Emerging Market Crises: Russia (1998) and Argentina (2001)

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Lessons 3 and 4, 27-28 October 2008

Course in Global Markets and Economic Policies

RUSSIA 1998

Russia98: How did it all start?

- Transition economy, no idea how to change the economy, conflicting approaches, property rights, banking sector… and cheap oil! GDP growth was very poor;
- Fiscal discipline in shambles. Tax payments, what tax payments? Pension payments, what pension payments?
- 1997 Asian crisis

Why was GDP growth poor?

- Macroeconomic environment: high real interest rates and an appreciating real exchange rate;
- Serious structural problems (the non-payments problem, financial sector underdevelopment, property rights)
- Fiscal/monetary situation rapidly deteriorated

Fiscal/Monetary Issues

- The non-payment problem;
- Tax arrears;
- Pension/wage arrears;
- Appreciation of the real exchange rate;
- Banking sector not a proper banking sector

The Non-Payment Problem

- It consisted of two parts:
  - (i) arrears/overdue payments and
  - (ii) growing use of non-monetary exchange
- Became entrenched because of high interest rates and soft enforcement;
- Killed growth and locked-in the fiscal deficit (tax arrears, pension/wage payments);
- Enveloped the entire economy.

Russia98: Debt Dynamics

(1) $$d_t - d_{t-1} = (pd_t - ndfs_t) + \frac{(r_t - g_t)}{(1 + g_t)} d_{t-1}$$

d	public debt/GDP ratio,
t	time subscript (in years)
pd	primary deficit/GDP
ndfs	non-debt financing sources/GDP
r	composite real interest rate
g	real growth rate

The key elements for reducing the debt burden are:
a.The primary deficit/surplus
b.r, the composite real interest rate
c.G, the real (GDP) growth rate

A closer look at the interest rate

$$r = wr_d + (1 - w)(r_f - \rho)$$

w share of domestic currency debt in total debt
r_d real interest rate on domestic currency debt
r_f real interest rate paid on foreign currency debt (e.g., interest rate paid by government on US dollar borrowing adjusted for US inflation)
ρ % change in dollar-ruble real exchange rate

(ρ > 0 means a real appreciation)

Russia98: Macroeconomic Framework

Table 1. Public Finances and Economic Growth, 1995-98
Units as indicated

Year	*Primary deficit (percent of GDP)*	*Interest Payments*		*Government debt*		*Real GDP Growth (percent a year)*
		Percent of GDP	*Percent of revenues*[a]	*Billions of dollars*	*Percent of GDP*	
1995	2.2	3.6	28	170	50	-4.0
1996	2.5	5.9	47	201	48	-3.4
1997	2.4	4.6	38	218	50	0.9
1998	1.3	4.6	43	242	75	-4.9

Sources: Ministry of Finance, Goskomstat, and internal IMF reports
a. Cash plus noncash basis.
b. Domestic plus foreign, end of period.

Russia98: Key Dates

- July 1995 3-year stabilization program agreed with IMF
- July 1996 Yeltsin re-elected in second round
- Early 1997 GKO/OFZ market liberalised, "DREAM TEAM"
- Oct 1997 Chronic tax problem prompts IMF to hold up disbursements
- The situation rapidly deteriorated in the Spring of 1998

Russia98: Approaching the Crisis (1)

- 23 March 1998: Yeltsin fires Prime Minister Viktor Chernomyrdin and the entire Cabinet, saying reforms were not dynamic enough. He names virtually unknown Energy Minister Sergei Kiriyenko as acting prime minister. Markets already uneasy over turmoil in Asia and a slump in world oil prices are shocked, and many investors retreat to the sidelines amid political uncertainty.
- 29 April: New Cabinet, packed with reformers, is announced. Markets mainly rise over this period, but major investors still sidelined.
- 12 May: Coal miners protest unpaid wages, blocking a major railway. Stocks tumble, due mainly to a law restricting foreign ownership of shares in electricity giant UES.
- 26 May: Yeltsin signs austerity package to stabilise budget and cut spending. Russia suffers a blow as no one bids for a 75 percent stake in Rosneft, the last big oil company still in state hands. Finance minister announces spending cuts of $10 billion.

