ARGENTINA'S SOVEREIGN DEBTS RESTRUCTURING AND CREATIVE SOLUTIONS

Prepared by Participants of
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SECTION I. EXECUTIVE SUMMARY

This report presents recommendations to the Government of Argentina on handling its current debt crisis. We advocate an approach substantively different from the one currently pursued by the Argentine Government.

Our objective is to formulate a longer term strategy to secure the welfare of the people of Argentina, focusing on development, partnerships and participation. Presenting a long term strategy, in our opinion, will embellish the credibility and confidence of the Government of Argentina in the eyes of International Financial Institutions, Private and Public Lenders, Global Investors, Multinational Corporations and trading partners.

We do not recommend an adversarial approach. Instead, we stress the importance of building partnerships, developing a congruence of interests and participation of our creditors in the upside of potential development.

Our recommendations are based on **three strategic pillars**:

a. **Development of strategic partnerships and a robust long term growth strategy to increase the value proposition of Argentina**
b. **Market driven debt restructuring options, including "Recapture" clauses that enable our "partner creditors" to benefit from the upside of economic growth**
c. **Permanent reforms of the structure of Provincial Debts to prevent future recurrence of mismanagement**

We believe the current approach of offering unilateral hair-cuts to the private creditors is short sighted. These are mere tactics, not a comprehensive strategy for development. The approach of offering to pay 25% of the value of the debt perhaps takes a snap shot of the perceived values of the economy today. **We feel this is a gross understatement of the potential of Argentina.** A value proposition built around a robust longer term growth strategy needs to be packaged and marketed aggressively to the international community.

Our current "adversaries" have to be encouraged to buy into the concept that if they become partners in our restructuring, they will benefit from participating in the upside. This, in turn, will boost the value of their Argentine credits.

For the Government of Argentina, the current crisis presents a significant challenge as well as a golden opportunity. The challenge is to return Argentina to the international economic and financial community as soon as possible while not jeopardizing the potential for future economic growth and social stability through unrealistically optimistic assumptions and policies.

The widely acknowledged difficult economic situation, coupled with broad popular support for President Kirchner makes it possible for the government to implement difficult and long-overdue reforms. Areas in dire need of such reforms include constitutional amendments to rationalize provincial debt, guaranteeing protection of property rights and promoting favorable attitudes toward foreign investors.

These reforms should not be implemented in isolation, but be part of a creditor quid pro quo. In return for these ground breaking reforms, the Government of Argentina should obtain assurances of participation from the creditors, ensuring a prompt return to the international economic community.

Argentina stands at a crossroad. The government can, through carefully devised reforms, backed by strong popular and political support, give the deciding impetus to set the country on the right track for the future.

There is no time to waste. The Government needs to find an immediate solution to restore creditor and investor confidence – NOW!

SECTION II. BACKGROUND

Our Mission

This study was undertaken as part of a graduate policy workshop at Princeton University's Woodrow Wilson School of International and Public Affairs. The writers researched the options available to the Government of Argentina through interviews with experts in Argentina, including former members of government and other practitioners, as well as from an academic perspective. We used Chile as a comparative model for the purpose of this study. Part of our research was carried out on a field trip to Argentina and Chile in October-November 2003.

The objective of this proposal is to provide the Government of Argentina our unbiased recommendations on dealing with the current sovereign debt crisis. To this end, we have taken a strategic approach aiming at longer term solutions to this present crisis. We feel such a strategic approach, which integrates market driven solutions, will provide a robust course for action towards maximizing long-term welfare for the Argentine people.

The Default

In December 2001, Argentina recorded the largest sovereign-debt default in history. Claiming inability to service its debt, the Government of Argentina suspended indefinitely payments on it's roughly US$100 billion debt to private creditors. This shocking announcement went hand in hand with a severe disruption of the domestic economy and the banking system, as the government froze bank deposits to prevent a potential bank run. The abandoning of the hard peg to the US dollar and the subsequent 70% devaluation of the peso had already decimated bank deposits; the strong step to prevent withdrawals from banks further added to the prevailing pessimistic mood among the population. The recession that followed was one of the deepest in Argentine history, raising the percentage of the population living in poverty to 53% and, for the first time, creating a hunger problem in this formerly affluent country. The government now faces the challenging task of bringing the economy back on its feet and restoring confidence, both domestically and internationally, in its economic policies.

Magnitude of the Debt Default

The following tables summarize Argentina's debt as discussed in the October 2003 restructuring proposal:

Gross Debt Stock Eligible for Restructuring in Argentina's October 2003 Proposal

	Outstanding Debt	
DEBT TO BE RESTRUCTURED	Millions USD	% of Total
Eligible Debt (Bonds)	87,050	48.7%
Bilateral	5,217	2.9%
Commercial Banks	1,724	1,0%
Other Creditors	311	0.2%
Total	**94,302**	**57%**
EXCLUDED DEBT		
IFI's	30,792	17.2%
- IMF: ~15,000		
- World Bank: ~8,000		
- IDB: ~ 8,000		
BODENs	22,580	12.6%
Guaranteed Loans	15,588	8.7%
Provincial Guaranteed Bond	10,200	5.7%
Exception Payments	606	0.3%
Others	4,727	2.6%
Total	**84,493**	**47.3%**
Total	**178,795**	**100.0%**

Source: Argentina's Restructuring Guidelines. Mecon, 2003.

Almost half of Argentina's total debt (US$87,050 million = 48.7%) is in the form of bonds and thus affected by our research question. The two main types of excluded debt worth mentioning are the debt to international financial institutions (US$31 billion, i.e. 17.2%) and the BODEN debt (US$23 billion, i.e.12.6%).

Crisis Management

After its December, 2001 default on its sovereign debt, the Government of Argentina embarked on a radical emergency action plan. After the freezing of bank assets, it mandated conversion of US dollar deposits into pesos through a process of "asymmetrical pesification," in which bank assets were converted at a less favorable exchange rate than liabilities. To compensate, the government issued bonds (BODEN) as compensation to the banks. This saved the banking sector from collapse, yet at considerable cost.

In October 2002, Argentina failed to make a scheduled payment of US$805 million and became one of a limited number of countries, including Iraq, Zimbabwe, Seychelles, and Liberia, that failed to repay its debt to the World Bank. On September 9th 2003, Argentina defaulted on a US$3 billion repayment to the International Monetary Fund (IMF). It is the largest non-payment of a loan in IMF history. The subsequent deal worked out with the IMF basically rolled over Argentina's debt and provided emergency assistance funds for the upcoming six months.

Playing Tough?

So far, it seems that Argentina has succeeded by playing tough. It was also confirmed from our field research that most Argentines are satisfied with the strong attitude of their government in negotiating with foreign creditors. In September 22, 2003, Argentine Economy Minister Robert Lavagna announced the repayment proposal, the centerpiece of which was a 75% face value reduction of the government bonds held by private bond holders.

Bondholders have summarily dismissed this proposal as unacceptable. Italians, who constitute about 15% of the bondholders, rejected the plan outright, saying it was "not an option." Argentine pension funds (AFJP), which hold 20% of bonds, are balking at the suggestion that they should accept a write-down of US$10.5 billion in the value of their bonds. Nonetheless, the Argentine Government seems to believe that it will succeed if it continues to be tough and continues with its populist rhetoric.

We do not subscribe to these views!

SECTION III. MARKET DRIVEN RESTRUCTURING

Market-Driven Restructuring - Three Options

- **Debt buyback: encourage Argentineans to buy back their debts on the secondary market – tapping into the $ 100 Billion offshore assets held by Argentineans**
- **Debt-equity swap: private investors buy Argentine debt at market prices and swap the debt for local currency which can be used for new or existing projects**
- **Longer maturity bond with recapture clause: private creditors can choose a new bond without any face value reduction but with lower fixed interest rate. The recapture clause enables them to re-negotiate favorable terms as the economy grows**

Framework of Analysis

a. Current restructuring proposal of the Government of Argentina – “haircut based”
b. Importance of re-negotiating with private creditors – to present new restructuring plan
c. Our proposal – “A market driven approach”

Government of Argentina’s “Haircut Based” Approach

On September 22nd, 2003, Argentine Economy Minister Robert Lavagna announced the repayment proposal unilaterally asking private bond holders to write off 75% of the face value their Argentine Sovereign Debts of $ 94 Billion. In effect, private creditors were being asked unilaterally to forgive debts exceeding $ 70 Billion to the Government of Argentina! Bondholders were asked to choose one of the following types of new bonds and simultaneously execute a swap of their existing debt.

New bonds proposed for swap:

- DISCOUNT: reduction in face value.
- PAR: with a small or none face value reduction, but lower coupons and longer terms.
- C BONDS: with capitalization.
- The menu is designed to obtain a 75% reduction in the nominal value of the stock of eligible debt.
- Denominated in USD, Euro, Yen, and Argentine peso (indexed).
- Governing laws will be those of: New York, England, Japan and Argentina.

Field Research Findings

It appears from our field research in Argentina that this 75 percent haircut debt-restructuring plan is well regarded by G-7 countries as a demonstration of a good faith effort for Argentina to repay its debt. However, the private creditors were not at all satisfied with this unilateral proposal of 75 percent haircut. Most of the private creditors believe that this restructuring plan discounts their assets excessively given their assessment of the current economic situation and expectations for future growth in Argentina. In this section, we assume that repaying 25 percent is the utmost value that the Argentine government can credibly commit at the present juncture.

"Full Default" and Reputational Risks

Argentina could have chosen full default instead of repaying 25% of its debt. If there had not been a debt service, Federal government could have run the fiscal surplus. According to William English (1996), military invasions were used to force sovereign to repay its debt in 19th century. Nowadays, military invasion is no longer an option, and there is no strong measure to enforce the repayment. Considering that, full default may have been a possible option for Argentina.

From our field research, however, we found that full default was not an option. For both economic and political reasons, it is in the interest of Argentina to have good relationship with the U.S. and other G-7 countries. Our interviews with the economists, business practitioners and former senior officials confirmed that Argentina does not want to be isolated from international community or to be treated as an irresponsible country.

The U.S. and other G-7 countries have made it very clear that Argentina should make good faith effort to repay its debt given its economic constraint. Complete default is definitely not acceptable option; the relationship with G-7 would have been seriously jeopardized if Argentina had chosen that option.

Thus, there was a strong incentive for Argentina to show to the U.S. and other G-7 countries that it was making a serious good faith effort to restructure its debt. This was the logic behind the proposal to repay 25% of the nominal value.

Importance of Re-Negotiations with Private Creditors

Argentina needs to restructure its debt to regain access to international credit markets and help the economy as it recovers from a four-year recession. Failure to restructure its bonds may also affect an agreement with the IMF to rollover its debt owed over the next three years to multilateral lenders. Argentine government, however, seems to believe that they would succeed if they continued to be tough. Although the Government promised that it would aim to conclude negotiations with private creditors by mid-2004, there is no positive sign of reaching an agreement.

Sovereign debt has significantly different characteristics from private debt:

1. There is often little that a sovereign entity can use as collateral to guarantee the value of loan.
2. The ability of a court to force a sovereign entity to comply with its wishes is extremely limited. Therefore, repayment incentives for a country are its desire to avoid some sanction, if it fails to repay, and/or to obtain some reward if it repays.

Reputational Risks and Linkages

There are several studies which attempt to clarify the role played by different benefit or penalties, for example, exclusion from future credit markets, inability to conduct trade, difficulties in borrowing in the domestic credit market, or a loss of output.

An early answer to the question, “Why the sovereign countries ever repay the debt?” was offered by Eaton and Gersovitz (1981); “Sovereign countries may repay their debt because they fear that defaulting on it will tarnish their reputations and thus hinder their ability to borrow in the future.”

Bulow and Rogoff (1989), however, argued “under fairly general conditions, lending to small countries must be supported by the direct sanctions available to creditors, and cannot be supported by a country’s ‘reputation of repayment’.”

Cole and Kehoe (1997) built a model in which the misbehavior of debtor country will result in negative consequences in other relationships and argued “if a country is involved in a myriad of trust relationships, the country’s reputation can spill over to a non-debt relationship which has enduring benefits.” A necessary condition for Cole and Kehoe’s model is that misbehavior in the debt relationship spills over to a relationship in different arena. An example given is that if the U.S. broke a fish treaty with Canada, it might cause a negative reputation in a mutual defense pact with Japan.

