on the dollar, the exchange bondholders bargained for certainty and the avoidance of the burden and risk of litigating their rights on the FAA Bonds. However, they knew full well that other owners of FAA Bonds were seeking to obtain full payment of the amounts due on such bonds through persisting in the litigation. Indeed, the exchange bondholders were able to watch year after year while plaintiffs in the litigation pursued methods of recovery against Argentina which were largely unsuccessful. However, decisions have now been handed down by the District Court and the Court of Appeals based on the *Pari Passu* Clause, which give promise of providing plaintiffs with full recovery of the

amounts due to them on their FAA Bonds. This is hardly an injustice. The exchange bondholders made the choice not to pursue the route which plaintiffs have pursued". This is a very narrow reading of the contract given the fact that the exchange bondholders did not choose the route of litigation because they did not have deep pockets like the hedge fund NML. The restructured bondholders, as I have already shown earlier, consisted of common people like the Argentine pension holders and the small retail investors in Italy who did not have the financial wherewithal to pursue litigation in US courts. Although this judgement might sound a narrow reading of the contract, it fits in well within the established principles of jurisprudence under the New York Law. In an earlier case arguing about the interpretation of the acceleration clause in FAA bonds in 2004, The Court of Appeals had observed that "In New York, a bond is a contract …. Thus the parties' dispute over the meaning of the Equal Treatment Provision presents a "simple question of contract interpretation."." (*EM Ltd. v. Republic of Argentina*, 382 F.3d 291,292 (2d Cir. 2004)).

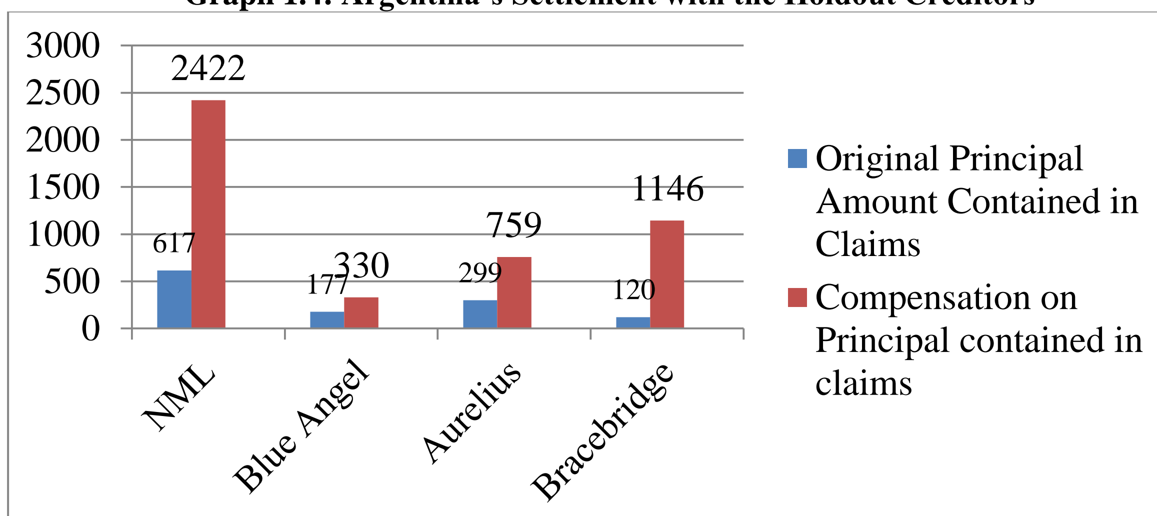
This order also had the power to impair the system of financial intermediation since the third parties were prohibited by this order to make payments to the restructured bondholders on behalf of Argentina. In the initial ruling of November 2012, only those third parties who were making payments to restructured bondholders with bonds issued under New York Law jurisdiction were included. Argentina used to make its payments to its US creditors who had agreed to the debt restructuring through the Bank of New York Mellon (BNY) which was the indenture trustee (financial intermediary). Judge Griesa observed in his ruling that "It goes without saying that if Argentina is able to make the payments on the Exchange Bonds without making the payments to plaintiffs, the District Court and Court of Appeals' rulings and the Injunctions will be entirely for naught. To avoid this, it is necessary that the process for making payments on the Exchange Bonds be covered by the Injunctions, and that the parties participating in that process be so covered" (*NML Capital, LTD., v. Republic of Argentina*, United States District Court, Southern District of New York). All through the litigation period, Argentina had refused to bow down to the pressures of the US courts and make payments to the holdouts. The government of Argentina was under the expectation that it would finally win the case in an upper level court in the US because it thought that these interpretations of the district court were violations of the sovereign immunity which Argentina enjoyed. Even after the BNY was barred from making payments to Argentina's US creditors, the government of Argentina held its fort and decided to focus on other sources of finance since the country anyway had lost access to international capital markets after the