Russia98: Approaching the Crisis (2)

- 27 May: Central Bank triples key interest rate to 150 percent after GKO yields soar and shares tumble (Remember equation on debt dynamics).
- 4 June: Central Bank cuts key interest rate to 60 percent from 150 percent in a sign of growing confidence.
- 18 June: The International Monetary Fund delays an expected $670 million instalment of its $9.2 billion loan to Russia, citing problems with implementing fiscal reforms.
- 19 June: Russia asks for additional $10 billion to $15 billion credit package from the IMF and other lenders.
- 23 June: Yeltsin and Kiriyenko present anti-crisis plan consisting mainly of tax laws. Yeltsin says the crisis has become "so acute that there are social and political dangers." He tells the Duma to waste no time in passing the laws, hinting at tough steps if it resists.
- 25 June: The IMF approves the release of the $670 million instalment, but it fails to impress traders and shares fall again.
- 1 July: Siberian miners renew picketing of railways, demanding wage arrears and the resignation of Yeltsin and his government. Stocks tumble on overall uncertainty.

Russia98: Approaching the Crisis (3)

- The “Bolshoi Paket”:
- 13 July: International lenders pledge $22.5 billion in extra credits spread over 1998 and 1999:
  - $12.5 bn from the IMF in 1998 and another $2.5 bn in 1999;
  - $6 billion from the World Bank
  - $1.5 billion from the Japanese Ex-Im Bank
- Not only money from International Organisations but also a Private Sector Initiative (PIN) was launched: the “megaswap”

Russia98: Approaching the Crisis (4)

- The “megaswap”:
- *” …In addition, the Russian Government will tomorrow morning be announcing the details of a plan to convert on a voluntary basis--that is important--GKOs, Treasury Bills, maturing through June 1999, into longer-term, dollar-denominated liabilities at 7 years and 20 years. This scheme is expected to be attractive to the holders of GKOs and is expected to help take some of the pressure off the markets in two ways. One is this rollover problem of GKOs over time, and second, it would reduce the interest bill, and in reducing the interest bill on the ones that are replaced, it is also likely to reduce the interest bill on existing GKOs, because there will be fewer of them.“*

Stanley Fischer, IMF First Deputy Managing Director, press conference, 13 July 1998

Russia98: Approaching the Crisis (5)

- Let’s take a closer look at the “megaswap”:
- Private investors to exchange rouble-denominated GKOs, yielding anywhere between 50-100% for …
- USD-denominated, Eurobond, yielding 14.88% (7-year bond) or 15.12% (20-year bond).
- Remember that the Rouble exchange rate was controlled
- Advantages for participating bondholders:
  - No currency risk and attractive USD returns (UST ~ 6.5%)
- Advantages for Russian Government
  - Spreading interest payments and lessening the debt burden

The Market View: Eurobonds

Table 7. Yield Spreads on Russian Eurobonds upon Issue, 1997-98
Units as indicated

Issue date	*Maturity date*	*Yield spread (basis points)*[a]	*Face value (billions of dollars)*
June 26, 1997	2007	375	2.40[b]
June 4, 1998	2003	650	1.25
June 18, 1998	2028 (2008)[c]	753	2.50
July 24, 1998	2005 and 2018[d]	940	6.44

Source: Ministry of Finance
a. Over U.S. Treasury securities of similar maturity.
b. Of which $0.4 billion was settled on October 28 at a yield spread of 334 basis points.
c. Issued as a thirty-year bond with a out-at-par option after ten years.
d. Seven-and twenty-year bonds issued as part of the GKO-Eurobond swap.

Source: **Lessons from the Russian Crisis of 1998 and Recovery ,** Brian Pinto, Evsey Gurvich, and Sergei Ulatov, Feb 2004
http://www1.worldbank.org/economicpolicy/documents/mv/pgchapter10.pdf

The Market's View: GKOs

Yields on one-year GKOs can be decomposed using the following to get the sovereign or default risk premium (SRP) and devaluation risk premium (DRP) as a residual.

$$i_d = i_f + SRP + (dx/x)^* + DRP$$

$(dx/x)^*$ is the target rate of devaluation of the currency against the U.S. dollar (= 6% in 1998)

Decomposition of GKO Yields

	GKO yield	**SRP**	**DRP**
May 15	**39.3**	**4.8**	**23.0**
July 13	**102.3**	**8.5**	**82.3**
July 14	**58.2**	**8.1**	**38.6**
July 24	**66.4**	**10.0**	**44.9**
August 10	**99.0**	**20.0**	**67.5**
August 14	**144.9**	**23.8**	**109.5**

SRP = sovereign or default risk premium
DRP = devaluation risk premium

Back to the Megaswap

- Recap of the main points:
  - Private investors to exchange rouble-denominated GKOs, yielding anywhere between 50-100% for …
  - USD-denominated, Eurobond, yielding 14.88% (7-year bond) or 15.12% (20-year bond).
- What would you have done? Why?