While it is not impossible, it seems to be too remote. Theoretical understanding has not yet come up with the robust conclusion on what would motivate a sovereign state to repay its external debt.

In spite of this limitation in theoretical understanding and the two constraints discussed above, (i.e. Argentina’s inability to commit to a repayment greater than 25%, or opting for a full default), **we believe the Government of Argentina should:**

a. Re-propose the debt-restructuring plan, and,

b. Reach an early agreement with its private bondholders

Rationale for Re-Negotiation

- **Investors have a strong preference for "Market-Driven" restructuring**
- **Harmful effects of prolonging debt restructuring negotiations**
- **"Holdout problems" could arise**
- **Reduced debt-GDP ratio would be positive for the economy.**

Investors' strong preference for "Market-Driven" restructuring

In our interview, Chilean economist, Juan Andres Fontaine underscored the importance of taking market driven approach in the debt restructuring process. He stressed the underplaying of the "haircut approach" in any restructuring process. Instead, greater reliance should be played on market mechanisms.

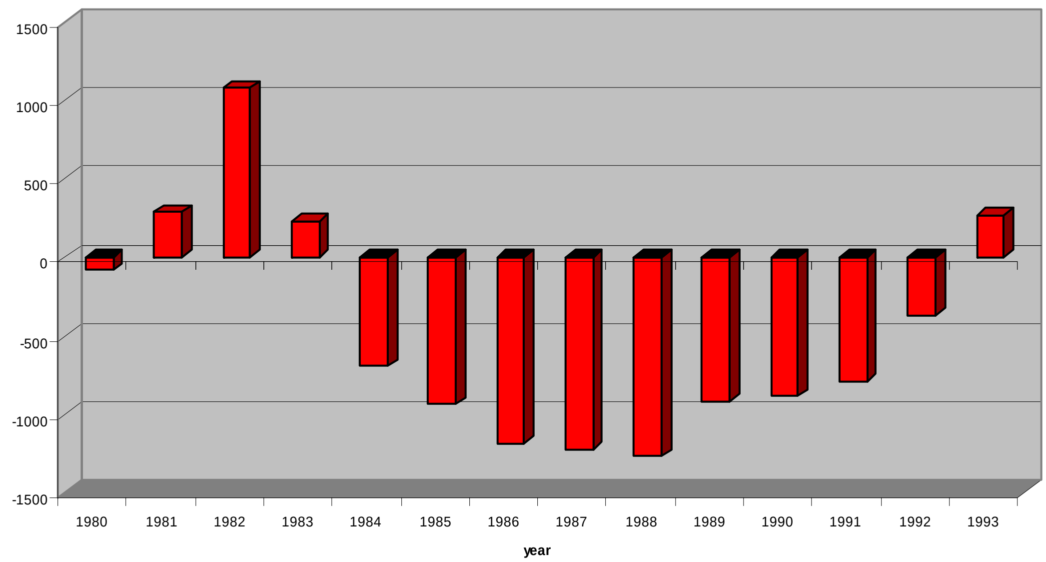
Empirical Evidence

To contrast the effects of a unilateral approach v. a market driven approach on direct investment, we present the comparative experiences of Chile (market driven approach) and Peru (unilateral approach) during the debt crisis in 1980s.

Peruvian Case

In July 1985, Peruvian president Alan Garcia stated that Peru has unilaterally decided not to pay more than about US$300 million -10% of export earnings – to service its US$14,000 million foreign debt during the next 12 months. This announcement upset foreign creditors, and some argue that the enormous amount of capital flight was caused by this declaration of debt repudiation. From Figure1, we can see that direct investment and other long-term capital had been negative for eight year after President Garcia's announcement.

Fig.1 Change in Direct Investment and Other Long-Term Capital (Peru)

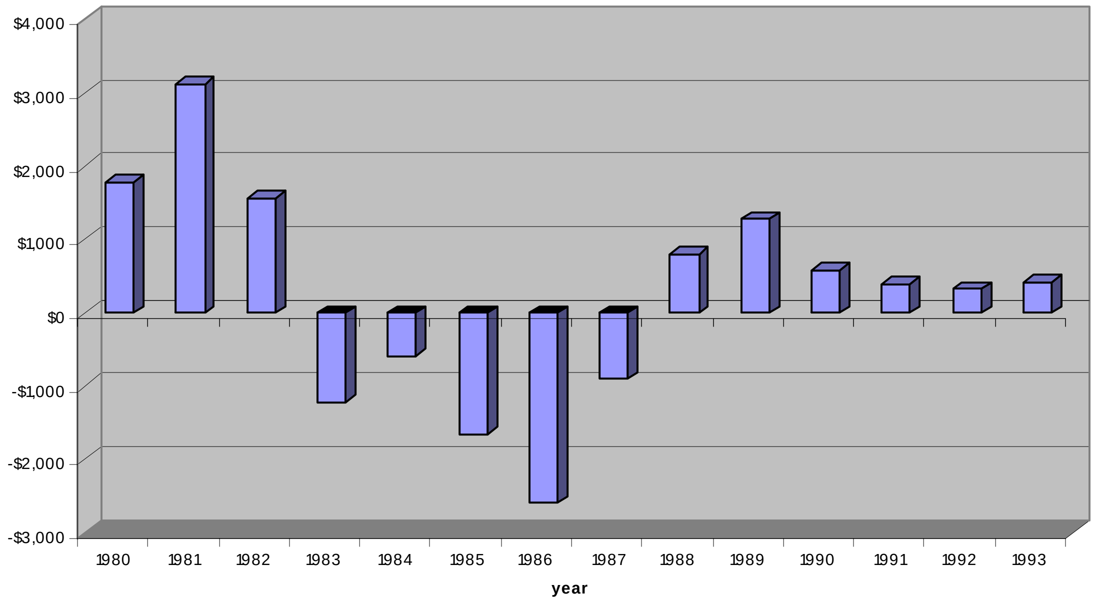


Source: IMF "Balance of Payment Yearbook" – note: Y axis figures in $ millions

Chilean Case

In 1982, Chile was hit by the international debt crisis and Chilean pesos, which was pegged to US dollar devalued by 78%. In 1985, Hernan Buchi was appointed finance minister and launched a major debt-restructuring program. Chile took market-based approach to restructure its debt. Consequently, the direct investment and other long-term capital turned to positive within three years, as is seen in Figure 2.

Fig.2 Change in Direct Investment and Other long-Term Capital (Chile)



Source: IMF “Balance of Payment Yearbook” – note: Y axis figures in $ Millions

Findings – Market Driven Approach Wins

From the comparison of above two figures, it is obvious that unilateral debt restructuring plan does bring a huge amount of capital flight from the country. It was not until Alan Garcia left the office that the fear of investors was eased. Alberto Fujimori defeated Alan Garcia in presidential election in 1990. Fujimori first tried to re-establish a free-market system, stabilized the inflation at about 140% after one year and regained the confidence of international lenders.

There is an argument that the enormous amount of capital flight, which Peru had experienced in late 1980s cannot be solely attributed to President Alan Garcia’s decision, to repudiate a substantial portion of that country’s debt. Some says that although Peru did experience serious economic difficulties in the years following its repudiation of foreign debt, there is no evidence to suggest that those difficulties were the result of a backlash on the part of foreign investors. They argue that it should be attributed to a number of drastic changes in the Peruvian economy, experimenting with price controls, and a fairly radical (but poorly thought-out) program of Keynesian spending.

Chile, on the other hand, by adopting a market driven approach, was able to turn around market sentiment in three years. By 1988, Chile was experiencing positive direct investment in its economy to the tune of $ 700 million, having taken only three years to reverse the capital flight after introduction of market-driven restructuring in 1985.

Harmful effects of prolonging debt restructuring negotiations

Prevailing Sentiment in Argentina

From our interviews, it appears that there is little incentive for the Argentine government to reach an early agreement with private creditors. The Government has reached an agreement with International Financial Institutions and the economy is growing as to achieve 7% growth in year 2003.

Devaluation of pesos has brought about pro-FDI environment. Other Latin American investors view this financial crisis as “opportunities which only come around once in a lifetime”. Acquisition of Argentine companies by Mexican and Brazilian investors ranges from the Telecom Company to a bread maker (Business Week Oct.13, 2003).

It is natural for Argentineans to become complacent with the current state of affairs, hence assigning a lower priority to reaching an agreement with private creditors. The prevailing sentiment in Government circles seems to indicate that there is no shortage of greedy investors eager to invest in Argentina at these fire-sale prices. Further, the market has a short memory and therefore the default would have little effect on investors’ sentiments.

We do not agree with these sentiments and feel that the prolongation of debt restructuring will have a negative impact on Argentina.

Time is Running Out

A full twenty-two months elapsed before Government of Argentina reached an agreement with International Financial Institutions. This is an extremely long period compared to other sovereign defaults.

For example, Ecuador announced a comprehensive exchange offer 11 months after the default and completed it after 1 month of announcement. In case of Russia, the exchange offer was completed after 14 months of default.[1]

In the Letter of Intent signed with the International Monetary Fund, Argentina says, “we are determined to seek a speedy resolution of the debt restructuring (with private creditors) and would hope to complete by mid-2004.” Of course it is almost unthinkable that IMF would change its attitude just because Argentina was not able to meet this agreement. However, a prolonged duration of debt restructuring with private creditors would increase the uncertainty of investing Argentina, and would hence have adverse effects on capital inflow into the country.

Adverse Credit Ratings

Sovereign credit ratings play an important role in determining the terms and the extent to which countries have access to international capital markets. As more countries are added to the list of rated sovereigns, the issue of the information content of ratings becomes even more important. Indeed, sovereign credit ratings are supposed to serve as a summary measure of a country’s likelihood of default. Hence, the countries with the lowest ratings are likely unable to borrow from international capital markets and depend on official loans from multilateral institutions or from individual government.

Credit ratings of Argentine sovereign debt cannot improve until the restructuring and exchange to new bonds is completed.

[1] Author’s calculation using the data in IMF (2003), “Reviewing the process for Sovereign Debt Restructuring within the Existing Legal Framework”.

Empirical Evidence

Uruguay Case

The effect of debt exchange completion on credit rating is clear from the recent experience of debt-restructuring in Uruguay. Uruguay announced the intention to engage in a bond exchange on April 10, 2003. The authorities proceeded with the exchange offer on May 15, after a sufficient number of eligible bondholders participated, and subsequently completed the exchange on May 29 when new bonds were issued.

Upon the announcement of the exchange offer, S&P lowered the long-term foreign currency rating to "CC" and indicated that in would downgrade Uruguay's foreign currency debt to selective default ("SD") if the authorities proceeded with the exchange offer, because it viewed the transaction as a distressed exchange. On May 16, S&P downgraded the foreign currency debt to SD, but clarified that it would consider the selective default to be cured if the debt exchange was successfully completed and new bonds were issued.

Following the completion of the debt exchange on May 29, new ratings on Uruguay debt were determined based on a forward-looking assessment of the sovereign's creditworthiness. S&P raised Uruguay's foreign currency rating to "B-"on June 2.

Other Empirical Evidence

Argentina's future credit rating will almost certainly suffer from the default; however, quantifying the effect and relating it to the magnitude of the NPV reduction may be difficult. The example of the three countries that recently restructured their debt (Pakistan, Ukraine, and Ecuador) shows inconclusive results. Pakistan restructured a small part of its external debt with a significant haircut for the creditors. Its S&P foreign currency credit rating one year prior to the restructuring (December 1998) was CC/Negative/C; immediately following the restructuring (December 1999), B-/Stable/B; three years after the restructuring (December 2002), B/Stable/B. The Ukraine received its first S&P foreign currency credit rating one year after its restructuring (December

2001) at B/Stable/B. It has basically remained stable in the following two years. Ecuador received its first S&P foreign currency credit rating immediately after its restructuring offer to creditors (August 2000); it was B-/Stable/C. One year later (August 2001), it had deteriorated to CCC+/Negative/C, and three years after the restructuring (September 2003), it was at CCC+/Stable/C

Argentina's Default Ratings

Currently the credit rating of Argentinean sovereign bond has been downgraded to default category. If the credit rating for the Argentinean bond stays near default status, it is impossible for investors such as pension funds or mutual to hold these assets. Downgrade to below investment grade rating or near default status triggers sell orders by investors. Furthermore, investment mandates of pension or mutual funds generally have restrictions on investing in "below investment grade" credits.