December 2001 default. The country started issuing more bonds under the Argentine jurisdiction so as to have a less volatile source of financing at hand. This attempt by the Argentine government to save itself from the judgements of the US courts (by not making payments to the holdouts) and still keep itself current on its payment commitments got a death blow after it lost its case in the US Supreme Court in June 2014. The US Supreme court denied a *writ of certiorari*[2] and denied Argentina's claim that the judgement transgressed sovereign immunity. FSIA (Foreign Sovereign Immunities Act) 1976 had already weakened such immunity. There are two kinds of sovereign immunity- "jurisdictional" and "execution". The court held that "The first, jurisdictional immunity was waived here. The second, execution immunity, generally shields "property in the United States of a foreign state" from attachment, arrest and execution. The Act[3] has no third provision forbidding or limiting discovery in aid of execution of a foreign-sovereign judgment debtor's assets" (*Republic of Argentina v. NML Capital , Ltd.* ,Certiorari to the United States Court of Appeals for the Second Circuit, Supreme Court of the United States). This vindicated the stand of the US district court and it was now ready to cross every jurisdiction to make sure that its orders are held. Since Argentina was adamant that it would not pay the 'vulture funds', Citibank which is into custody business for dollar denominated bonds issued under the Argentine jurisdiction was asked to stop making payments to the restructured bondholders by Judge Griesa on July 28th 2014. This led Argentina to another default on payments due on 30th July 2014 since it could not violate the RUFO clause and the hands of the financial intermediary Citibank were tied by the court's orders. Citibank appealed again in the district court requesting that it be allowed to resume its duties (that of an intermediary) citing sanction by Argentine government as the reason. To this, Judge Griesa replied in another judgment on 12th March 2015 that "By observing the injunction, Citibank asserts that it risks sanction in Argentina. However, if Citibank processes payments on exchange bonds, it violates the Injunction issued by this court. Neither option is appealing. But if Citibank's predicament is a matter of comity, it is only because the Republic has refused to observe the judgments of the court to whose jurisdiction it acceded. Comity does not suggest abrogating those judgments, or creating exceptions to the Injunction designed to enforce them. Rather, comity suggests that the Republic not penalize third parties, like Citibank, who *must* observe the orders of United States courts" (*NML CAPITAL, LTD. v. THE REPUBLIC OF ARGENTINA,* United States District Court, Southern District of New York; 12th March 2015). Argentina had explored the

[2] A writ seeking judicial review.
[3] The Act here refers to the FSIA, 1976.

possibility of issuing bonds to its restructured bondholders in its own jurisdiction but the "original sin" problem had played its role. Although the bonds were issued under the Argentine jurisdiction, the currency denomination of most of the bonds remained US dollars and the US court decision made full use of this lacuna to hold Argentina accountable in this case. Between June and October 2015, Judge Griesa granted the "ME TOO" injunctions to 49 more plaintiffs so that even they could seek legal aid under the "*pari passu"* clause (Rule 62.1 Indicative Ruling, S.D.N.Y., February 2016). The change of government in Argentina in December 2015 vindicated the stand of the US courts even further because the new government under the stewardship of Mauricio Macri settled with the holdouts. The injunction which was applied in 2012 was removed by Judge Griesa and Argentina is now free to pay everybody including the holdouts. The Argentine Congress has also ratified the proposal in the end of March 2016 and in the first round, Argentina has agreed to settle with four of the "holdouts" for the following sums as shown by the graph below. The important point here is that these holdouts had not even bought these securities at their original face values. They had hedged and bought the securities at deep discounts – NML for example, had bought the bonds at around 177 million $ and were now asking for full face value, full past due interest and also legal fees which they had to incur during the litigation process. Graph 1.4 shows the compensation on principal which the 4 holdouts with whom the Republic of Argentina has agreed to settle would receive –

Graph 1.4: Argentina's Settlement with the Holdout Creditors



Source: Data filed in the court on 29th Feb 2016 by the Under Secretary of Finance, Argentina. All figures are in US million $.