The Outcome of the Megaswap

- Disappointing:
- Investors holding the equivalent of $4.4 bn, about one third of the GKOs estimated to be held by foreigners, participated in the exchange. Little relief for the Russian authorities
- Why such a low participation?

Why a Poor Megaswap?

- From The Wall Street Journal:

  "With the threat of rouble devaluation now waning, some debt analysts wondered what incentive investors had to exchange the high-yield rouble denominated GKOs for safe and stodgy Eurobonds. One trader said the swap could mean trading 'a bronco for a mule' "
- From Merrill Lynch's Emerging Markets Daily, 16 July:

  GKOs pose "little risk of devaluation"… "Remember also that the IMF loan virtually assures a stable exchange rate, at least through the summer"

  Source: The Chastening, by Paul Blustein, Public Affairs, 2003

The Megaswap: Moral Hazard

- Investors and many investment bankers took the IMF announcement as evidence that Russia was “too big and too nuclear” to fail,
- It was the classic “moral hazard” situation
- Hence greed took over fear/prudence.
- Take another look at the decomposition of the GKOs’ yields

Decomposition of GKO Yields

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IMF Programme announced on the 13th

SRP = sovereign or default risk premium
DRP = devaluation risk premium

Russia98: Approaching the Crisis (6)

- 15 July: The State Duma fails to adopt most of government anti-crisis plan, approving measures that Kiriyenko says will provide only one-third of targeted revenues. He vows to compensate through government resolutions and presidential decrees, a legally questionable approach.
- 20 July: IMF approves its $11.2 billion share of the new international loans. First $4.8 billion made available.
- 6 August: World Bank approves $1.5 billion structural adjustment loan for Russia, including an immediate advance of $300 million.
- 12 August: Central bank says interbank market virtually paralysed by liquidity problems and lack of confidence; imposes limits on purchases of foreign exchange by banks and says it will act to prevent crisis from spreading.
- 13 August: George Soros advises the Russian government to devalue rouble and introduce a currency board, pegging rouble to dollar or Euro. Central bank official says devaluation would not help solve crisis. Stocks plunge to lowest levels in more than two years and short-term GKO yields soar as banks dump paper for roubles. Central bank expands banks' access to overnight credits. Kiriyenko says there is no economic basis for the market decline and his government is in position to meet obligations.

Russia98: Crisis

- 14 August: Stocks rebound and debt market stabilises. Yeltsin, on visit to Novgorod, rules out devaluation and backs Kiriyenko. He says he will not cut short his vacation and urges parliament to hold special meeting to consider government anti-crisis drafts. Russia's communist bloc backs Yeltsin's call for an extraordinary summer session of parliament, saying it should focus on the current crisis. Some major banks have trouble meeting payments to each other. Dollars become scarce on the street.
- 17 August: Statement of the Government and the Central Bank:
  - non-residents are not allowed to invest in short term (i.e. less than 1 year) rouble assets;
  - conversion of GKOs/OFZs into new governmental securities; and
  - 90 day moratorium on certain hard currency transactions.

What did it mean?

- Russia was not going to pay its GKO/OFZ obligations;
- External debt obligations were also suspended;
- The country was no longer part of the international financial system;
- The rouble was worthless. The band was initially devalued from Rub 5.3–7.1 per dollar to Rub 6.0–9.5 per dollar on August 17. However, amid the economic and political turmoil and central bank credit expansion, the market exchange rate depreciated through the Rub 9.5 level on August 26;
- Hyper-inflation and a severe recession were looming large.

The Extent of the Russian Default

The debt affected by the default amounted to 24% of GDP and 39% of total public debt. More specifically, Russia defaulted on its t-bill obligations in August 1998, on restructured loans (PRINs) in December 1998, on the MinFin-3 bond in May 1999, and on interest arrears notes (IANs) in June 1999. Russia had been in arrears to Paris Club creditors since 1998 (regularized in July 1999), and to some non-Paris Club bilaterals since 1996, in pursuit of comparable treatment to the 1996 Paris Club agreement.

