

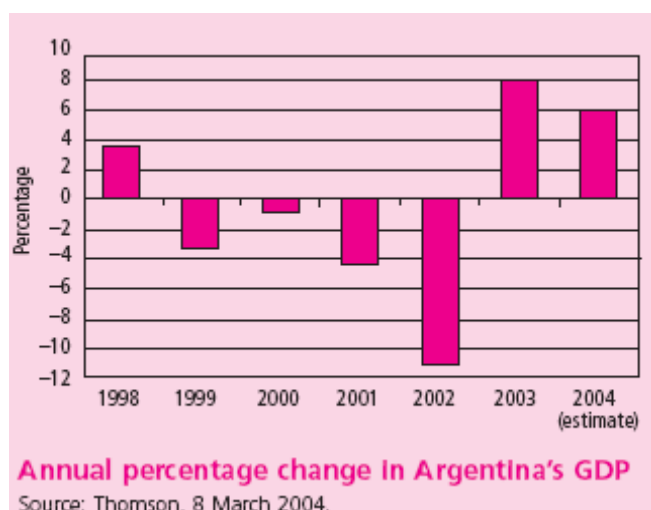
Argentina tests international financial institutions

Case taken from The International Business Environment, second edition (Palgrave, 2006), by Janet Morrison

In the 1990s, Argentina was heralded as a model for emerging markets, but by 2001, the country was in financial chaos, causing it to default on IMF loans and devalue its currency, which had been pegged to the US dollar. Financial collapse was accompanied by political crisis and social instability, as ordinary Argentines saw their savings wiped out. Two presidents were forced out of office within the space of two weeks by protests and demonstrations. How did Argentina, a country rich in natural resources, manage to plunge into financial crisis?

Argentina enjoyed strong economic growth in the 1990s. Privatization schemes, most notably in electricity, gas and telecommunications, attracted foreign investors and contributed to the impressive modernization of the country's infrastructure. The economy grew on average 4.4 per cent a year from 1993 to 1998. However, high levels of public spending led to growing public deficits. The country became dependent on foreign capital, but it did not put in place a strong internal financial system or a system of internal borrowing. Nor did it develop an effective regulatory system for overseeing the newly privatized industries. The Asian and Brazilian financial crises, combined with the failure of the hedge fund, LTCM, led to a dramatic fall in capital flows in 1998, which had a devastating effect on Argentina. It looked to international financial institutions for loans, most notably the IMF. An IMF condition was the preparation of a coherent economic plan, but Argentina was unable to meet repayments and defaulted on a total of \$141bn. debt in December 2001. Its liability to the IMF amounts to \$15bn., while it owes \$7.5bn. to the World Bank and \$8.4bn. to the Inter-American Development Bank. As urged by the IMF, the currency was devalued in 2002, decoupling it from the dollar.

During the heady days of the 1990s, Argentina issued a huge array of debt instruments, to both institutions and private investors, taking full advantage of global capital markets. In all, there were 152 types of bonds issued in eight jurisdictions and seven currencies. Moreover, many small investors across the globe bought Argentine bonds, which held out the hope of higher returns than their own governments could offer. They included, in particular, Italian and Japanese investors, who are now nursing losses. In all, there was more than \$100bn. in defaulted sovereign debt. Some of these investors have mounted lawsuits against the Argentine government, including an American investor who won a \$700m. lawsuit in 2003. They are encouraged by the recent economic recovery which has taken place in Argentina.



The depth of Argentina's recovery, however, is open to question. Its economy grew at a rate of 8 per cent in 2003 (see figure), hardly imaginable two years earlier, and second only to China. The devaluation of the currency gave an impetus to local industries and also helped agriculture. The record highs of international commodity prices also aided recovery. Surging demand from China for products such as copper, soya and iron

is helping to swell current accounts. However, structural problems, such as the weak banking system, remain. While unemployment had been reduced to 14.5 per cent by the end of 2003, the new prosperity is very unevenly spread and 50 per cent of the population live below the poverty line.

The government of Néstor Kirchner now enjoys fiscal surpluses, but was slow to engage in restructuring the country's debt. It devised a scheme to settle with private bondholders by paying them only about 30 cents in each dollar they hold. When questioned about the debt restructuring plan, President Kirchner said: 'We will not pay if that means an increasing number of Argentines having to go without education, healthcare, housing, a decent job' (Thomson, 8 March 2004). By March, 2005, the deal was accepted by 76 per cent of the private creditors, a level deemed to be sufficient to satisfy the IMF that the country had acted in good faith. However, many questions remain for both Argentina's prospects and the IMF's approach to the default crisis.

The case of Argentina highlights the weaknesses of current arrangements for dealing with sovereign default in bond markets. A group representing the private investors maintain that Argentina did not act in good faith and that the 30 cents in the dollar offered to them was far below the country's present ability to repay. Sensitive to the global issues, the former economics minister has said: 'I agree that you must not use the money of American plumbers and carpenters or German dentists to bail out Argentina' (Thomson, 8 March 2004). Argentina had damaged its credibility in the world's capital markets and alienated potential investors in the country's future growth. Its behaviour could undermine the IMF system in the long term, as the countries which advance money to the IMF for borrowing by countries in distress might be reluctant to do so in future. The sustainability of Argentina's recovery is a cause for concern, resting, as it has done, on a favourable international environment and the country's failure since 2001 to service the debt to its private creditors. The country again seems to be at loggerheads with the IMF, which continues to press for structural reforms which the government is resisting.

Sources: Catán, T., 'Bad luck is mixed with some bad management', *Financial Times*, 8 March 2002; Thomson, A., 'Rising fast from the lower depths of crisis', *Financial Times*, 29 March 2004; Thomson, A., 'Argentina on the edge: what are the consequences of another default?', *Financial Times*, 8 March 2004; 'Argentina again', *Financial Times*, 28 September 2004; Balls, A. and Thomson, A., 'Argentina goes head to head over debt restructuring offer', *Financial Times*, 2 February 2005; Wolf, M., 'Argentina's debt deal leaves it holding a weak hand', *Financial Times*, 9 March 2005; Thomson, A., 'All to play for on investment as leftwing leadership revisits a decade of disposal', *Financial Times*, 9 May 2005.

Case questions

What were the causes of financial crisis in Argentina?

What are the long-term prospects of restoring international confidence in its financial system?

@ The IMF's country page on Argentina can be found at:
<http://www.imf.org/external/country/ARG/index.htm>