This settlement of Argentina with the ‘vulture funds’[4] which bought its debt at heavily discounted prices and are now being paid in full the face value of their bonds has brought the idea of sovereign debt restructuring in “good faith” (Brookings report on Revisiting Sovereign Bankruptcy, 2013) under serious threat. This agreement with the hedge funds has set a very wrong precedent for restructuring attempts in the future. It would be extremely difficult to have a binding agreement with the creditors who were ready before this episode to renegotiate their contracts in “good faith” with the sovereign debtor unlike the holdouts (which includes hedge funds who buy emerging market debt for speculative purposes). The idea of collective action clauses (CAC’s) will take a beating in the future. The most important fallout of this deal in Argentina for economic theory is the following - **Sovereign debt no more remains *unenforceable*; creditors can force a sovereign debtor to pay off its debts**. The most important assumption of the theoretical models of the 1980’s stands shaken to the core.

1.4: Looking Back: Was History *Any* Better?

It is instructive to look back at history and see whether it has some lessons to offer. I am looking at the terms on which Argentine debt was restructured after the Barings’ crisis of 1890. This way of looking at history is not entirely novel. Economists have drawn an analogy between the Barings’ crisis and the tequila crisis of 1995 (Eichengreen, 1999). Some have also looked at quantitative easing in the US through the “prism of the Barings’ crisis” (Vasudevan, 2014). But the comparison of the debt restructuring “then” and “now” for Argentina has hitherto remained unexplored although the Barings episode in general has been looked at before (Fishlow in Eichengreen and Lindert, 1989). Latin American countries in general have had a long association with the international capital markets dating back to the Gold Standard era when the capital markets were as thriving as they were in the 1990’s. Argentina saw a similar wave of liquidity flowing in the 1880’s as it saw in the 1990’s. There were striking similarities between these two decades separated by a century. There were low interest rates prevailing in the *core*[5] in the 1880’s and the early 1990’s which facilitated huge capital inflows into the *periphery* Argentina. During both of these decades, Argentinian economy was working on more or less fixed exchange rate systems (the gold standard from the early 1880’s and the convertibility programme from 1991) and the “euphoria”

[4] A term used by Former Argentine President Cristina Kirchner to refer to the hedge funds who refused to participate in the restructuring process.
[5] Britain constituted the core in the 1880’s while the fulcrum shifted to the United States after the Great Depression.

(Kindleberger, 1978) in both was succeeded by "sudden stop" (Dornbusch, Goldfajn and Valdes, 1995).

The Baring Brothers (richest merchant bankers of the time in Britain) had invested heavily in Argentina in the 1880's and the shock came in 1888 when Barings failed to float a bond (Buenos Aires Drainage and Waterworks Company bond). Argentina was unable to pay and its GDP fell by 11 % between 1890 and 1891. Like the Lehman Brothers case, the "too big to fail" theory was put forth to save the Barings' Brothers. This was unusual since governments in the gold standard era had an "ambivalent attitude" towards intervention in the creditor-debtor negotiations. Some economists in the past have also argued that lesser intervention by the governments and national banks were the reason for the default clusters in the late 19th century (Eichengreen and Portes in Eichengreen and Lindert, 1989). Although intervention to save Barings' brothers was an exception rather than a rule in those times, the case itself is interesting to explore for its ramifications. The liquidation of the Baring brothers required that its assets be in a "marketable" state and since most of its assets were Argentine securities, the panacea to the Barings' crisis was a recovery of the Argentine economy so that repayment on its debt could start again. A committee was set up under Lord Rothschild who was also a merchant banker in England to suggest solutions for Argentina's debt overhang. The committee thought of three solutions –

1. Argentina should go for structural reforms and no finance should be extended till the time serious reforms have started.
2. Argentina should be pressurised for clearing its dues towards its creditors but at the same time, some sources of external finance should be kept open for the country.
3. A funding loan which is commensurate to Argentina's needs should be advanced to the country and the policy reforms should be pushed in the long term (Fishlow in Eichengreen and Lindert, 1989).

The first two solutions seen retrospectively from the vantage point of today seem to be two variants of austerity though with difference of degree. The first solution cited above is the harsher version of austerity while the second one is more like the Lending-in-Arrears policy of the IMF which envisages structural reforms in the future as the cost of emergency funding. It is heartening to note that the committee chose the third option and Argentina was lent money without being coaxed for immediate reforms in exchange. What followed next is even more surprising given the generally assumed antagonistic nature of the relationship between

the debtor and the creditor. The loan which was approved by the Rothschild Committee failed to improve situations much since the amount extended could cover only about a third of foreign exchange requirements for full debt service. Due to the failure of the above plan, a debt restructuring deal (The *Arreglo Romero*) was worked out in 1893 which had the following suggestions –

1. **"For 5 years till 1898, interest payments were to be reduced by an average of 30 per cent.**
2. **Amortisation[6] was to be suspended until the beginning of 1901." (Fishlow in Eichengreen and Portes, 1989).**

Creditors acceded to this demand and the Argentine economy saw a large influx of capital post restructuring – between 1901 and 1915, 47% of gross fixed investment was foreign financed (Diaz-Alejandro,1970).