The Restructuring: External Debt

- The London Club (LC) debt had three components:
  - Prins, or principal, ($22.2 billion);
  - IANs, or interest arrears notes, ($6.8 billion);
  - past-due interest on the first two components ($2.8 billion).
- The agreement reached with the London Club in August 2000 involved a write-down of $10.6 billion on Prins and IANs and the replacement of all three components by long-term eurobonds of the Russian Federation. The package resulted in a debt reduction estimated in present value terms of 50 percent.
- Two factors facilitated the conclusion of this deal: Prins and IANs were the obligations of Vneshekonombank, and not a sovereign liability. Had Vneshekonombank been allowed to go bankrupt, this would have created a legal nightmare for the holders of the debt, which meant that the offer to issue sovereign bonds in exchange was difficult to refuse. Moreover, the market value of Prins and IANs was a paltry $1.8 billion in October 1998, compared to $14.2 billion in July 2000 just before the exchange.

The Restructuring: Domestic Debt (1)

- The face value of GKOs/OFZs (excluding OFZ coupons) subject to restructuring was about $45 billion at the immediate pre-crisis exchange rate.
- This debt was held in almost equal amounts by Russian commercial banks, the Central Bank of Russia, and non-residents.
- Under the restructuring terms, Russian commercial banks and non-residents are estimated to have suffered losses estimated at 70 percent of the face value, a substantial fraction of this owing to the devaluation.

The Restructuring: Domestic Debt (2)

- The amount of the original GKOs/OFZs held by investors was adjusted by discounting the stream of payments on such GKOs/OFZs from their scheduled payment date to August 19 1998 at a rate of 50% per annum. Subsequently, they received a package combining cash, GKOs and OFZs, mostly (70%) 4-5 year OFZs.
- The roubles received by foreigners under the agreement had to be deposited in S-accounts. These “restricted roubles” could be used to buy permitted Russian corporate bonds and equities. Non-residents electing to convert and repatriate these “restricted roubles” would need to deposit these funds in non-interest bearing bank accounts for one year, after which repatriation would be allowed.
- Remember that GKOs/OFZs were under Russian Law!

Lessons from the Russian Crisis

- Fiscal discipline matters;
- Fixed exchange rate cannot be an anchor if macro-policies are not supportive;
- "too nuclear to fail" was the wrong approach BUT the moral hazard play was available to investors for too long a time;
- Bond investors do not really have major legal weapons in their negotiations. Reputational issues not as important as people thought;
- Why didn't the Russian authorities just inflate the debt away?

ARGENTINA 2001

Argentina 2001: How did it all start?

- The adoption of the currency board regime, which limits the degrees of freedom in conducting monetary policy;
- In this context, fiscal policy has to be prudent, especially when relying upon foreign capital;
- In the IMF's words:

The chief locus of vulnerability was the increase in public sector indebtedness; the main structural deficiencies were the low share and high concentration of exports, the economy's reliance on external savings, and the lack of labour market flexibility. At the same time, heavy reliance on foreign-currency denominated borrowing and generally high dollarisation raised the stakes associated with an eventual exit from the currency board.

Lessons from the Crisis in Argentina, IMF 2003

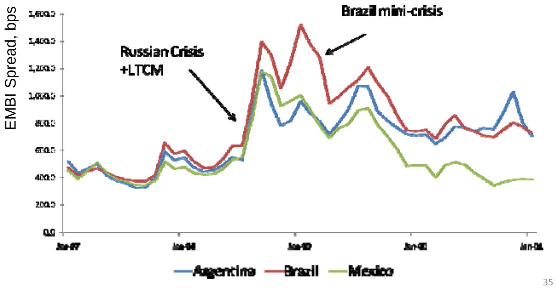
http://www.imf.org/external/np/pdr/lessons/100803.pdf

Argentina 2001: How did it all start? (2)

- 1997-98: Asian and Russian crises/LTCM, Brazil mini-crisis…. General risk aversion, flight to quality…
- Consumer confidence was sapped by external financial shocks and domestic political uncertainties, compounded by tighter monetary conditions and trade-related shocks; thereafter, the structural weaknesses came into play.
- The structure and low share of exports in GDP, arguably partly related to an appreciated real exchange rate, meant that the economy could not export its way out of recession;
- Labour market rigidities limited the adjustment of real wages and contributed to a sharp increase in unemployment which further eroded consumer confidence;
- Debt dynamics ruled out expansionary fiscal policy; and while the scope for monetary policy in a small and financially open emerging-market economy is limited, the currency board regime precluded even a modest monetary stimulus.