Downgraded sovereign bond status also affects the credit rating of a country's corporate bonds. Generally, credit rating of sovereign bonds forms an upper limit (country ceiling) for corporate bonds issued in that country. In that sense, the prolonged debt-restructuring negotiation on sovereign debt would negatively affect corporate financing in Argentina as well.

Other Significant Research Supporting Early Restructuring

Bulow & Rogoff argue that the primary motivation for repayment is the threat of direct sanctions that lender can impose by going to creditor country courts and by influencing their respective domestic legislations. Such sanctions can cost defaulting debtor countries their ability to transact freely in the financial and goods markets.

For example, if a country repudiates its foreign loans, it may be forced to conduct its trade in roundabout way to avoid seizure. To compound this problem, the country will also be blocked from normal access to trade credits. Very short-term trade credits, such as bankers' acceptances and letters of credit, are enormously important in reducing transactions cost in international trade.

In the model Bulow & Rogoff develop, a country is willing to make some repayments on its debts in order to enjoy its full gains from trade. Legal sanctions can also make consumption smoothing more difficult by preventing default countries from openly holding assets in the industrialized countries for fear of seizure.

There is also a broader view to this issue; Cole and Kehoe point out that "if a country is involved in a myriad of trust relationships, the country's reputation can spill over to a non-debt relationship which has enduring benefits"

"Holdout" Risks

There are several Vulture Funds which buy "distressed securities" in the secondary market at discounted prices, and then seek full payment sometimes by filing lawsuits against debtor thereby achieving high capital returns. Prolonged negotiation of debt-restructuring and consequently the increase in turnover of Argentine Sovereign Debt in secondary markets will create increased opportunities for such vulture fund activities.

There are a couple of cases in which the sovereign was forced to fully repay such vulture funds. Anne O. Krueger, the First Deputy Managing Director of IMF mentioned Elliott case in her address to SDRM. In 1997, Elliott Associates bought US$20 million of commercial loans guaranteed by Peruvian government. Rather than accepting the Brady bonds offered when Peru tried to restructure its debt, Elliott demanded full repayment and interest.

In June 2000, Elliott obtained a judgment for US$56 million and an attachment order against Peruvian assets used for commercial activity in the U.S. Elliott targeted the interest payments that Peru was due to pay to its Brady bond holders who had agreed to do the restructuring. Rather than be pushed into default on its Brady bonds, Peru made full repayment to Elliot Associates.

It could be argued that the Elliot case may be an exception. If there were several vulture funds trying to get full repayment, they would end up diluting their own interests and achieve minimal payoffs. However, the Elliot case is significant as it shifted balance of power from debtors to creditors. As to the recent case of Ecuador, 3% of bondholders were left out of the debt-restructuring.

It should be borne in mind that investors' discontent and prolonged debt restructuring may increase the opportunity for vulture fund as investors will increasingly sell their bond from the uncertainty of return.

Reduced debt-GDP ratio would be positive for the economy

Debt GDP ratio is one of the key determinant of solvency. It is also important for credit rating. According to the announcement of Argentine government, the debt-GDP ratio will be improved from current 150% to 90% after restructuring.

Argentine businesses are suffering from the uncertainty arises from this long lasting debt settlement dispute. We believe that their request for the government to have a quick settlement should not be ignored.

The reason is simple: the recovery of the economy depends on the performances of these enterprises. The high unemployment rate, which is both an economic problem and a huge political problem, could be lowered if the domestic enterprises could do their business in a healthier environment. Therefore, it is urgent for the country to settle this debt problem so that the economy could move on.

Market-Driven Restructuring Proposals

As noted earlier, it is admittedly difficult for the Government of Argentina to commit a higher repayment schedule at present given their estimation of debt capacity and potential valuations. At the same time, it is highly unlikely for the private creditors to accept the current proposal set forth by Argentina. The private creditors, different from G-7 countries, do not believe 25 percent repayment demonstrates good faith effort from Argentine government.

We believe that one of the key reasons why Argentina and private creditors disagree lies in their different expectations of future economic growth of Argentina. **We present a value proposition to increase the future expectations of economic growth by presenting a long term strategic growth plan. We feel the robustness of this plan will bolster the credibility and confidence in the Government of Argentina and develop a congruence of interests with private creditors.**

As a reward for buying into our plan, we propose a menu of three repayment options, coupled with creditor incentives in the form of a "**Recapture Clause**". This recapture will enable private creditors to participate in the upside of the economic growth. Obviously, the credibility and confidence that the Government inspires in its long term strategy has firm linkages in the debt restructuring efforts. In return for concessions now, the creditors will gain from increased expectations in the future, which, in turn, will translate to higher economic growth, and correspondingly higher values in market values of Argentina's Sovereign Debt.

In order to solve this conflict between creditors' (high) and the Government's (low) expectations, we propose a menu of repayment options, which takes a market-based approach. This will increase the incentives for the Argentine government to repay its debts and demonstrate that Argentina is willing to repay more if the future economic growth goes well.

Our proposal tries to convince the private creditors by bringing potential gains to them without making Argentine Government endure more current pains. Our restructuring plan consists of following **three options**:

- **Debt buyback**: encourage Argentineans to buy back their debts on the secondary market.
- **Debt-equity swap**: private investors buy Argentine debt at market prices and swap the debt for local currency which can be used for new or existing projects.
- Longer maturity bond with **recapture clause**: private creditors can choose a new bond without any face value reduction but with lower fixed interest rate. The recapture clause enables them to re-negotiate favorable terms as the economy grows

Debt buyback

We suggest that Argentine government provide incentives for its people to buy back the sovereign debt on the secondary market. It is estimated that Argentineans have an excess of **$100 Billion invested offshore**. Thus, the government could provide more incentives to domestic investors in order to induce them to hold domestic debt.

It is recommended that the government provide tax breaks for domestic investors to buy the debt. This tax holiday regime would reduce the cost for domestic people to invest in the debt, thus creative economic incentives. The demand surge for the debt will boost prices of the debt in secondary markets. In this way the original debt holders would gain from market appreciation.

These carrots could be coupled with sticks with the Government unleashing a tax crackdown campaign. This campaign could be widely publicized, declaring the Government's intentions to investigate sources of overseas assets coupled with punitive taxation and/or prosecution. Of course, the asset holders will be given an amnesty if these overseas assets were used to buy the Sovereign Debt on secondary markets by a certain deadline.

Another advantage of this measure is that the government will become more credible for repaying its debt. As this buyback would lead to more domestic debt holders, the government would have more domestic support to repaying its debt. As a result, the investment environment would be healthier and the country would become more credible both domestically and internationally, which would help restore confidence among investors.

As economic development literature suggests, the new investment will boost economic growth in the long run, benefiting Argentina's economy.

It is also a good time to take this measure now. Since many Argentineans invest in the US. Treasury bond and at present the return on this bond is very low, so that it will not be too hard to persuade this U.S. bond holders to invest domestically with the tax incentives.

As Jeremy Bulow & Kenneth Rogoff (1991) argues, the open market buybacks will lead to increased efficiency-enhancing investment and creditor will reap the efficiency gains. Thus, we believe this proposal would be more appealing to the private creditors. In addition it will not impose painful burden to the Argentine government.

Empirical Evidence – Chilean Debt Buybacks (1985-91)

One of the most hotly debated issues of the Chilean recovery of the second half of the 1980s concerns the different foreign-debt conversion plans aimed at rapidly reducing foreign indebtedness. When the debt crisis erupted in 1982, Chile's foreign debt was US$17.2 billion, one of the highest debts per capita in the world. Through the aggressive use of a variety of debt-conversion plans, most famously Chapters 18 and 19 of the between 1985 and 1991 Chile retired an estimated US$10.5 billion of its debt, most of which was converted into equity in Chilean companies. The main component of these conversion programs was the systematic (and ultimately successful) attempt to use offshore US dollar reserves to buy back the government debt, augmented by bank loans and IMF funds used to pay off some debt directly. As a result, the government managed to significantly reduce the stock of debt and consequently reduce interest payments. Critics of the process allege that the government used excessive discretion at auctions to allocate buybacks in a systematic manner; nonetheless, the program has been widely hailed as a success.

Chile's net international reserves totaled US$9 billion in 1992, enough to cover a year of imports and equivalent to roughly half of its foreign debt. The stock of foreign direct investment in Chile was estimated to be between US$10 billion and US$13 billion, roughly 30 percent of GDP. About US$4 billion of this was acquired through Chapter 18 & 19 debt-equity conversions. **The Chapter 18 & 19 debt-swap program was ended when the growth of direct investment and the strength of the economy had done away with the need for special incentives to attract foreign capital.**

Debt-equity swap

Since 1985, Debt-equity swaps have been used in sovereign debt restructurings of several developing countries. As discussed in the preceding paragraphs, Chile has successfully used debt-equity swap to restructure its sovereign debt.

There are two major elements in the conversion scheme of Chile. Chapter XVIII of the Compendium of Rules on International Exchange allowed Chilean residents or foreigners to purchase Chilean debt and convert it to pesos or peso-denominated debt instruments. The debt is paid with flight capital or foreign exchange obtained in the informal domestic market.

The Central Bank set monthly quotas of the magnitude of funds to be converted to control the exchange rate stability and money supply. Banks, financial companies and public entities were not allowed to buy Chilean debt overseas. Chapter XIX allowed foreigners to convert Chilean foreign debt into equity. The Central Bank analyzed and approved each operation on a case-by-case basis.

Many Chilean economists we talked to strongly believed that this restructuring plan make significant contributions to Chilean fast recovery from the crises as well as to its robust economic growth since then.

The compelling reasons for success of these plans were succinctly highlighted by Juan Andres Fontane, former member of Chile's Central Bank:

- These swaps leveraged market debt discounts – the Central Bank thought it was better to use the market than to fight it
- There were much bigger issues to deal with than debt restructurings – the priority was to get on with life
- Thus no haircuts were needed
- The Central Bank decided it wiser to accept market discounts (opposed to Argentina taking hard line and dictating haircuts to markets)
- The investors bought pesos with their hard currencies (including Chilean's offshore dollar deposits) to pay discounted debt in Chile
- Chile did not have significant sovereign debt, thus they had better capacity (than Argentina)
- These bold measures created favorable market perceptions – embellishing the confidence and credibility in the Government of Chile
- Chile acted more like an Asian developmental state
- The market stabilized in about five years, when these incentives were withdrawn

Such swaps create win-win situations for both the Government and investors. When debtor governments redeem the swapped debt at less than its face value, swaps permit the early retirement of foreign debt at a discount. Further, because the governments redeem the swapped debt at more than its current market value, swaps reduce the cost of an investment, and are incentives to investors.

Joel Bergsman and Wayne Edisis (1988) analyzed how the existence of the swap program affected the decisions of foreign investors. They found that about one-third of the investments made by multinational creditors (private creditors excluding banks-called MNCs) using swaps would not have been made unless a swap program was available, and another ten percent of those investments were made sooner or for larger projects than they would have been without the program.

Thus, for the transactions they studied, swaps made a difference for a bit less than half of the MNCs as well as for all the bank investments, while a bit more than half of all the MNCs that used swaps would have happened anyway.

One beneficial side effect of debt-equity swap is privatization. Milman (1996) argues that debt-equity swap could facilitate the privatization of large conglomerates without creating unnecessary inflationary pressures. Milman's study suggests that debt-equity swap speeded up the privatization process in Chile and made the privatization of large State Owned Enterprises easier.

Even though Argentina has almost finished its process of privatization in the late 1990's, it is a good opportunity for the government to use this debt-equity swap to privatize the large inefficient state-owned enterprises thereby generating greater efficiencies in the economy.

Longer maturity bond with Recapture Clause

One would argue that a new bond without face value reduction will not reduce the debt-GDP ratio of the debtor country. Moreover, if the net present value of the bond is less that the face value, holding such bond means the manipulation of investors' balance sheets. Why is it still necessary to include par bond as an option of debt-restructuring? One of the reasons why Brady plan worked well is known that it took a menu-based approach. Menu-based approach allows banks to freely choose among the menu options, and therefore does not impose the same treatment to all banks.

