Argentina: Unresolved debts
By Benedict Mander, Elaine Moore and John Paul Rathbone

Default creates uncertainty over the nation’s economic prospects and future sovereign debt cases

It was a sweltering evening in Manhattan last week when Axel Kicillof, Argentina’s economy minister, confronted the cameras to insist his country had not defaulted on its international bonds for the eighth time in its history, but instead had suffered a “freak occurrence”.

Only minutes earlier Standard & Poor’s, the rating agency, had declared Argentina in “selective default”. Ramming the point home, a court-appointed mediator then released a statement halfway through Mr Kicillof’s lecture saying that negotiations in New York between the minister and a group of holdout creditors to stop the default had failed.

The semantic disagreement over “default” is just one of the confusions thrown up by what has been dubbed “the sovereign debt trial of the century”. Another is why Argentine bond prices have held up at about 80 cents to the dollar. Even allowing for the continuing market “melt-up”, that stands in sharp contrast to the aftermath of its calamitous $95bn default 13 years ago, when defaulted bonds traded as low as the mid-teens.

“We are entering unknown territory,” says Roberto Lavagna, a former Argentine economy minister. “There are no precedents. That is why there is so much confusion.”

At stake now, however, is more than just whether such elevated bond prices are justified by investor bullishness that Buenos Aires will strike a deal with the holdouts. A successful deal could calm fears that Argentina’s decade-long legal battle with a group of US hedge funds might hurt New York’s status as an international financial centre. The funds’ success in suing for full repayment on bonds issued under US law could make it easier for holdout creditors to disrupt future sovereign debt workouts and encourage countries to issue debt in other jurisdictions.

“There is a cost to the world,” Olivier Blanchard, chief economist at the International Monetary Fund, warned last month.

A deal would also ease doubts over the longer-term prospects for Latin America’s third-largest economy, and whether its president, the enigmatic Cristina Fernández even wants to resolve a situation which, for now, has bolstered her popularity at home while completely cutting off the country from international markets.

“We reached this situation by accident, not by design,” says Mario Blejer, a former Argentine central bank governor who remains
optimistic that a deal can be reached. “Nobody wanted a default.”

Following its 2001 default, Argentina has two types of external bonds. The first is the result of two restructurings in 2005 and 2010 that paid 30 cents on the dollar and was accepted by 93 per cent of creditors. They are referred to as “exchange bonds”, and Argentina has continued to service them. That is why the country, until last week, enjoyed a non-default credit rating and some semblance of paying its debts on time.

The second group are bonds Argentina has not serviced, owned by holdout creditors such as the New York hedge funds, led by Elliott Management and Aurelius Capital. Two years ago these investors won a groundbreaking legal ruling that the boilerplate “pari passu”, or “equal footing”, clause in their bond contracts required they be paid in full – just as exchange bondholders were also being paid in full as stipulated in their own restructured bond contracts.

Judge Thomas Griesa, the US judge who has presided over the decade-long case, subsequently ruled that if Argentina paid the exchange bondholders, then under the pari passu clause it must pay the holdouts too. Hence confusion about the “default”.

Last month Argentina deposited $539m with its trustee, Bank of New York Mellon, to pay exchange bondholders. But because Buenos Aires did not pay the holdouts as well, BNY Mellon was legally barred from passing on the funds. As the exchange creditors’ bond contracts require that they get the money, this left the country in default.

For now, bond markets remain calm. Exchange creditors have resisted “accelerating” their bonds to demand immediate payment in full since that would amount to a $30bn demand, more than Argentina’s foreign exchange reserves. Payment would therefore require yet another restructuring and, quite possibly, an even worse “holdouts 2.0” situation.

Globally, most investors also see Argentina as a unique case with few ramifications. International bond issuance, fuelled by ultra-low western interest rates, continues to swell: governments and companies in emerging markets have issued $796bn in debt this year, compared with $734bn in 2013, according to Dealogic data. Exotic issuers such as Pakistan, Zambia, Mongolia and Ecuador have successfully issued debt as Argentina’s creditor battle rolled on.