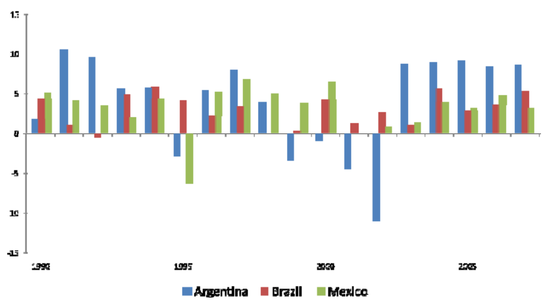
How about the market?

Not much of a reaction, until the end of 2000



The collapse of the economy: 2000-2001

(GDP Growth, % yoy)



Source: ECLA

The collapse of the economy: 2000-2001

- At the end of 2000, Argentina's debt dynamics had become explosive (remember the formula on debt dynamics:

$$(1) \qquad d_t - d_{t-1} = (pd_t - ndfs_t) + \frac{(r_t - g_t)}{(1 + g_t)} d_{t-1}$$

d	public debt/GDP ratio,
t	time subscript (in years)
pd	primary deficit/GDP
ndfs	non-debt financing sources/GDP
r	composite real interest rate
g	real growth rate

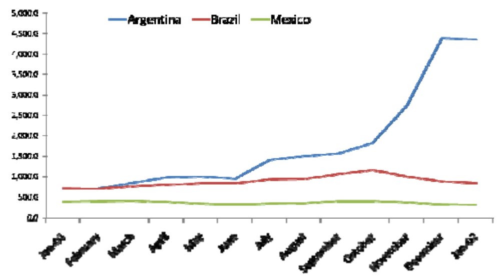
In October 2000, the yield of one-year bills was 16%, as compared with 8.89% in mid-July.

The collapse of the economy: 2000-2001

- In January 2001, the IMF approved a programme centered on fiscal adjustment and accelerated structural reforms. The financing provided was boosted to an equivalent of $14 billion, as part of a broader international support package of nearly $40 billion;
- Financial markets initially responded positively to the revised program, but already by mid-February, it became evident that the fiscal deficit was about to exceed the agreed ceiling for the first quarter. Moreover, following the resignation of the finance minister, his successor was forced out of office in less than two weeks as his planned budgetary cuts and reform measures failed to find the necessary political backing. Doubts about the sustainability of the public debt dynamics and the currency board arrangement resurfaced quickly, evidenced by rising spreads and sizeable deposit outflows.
- The authorities kept tinkering with the economy, trying to devise a new exchange rate regime for exporters and changing the banking law as to allow the injection of more liquidity in the system. The result of all these efforts amounted to a further loss of confidence in the policy stance on the part of the markets

How about the market?

EMBI Spread, bps



What was the market saying?

- "Argentina is on the verge of insolvency", Walter Molano, BCP Securities, October 23, 2000;
- "Argentina has neither devalued its currency nor defaulted on its debt obligations and we continue to believe that neither scenario is in the cards" ABN AMRO, January 2001

The Unfolding of the Crisis (1)

- March 19-20: Minister Lopez-Murphy resigns. Mr. Cavallo is appointed Minister of Finance.
- March 26-28: Rating agencies lower Argentina's long-term sovereign rating (S&P from BB to B+ and Moody's from B1 to B2).
- March 28: Minister Cavallo secures "emergency powers" from congress. Announces economic program comprising a tax on bank transactions, changes in other taxes and tariffs, and sectoral "competitiveness plans."
- April: Central bank reduces liquidity requirements and allows banks to include government securities up to Arg$2 billion among liquidity requirements.

EMBI Spread	February	March	April
bps	706.3	846.6	981.4

The Unfolding of the Crisis (1a)

- What was the market saying?
- "The government's capacity to service its debt this year is not in question… We believe that the fears of abandoning convertibility are overdone and point out that devaluation is not a policy option due to the limited benefits" JPMorganChase, March 2001

The Unfolding of the Crisis (2)

- April 16: Minister Cavallo sends to congress a bill to include the Euro in addition to the U.S. dollar in the Convertibility Law.
- April 25: Minister Cavallo's letter to the markets (see Appendix)
- May 8: Standard & Poor's lowers Argentina's long-term sovereign rating further from B+ to B.
- May 21: IMF completes third review of Argentina's stand-by arrangement, re-profiling the path for the federal government deficit target during 2001 to accommodate the deviations observed during the first quarter.
- June 3: Authorities announce the completion of the "megacanje". Government bonds with a face value of US$29.5 billion are voluntarily exchanged for longer-term instruments.
- June 15: Minister Cavallo announces package of tax and trade measures, including a trade compensation mechanism for exporters and importers of non-energy goods.