Par bonds give more choices to private creditors. For the institutional lenders, reduction of face value will result in an immediate write off to their P/L account, which will immediately reduce their capital. The options provided by a menu-based approach are beneficial when the interests of the lenders are heterogeneous.

In case of Argentina, the creditors are not only heterogeneous but also numerous. There is tremendous diversion of creditors' interests. Adding par bond as an option would certainly increase the number of creditors who would agree with the debt-restructuring proposal. Empirically, Par Bonds were included in the Brady agreements of Argentina (1992), Brazil (1992), Mexico (1990), Venezuela (1990), Ecuador (1994), Poland (1994), Nigeria (1991), and Philippines (1992).

A key element of our proposal is not only to include par bond but also to add recapture clause to it. A Recapture Clause will enable a lender to recover part or all of his previously lent assets if economic circumstances improve.

As noted earlier, **the key reason for the current discord between the Government of Argentina and Private Creditors is the vastly different expectations of the potential of the economy.** The Government is taking a minimalist approach, hence putting a figure of 25% of the face value of the bonds as a fair value. On the other hand, the private investors feel this is a gross understatement of the true economic value of the country's potential. In our proposal, we stress the importance of long term strategy, thereby boosting credibility and confidence in the Government. By creating a linkage between these confidence building measures and securing concessions from creditors, we hope to convert our current "adversaries" into partners of Argentina. **The Recapture Clause is the capstone of this concept, and will enable our partners to share in the upside of economic development by offering concessions to day in exchange for higher potential values of the economy tomorrow**. Thus we seek to create a congruence of interests between the Government of Argentina and the Private Creditors.

We feel adding a recapture clause will provide strong incentives for creditors to accept the proposal. For example, without a recapture clause, the new bond will never yield more than 25% of previous bond, irrespective of the recovery of the Argentine economy. In that case, holding par bond might be seen as a manipulation of balance sheet as there is a huge gap between the nominal value and the real value. These problems can be corrected if a recapture clause is added to the re-negotiated loan agreements.

Recapture clause gives hope to investors. If the Argentine economy grows, the investors can benefit from it. Both Argentineans and foreign investors share an interest to the future of Argentina. They are no longer the adversaries. Both of them will benefit from cooperating for the economic development of Argentina.

Recapture clause is also seen as fair commitment of the Argentine government. By adding this clause, government can show their good faith effort to repay its debt. Responding to the question of its repayment capacity at the meeting with the representatives of private creditors, the Argentine government said that 25% is the utmost value they can commit for now based on the agreement with IMF. Private creditors are, however, still skeptical about it. Recapture clause will be able to dissolve their skepticism. It is equal to saying, “I cannot commit to repay more now, but if I found myself capable of further repayment in future, I would pay you more.

Recapture clause is also benefit for those investors who cannot reduce face value now but also cannot hold a bond the real value of which is largely different from the nominal value. Thus, by including recapture clause, we can anticipate the early completion of debt restructuring as it is more favorable for investor while it does not incur additional cost to the government right now.

One way of sharing the future economic profit with the bondholders is to issue a par bond carry warrants linked to indices of oil export prices or of national oil export receipts. This measure was taken by Mexico, Venezuela and Nigeria (The 1995 Guide to Brady Bonds. Merrill Lynch, December 6, 1994). In case of Mexico, under the recapture clause, beginning July 1996, 30% of the extra oil revenues Mexico gets if the price of oil rises above $14 per barrel will accrue to the banks that have granted debt service relief. (Stijn Claessens and Sweder van Wijnbergen 1990) The other way is to index interest payment to future economic growth. It should be noted that this type of indexing might work as a tax to economic growth and would be de-motivating to Argentineans.

At the Dubai meeting, the Secretary of Finance Dr. Guillermo Nielsen said, "Our offer will also include different alternatives for such bonds, with coupons including a lower fixed interest rate coupled with a variable rate indexed on the basis of the growth of Argentina's GDP". But he also continued, "There indexed bonds reflect our intention to share the benefits of increased growth in the medium term and to pay a lower interest rate flow in the case of possible slowdowns of or drops in Argentina's GDP. It seems to be a reasonable option since nobody knows which Argentina's economy growth rate will be in, let's say, five or ten years."

Current offer of the Argentine government is not quite a recapture clause. It is equal to say that even 25 percent of repayment may not be assured. This statement would evoke further suspicion and distrust toward the government as it sounds like the government is trying to endeavor deeper haircut in future**. Recapture clause should be the manifestation of the government's good faith to share its profit with the bondholders**.

SECTION IV. CREDIBILITY BUILDING – LONG TERM STRATEGY

Summary of Recommendations

- **Focus on the Bigger Picture – Develop a Congruence of Interests**
- **Commitment, Credibility and Confidence**
- **"The Argentina Partnership"**
- **Export Promotion – Leverage off New Comparative Advantages**
- **Bilateral partnerships**
- **Mobilize offshore dollars**

As Argentina tries to navigate its way through the debt crisis, the Government's efforts have been largely focused on restructuring the debts through various debt restructuring measures. One common thing about these measures is the reflection of the Government's intent on minimizing the amount of debt service payment it is subject to through haircuts.

Even if the Government succeeds in imposing these haircuts on creditors and thus derives large savings from not having to pay the country's debts in full, haircuts still involve significant long term costs that can hamper the future growth of the Argentine economy. For one thing, haircuts do not automatically erase past liabilities and restore the confidence of creditors and investors and thus can still cause significant reputational costs.

Problems with Government's Current Posture

The debate is still open as to how long it takes for a country implementing haircut measures to fully restore its credit rating, a measure of creditors' assessment of the country's ability to repay its debts. However, the unavoidable reputational costs associated with such measures are significant enough to provide incentives to the Argentine Government to explore debt resolution alternatives that can help reduce or avoid these costs altogether.

There are no perfect excuses for a country not to repay its sovereign debts in full. A failure to do so can stigmatize the country's future prospect for economic development. As discussed earlier, we feel that Argentina's 25% offer has grossly underestimated its economic developmental potential. As a result of this underestimation, the Government feels it does not have the resources to repay more than 25% of the face value of the debt. At the same time, it does not want to completely dishonor its payment obligations, making "haircuts" a palatable in-between solution.

While haircuts temporarily provide relief from the creditors' pressure to repay, savings derived from this option are often not in liquid form so to be useful for the country's productive investments, which play a vital role in promoting future growth.

At the moment, the sentiments of the financial markets are that Government has yet to come up with any credible economic program – instead, has only spent time thus far haggling with the IMF. The business community takes on an especially unfavorable view of the way President Kirchner is handling the crisis -his strongly populist stand and somewhat anti-business attitude.

The view of the economy is not much more optimistic. People are complaining about the absence of an operation banking system in Argentina—(what is in place now is just a payment and clearing system), the gloomy atmosphere characterized by the lack of growth potential, and the absence of the rule of law among others.

These negative sentiments are clearly not conducive to the successful implementation of the plan we outlined above because the latter requires a great deal of public confidence in the way the Government handles economic policies. If the public does not have confidence in the Government, there will be no cooperation and thus no development partnerships.

More importantly, in the absence of a credible long term strategy, hair cuts merely provide a band-aid to temporarily patch up the bleeding economy while at the same time adding on severe reputational risks.

"Rational Actors" Equilibrium

One should necessarily assume that both the Argentine Government and the creditors enter debt restructuring negotiations as rational actors. The Argentine Government, hoping to convince the creditors to accept a certain level of haircut, should be able to show that this level reflects the country's maximum ability to repay. In other words, to arrive at a specific haircut level, the Argentine Government has exhaustedly taken into account all resources that can be used to repay the debts.

The creditors, on the other hand, wishing to recover the maximum amount of their debts, should and would rationally accept a haircut level only if they believe in the same thing. An equilibrium is reached at a point where the Argentine Government's maximum ability to repay equals the creditors' maximum willingness to accept. This undoubtedly should be a point where all resources available for repayment are dedicated to that purpose.

The Argentine Government has disincentives in deliberately hiding resources from the creditors as there are independent means to monitor such an action. Besides, being found out means starting the costly negotiations all over again. Both the Argentine Government and the creditors therefore have no incentives to back off from the optimal position.

This also implies that no significant resources in liquid form will be left for investment needs. If the country's credit standing does not improve fast enough, access to credit will be limited and when available can be very costly. The country basically will be working to repay its debts indefinitely while awaiting improvements. In this case, capital formation and accumulation will be very slow and the impact and consequences to the overall economy can be painful.

The above argument should be further supplemented with additional assumptions. While the Argentine Government is free to choose a haircut level that maximizes its respective utility, it cannot force the creditors to accept that specific haircut level if it is sincere in its desire to quickly resolve the debts.

Should the Argentine Government forcefully impose a haircut level favorable to itself but not so to creditors, negotiations can break down and the Government's reputational costs will increase. Another assumption is that the Government can use the haircut level as a bargaining instrument. For example, it can propose to large creditors a slightly smaller haircut level in return for longer repayment term. If haircut is used as a bargaining instrument in this fashion, which is essentially similar to price discrimination, creditors have incentives in pooling their claims together so to aim for lower haircut levels.

We do not recommend a hard negotiating posture centered on "haircuts". Instead, we believe that by reducing the current adversarial posture, the Government can achieve a more favorable outcome for the present crisis.

Focus on the Bigger Picture – Develop a Congruence of Interests

We strongly believe that the Argentine Government should not view any resolution to the debt crisis as an end in itself but as a means to launch the country's economy to a higher growth trajectory.

As such, the Argentine Government should not resolve the debt issue in any fashion that would isolate the country from the rest of the world afterwards. Instead, it should choose its moves carefully enough so to strengthen its ties to the world so that its access to the international credit market remains available. Access to international credit is crucial in realizing the goal of launching the Argentine economy to a higher growth path, especially in Argentine's current cash-tight situation.

Toward this end, it is clear that Argentina cannot act alone. Past mistakes have put Argentina on the world's black list of countries to be handled with caution. Other countries, lending institutions and private investors are reluctant to support economic development in Argentina through lending or investment arrangements out of the fear that they cannot recover their loans/investments.

In order to regain its credibility, Argentina has to show credibly and sincerely that it has strong intent to correct past mistakes. To creditors and investors, a meaningful evidence of Argentina's intent to correct its past mistakes is an assurance that they will receive greater returns as the Argentine economy grows. **The Government has to demonstrate high degrees of credibility and confidence – and to create a strong linkage between higher growth levels and improved repayment levels to the creditors. The "Recapture Clause" discussed in the previous section is an example of this strategic partnership approach.**

While it is not currently feasible for Argentina to repay its debt in full as its creditors want, what Argentina can do is to promise to repay its pending debts increasingly tied and conditional on the country's economic growth. The higher the future growth rate of the Argentine economy, the larger share of debts the creditors can recover.

Such a market friendly posture will immediately provide incentives for creditors to play a role in promoting higher economic growth in Argentina. The flip side to not cooperating with the Government will be to accept the status quo, i.e. be resigned to repayments based on deep haircuts. As the prospect of future growth becomes realistic, creditors will be even more willing to be a development partner of Argentina.

Thus Argentina's long term economic growth can act as a common ground in place of the ongoing head-to-head confrontation between the Argentine Government and creditors.

Developing a sustainable congruence of interests is the keystone of this approach. To sustain this common ground, there is a real need for both sides to act in cooperation and to form developmental partnerships.

Commitment, Credibility and Confidence

The specific working of the development partnership is expectedly complex and subject to case-specific adjustments but the central idea of this plan is to delay service payments on Argentina's debts and to channel all available resources toward domestic productive activities.

These new economic activities will fuel growth and instill renewed vitality and confidence into the economy. The debt payments will be spread out over time conditional on the economic health of Argentina while the country's access to credit is gradually restored. Given enough time, as the economy gets to a higher growth path and macroeconomic stability is restored, honoring pending debt obligations will be easier.

The success of this plan relies heavily on the Government's ability to come up with a realistic long term growth strategy. Since the implementation of this strategy requires a great deal of initial financing at a time when most of the Government's revenues are expected to be channeled into IMF debt servicing and social programs, to sustain this strategy the Government will have to find alternative sources of funding.