Predictions that emerging markets would rewrite bond contracts to avoid holdout disruption have also failed to materialise. Pari passu clauses remain and, unlike eurozone nations, emerging market issuers have not turned to collective action clauses, which allow investor majorities to override minority holdout positions.

“Issuers tend to benchmark new bonds against old, and are reluctant to issue bonds with terms and conditions that differ,” says Peter Young, partner at Norton Rose Fulbright, which advised Pakistan on a $2bn issue this year. “There has not been a wholesale move to include these [collective action] clauses from emerging market countries with debt already in existence.”

Nonetheless, market participants are not sitting on their hands. The International Capital Market Association is drawing up guidelines that could compel holdouts to take part in debt restructurings should a majority of investors agree.

Others warn that the case, which ostensibly enhances creditor rights, could prompt investors to turn to local law bonds to avoid being similarly held hostage. After all, even Judge Griesa has at times been unsure which of Argentina’s exchange bonds, such as those issued under UK or Japanese law, were affected by his ruling – a confusion that hardly inspires confidence in US law.

“Bond holders might conclude that a legal framework that places the interests of a minority above the interests of the majority of bond holders – the precedent set in this particular situation – is too risky,” says Jan Dehn, head of research at Ashmore, a specialist emerging markets fund manager. “The future in emerging markets belongs firmly to local law.”

However uncertain the international implications, what comes next in Argentina is even more uncertain. Court-ordered mediation talks between Argentina and the holdouts have become poisonous, limiting the likelihood of a deal. Argentina has threatened to sue BNY Mellon and has questioned the mediator’s independence. It also wants an investigation into whether Elliott pushed Argentina into default so it could then profit from default insurance. Elliott denies that it owns such credit default swaps on Argentine exchange bonds. . .
Despite the bitter atmosphere, investors remain bullish on Argentina. The first reason for that is a belief that Buenos Aires has only refused to settle with the holdouts because it does not want to trigger the so-called Rufo clause in the exchange bonds requiring it to pay all creditors the same amount – a hugely expensive proposition that would essentially reverse the 2005 and 2010 debt restructurings.

When the Rufo clause expires at the end of the year, that problem disappears. Argentina, so the thinking goes, could then settle the case, regain market access and issue fresh debt to pay off commitments and boost investment in its vast shale reserves. Credit risk would then drop, justifying current bond prices.

So goes the theory. But some wonder if the Rufo clause is merely a fig leaf for Ms Fernández, 61, for whom standing up to the hedge funds, the “vultures” as she calls them, is central to her domestic political platform. Rufo may only be “a convenient red herring”, suggests Stuart Culverhouse, chief economist at Exotix, an emerging markets boutique.

Such thinking is mirrored by increasing scepticism in Argentina about a private sector-led deal, under which a group of Wall Street banks, including JPMorgan and Citigroup, would buy the holdouts’ debt and then sell it to the government once the Rufo clause expires.

Nicolás Dujovne, an economist in Buenos Aires, believes such a deal is “very unlikely”, not least because the Rufo clause means the government cannot give the banks any assurance it would buy the debt next year.

Furthermore, Ms Fernández may not believe a deal is strictly necessary. Although the economy is in recession, and suffering high inflation and dwindling foreign reserves, it has been largely cut off from international credit markets for more than a decade and not done so badly.

“If no deal is reached . . . the world isn’t suddenly going to fall apart,” says Aldo Ferrer, an Argentine economist. “Argentina wasn’t paralysed in the past, and it won’t be now either. Our problems are the same with or without the vultures.”

Ms Fernandez may also be counting on help from other emerging economies to tide her over. Vladimir Putin, Russia’s president and another populist leader of a commodity exporting economy chafing under western legal sanctions, visited Buenos Aires last month. So did Xi Jinping, China’s president, when he announced a $10bn currency swap that could bolster depleted foreign reserves.