EMBI Spread	April	May	June
bps	981.4	999.9	956.2

A closer look at the "megacanje" (a)

- Why the swap?
- Argentina had to repay (interest+principal) about $80 bn in the following 4 and a half years and it clearly did not have the money to do so;
- Solution: voluntary exchange of the maturing debt for new paper

A closer look at the "megacanje" (b)

- A plethora of old bonds were replaced by 5 new ones:
  - one maturing in 2006; two in 2008; one in 2018 and one in 2031
- Let's look at one of them, the 2018:
  - No interest payment until 2006;
  - Thereafter, the coupon was 12.25%;
  - Deferred interest to be added to principal, bringing the YTM to 15.24%
- Overall, it was a "success": $29.5 bn of old bonds were swapped, much more than anticipated

A closer look at the “megacanje” (c)

- But was it a success?
- The swap would “dramatically” increase Argentina’s long-term debt burden despite the near term relief. The markets would experience “a short honeymoon period, and then a renewed focus on the still-recessionary economy”, Bear Stearns, 4 June
- IMF confidential calculations: $12 bn of savings for 2001-05 BUT the swap would add $66 bn for 2006-30 at an effective interest rate of 16% (remember debt dynamics!)

$$d_t - d_{t-1} = (pd_t - ndfs_t) + \frac{(r_t - g_t)}{(1+g_t)} d_{t-1}$$

- Outcome: Gov’t bond prices gained 7% by 12 June but by the following week the “country risk” was back close to 1000bps.

The Unfolding of the Crisis (3)

- July 11: Minister Cavallo announces a drastic programme of fiscal adjustment aimed at eliminating the federal government deficit from August 2001 onwards (the “zero-deficit plan”).
- July: Rating agencies lower Argentina’s long-term sovereign rating further (S&P from B to B- and Moody’s first from B2 to B3 and then from B3 to Caa1).
- July 30: Senate approves the zero-deficit plan (lower house of Congress had approved it on July 20).
- August 21: IMF announces a likely US$8 billion augmentation of Argentina’s stand-by credit.

EMBI Spread	June	July	August
bps	956.2	1410.1	1501.4

The Unfolding of the Crisis (4)

- September 7: The IMF board approves the augmentation of stand-by credit to about US$21.6 billion and completes the Fourth Review.
- September 20: The Central Bank activates the contingent repo facility with international banks, boosting gross reserves by about US$1.2 billion (US$500 million was disbursed in October).
- October 9-12: Rating agencies lower Argentina’s long-term sovereign rating further (S&P from B- to CCC and Moody’s from Caa1 to Caa3).
- October 14: Ruling coalition obtains less than 25 percent of the votes in mid-term congressional elections.
- October 28: Minister Cavallo announces that he will seek a “voluntary” restructuring of all the government debt.
- October 30: Standard & Poor’s lowers Argentina’s long-term sovereign rating from CCC+ to CC.

EMBI Spread	August	September	October
bps	1501.4	1566.5	1827.7

The Unfolding of the Crisis (4)

- November 1: The authorities announce a new fiscal package, including a new batch of competitiveness plans, the rebate of VAT payments on debit card transactions, a temporary reduction in employee social security contributions, a corporate debt restructuring scheme, and a tax amnesty that writes off interest and penalty obligations accrued to end-September 2001.
- November 6: Standard & Poor's lowers Argentina's long-term sovereign rating from CC to SD (selective default).
- November 16: FX reserves back to their level prior to the Sept 7 IMF approval
- November 23: The Central Bank introduces an effective cap on bank deposits, by imposing a 100 percent liquidity requirement on deposits paying an interest rate more than 1 percentage point above average of all local banks.
- November 30: The authorities announce completion of the local-leg of the debt restructuring. Government bonds with a face value of $41 billion at the Federal level and $10 billion at the provincial level are "voluntarily" exchanged.

EMBI Spread	September	October	November
bps	1566.5	1827.7	2742.4

The Unfolding of the Crisis (5)

- December 1: Facing a substantial run on deposits, the government introduced wide-ranging controls on banking and foreign exchange transactions, including a weekly Arg$250 cash withdrawal limit on sight accounts. (*corralito*)
- December 3: The IMF recalls its mission chief from Buenos Aires
- December 5: The IMF announces that it is "unable at this time" to disburse the $1.24 billion tranche of the programmme.
- December 10: The BCRA imposes a 98 percent reserve requirement on deposit increases after December 1, 2001; aimed at limiting flight to quality within the system.
- December 13: Phase one of the government debt exchange is completed.
- December 19: State of emergency is declared to stop protests against Minister Cavallo's economic policies. The lower house of Congress repeals the special legislative powers granted to Cavallo.

