B Brief

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ARGENTINA: HOLDING UP AFTER HOLDING OUT

by Samuel George

The single seat at the press conference said it all. Argentine Finance Minister Axel Kicillof would be speaking alone. He would not be accompanied by a court-appointed mediator or representatives of holdout firms. There was no deal that would allow New York banks to process Argentina's payments to the vast majority of its creditors. The country was solvent and willing to pay. Yet, extraordinarily, Argentina was again in default.

The saga that began in 2001, when Argentina executed the largest-ever sovereign default, continues. Since that crisis, Argentina successfully restructured 92 percent of its outstanding debt and paid these holders more than US$190 billion in principal and interest.

But the remaining eight percent—mainly large hedge funds—refused the restructuring. Instead, they initiated a lengthy legal battle, demanding that Argentina pay the bonds' full nominal value. The strategy paid off in 2012 when, in New York, Federal District Court Judge Thomas Griesa barred any further payment on restructured debt unless the debt to the holdouts was also honored.

Argentina appealed the decision to the US Supreme Court, but it refused to hear the case. This put Argentina on the hot seat. Its next round of interest payments on the restructured debt was due June 30, with a 30-day grace period. A deal with the holdouts needed to be reached by then.

Time finally ran out as Minister Kicillof took his seat for the press conference.

The minister took a hard line in his statement, but this may have been posturing. Rumors of an arrangement among the Argentine Association of Private Banks (ADEBA), major investment banks and the holdouts continues to swirl. The markets appear to be keeping faith that a solution is near: Despite a rough day-after for Argentine equities, yields on the country's bonds did not rise dramatically.

As it stands now, there are no winners. Argentina is again in default, no one is getting paid and the eight-percent holdouts have exhausted their biggest trump card—another Argentine default—without extracting anything tangible from Buenos Aires.

The Economic Consequences: A Simmer, Not a Boil

As Argentina knows all too well, sovereign default often goes hand in hand with economic disaster. The 2001 crisis gave the country three presidents in two weeks. Violent protests shook the streets of Buenos Aires. Millions of Argentines lost their life savings as the peso plummeted against the dollar.

By contrast, the reaction to the current default will be comparatively muted. The usual punishment for countries in default includes lost access to international markets as well as lengthy and costly litigation with creditors. That, however, is nothing new for Argentina. It has lacked market access since 2001, and its government knows the well-trodden path to the courthouse.

The default will likely stoke inflation and capital flight, but Argentina already faced these macroeconomic pressures. Potential spillover is also limited. The 2001 default had significant contagion risk because so many ordinary investors held Argentine sovereigns, but the current notes are held primarily by hedge funds.

There will still be ramifications. Buenos Aires may be barred from international markets, but Argentine firms and sub-sovereigns are not. They are likely to face higher borrowing costs, which could, for example, hamper efforts to expand energy infrastructure.

Avoiding default, however, would not have left Argentina unscathed. A settlement could have brought solvency issues. The holdouts estimate that Argentina would have owed an additional US$7.5 billion. Buenos Aires estimates are double that. Either way, it is a tall order for a country with reserves of, at best, US$30 billion.

Moreover, any settlement could have triggered the now-infamous Rights Upon Future Offers (RUFO) clause written into the restructured debt. This clause entitles "equal treatment" to those who accepted a haircut if Argentina "voluntarily" agrees to pay holdouts at a better rate. Had Argentina satisfied the holdouts' demands, restructured creditors could have activated the clause, putting Argentina on the hook for upwards of a mind-boggling US$500 billion. The RUFO clause expires on January 1, 2015. An Argentine request to stay Judge Griesa's verdict until the new year was rejected.

Some analysts believe that the emphasis on RUFO was an Argentine ploy to buy time. They have suggested that the courts would not interpret capitulation to the holdouts as "voluntary" and that restructured creditors may not exercise the RUFO clause anyway. Yet Argentine apprehension is understandable. After all, Judge Griesa’s novel 2012 *pari passu* ruling was unexpected, unprecedented and questioned by key international institutions such as the International Monetary Fund. Argentina can ill afford risking a similarly controversial ruling on the RUFO clause.

The Political Consequences: A Rallying Cry for the Government?

Governments that steer their countries into economic crises often face severe domestic political reckoning. Yet even as President Cristina Kirchner’s popularity wanes, the inability to reach a deal with the holdouts is unlikely to spark a backlash. While Argentines are generally anxious to shed their reputation as economic pariahs, capitulation to the so-called *fundos buitres* (vulture funds) would have been a tough pill to swallow.

The holdouts comprise, primarily, hedge funds that purchased Argentine debt in the months leading up to the country’s catastrophic 2001 default and in the months *after* the default. In many cases their money was never truly invested in Argentina. Rather, the hedge funds scooped up the notes on the secondary market at steeply discounted prices with the explicit intent of eventually taking the case to court and forcing Argentina to pay full nominal value.

From the Argentine perspective, these funds seek to capitalize richly on Argentina’s most harrowing national crisis of the last 20 years, at the expense of the current Argentine government. According to Buenos Aires, if holdouts had accepted the 2005 or 2010 restructurings, they would have garnered a 300-percent profit. As it stands, they are holding out for a gain of 1600 percent.

Since the recent default flows from the ruling of a judge in New York, President Kirchner will not struggle to portray Argentina as the victim of high finance. If anything, Minister Kicillof’s confident, stout and dramatic performance at his press conference could provide a much needed boon for the Kirchner administration.

The Legal Consequences: Advantage Creditors

As a potential watermark victory for creditors' rights, Judge Griesa's ruling could reverberate well beyond Buenos Aires. Countries under severe economic duress often rely on haircuts to manage structured defaults and emerge from crisis. This strategy, however, is contingent upon creditors' accepting a loss. Greece, for example, executed in 2012 a bond-exchange program that offered 34 cents on the dollar, which is viewed as vital to that country's rehabilitation.

But after Judge Griesa's ruling, creditors may be reluctant to accept a write-down if they believe they can hold out for full payment. Even if retail creditors could never mount the litigation efforts of hedge funds, the ruling seems to encourage firms that specialize in amassing distressed debt on the secondary market with no interest in a restructuring.

On the other hand, if the global financial community determines that such behavior is counterproductive, the ruling could fast-track efforts designed to prevent similar situations in the future. Some argue that the answer lies in collective-action clauses that allow a supermajority of bondholders to enforce restructuring for all holders of a given set of bonds.

Of course, the precedent set by Judge Griesa may make reaching a supermajority tougher.

Moving Forward

The true shame of recent developments is that Argentina will continue to be an economic outcast. The country has been roundly criticized for cooking the books, manipulating economic data, and exercising a heavy hand on its finances. Part of this is due to shortsighted governance. But Argentina's inability to access international credit is also to blame. Buenos Aires has overvalued its currency, implemented capital controls and limited imports because it cannot finance a significant deficit.

The latest default will not drastically alter Argentina's already-troubled status quo. The country remains unable to rejoin the global financial community until it resolves the lingering effects of the 2001 crisis.

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