Should Argentina need further balance of payments support, some suggest it could be the first customer of the new Brics development bank, created with great fanfare last month as the emerging world’s response to western-dominated financial institutions. “It would make a lot of geopolitical sense, from the Brics’ perspective,” says Daniel Kerner, analyst at Eurasia Group, the risk consultancy.

Whether or not Ms Fernández decides to settle, the second reason for the continued buoyancy of Argentine bonds is that her presidency ends in December 2015. Then, some believe, a more market-friendly administration will take her place and make resolving the holdouts problem a priority.

But it is an open question whether the next Argentine president, who will probably be drawn from the Peronist party, really will be more market friendly. Whatever happens, there is little chance Ms Fernández can stop the holdout saga from casting a shadow over her political legacy.

She refers to the period since 2003, when her predecessor and late husband Néstor Kirchner became president, as the “victorious decade”. It is based on the founding myth that the couple’s harsh treatment of foreign creditors was largely responsible for resurrecting Argentina from the 2001 crisis.

But as the Kirchner era draws to a close, the country has come full circle with a fresh default and the possibility of a new economic crisis. “Argentina’s problems were there before the default, even if it will make things worse,” says Alberto Fernández, a former cabinet chief in both Ms Fernández’s and her husband’s governments, who points to the economy’s “very serious” problems. “It will be very difficult to solve these problems in the time Cristina has left. Her presidency isn’t going to end well.”

The same may prove true for international debt markets. In recent decades the move towards an agreed resolution to critically indebted countries has been slow but visible, says Anna Gelpern, a law professor at Georgetown University. “The precedent set by Argentina threatens to put it into reverse,” she adds.
Pari passu clauses: Creditors scramble to recover debt

In the aftermath of two hurricanes and the global financial crisis, Grenada announced a plan to restructure its bonds in 2013, writes Elaine Moore. Not all of its creditors were happy.

Taiwan’s Export-Import Bank sued in US courts for full payment of a loan not repaid in 2005 when Grenada re-established diplomatic ties with China, using the same pari passu argument employed by Argentina’s creditors.

The case is on hold while the country restructures its debts but Mark Weidemaier, associate professor of law at the University of North Carolina, says that whatever the outcome, it is proof that Argentina’s case will not necessarily be unique. Pari passu clauses are standard across sovereign bond contracts, he says. Ukraine’s debt contains the same clause, as does that of Cyprus.

Eric LeCompte, executive director of Jubilee USA Network, which campaigns for debt relief in poor countries, says Argentina’s default has set a precedent that could be used by holdout creditors all over the world. He says jurisdiction also matters. In the 1980s the Democratic Republic of Congo (then Zaire) borrowed from energy company EnergoInvest. The planned power lines were never built and the country stopped payments. In 2004 the debt was purchased by US hedge fund FG Hemisphere for about $3m, which then sued the country for more than £100m for full repayment. Courts in the British crown dependency of Jersey ruled in the investors’ favour in 2010. But this was overturned by the Privy Council in England in 2012.

The DRC is also considering a challenge to a US ruling that it should pay $68m for 1980s debts purchased by Themis Capital and Des Moines Investment. Jubilee says the Argentina case makes an appeal look less likely.

RELATED TOPICS United States of America, International Monetary Fund

Content recommended for you

Based on your browsing history

Escape from New York, pari passu edition
Argentine bonds fall on debt swap plan
Argentina proposes voluntary debt swap
The Closer
Argentina attacks BNY over debt payments

New framework agreed for sovereign defaults
Argentina and Elliott - was it really a bond play?
Companies fear radical turn in Argentina
M&G unveils bond fund to weather interest rate rise
Bond fund sales on track for record year

Printed from: http://www.ft.com/cms/s/0/96b56394-1d68-11e4-b927-00144feabdc0.html

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© THE FINANCIAL TIMES LTD 2014 FT and 'Financial Times' are trademarks of The Financial Times Ltd.