EMBI Spread	November	December01	January02
bps	2742.4	4383.9	4366.9

The Crisis

- December 20: President de la Rúa and Minister Cavallo resign after days of riots and protests that leave over 20 demonstrators dead. A banking holiday is declared for December 21, extended through December 26. Moody's lowers Argentina ratings to Ca from Caa3.
- December 23: Rodriguez Saá is named interim President; announces the default on external debt and calls Presidential elections within 60 days.
- December 30: President Saá resigns after his emergency policies are rejected by the Peronist governors.

2002

- January 3: Senator Duhalde is sworn-in as President with a mandate to conclude the remaining period of the de la Rúa presidency; President Duhalde announces the end of convertibility, and the introduction of a dual foreign exchange regime

EMBI Spread	November	December01	January02
bps	2742.4	4383.9	4366.9

One question…

- Why were there still investors holding about $100 billion of Argentina's debt?
- Aside from retail investors, why were the professionals still holding a large chunk of Argy debt?
- Indexed fund is the answer.

What after the debt repudiation?

- For the country: Dramatic fall of GDP, depreciation of the exchange rate, inflation (but less than expected)… then, massive and fairly quick rebound (see p.36) helped by depreciation and commodity prices boom;
- For bondholders: "take it or leave it" debt restructuring in 2005. The restructuring was very onerous for bondholders: haircut was 65%.

What have we learned?

- A sovereign country can default and there is not much bondholders can do;
- The market moves quickly, pre-emptive action must be REALLY pre-emptive and bold;
- Exchange rate-based stabilisation programmes do not work unless the government seriously pursues fiscal prudence;
- Indexed funds are riskier than total return funds when the market turns negative.

Domingo Cavallo 23 April 2001 An Open Letter to the Markets

APPENDIX

In the four weeks since I became finance minister I have been working on a comprehensive program to get Argentina moving again. I would have never thought four weeks ago that we could have made so much progress in such a short period of time. However, this progress does not seem to be reflected in the market valuation of Argentine assets. In fact, last Friday, prices continued to drop reflecting ongoing concerns on Argentina's solvency.

This note is to clarify what we have done, to explain where we are in terms of our financing program, and to clarify what our intentions are.
When I was appointed minister I realised that we had to solve quickly three very critical problems that the economy was facing. On the one hand, we had a serious problem of credibility regarding our capacity to run an effective government.

Second, we had to tackle the issue of fiscal solvency, which had critically aggravated in the months preceding my appointment. Finally, we had to get the economy going again, reverting three years of economic stagnation.

The first couple of days I devoted my energy to help President Fernando de la Rua in rebuilding the Alianza as an effective governing coalition and in bringing other political forces to play cooperatively in building a working government. I believe we were effective in attaining this objective and the results are clearly evident.

I started my appointment with two important legislative initiatives: the competitiveness law and the creation of a new tax on financial transactions. This tax received strong support from all of society because it was a mechanism by which the tax burden was paid by the society at large. An effective mechanism to have the effort shared by all economic agents and not just those already "in the system." In addition, the tax will open the ground for long run fiscal solvency, as it will be one of our critical instruments for curtailing tax.

But beyond those considerations, the tax, which is expected to collect about 1% of the GDP coupled with the $700 million decline in government expenditures decided upon last week, put the fiscal numbers back on track.
Today we do not risk compliance with the Fiscal Responsibility Law. In short, with creativity we overcame the shortage of tax revenues that we were anticipating for the remainder of the year (about $2bn).

Domingo Cavallo's letter, p.2

I want to emphasise that this was the first thing I did, and my role was to make this a feasible possibility. With the problem solved I moved to the important task of stimulating growth, both selling Argentina to the Argentines and to potential foreign investors, leaving the polishing of the numbers to my technical staff. In the next few days we will be able to get a seal of approval from the IMF.

To be honest, I am a bit surprised by how little credit was have been given for getting the fiscal numbers back on track. If markets are concerned about long run fiscal solvency, you can bet we will be working on both ends of the equation: revenues and expenditures in order to assure its achievement. In terms of revenues we will be developing a more efficient, simpler and better-controlled tax system. But I should not dwell into this until we have real and concrete achievements.

