



Argentina's Impressive Economic Recovery and the Debt Swap

by Carlos E. Alfaro

The government of Argentina—and particularly the Ministry of Economy—is pleased not only with the results of the Argentine debt swap but with the general state of the economy. Bondholders that declined to participate in the exchange could not be more disappointed. A long legal battle between these disappointed bondholders and Argentina is likely to ensue.

Nevertheless, considering the default and financial crisis of two years ago, economic recovery looks promising. The speed of the turnaround is impressive. Asset values (real estate, industrial, farms, etc.) are higher than during the Convertibility Law in dollar terms, bank deposits are at record levels, and consumer spending is booming. Industrial production is approaching levels of the prosperous mid '90s, and revenues from exports have increased. Tourism is up sharply. Perhaps most surprising of all, to many who expected long lasting, dire consequences from the default, is that the quality of life that many enjoyed prior to the default is also returning.

Most analysts predicted that the offer that the Ministry of Economy of Argentina presented at the meeting of the IMF in Dubai more than a year ago was going to fail. The end result: 76.15 percent of bondholders accepted the largest discount exchange proposal in modern history. Despite misgivings about the government's negotiating tactics, the exchange has been an impressive success.

Warnings of Clouds on the Horizon

Despite the favorable news, some economists warn that the good times may be short lived. They argue that:

- Argentina still needs massive inflows of foreign capital and fresh money from multilateral organizations to sustain growth, and that such money will not be available;
- there are structural reforms very much needed to convert any plan in a sustainable program;
- inflow of genuine foreign capital necessary to sustain growth will not come;
- the attitude of the government will isolate Argentina from the IMF and the G7;
- Kirchner will fight with other leaders of the Peronist Party (particularly Duhalde) and will lose power with the unavoidable consequence of becoming a lame duck by the end of his third year as president; and
- consumption will slow because the 2003 and 2004 recovery was not more than a revamp due to more than five years of recession.

If the Cup is Half Full

However, there are also plausible, and more favorable, alternatives:

- the IMF becomes more flexible and extends payment terms of the debt to make it feasible for Argentina to meet its commitments;
- local credit becomes available at normal rates;
- consumption continues to grow as well as production;
- the value of the peso follows the fall of the dollar and therefore Argentine exports continue to benefit from its competitive advantage;
- commodities prices start rising again; and
- conditions of the financial world markets make Argentina an attractive place for investments.

Chances are good that Argentina will continue to make progress toward a true recovery precisely because of favorable international conditions, in both the political and economic areas.

However, in order to benefit from the advantageous external condition, Argentina must first resolve some problems at home. These include:

Judicial and Security Reform

The government has recently appointed new justices to the Supreme Court. New members come with considerable judicial experience and a more liberal center left ideology than before.

Corruption in the lower courts remains a problem, however public scrutiny has increased and several judges have been impeached. Public pressure has also triggered reforms in the police force and a significant improvement in security.

Elections

The Peronist Party has no credible opposition. In the House of Representatives, the party controls 129 seats out of 257. The second majority party, the Radical Party, only has 44 seats followed by a new party, ARI (center left), that has 10 seats.

In the Senate the Peronist Party has 41 seats out of 71, with 14 seats held by the Radical Party. The rest of the seats are divided among the 12 provincial parties.

In October, 2005, there will be elections for the renewal of one-third of the House of Representatives and seats in the Senate of eight provinces. Unfortunately, the political battle will be centered only within the Peronist Party which is divided among many sectors.

Payment of the New Debt and Holdouts

The government closed its \$103 billion Private Debt restructuring offer on February 25 and announced a final acceptance rate of 76.15 percent on March 18.

Argentina's \$103 billion debt has been converted into \$35.2 billion of restructured debt. Of that amount, \$15 billion will be issued in par bonds, \$11.9 billion in discount bonds and \$8.3 billion in quasi-par bonds.

The debt has been extended until the year 2046 at a lower interest rate, and partly in pesos. According to government figures, 37 percent of the country's total debt load will be in pesos after the new bonds are issued, compared with 3 percent in December 2001.

At the time of the restructuring, the government tried to convince creditors that its offer was final, by passing a law prohibiting the re-opening of negotiations. The closer we get to the October elections, the more difficult it will become for the government to reopen negotiations with the hold-outs.

Some of the funds with bond positions are seeking to attach the old bonds deposited with the trustee, the Bank of New York. Technically the bonds still belong to the private individuals or institutions that enter into the exchange, and the trustee has immunity. Even if this action is not likely to succeed, it produces uncertainties and a delay in the exchange of the new bonds that were originally scheduled to be issued on April 1.

Payments to Multilateral Financial Institutions

The government must pay \$12 billion this year in principal and interest to international financial institutions. Between 2005 and 2010 it will have to pay some \$70 to \$80 billion.

After 2010, Argentina must then renegotiate with the multilaterals its payment obligations and obtain better financial terms. In order to renegotiate the IMF has demanded:

- a higher fiscal surplus;
- closing of negotiations of the Concessions;
- the enactment of some federal laws, such as the Federal Tax Co-participation, and "Structural Political Reforms."

