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Defend Argentina from the vultures

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By Martin Wolf

June 24, 2014

A creditor paid more to take on the risk of a default cannot then be surprised by it

Not far from the London offices of the Financial Times was the Marshalsea prison where debtors used to be sent. In the 18th century, more than half of London's prisoners were incarcerated for their undischarged debt. The moral hazard Taliban of the day insisted that such harsh penalties were necessary. Then, in 1869, imprisonment for debt was abolished and bankruptcy introduced. Both economy and society survived.

Things sometimes go wrong. Sometimes this is due to bad luck and sometimes to irresponsibility. But society needs a way to allow people to start over again. This is why we have bankruptcy. Indeed, we allow the most important private actors in our economies – companies – to enjoy limited liability. This lets shareholders walk away from their companies' debts unscathed. That idea, too, was condemned as a licence to irresponsibility when introduced. Limited liability does bring problems, notably in highly leveraged businesses (such as banking). The ease with which US corporations can walk away from their creditors is breathtaking. But this is better than unlimited liability.

A similar logic applies to countries. Sometimes their governments borrow more than they turn out to be able to afford. If they have borrowed in domestic currency, they can inflate their debt away. But if they have borrowed in foreign currency, that possibility disappears. Usually, it is countries with a history of fiscal irresponsibility that find themselves obliged to borrow in foreign currencies. The eurozone has put its members in the same position: for each government, the euro is close to being a foreign currency. When the costs of servicing such debts become too high, then restructuring – default – becomes necessary. As Carmen Reinhart and Kenneth Rogoff of Harvard University showed in This Time is Different, this is an old story.

As I argued at the time, Argentina found itself in this position at the turn of the century. It was difficult to feel much sympathy for the country, which suffered from chronic mismanagement before its default in December 2001 and was to suffer yet more thereafter. But it had become impossible to service its public debt of $132bn at tolerable cost. Moreover, creditors had been rewarded for the possibility of default. Even at its lowest point, in September 1997, the spread of Argentine dollar bonds over US Treasuries was close to three percentage points. A creditor compensated for the risk of a default cannot be surprised by it. The solution is portfolio diversification.

While the principle of sovereign debt restructuring is compelling, in practice it is difficult. No court can seize and then liquidate a country's entire assets. This legal limbo creates two opposing dangers: the first is that it is too easy for a country to walk away from its debts; the second is that it is too hard. The Argentine story illustrates both: confronted with an intransigent government, holders of 93 per cent of defaulted debt accepted exchanges for debt with a hugely reduced face value; but "holdouts", who reject such an exchange, have blocked a clean resolution. The mess has lasted more than 12 years from the default.

If Argentina is forced to pay holdouts in full, the price will be borne by Argentines

As first deputy managing director of the International Monetary Fund, Anne Krueger advanced a proposal for a sovereign debt restructuring mechanism in 2002. She argued that the restructuring process could be delayed or blocked if some creditors were able to hold out for full payment.

Her ideas were more supranational than governments – above all, the US – could bear. But "collective action clauses" were at least introduced. Yet such clauses might not have prevented the success of holdouts over Argentina, led by Paul Singer of Elliott Management. As the IMF recently noted, these clauses "typically only bind holders of the same issuance". A holdout creditor can "neutralise the operation of such clauses" if they secure a blocking position, normally more than 25 per cent.

Moreover, adds the IMF, US courts have interpreted a "boiler plate provision" of these contracts (the so-called pari passu clause) as requiring a sovereign debtor to make full payment on a defaulted claim if it makes any payments on restructured bonds. In addition, the US courts will force financial intermediaries to help creditors obtain hold of the sovereign's assets. All this will make restructurings harder. Why should creditors accept an exchange for instruments with reduced value in future?

I am no lawyer, but to me the idea of equal treatment means treating like cases in the same way. Yet creditors who have accepted exchanges and holdouts are not like cases. To force debtors to treat them equally seems wrong. Moreover, the argument that holdouts are helping Argentines by punishing government corruption is absurd. It is up to Argentines to choose the government they desire. Worse, if Argentina is forced to pay holdouts in full, the price will be borne by Argentines. This is extortion backed by the US judiciary.
The immediate issue is how Argentina might settle these cases. The options – paying the holdouts, reaching a deal with them, transferring restructured debt into domestic law and outright default – look costly, humiliating, difficult or damaging. Worse are the longer-term implications for debt restructurings.

One possibility is to eliminate the pari passu clause. Another is to introduce stronger collective action clauses, particularly ones that cover all outstanding instruments. Another is to shift issuance from New York. But all three would apply only in future. Another possibility would be to amend US law. A final possibility, as José Antonio Ocampo of Columbia University notes, is to revive the idea of a global mechanism. These last two options look very unlikely.

Yet in a world of global capital flows, a workable mechanism for restructuring sovereign debt is not an optional extra. It is possible that Argentina is an exceptional case. It is more likely that the interpretation of the pari passu clause and the ability to pursue assets will now make it more difficult to restructure debt. A world in which the choice for sovereigns and their creditors is between full payment and absolute non-payment would be as bad as one in which debtors had to choose between starvation and prison. A better way must now be found.