According to Mario Teijeiro, the president of the Argentina Centre for Public Studies, the primary source of funding is national savings, which, as a result of the default and the collapse of the banking system, continue to flee abroad or to be hoarded under mattresses.

The second significant source is productive investment of new foreign and Argentine capital abroad.

The third critical source is the reinvestment of profits by businesses located within Argentina that are making profits. It is worth emphasizing here that in order to maximize their returns, these funds should be oriented into the current most productive sector of the Argentine economy, namely the export sector.

Argentina needs just the opposite of Kirchner's 1970s prescriptions if it is to benefit the most from the liberating effects of a massive debt reduction and devaluation. The formula for success that has worked in developing countries around the world, including Chile next door includes increasing exports and foreign investment, and restoring confidence in the rule of law. That prescription also includes aggressive deregulation and tax reductions that promote growth and job creation on a sustainable basis; in other words, a market-oriented pro-growth strategy built around partnerships.

It is important then that the Government unfailingly shows a strong commitment to restoring the health of the economy by enlisting the support of private investors. To do so, it will have to subscribe to a pro-business and pro-growth policy aimed at more aggressive deregulation, tax deductions that promote growth and job creation.

More importantly, it needs to "stop trampling on property rights which have destroyed investor confidence". A re-focus toward much needed sustained growth, clearly articulated, coherent economic policy is absolutely imperative.

As mentioned above, in order for this plan to work, the Government must be able to convince creditors that the prospect of future economic growth in Argentina is promising. Creditors can be convinced if they see that the prospect is also realistic, and are also inspired to develop confidence in the Government's commitment and vision. But a promising and realistic prospect of economic growth is necessary but not sufficient.

The Government must show that its plan has credibility in order to win investors/creditors confidence. Restored creditors and investors' confidence will lead to better access to trade and investment credit.

The market will respond favorably to the Government's display of sincerity and determination. National savings and FDI flows can be mobilized into new investment projects.   Argentines abroad will bring their money back into the economy as suggested in the previous section on Debt buy-backs and tax incentives.

The new capital infusions will help to revive the ailing banking sector. All these developments will generate sustainable and higher growth rates. Stakeholders will be rewarded with equity sharing in incremental growth and incentives enabling them to "Recapture" the upside of economic growth.

A market driven approach will help creditors benefit from a positive impact on market prices of debt, thereby leading to additional reward for our Partners in development.

"The Argentina Partnership"

The treatment we propose herein focuses mainly on engaging Argentina's foreign and domestic creditors in new roles as development partners. Those are the main stakeholders of this plan.

There are other parties who can benefit from having a supporting role in this process and yet others, such as the people currently unemployed, who will benefit from getting jobs created the newly created economic activities and other ripple/carry-over effects.

The IMF and various international development organizations can provide investment promotion and growth facility loans and technical support. The Government will act as a coordinator of these efforts and can set up new government bodies to be in charge of the debt-investment conversion.

Investment funds can be established to provide small creditors channels to invest their debt claims into profitable businesses. The Government can present the creditors investment options into which the creditors can choose to invest the amount they are owed to. These investments can either be directly into existing or new firms or indirectly into revenue sharing financial instruments. Those who choose to invest in company shares get their returns from the companies' profits while those who choose other indirect schemes get returns that are indexed against the annual GDP growth rate.

Pillars of Developmental Strategy

In the previous part, we listed three sources of funding that we believe are critical to pushing long term growth in Argentina:

a. National savings currently not deposited with domestic banks
b. productive investments of new foreign and Argentine capital abroad
c. reinvestment of profits by profitable businesses located within Argentina

We also note that while these three sources of funding form the three pillars of the sustainable growth plan, the dominant strategy is to channel them into the export sector. As the bulk of Argentina's debts are in dollars, increased export earnings in dollars can be used directly to service debts without additional transactional costs to the economy.

Export Promotion – Leverage off New Comparative Advantages

While the 2001 devaluation inflated the amount of Argentina's dollar-denominated debts, it has also led to a much better export competitiveness for Argentine goods. A deeply depreciated peso can also be viewed as an expenditure shifting instrument as it shifts the consumption pattern of the public away from expensive import goods.

This shift should open way for higher growth in the import substitution and export-oriented sectors. At the same time, as price has grown faster than wages, real wage level has fallen against a backdrop of increased unemployment resulted from low output. This implies that Argentina now has also a competitive edge in labor.

There is tremendous idle capacity in the economy that can be rented cheaply, a plus point which makes Argentina a very good place to invest into right now. These are the strengths that Argentina should try to use fully to its advantage.
Thank to increased export competitiveness and decreased import value, Argentina's trade surplus grew by almost 300% between 2001 and 2002. Though this growth is impressive, it has raised some relevant concerns.

The first concern is with the composition of export goods. As it is reasonable to expect that the export competitiveness would not only deepen but also broaden Argentina's export base, the latter has not materialized. Argentina's export base is still limited to traditional commodities, and not only that, the growth has been most impressive in export of primary commodities, namely oilseeds, fats and oils, scrap and waste from the food industry, and fuels. These four commodities alone account for 88% of the rise in export value. As the prices of these four main export commodities are quite volatile, the revenue dependence on these commodities is a risk that will need to be hedged against. The second concern is with the fact that these primary commodities have very little value added. More specifically, they do not generate significant employment for the country. The third concern is the difficulty experienced by exporters in securing access to trade credit. The fourth concern is with high taxes that the Government seeks to impose on export goods, which should be discouraged because they put a downward pressure on export growth.

It is recommended that the Government address these concerns as soon as possible. There are several things it can do. For example, it can sponsor studies that explore possible non-traditional exports so to broaden the base of export commodities and to reduce the country's exposure to price volatility.

It can work with banks to form credit alliance to provide export credit to exporters. A successful example of this kind of private alliance is the Exportadores II program – a financial trust organized by 3 leading domestic banks that has provided $20m in 270-day funding to exporters to securitize pre-shipment of exports and provide letters of credit. The Government should also structure the export tax system more accurately so to balance between tax revenues and export growth.

To improve the value added component of its exports, the Government can help exporters to improve the quality of their products through the use of technology and know-how. A higher value added component means higher export prices and revenues. It can establish Export Processing-Free Trade Zone; give tax incentives and favorable land rent to foreign investors who invest into these zones.

Excessive dependence on commodities could create problems in the future because of the sharp volatility of their prices on world markets. A simultaneous fall in the world prices for oil and Soya beans would quickly throw our trade out of balance. In order to reverse this situation experts are recommending diversification in exports and adding value to them in order to reap greater advantages in foreign trade and to create skilled jobs.

The issue is not exports of natural-resource-intensive products; it is how much added value there is in output. The profile of Argentine exports is heavily skewed towards products that are natural-resource-intensive but have very little processing. Exporting them is better than nothing but this export pattern is subject to great volatility, because prices are very variable and because the concentration of sales among large marketing firms hampers the creation of a dynamic, diversified entrepreneurial community.

The first thing that needs to be achieved to change this situation is a relatively stable macroeconomic climate, with a currency that has not appreciated and is not very volatile. Then, we must pursue specific, horizontal policies in order to provide small and medium-sized exporters with technological advisory services, market know-how and contacts. In addition, they need to be given financing.

In Chile, for example, the ProChile Foundation does a very effective job in this respect, whereas we have an institution such as the Export Foundation, which is quite a bit smaller, has budget difficulties and is less effective.

One area that seems to have been largely overlooked is the service sector. Services such as inbound tourism and shopping have not developed up to Argentina's ability to provide them. The export of these services, and others such as outsourcing of Spanish language services to the USA, is promising and should be fully explored.

Export promotion measures such as those outlined above are expected to have a positive impact on Argentina's export growth and trade surpluses. Export opportunities can attract both foreign and domestic investments and mobilize important capital infusions into the economy.

Bilateral partnerships

Another activity that the Government can engage in is to promote trade and investments through the formation of multi and bilateral partnerships with other countries. One highlight in this area is Argentina's trade relationship with China, which has grown 150% since last year. In 2003, China's imports from Argentina in 2003 will be approximately. $2.5 billion, mostly in agricultural products (soybeans, wine, leather). Recent trade protocols signed with China for agricultural-livestock products forms a major milestone in further bilateral trade and economic cooperation.

Argentina now has significant incentives to form partnerships with other countries in a similar manner. Even though there has been a 20% drop in export to Brazil, Argentina's traditional main trade partners, this drop is expected to recover. In the meantime, Argentina can work with Brazil to form the nucleus of a strategic alliance. Other potential partners are South Africa, India, and Mexico.

We would recommend building upon these relationships and encouraging Argentina's partners to invest in the country to help promote development.

Mobilize offshore dollars

It is estimated that Argentineans hold **$ 100 Billion** in offshore assets. This amount is potentially larger than the sum total of Argentina's debts. Successfully mobilized, this money is put to some good use in restoring the health to the economy.

One of the reasons that Argentines abroad do not bring their money back to invest in the country is because of the high risk they associate with President Kirchner's Government—perceived to be not pro-business. To counter this fear, the Government should make it publicly clear that property rights will be respected and protected.

Furthermore, the Government should provide incentives for this money to be used to buy Argentinean debt held by foreign creditors. If domestic growth can be sustained and the rule of law maintained, it is expected that Argentines will gradually bring their money back to invest in the country.

Recap

The success of any restructuring strategy depends on support from the domestic public and strong determination of the Government. We feel the people of Argentina are hopeful of a bright future and are therefore willing to make short term sacrifices to achieve long term growth and development.

1. President Kirchner currently enjoys very high levels of public support and confidence. The President should use this support to extract concessions from all segments of the population to ensure that the public agrees to cuts in social spending programs.

2. The Government should engage the IMF in further talks to negotiate a repayment agenda of the IMF loan so that a larger share of the budget surplus could be used for in-country investment needs. The IMF currently asks for a budget surplus of at least 4.5% of GDP, a level that we find unrealistic in the long run. Most of the surplus will go into repayment of the IMF loan anyway leaving very little money left for domestic spending on social programs and investments. A repayment schedule that can be adjusted to the actual budget performance with investment needs having the top priority can be reasonable and useful.

3. To further enhance trade, the Government should be more active in negotiating trade pacts with both traditional and non-traditional trade partners. Playing on its current popularity with the USA and its hard-to-beat competitive export prices, the Government should explore the possibility of getting a free trade agreement with the USA. Such an agreement will not only allow even more Argentine goods to enter the US market but will also create possible access to US Eximbank's trade credit, now much needed by Argentina exporters. Further, the Government should leverage its trading relationships to drive at bi-lateral free trade treaties with its major partners.

4. The Government should continue to build its legitimacy through the promotion of the rule of law and respect for private property/contract rights. Improved and better defined legitimacy will help the effectiveness of the Government's tax collection system. Thus far, the Government has tended to use some harsh rhetoric against investors and the business communities, which in a way can be seen as it seeks to punish those who invest and take calculated risks. At the same time, it has been willing to reward the well-connected by changing the rules for them. This practice is strongly discouraged and so should stop.

5. The most important thing that the Government has to do is to maintain budget discipline. During this time of crisis, the Government must adopt a minimalist state. It should impose hard budget constraints by perhaps curtailing provincial debts. If the Government can demand an amendment in the country's Constitution that prohibits

provinces to run a budget deficit, it will be able to show the population and the investors/creditors that it is seriously committed to making Argentina grow again. (This will be further discussed in the following section).

SECTION V. PROVINCIAL DEBT REFORMS

Summary of Recommendations

- **Reforming the Coparticipations Scheme**
- **Creating Rules for Fiscal Discipline**
- **Increasing Reliance on Provincial Tax Revenues**

Shortcomings in intergovernmental fiscal relations form structural roots of Argentina's proclivity to experience debt crises. Introducing permanent reforms in Argentina’s frequently recurring provincial debt problems forms an integral part of our recommendations to develop a long term credibility building and promoting market driven restructuring for Argentina’s sovereign debt.

Together with an appropriate restructuring of outstanding debts to foreign private creditors and international financial institutions, the Argentine government needs to devise a comprehensive scheme for fiscal overhaul which corrects implicit incentives for fiscal irresponsibility inherent in the current budget structure.