I now shift my focus to the inter-war period[7] when major geo-political and institutional changes pertaining to sovereign debt renegotiations had taken place. After the First World War, US became the new centre of global finance after achieving a net creditor status. The role of US in deciding the direction of global capital flows became entrenched by the end of the Second World War. The US had used "gunboat diplomacy" to establish its supremacy at the dawn of the 20th century; by the time of the Great Depression it turned to the carrot policy of "dollar diplomacy". The major institutional change which had taken place is that creditor country governments had now started intervening in the creditor-debtor relationship on behalf of their creditors, though the extent was still small when compared to their actions today. Argentina was a "poster child" even during the inter-war period since it remained current on its repayment obligations while other sovereign debtors in its neighbourhood like Bolivia, Colombia, Chile and Peru around the same time had reneged on their payment commitments to their creditors. This can be seen clearly from the historical data which I have shown in Table 1.2 –

[6] Repayment of prinicipal loan.
[7] The period between the two world wars.

Table 1.2: Sovereign Borrowings and Repayments during the Inter-War period

1920	Total Borrowings (million US $)	Total Repayments (million US $)	Present value ratio
Argentina	258.59	323.12	1.25
Bolivia	49.13	26.32	0.54
Chile	178.12	99.25	0.56
Colombia	46.59	39.74	0.85
Peru	54.45	28.08	0.52

Source: Jorgenson and Sachs in Eichengreen and Lindert, 1989. The above figures are for the inter-war period and are discounted for 1920 year-end.

The present value ratio is the ratio of repayments to borrowings and as the above table shows, Argentina was the only country which was a faithful debtor in the region. All other countries considered here were "defaulters" during the inter-war period (Jorgenson and Sachs in Eichengreen and Lindert, 1989). There were economists who developed utility models on willingness to pay and one of their major assumptions in their models was that countries would pay because of the fear of "loss of reputation" (Eaton, 1981; Eaton, Gersowitz and Stiglitz, 1986). The evidence from Argentina from the inter-war period poses a serious threat to this assumption in their models. Although Argentina was a faithful debtor and conducted its negotiations in "good faith" with its creditors, it did not receive any prizes for preserving its "reputation" (Table 1.3) –

Table 1.3: 15-year averages of the ratio of external finance to exports

15 year averages of ratios of the following to exports for the period 1950-64	Govt.	Private	Official Transfers	Total (including direct investment)
Argentina	-0.473	5.0085	0.0431	9.1614
Bolivia	1.6654	2.8509	22.046	36.502
Chile	4.0817	2.7391	1.8566	13.792
Colombia	2.4770	3.7858	0.5367	8.0554
Peru	1.4958	5.9489	1.0589	15.685

Source: Jorgensen and Sachs in Eichengreen and Lindert, 1989.

Table 1.3 shows 15-year averages of the ratio of external finance (flowing through various sectors mentioned in the columns) to the exports of the countries for the period 1950-64. It explains the fact that after the effects of the Great Depression had started waning and the international lending exercise picked up post World War II, Argentina performed worse in attracting capital inflows compared to countries in its neighbourhood which were serial defaulters in the inter-war period. As far as inflows through official transfers in the post-war period are concerned, it was the worst performer; all countries in the region which are considered here were shown more generosity by official lenders. This can be seen from the above table as the "defaulters" have a higher ratio of official transfers to their exports than Argentina.