Though some predict tough negotiations Argentina is in a more favorable position than a few years ago. It has paid 100 percent of its debt with the IMF and is not in urgent need of fresh money.

Likewise, after the restructuring the World Bank has liberated substantial amounts of money for infrastructure development (roads, water sewage, etc.) that were suspended during the crisis. This is a sign that pessimists are ignoring.

Concessions

The government must renegotiate 49 concession agreements. It is expected that 35 agreements will be concluded by the end of this year. The government has required concessionaires to withdraw claims before ICSID (International Center for Settlement of Investment Disputes) as a condition for the renegotiation.¹ (While some of the concessionaires have filed suits that would permit ICSID claims to go forward, the newly constituted Supreme Court is expected to side with the government.) Gas Natural Ban (a distributor of natural gas) has already announced that as a result of negotiations with the government it is withdrawing its claim before ICSID. Following suit the Senate has approved a renegotiation agreement with a concessionaire of public services (EDELAP-electricity). The agreement contemplates a tariff increase of 23 percent for major consumers (industry) as from May 2005. The government expects to use this agreement as a model for other companies. The House of Representatives most likely will ratify the Senate decision.

Tariffs, committed investments, debts, and judicial suits are all pending issues that must be renegotiated. In the 12 negotiations that have been concluded so far, the government has already authorized tariff increases. The government permitted natural gas distributors a 15 percent increase; water companies were allowed increases between 16 and 20 percent. The impact of these increases on the inflation rate and salary adjustments remains to be seen.

Exchange Rate and the Dollar

A favorable exchange rate is necessary to maintain the competitiveness of Argentine exports. However, to keep the peso undervalued, the Central Bank must print money to buy dollars in open market operations. The government will intervene as necessary through institutions like Banco Nacion (a national owned bank) to maintain the present rate.

The inflationary effect of buying dollars with new printed money can be compensated with operations in the open market like the offering of new treasury bills (Lebac) to take pesos out of circulation, creating an opportunity for the inflow of speculative short-term investments.

Notwithstanding the low value of the peso, it is estimated that exports will grow only 4 percent in 2005, compared to a 20 percent expansion in imports, due to increased consumption and increased industrial activity.

Inflation

Inflation will not only be closely associated with the increase in the money in circulation (by the printing of new money by the Central Bank) but also by:

- the increase in tariffs to be renegotiated with the Concessionaires;
- salary pressures in an election year;
- the increase of prices as an undesired effect of tourism;
- producers of consumer goods and public service providers possibly also raising prices.

President Kirchner has aggressively fought price increases. In March, Kirchner asked Argentines to boycott Shell's gas stations (!) after the oil company raised prices by 4 percent. In more pacific—and appropriate—negotiations, the government reached an agreement with meat producers and supermarkets to reduce prices. Other similar agreements will likely follow. While these measures will have only a temporary effect (and have generally failed in the past) they may dampen an inflationary surge in 2005 and allow the government time to take other actions.

Salary and Redistribution of Profits

Some specialists say that salary increases will accompany increases in domestic productivity and internal economic activity. The Ministry of Economy says that salaries will rise with investments

that generate employment. The Ministry opposes adjustments of salaries by inflation rates proposed by unions.

It remains to be seen if the government can resist the pressure of unions in an election year.

Tax and Social Security Reforms

A sustainable recovery requires a tax reform to eliminate distortion in the tax system, increase compliance and eliminate tax evasion as well as unregistered employment—i.e., large numbers of workers working outside the formal economy.

Argentina has a withholding tax on exports that ranges from 25 percent to 45 percent and an income tax of 35 percent. There is no withholding on the payment of dividends.

It is very unlikely that the government will eliminate or reduce withholding taxes on exports. As exports have helped fuel the recovery, the tax on exports has been a crucial contributor to the treasury. Reliance on the withholding tax on exports has permitted the government to protect the internal market and compensate the benefits of a low peso for the exporting sector, a benefit that other sectors of the society do not receive.

The withholding is also a crucial source of revenue for the federal government—the funds collected do not have to be shared with the provinces, like the income tax.

Conclusion

Certainly the president of Argentina has a controversial style and the Ministry of Economy is a tough negotiator. But the circumstances in which Argentina is involved may require this kind of leadership. Once the main issues have been resolved, such style will not be productive. But while the main political and economic issues are still unresolved, like the renegotiation of the concessions contracts, the medicine applied may prove successful. Likewise, government revenues are at a high level which will allow development of infrastructure projects and further reduce unemployment. Consumption will continue to grow as a result of this factor as well as the level of economic activity (GDP growth in January was 9.1 percent and it is estimated to be above 7 percent for the whole year).

¹For more on the suits before the ICSID, see “ICSID Arbitration Cases against Argentina Revisited,” *LALBR*, page 10, Nov. 30, 2004. □