A reform in Argentina's fiscal federalism should also aim at increasing public revenues both through maximizing efficiency and equity in the utilization of existing resources, as well as through expanding a horizon of sources of public revenues.   This will enable Argentina to move away from a structure where there is a preponderance of transfer of revenues from the center to the provinces, coupled with prodigality and irresponsibility at the provincial level.

The reform will enhance fiscal solvency of federal and provincial governments by providing an enlarged and more stable stream of incomes. This should enhance Argentina's ability to honor its foreign debt obligations and ensure greater control over its sovereign destiny. Further, these bold measures will also demonstrate to the foreign creditor community a willingness of the Argentine government to tackle its sovereign debt problem from a structural perspective. This should bolster the credibility and confidence in the Government of Argentina, thus facilitating a return to international capital markets.

Objectives of Provincial Fiscal Reform

1. **Increase revenues of provincial governments** in order to match their spending needs, to reduce dependence on federal transfers, and to service debts to domestic creditors and to the Federal government.

2. **Institutionalize mechanisms to ensure strict compliance to federally mandated fiscal discipline** in order to reduce tendency of provincial governments to incur future debts, and to curb moral hazard in provincial spending by mandating a greater share of fiscal responsibility.

3. **Reform the Coparticipatiosns Scheme** in order to offset its procyclical nature and to correct the vertical imbalance in federal and provincial budgets

Given the complexity of Argentina's fiscal system, an analytical framework which captures drawbacks of the system at both federal and provincial levels is needed to identify major needs for reforms and possible strategies of implementation. This report has adopted a framework proposed by Miguel Braun, Director of Fiscal Policy at *Centro de Implementación de Políticas Públicas para la Equidad y el Crecimiento* (CIPPEC) in selecting main fiscal problems and making targeted policy recommendations.

Analytical Framework for Fiscal Reforms

Key institutions \ Policy challenges	Common pool problems	Soft budget constraints	Transparency and control
Federal fiscal arrangements	Reduce vertical fiscal imbalance	Limit sub-national borrowing autonomy	Increase fiscal correspondence between taxes paid and services received
Budget process	Limit Congress' capacity to increase spending	Clear rules for increasing debt.	Cost-benefit analysis and program evaluation
Fiscal rules	Limit spending and debt in good times	Penalties for fiscal excesses	Clear, simple rule that can be evaluated by public

Source: Miguel Braun, "Institutional Reforms Proposals for Fiscal Solvency in Argentina", presentation at the World Bank, May 8th, 2003.

Recommendations for Reform

Fixing the Common Pool Problems: Reforming the Coparticipations Scheme

Federal commitment with the IMF provides a momentous opportunity for the federal government to push forward a meaningful reform of the Coparticipations Scheme. Indeed, federal surpluses required by the IMF are unlikely to be attained unless a serious reform of the Coparticipation Scheme aiming at provincial financial self-reliance takes place. This necessitates cooperation from provincial governments.

Even with the growth rate and a favorable renegotiation of its debts, projections suggest federal fiscal surpluses of about 3 percent of GDP, as required by the IMF for Argentina to service it debts with 75% haircut, is unprecedented. The federal government will need to generate even larger surpluses to reduce its high level of debts per GDP in order to minimize vulnerability to future shocks.

Raising such surpluses while simultaneously avoiding increasing some taxes that inhibit growth is even more challenging. Therefore, as the federal government is committed to attain higher fiscal surpluses without hampering growth, there is a good justification for it to reduce or abolish guarantees on definite amounts of federal transfers to provincial governments to shelter adequate resources for the targeted surpluses. This can jump start a *de facto* reform of the Coparticipations Scheme in a desirable direction.

In seizing this rare, externally-driven opportunity, the federal government should take its commitment with the IMF to maintain federal primary surpluses as ground to push for reform of the Coparticipations scheme, preferably through legal means such as constitutional amendment or issuance of legislative orders.

Policy Recommendations

The federal government should initiate "new principles" as a new framework for reforming the Coparticipations law. Most importantly, it should use external constraints to justify the inappropriateness of the currently proposed principles of fiscal reform, which commit the federal government to a magnitude of federal transfers irreconcilable with its needs to maintain surpluses. New principles for reform should aim to;

- **Simplify the revenue-sharing system**
  One general revenue pool, eliminating various reductions and earmarks before reaching the pool.
- **Reduce the procyclical nature of transfers**
  Less transfers in good time, more in bad time. Structural rules to eliminate procyclicity are crucial for attaining fiscal surpluses.
- **Decentralize taxation**
  Strengthen the trend of decentralization in the last decades, especially in areas where the federal government previously shared authority and provision of public goods with provinces. Instead, broaden more tax categories classified as "provincial"
- **Set target to gradually reduce fiscal transfers**

As decentralizing tax collection, set targets to reduce "primary distribution". Observe equity principle by setting longer targets for a reduction in transfers for poor provinces.

- **Initiate matching-fund mechanisms**
  Many provincial administrations use the federal funds as substitutes for their own financing. Establish rules, depending to the nature of sectors, that initial spending of own revenues is required in order for provinces to receive matching proportional transfers from the federal government.
- **Consider elimination of provisions that allow nationalization of provincial debts**
  Refrain from federal bailouts. As banks anticipate federal bailouts, they continue lending to provincial governments since the bailouts distort market risks. Therefore, avoiding federal bailouts of provinces in financial distress is central to the breaking of provincial debt cycle.

Fixing Soft-Budget Constraints: Creating Rules for Fiscal Discipline

The existence of a dual budget system makes fiscal control difficult in Argentina. The migration from formal rules to informal arrangements reflects more a severe lack of enforcement of rules than the lack of rules itself.

Indeed, Argentina has an ample supply of restriction mechanisms to promote fiscal discipline, including fiscal limits in provincial constitutions, restrictions designed by the federal government and new laws of solvency and responsibility. Though the design of mechanisms is far from perfect, the main problem lies in enforcement.

Recent history shows consistent lack of commitment to rules, both at the national and provincial level, and lack of effective costs of non-compliance. This lack of commitment to rule accounts for deterioration in domestic negotiating environment, both between federal and provincial governments, and between governments and domestic creditors. It is also responsible for Argentina's loss of external credibility.

Therefore, fiscal reform strategies should aim at strengthening the enforcement of existing rules, in addition to improving rules overtime.

Policy Recommendations

- **Create effective costs of non-compliance to fiscal rules**
  Establish penalties for non-compliance. Look at Brazil as a case study

- **Mandate fiscal rules that include intertemporal factors.**
  Factor in intertemporal budget constraints when establishing fiscal targets both at the federal and provincial level. This will encourage better decision making about contingent liabilities and extra-budgetary commitments in the future.

- **Create countercyclical rules for increasing debts**
  Less debt creation during good time. Set targets of debts and spending relative to provincial tax revenues and GDP.

Fixing Transparency and Control Problems: Increasing Reliance on Own Tax Revenues

Argentina has one of the highest degrees of vertical fiscal imbalance in the word. This is due to the fact that taxes are mostly collected at the federal level (77.3%) but expenses are generally undertaken at the provincial level. This mismatch between the locus of taxation capacity and that of public spending is a structural cost of provincial dependence on federal transfers.

In addition to weak provincial capacity to tax, weak fiscal control resulting from the lack of federal monitoring and public scrutiny further aggravates a moral hazard problem; local tax authorities do not exert a high level of effort to enforce the collection of national (pooled) taxes and choose to rely on inefficient, but less pooled, taxes to increase provincial revenues.

However, the current situation provides promising incentives for provinces to reform taxation. As the federal government is obliged to maintain higher fiscal surpluses, transfers to provincial governments through the Coparticipations Scheme will likely be reduced.

This imposes a need for provinces to rely more on its own revenues. An ability to create alternative sources of revenues in the midst of declining federal transfers will prevent more debt creation and crises.

Policy Recommendations

- **Improve provincial taxation capacity as an utmost priority**
  Closer collaboration between local and federal tax collection agencies. Enforce penalties for tax evasion. Stop the use of tax amnesties and discounts. Provide better training and invest in informational technology that enhances tax collection capacity. Consider creating new and efficient tax instruments.

- **Rely on less distortionary taxes**
  Focus on increasing property tax collection by improving the roll, identifying and concentrating monitoring efforts on property owners with more than one property, and crosschecking information with municipalities and public utilities. Consider replacing the gross receipt tax (GRT) and stamp tax with either a dual federal-provincial VAT or by piggybacking onto the federal personal income tax.

- **Devise strategies for efficient use of tax revenues**
  Establish a tradition of cost-benefit analysis of public expenditures.

SECTION VI. CONCLUSION

For the Government of Argentina, the current crisis presents a significant challenge as well as a golden opportunity. The challenge is to return Argentina to the international economic and financial community as soon as possible while not jeopardizing the potential for future economic growth and social stability through unrealistically optimistic assumptions and policies.

The golden opportunity is that the widely acknowledged difficult economic situation, paired with broad popular support and important alliances for Kirchner, makes it possible for the government to implement difficult and long-overdue reforms in the federal system. We believe the people of Argentina are ready and willing to make short term sacrifices in order to secure long term growth and welfare.

This it the time to make bold structural reforms. This is the time to engage creditors, not as adversaries but as partners in Argentina's growth and development.

Rather than proposing short term band-aid solutions like the "hair-cut" proposal, the Government of Argentina should aim to inspire confidence and develop credibility by engaging its partners.

Developing a congruence of interests whereby our partners' prospects improve hand in hand with Argentina form the essence of our recommendations.

Our recommendations for the Government are based on three solid and intertwined pillars:

a. **Market-driven debt structuring – with a “Recapture” clause to enable creditors to participate in the upside of the economy**
b. **Developing credibility and confidence by pursuing long term development strategies**
c. **Introducing permanent provincial debt reforms that will prove resilient to the push-pull dynamics of internal politics**

Argentina stands at a crossroads. This golden opportunity can be ignored at Argentina’s own peril.

We believe the Government of Argentina can, by incorporating our recommendations into an overall development strategy, put the country back on track towards development and growth.

APPENDIX I. DEVELOPMENT OF THE ARGENTINE DEBT CRISIS

Reference: Galiani, Heymann and Tomassi – Great Expectations and Hard Times: The Argentine Convertibility Plan, Economia, Spring 2003

The most striking aspect of Argentine monetary policy in the decade preceding the current crisis is the peg to the US dollar ("convertibility"), which was finally abandoned in December 2001. The following depreciation of the peso by approximately 70% caused massive disturbances in the Argentine economy, especially those parts related to foreign exchange, i.e. foreign debt and foreign currency deposits.

Galiani, Heymann, and Tommasi argue that the fiscal policies during the convertibility period were inconsistent with the fixed exchange rate. The convertibility regime induced sustained overvaluation; hence, it was bound to collapse. The fiscal policies led to high deficits. Furthermore, fluid access to credit markets implied that the probability of default was negligible. The dollarization of contracts further increased confidence in the stability of the regime. As pressures to devalue mounted, the government was reluctant to abandon convertibility as the perceived exit costs were very high due to the denomination of debt in US$ dollars. Furthermore, agents showed strong dislike for a possible devaluation. It seemed clear that exit from convertibility would bring large economic losses.

According to the authors, the root causes for the large debt lie in the policies instituted in the early 1990s. Private Consumption increased 40% during the first half of the 1990s; private savings, on the other hand, declined. While privatizations in the 1990s provided an important source of funding, public debt continued to rise after 1995.

The option for exit from convertibility existed on several occasions. Many foreign analysts recommended devaluation, but local actors were skeptical. If exit was not chosen, the authorities signaled even stronger commitment, raising exit costs. In choosing the riskier option, the government signaled toughness in maintaining monetary rule. The institution of the hard currency peg in 1991, rather than a more flexible regime, on the one hand increased credibility of the system, but, on the other hand, deprived the authorities of flexibility. Significantly, the hard peg prevented the central bank from acting as a lender of last resort.

During the 1994 Mexican crisis, convertibility prevented a fall in currency values to accommodate excess demand for foreign currencies. Bank deposits were withdrawn, almost creating a run on the banks. This exogenous shock could have been an opportunity to replace the fixed exchange rate without loss of credibility. Conversely, the government saw this as a big test of strength, which it passed, greatly enhancing credibility. As a result, the government received large packages of multilateral credit, denominated in US dollars, which in turn further increased exit costs.