The lesson one learns from the historical experiences cited above is quite clear – though there can be no denial of the fact that the relationship between the debtor and the creditor is always antagonistic, there *were* possibilities by which the debt negotiation solution could be made amicable. What one observes is a gradual worsening of the policy alternatives available to a sovereign debtor who wants to show "willingness to pay" but not at the cost of starving its people. During the gold standard era, the intervention by the Central Bank of England on the part of Barings' Brothers was a rare instance. Creditor country governments would not resort to such intervention on the behalf of their creditors on a routine basis. And even after the intervention in the Barings' case, the solution was in the interests of the sovereign debtor. This got worse in the "dollar diplomacy" days of the inter-war period when interventions in the private creditor- sovereign debtor relation became contingent on the foreign policy of the major creditor nation of the world and the new linchpin of global finance – the United States. But even those days look brighter from the vantage point of today when the methods to protect the interests of the financial bourgeoisie have become 'systemic'; when the courts have crossed their jurisdictions to protect the hedge funds in the contemporary global economy. The worsening possibilities for a negotiation between the sovereign debtor and its creditors can have serious repercussions. The *Arreglo Romero* in 1890's was partly a result of the humiliation which Argentines faced at the hands of the Rothschild Committee and the Bank of England (when lesser funding was advanced to Argentina); the Peronist movement which came up in the early 1950's was in part a *xenophobic* backlash against the "continued debt servicing" by Argentina in the inter-war period (Jorgenson and Sachs in Eichengreen and Lindert, 1989) – time is ripe for another *xenophobia* after the government of Argentina succumbs to Judge Griesa's orders. There are protests on the streets of Buenos Aires. The

idea that repayment by the debtor is *sacred* would take a heavy toll on human lives. History, if anything, seems to be a translucent mirror. It has both good and bad lessons on offer but unfortunately only the bad lessons are able to peep through the passage of time and that too, with greater ferocity in the era of new imperialism.

1.5: Lessons for Other Developing Countries from This Episode

There are two important lessons on offer from the study of the Argentine case. The first one pertains to the factors leading to the onset of the crisis and the second relates to the crisis resolution strategies that Argentina employed. Argentina implemented a macroeconomic programme in the early 1990s that used fixed exchange rates as a nominal anchor to the runaway inflation in the economy. The commitment to this hard currency peg became difficult later because of the following logic - the capital inflows led to an overvaluation of the currency making the tradable goods sector less competitive on the world market. The worsened export capacity of the country led to a deterioration of the current account balance, which, in turn, led to an increased requirement for external financing. This increase in the external borrowing then raised concerns about the ability of the government to hold on to the fixed exchange rate regime. The rise in the country risk invited speculative attacks against the domestic currency and triggered a flight to other currencies like the US dollar (Frenkel and Rapetti, 2014). The banking and currency crisis that followed made it difficult for Argentina to service its debt burden and it eventually defaulted in 2001. The mechanism described above suggests that there are many imperfections that operate in the international capital markets and that the developing countries cannot be dependent on foreign capital inflows for their economic sustenance. So, a policy focussed only on price stabilisation and one that does not take into account the losses suffered by the tradable goods sector of the economy due to overvaluation of the currency might not be sustainable in the future. Developing countries need to maintain a stable and competitive real exchange rate to enjoy the benefits of opening up their economies. Many recent studies have shown that undervalued real exchange rates lead to stable long-term growth by keeping a check on the external debt accumulation and hence the case of “sudden stops” of capital flows to the economy is avoided (Prasad et al., 2007).

The second important lesson that the developing countries can learn from the Argentinean story is related to the crisis resolution strategies. Although the government of Argentina went in for bilateral debt renegotiations with its creditors in “good faith” without involving the

IMF, it still could not be successful in its attempt to restructure its debt burden. Although 92% of the creditors accepted the debt swap that took place twice in 2005 and 2010, some holdout creditors wrecked this deal having won the litigation in the US courts. This deal with the holdout creditors does not bode well for the sovereign debt contracts that are still under the jurisdiction of the US courts. The original sin problem was that "Countries cannot borrow abroad in their own currency" (Eichengreen, Hausmann and Panizza, 1999; 2003). This problem has now gone worse after the judgement given by Judge Griesa in which he narrowly read the "pari passu" clause. Even if 1% of the sovereign debt of a developing country is issued in a developed country jurisdiction like the US, it has the threat of foiling the restructuring deal that might have been accepted by the other 99% creditors (with whom the debt contract is not signed in the US jurisdiction). Sovereign debt was considered unenforceable in the literature before the Argentina episode happened. The idea was that sovereign debtors cannot be forced to repay by their creditors by legal means. The threat now for other developing countries that have issued sovereign debt under the US jurisdiction is that sovereign debt might not be unenforceable anymore. They can be dragged to courts in the US if the holdout creditors wish to do so and the developing country debtors might end up paying the full amount due to the holdout creditors. As the historical evidence presented in this chapter shows, the global financial architecture has gradually worsened over time as far as the treatment of debtors in any sovereign debt contract is concerned.

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