In my previous tenure as finance minister, the number of public employees was reduced in 300,000, and public accounts were balanced after forty years of chronic deficits and inflation financing. Yet, you have never heard in those years a single announcement regarding expenditure rationalisation.
We prioritise action over announcements. And there is still so much to be done. Who can believe I will settle for anything less than attaining long run fiscal solvency in Argentina?

As a proof of my determination, in the last few days the administration has signed decrees reducing expenditures for more that $380 million. More, obviously, is coming. In fact, the programme considers an additional expenditure reduction of close to $320 million for the remaining of the year, for a total of the $700 above mentioned. This would bring the expenditure level back to that implied in the 2000 budget.

At the same time, much greater emphasis is being placed on the discipline of the provinces where transfers are now conditional on fiscal performance, as illustrated by the reduced transfers to four non-performing provinces. Or the fiscal pact with the province of Buenos Aires that implies sizeable annual deficit reduction of more than $400 million over the next 5 years. Expenditure control is practised, not declamated.

In the last couple of weeks you have heard lots of talk about the possibility of a default. This talk, truly surprising given the strengthening of our fiscal situation, was, I believe, stimulated by the opinion of some uninformed people. I have thought a lot as to why honest people may dare write a recommendation as to how Argentina may default. Who could conceive such a destructive idea for a country, and be bold enough to propose it?

My reading is that there is an ongoing debate, regarding the role of the IMF in helping emerging economies. Many would like to see Argentina default as a way of proving the IMF wrong it its attempt to smooth out the instabilities of world capital markets. We are not sorry that we will prove these predictions wrong. In the analyses that I have seen on this alternative, there is a complete misunderstanding (almost omission) of the costs that a compulsory restructuring of our debt would have. For those with more experience, and who have lived in a country which has exposed itself to this kind of alchemy, the costs are so clearly evident that it just doesn't make sense to spend a minute thinking about it. We know of the magnitude of the costs of default. Particularly for a country such as Argentina with over 8,000 dollar per capita income and a fairly well developed domestic financial market.

On the contrary, in the context of a stronger fiscal situation, we have our external financing program nearly completed for the year. The domestic financing is based on the placement of programmed debt in pension plans, the placement of some Bontes plus the rollover of short term instruments through local market makers. Given the quantity of economic news that are hitting the markets and the advance execution of our financing program, we decided to postpone next Tuesday's auction.

We are already working on 2002, not only in terms of putting together our financial program but in terms of improving our fiscal solvency. We will soon be announcing a reorganisation of the government, which will allow a much tighter control of the social security system that today accounts for half of the national government expenditures.

With the financial program covered for the year, I believe the main concern of the market is not Argentina's ability to pay (in this regard we are in much better shape than a month ago), but its willingness to pay. Well, being the person responsible for the Argentine economy, I reaffirm our commitment to the continued improvement of our public credit. I believed we had moved this way, given the fiscal measures taken with my first piece of legislation. I thought the market would acknowledge the bold move and that they would interpret correctly what had done. I have since been concerned with pumping Argentine consumers and investors confidence to get the economy going, in selling the substantial upside that Argentina has and by pushing and motivating foreign investors to undertake business opportunities in Argentina.

On Thursday, when apparently market rumours were commenting my resignation, I was working with British CEOs in order to get the commitment for new foreign direst investment projects.

Domingo Cavallo's letter, p.6

For those who are holding Argentine assets, I can only congratulate you for your judgement. It is clear that you have kept your eyes focused on fundamentals. The truth is that what is important is the final product, not the packaging. For your sake and that of your clients, keep your sight on the contents but let me choose the packaging. As any good economist knows, in the end it is only the fundamentals that matter.

Domingo Cavallo's letter, p.7

Further Readings

- RUSSIA
- http://www.twnside.org.sg/title/1998-cn.htm
- http://www.imf.org/external/pubs/ft/weo/weo1298/pdf/file2.pdf
- http://www1.worldbank.org/economicpolicy/documents/mv/pgchapter10.pdf
- ARGENTINA
- http://200.32.4.58/~fsturzen/Victory%20by%20Default.pdf
- http://www.petersoninstitute.org/publications/chapters_preview/343/2iie339x.pdf
- http://www.petersoninstitute.org/publications/chapters_preview/343/3iie339x.pdf
- http://www.imf.org/external/np/pdr/lessons/100803.htm

Two excellent and easy-to-read books on EM crises, both by Paul Blustein:

- The Chastening, Public Affairs, 2003;
- And the Money Kept Rolling in (and out), Public Affairs, 2005