After the 1995 shock, optimism increased; exports rose, inflation decreased, GDP grew rapidly. FDI also increased during this period. The successful weathering of the 1997 Asian Financial Crisis further exacerbated the optimism. With the end of the expansion in 1998, the government was left with high debts and the inability to raise taxes without further raising output. Higher output, however, could not be based on higher deficits. The 1999 Brazil devaluation led to a decline in exports, further cutting the current account available for debt service.

With the change of government in 1999, the market demanded measures to show that the government was reliable. This led to a new policy announcement: an increase in income taxes and cuts in spending, the combination of which led to a decline in domestic demand. The mood grew increasingly sensitive to the short-term.

In early 2001, the situation appeared serious. While an IMF credit package eased financial conditions, the internal political system criticized the government's policies. Bank deposits started to drop sharply. Domingo Cavallo re-entered the government, instituting active fiscal and monetary policies with multiple targets, also aimed at generating growth. By pegging the peso to a US dollar-Euro basket, the government achieved a small devaluation.

Government financing became increasingly complicated. International credit became scarce; as a result, domestic borrowing increased. The risk indices went up as bond holders assigned a higher probability for non-payment. The massive swap of shorter maturities for longer ones aimed at averting a liquidity crisis caused an increase of interest rates to 15% and raised questions of solvency. Bank deposits declined rapidly as a result.

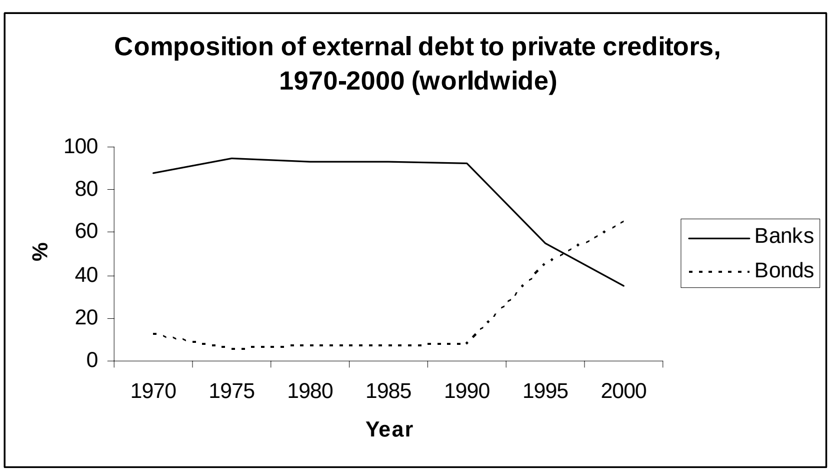
Faced with a significant crisis, the government announced a zero deficit policy and turned to the IMF for emergency assistance. The three D's—devaluation, default, dollarization—lowered expectations for holders of government debt. With the receipt of the IMF emergency loan, the government announced a restructuring of the public debt. With public revenues falling, emergency monies ("bonos") were issued, and the government imposed restrictions on withdrawals of deposits and exchange controls.

Convertibility had formed the basis for an elaborate system of contracts based on expectations. These high expectations had increased consumption and investment. All this collapsed as contracts became contingent. The private sector as well had accumulated massive US dollar debts. A set of promises held together the expanding contractual obligations. These promises either held together or broke down together; in the end, they broke down together.

APPENDIX II. TRENDS IN BANK LENDING AND GLOBAL BONDS

The world trend in debt flows has experienced a profound change in recent years. Overall net debt flows to developing countries have been decreasing; they peaked in the years of 1995-96 and have steadily dropped since then. The total was approximately US$135 billion in years 1995-96 but has been negative since 1999.

In the 1990s, the sources of lending shifted. From 1970 to the late 1980s, banks accounted for about 90 percent of developing countries' public external debt to private creditors. The World Bank report explains this reemergence of sovereign borrowing in the form of bank loans from the following three points of view. First, the banks were flush with liquidity with the recycling of oil wealth and the drop in US real interest rate that accompanied the inflation: the U.S. long-term bond yield averaged between 6 and 8 percent in every year from 1970 to 1978, while consumer prices increased by almost 8 percent a year. Second, many emerging markets were experiencing respectable growth rates, which bolstered lenders' confidence in repayment prospects. Finally, there was a belief that major emerging markets would not default. This boom in bank lending came to an end with sharp tightening in U.S. monetary policy at the end of the 1970s. In the 1980's, 24 middle-income countries were forced to renegotiate their debt with commercial banks.



Source: Global Development Finance. World Bank, 2003.

Net bond flows to developing countries rose from US$11 billion in 1991 to a peak of US$40 billion in 1997-98, before dropping with the fallout from the East Asian Financial Crisis. The World Bank report explains that the rise in bond finance can be attributed to the improved prospects and greater stability in may debtor countries; the opening of capital markets; market innovation such as derivatives and securitization; and the reduction of inflation in industrial countries.

Unlike the bank loans, bondholders are more numerous and may be anonymous. They generally do not have long-term relationships with debtors or regulators, and their incentive to sue is greater because they often do not have to share the proceeds of litigation. Thus the potential has increased for coordination failures and disorderly debt restructurings characterized by competition among creditors to collect and legal disputes among creditors and between creditors and the debtor.

APPENDIX III. FOREIGN DIRECT INVESTMENT AND GLOBAL PORTFOLIO INVESTMENT

Source: Global Development Finance, World Bank Report 2003

The world trend in net private-sector equity flows is robust; it does not show the sharp drop experienced by net debt flow. Net equity flow to developing countries hit a peak of US$196 billion in 1997. Although it decreased to $152 billion in 2002, it is still resilient to the crisis. One of the reasons for decline in FDI that is especially related to Latin American countries is the fact that the privatization process in Latin American countries has moved towards completion. For almost a decade, Latin American governments have been aggressive sellers of state-owned assets and they do not have much left to sell to foreign buyers. The robustness of net equity flows, especially of direct investment, is in part due to the fact that direct investments are long-term strategic decisions that may not be affected by a financial crisis that is perceived to be short-lived. Moreover, a fall in asset prices, combined with currency devaluation, may attract more FDI, especially in the tradable sector.

However, FDI has shown a deep decline in Argentina just like in Indonesia. The World Bank report explains this as an effect of deep-seated social and political risks that currency devaluation cannot address. A stable and credible investment climate is an important factor for attracting FDI.

The FDI forecasting model of the World Bank uses the following factors as explanatory variables: the growth rate of G7 countries; the difference between the GDP growth rate of developing countries and that of G7 countries; the growth rate of exports of goods and services; institutional investor rating; increase in oil price; volatility of oil price; FDI as percentage of GDP (lagged one year) to represent the persistence of FDI flows over time.

When considering the Argentine government's options for default and debt restructuring, two issues deserve special attention. The first is that there is no direct relationship between cutting back the interest payment and net equity flow. If the government also cuts the tax incentives provided to foreign investors in order to increase government revenue, it would affect the net flow of equity but only in the future term. The second is that the effects of default on future FDI flows are quite controversial. As the World Bank model suggests, GDP growth is an important factor for attracting FDI. In this regard, the macroeconomic effect of default would be similar to that on future lending. On the other hand, the devaluation of the peso itself has brought about an environment conducive to increased FDI inflows; other Latin American companies view this financial crisis as one of the "opportunities which only come around once in a lifetime." Acquisition of Argentine companies by Mexican and Brazilian investors ranges from telecommunications companies to bread makers. Devaluation the peso had a negative effect on repaying the foreign currency denominated debt, while it had a positive effect on exports.

APPENDIX IV. CREDITOR PROFILES – INTERNATIONAL FINANCIAL INSTITUTIONS AND PRIVATE CREDITORS

Source: Argentina's Restructuring Guidelines. Mecon, 2003.

International Financial Institutions (IFI's)

The major part of the IFI debt was with the IMF. In January, 2003, the Government of Argentina negotiated a new IMF credit arrangement providing US$2.98 billion to provide transitional financial support through the period ending August 31, 2003. The IMF also granted a one year extension of payments worth US$3.80 billion that would have been due by August, 2003. In effect, the IMF rolled over Argentina's debt.

BODEN

Bono Optativo del Estado Nacional (BODEN) are federal bonds issued after the 2002 default in exchange for reprogrammed bank deposits (i.e. those deposits frozen in 2002) as well as to banks in compensation for asymmetrical pesification (the use of different exchange rates for assets and liabilities that had hurt the banks). These bonds are tradable; they are not included in the October, 2003 restructuring proposal because:

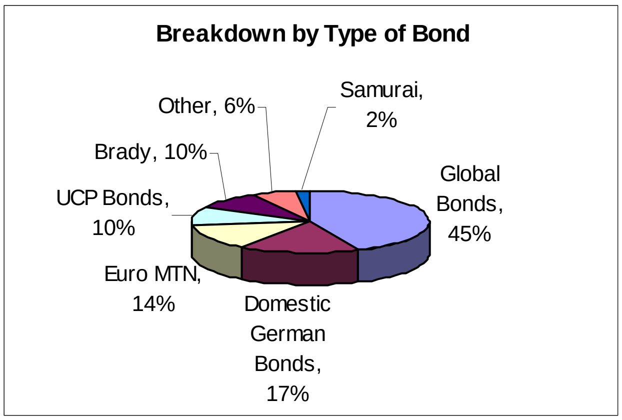
> "[This debt] was issued to overcome the crisis and [such] debt is performing debt. Unlike the defaulted debt, this debt was placed to keep the banking system in operating conditions and to be swapped for frozen rescheduled deposits. **This debt is part of the solution of the Argentine crisis and is not part of the problem.** Therefore, we will state again the Boden are not included in the restructuring."

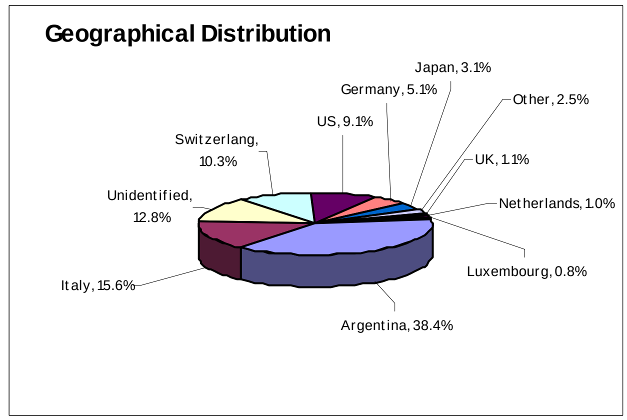
Structure of Private Lenders

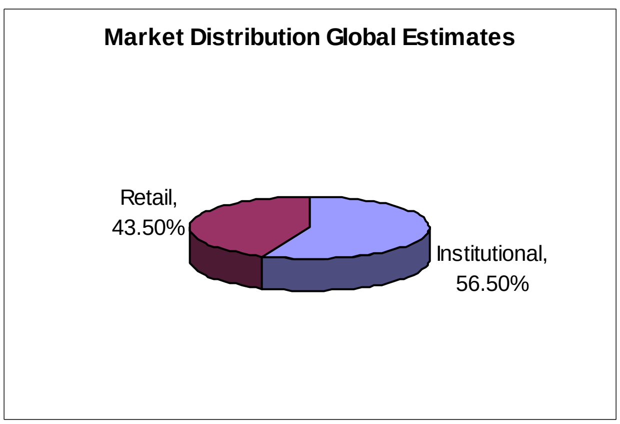
Debt Breakdowns

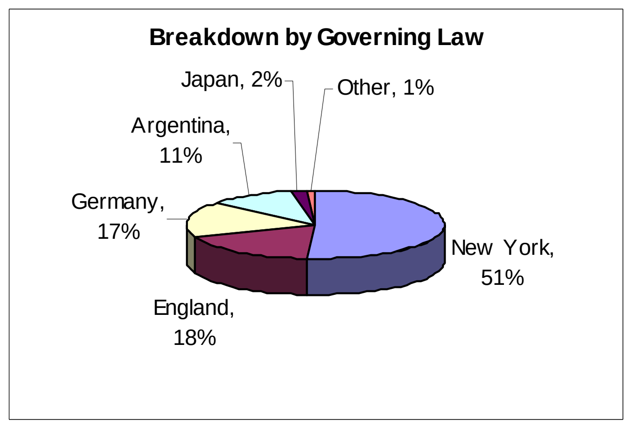
Summary of Debt Eligible for Restructuring in Argentina's October 2003 Proposal

Eligible Debt Summary		
# Bonds	# of Currencies	# of Governing Laws
152	7	8









Lender Groups

The following groups represent the interests of the lenders in various countries:

Organization	Country	Debt Value
ABRA	Germany	$1.4 billion
TFA	Italy	$15 billion
IGA	Germany	$200 million
ABC	USA	$7.5 billion

In Japan, lender interests are spearheaded by large banks, which carried Yen-denominated Samurai bonds in their portfolios. Recently, a group of several thousand investors angrily demanded the seizure of Argentine land holdings.

In early September, a New York court gave Argentina 45 days to negotiate with creditors before allowing an American investor, Kenneth Dart, to claim full repayment of his bonds plus interest, worth $700 million. (NYT 9/23/03)

APPENDIX V. IMPACT OF EDUCATION

Quality of education is positively and significantly correlated to long-term GDP growth. Hence, Argentina should strive to improve the quality of education from its already considerable base. In this section, we will argue that while the temptation is great to improve education spending (and use this as an excuse to reduce debt service payments); this is, in fact, not the most effective strategy for improving education quality. Most importantly, there is a considerable *negative* correlation between public surplus and education spending. i.e. more disposable funds for the government do not mean more education spending. The reasons for this phenomenon are explained in detail below. We therefore recommend that the federal government take the opportunity of fiscal tightening to:

- Preserve the direct funding for university education;
- Improve management of education under the reason of fiscal tightening.

We base these recommendations on the following findings, which are further explained in the sections to follow:

Empirical evidence from past years shows that even in times of fiscal tightening the federal government has maintained or even increased the level of spending in university education, which has the greatest impact of all education indicators on growth rates. It is therefore to be expected that spending on university education will be taken as a priority and as a result spending will remain at least constant. This may appear contradictory to the aforementioned negative correlation of education spending with GDP; however, federal university funding is only a subset of overall education spending, and therefore it is not, in fact, contradictory.

As to provincial education spending, the main channel through which fiscal balance has an effect on provincial spending on education are coparticipations funds. Therefore, if fiscal surplus is based on greater tax collection, then coparticipation funds will increase, and this might even have a positive effect on education spending by provinces (which covers primary and secondary education). On the other hand, if there is a reduction in the coparticipation funds, one might expect a reduction on education spending by provinces. Empirical evidence, however, shows that even with a cut in resources to the sector, management of the system should be sustainable as provinces will certainly be able to cover the main needs of the sector, particularly, payment to teachers (which has been their 1st priority).

Since spending on education does not, empirically speaking, a real effect on the quality of education, a decrease in this spending (within reasonable limits) should not actually deteriorate the system further. Therefore, we arrive at two main conclusions:

- Provinces will at least be able to cover the main needs of the system: payment to teachers, and the national government has shown a commitment to maintaining or even increasing spending on university education, which actually has a greater impact on growth rates;
- Independently of the above conclusion, this kind of education spending is not enough to improve quality and therefore to have an impact on growth. Thus, fiscal tightening could represent a good opportunity for the national and provincial governments to rethink the education strategies, and based on this, to put pressure on provincial governments to use resources more efficiently and effectively to achieve not only quantity but also quality results.

Recent Reforms and Current Legislative Framework

During the 1990s, reforms focused on decentralizing the education sector were implemented. The major thrust was to put all responsibility for education, with the exception of universities, in the hands of the provinces. The main legal reforms, and prevailing rules, are the following:

- Ley de Transferencia de Servicios Educativos Secundarios y Terciarios no Universitarios (Law of Transfer of Secondary and Tertiary Education) in 1991 (primary education has been the responsibility of provinces since the 1970s);

- Ley Federal de Educacion (Federal Education Law) in 1993, which lists the responsibilities and competence of the nation and the provinces;
- Pacto Federal Educativo (Federal Education Pact) in 1994, through which the federal government promised to transfer resources to provinces and the latter promised to comply with education law;
- Ley de Educacion Superior (Superior Education Law) in 1995, which consolidated the rules to be followed by national universities.

Responsibilities of each Level of Government

National Government

- finance and regulate the national university system;
- supervise and give assistance to assure quality in basic education through implementation of national evaluation systems, technical assistance for curriculum management and training;
- financing compensatory programs to solve social disequilibria between regions.

There are 3 main programs or areas that are covered by the National Government (and included in the budget allocated to the National Ministry of Education) – implemented to comply with the laws described above:

- Pacto Federal Educativo (Federal Education Pact). This law materialized in the Program for Infrastructure and Equipment for Schools;
- Plan Social Educativo (Education Social Plan) also known as Program of Compensatory Actions in Education (includes provision of books and materials, improvement of infrastructure, scholarships, among others);
- Fondo Nacional de Incentivo Docente (FONID – National Fund for Teacher Incentives) with the objective of assisting provinces in the payment of delayed salaries and with further salary demands.

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Provinces

The provinces provide and finance all levels of non-college education: initial level (1 year), General Basic Education (EGB- 9 compulsory years), Polimodal (3 years), and Superior non-college (3-4 years). This includes payment of salaries to teachers, maintenance and investment in school infrastructure, management of the system in terms of choosing the personnel, supervision, and general administration.

Provinces seek to produce enough supply to fulfill the demand for education services and do this in two ways 1) by partially or wholly financing public schools and 2) through transfers to private institutions (public schools with private management) through subsidies that cover the cost of teachers (private institutions cover 25% of total students and receive 13% of the spending by provinces in education).

Sources of Financing for Provincial Governments

95% comes from the provincial treasury (free availability resources), 63% of which are resources from the coparticipation system and 37% are own resources. The percentage of own resources varies greatly among provinces with medium size provinces averaging from 10% to 20%. The remaining 5% are transfers from the National Ministry of Education, allocated to established programs (compensatory actions, infrastructure, and technical assistance) and FONID.

Use of Resources

In 2001, expenditure on education as a percentage of total expenditure averaged 29.3% for all provinces, with the province of Buenos Aires exercising 35.7% of the total provincial expenditure on education. Provinces account for 80% of total spending in education, the federal government accounts for 17%, and municipalities account for 3%.

Provincial spending is allocated as follows:

- 78% teacher and staff salaries
- 13% subsidies to private institutions

- 3% maintenance and services
- 3% different programs via transfers
- 3% capital spending

In fact, the above numbers are a bit misleading since with the exception of the province of Buenos Aires, provinces almost allocate nothing to non-salary expenditure (maintenance, pedagogic equipment, books, improvement and extension of school infrastructure). New capital investment (through the Federal Education Pact and the Education Social Plan) and other compensatory or pedagogic actions are executed by the federal government. Most spending in maintenance of schools and materials is financed by families through cooperative contributions.

Effect of Changes in Public Sector Balance on Education Expenditure

Correlation between GDP Growth and Education Spending

The following table shows the correlations obtained for data from 1993 to 2002:

Correlation of Public Budget Balance (as % of GDP) with:			
(as % of GDP)	Consolidated Public Sector	National Government	Provinces
Social Public Expenditure	-0.32	-0.36	-0.29
Public Expenditure on Education	-0.75	-0.34	-0.70
Public Expenditure on Basic Education	-0.74	-0.05	-0.65
Public Expenditure on College Education	-0.87	-0.80	-0.86
Public Expenditure on Science and Technology	0.52	0.49	0.41

These indicators allow us to make the following observations:

- The higher the budget deficit, the higher the expenditure on education, with the exception of science and technology.
- All correlations are considerably high.

- The variable that could be most affected by reductions in the public deficit is expenditure on college education followed by expenditure on basic education. On the contrary investment in science and technology might be expected to increase with public surpluses (although the correlation is low).

In general, expenditure on education seems to be better allocated than the whole expenditure in social areas.

Empirical evidence

This section will show some of the facts that highlight from the evolution of education financing in the last years. The purpose is to shed more light on which factors are more vulnerable to changes in essential variables such as GDP growth, public balance position, etc.

System and national government

During the 1990s, there was an expansion of fiscal resources as well as increasing indebtedness. These two factors allowed for a sustained increase in education spending. The number of students increased and was accompanied by a budget increase in both current spending and capital investment. Therefore, even with huge differences between provinces, the higher demand for education was satisfied through a substantial increase in resources. According to some authors, the fact that the economy was growing was one of the main reasons why authorities did not assess the need to improve the efficient use of resources, rather than just its quantity.

In the period of 2000-2001, expenditure on education remained constant. During 2002, with a substantial decrease in GDP growth, education spending was reduced but much less than expenditure on health and social assistance (which the government considered to be priorities). This was due to the fact that salaries were frozen and certain other inputs (to be explained below) even increased, resulting in a smaller impact on service provision than in other sectors.

Analyzing the evolution of the federal programs implemented in the last years shows interesting results:

In the first stage of the educational reforms and as the economy was growing, the federal government fulfilled its commitments with the law: allocating resources for training teachers, managing curriculum, compensatory actions (books, material, scholarships, etc), improvement of managing systems and school infrastructure. However, this strategy, accompanied by a period of economic expansion, revealed that the system lacked incentives for provincial governments to use resources more effectively.

Programs such as the FONID (support for salary payments) started in 2000, showed another problem of the system: programs aimed to function as complementary or compensatory actions actually crowded out investment by the federal government in other areas. As included in the budget of the Ministry of Education, these resources eventually absorbed part of the budget allocated to non-salary investment. Also, this type of transfers generated distortions in the allocation of resources by the provinces (as part of the salaries was actually paid by the federal government).

Another problem of this nature showed up in 2002, when the federal government redirected resources to reinforce school lunches and increase the number of students receiving scholarships. This led to the crowding-out of investment in other crucial components of the system, and to the federal government's absorbing actions, which were supposed to be the responsibility of provincial governments. In effect, the federal government's guarantee removed the provincial governments' incentive to work efficiently.

Finally, with respect to college education, even during the crisis, there was no substantial cut in the budget allocated for this purpose. Resources for this area have also been increasing in the last years.

Provinces

The most important factor are the acute differences found between provinces: although there is a positive correlation between provincial GDP per capita and expenditure per student, it is also true that among provinces with similar levels of GDP per capita, there are significant differences in their levels of expenditure in education.

The same holds true when analyzing the relationship between coparticipation transfers per capita and expenditure per student. Provinces with similar levels of coparticipation funds show considerable differences in their expenditure per student. This is consistent with the idea of lack of incentives in the system. Therefore, most of the authors conclude that the huge disparities prevailing between different provinces in the allocation of resources for education and outcomes prove that there is still enough room for improvement in the sector. Accumulation of free capacity in human and physical resources allows assuming that the system has margins to increase the amount of students without increasing its spending.

Other issues that warrant attention:

- Payments to teachers apparently do not correlate to results achieved but rather to factors such as years of experience of being in schools in remote areas. The lack of incentives through salaries should be further analyzed as 90% of the provincial spending on education goes to this concept;
- Provinces still owe some delayed salary payments to teachers. This must be analyzed to understand current province positions with this respect. Teachers are a crucial political factor—interruptions in class schedules have been proven to have an effect on children's education;
- Subsidies to private schools are very inefficient mainly due to lack of supervision on their actual use.

Channels through which Changes in Budget Capacity Might Affect Education Expenditure

National Government

For university education, on one hand, correlations show that expenditure on college education is highly and negatively correlated with fiscal surplus. On the other hand, the evolution of this kind of expenditure shows that even in difficult times, university financing has not been subject of cuts in its budget, probably partly due to political factors. Therefore, in the presence of a surplus and given the current social conditions of the country, we might expect university expenditure to remain constant or decrease slightly but maintaining sustainability levels. It is important to note that this does not guarantee quality or improvements in quality in college education.

In times of fiscal tightening we might also expect the federal government to maintain, to some extent, programs such as school lunches, scholarships, and provision of books and basic materials, which have a more important political component and are easier to manage. This will crowd out any investment programs or projects, which possibly will have more long-term and sustainable results in the improvement of education. Also, government might keep constant or reduce resources for teachers incentive programs (they already bear the cost of doing so in 2002).

Provinces

Two papers show regression results that measure the impact of several variables in the decisions of provincial governments to spend on education. Nicolini, Sanguinetti, and Sanguinetti found that an increase of 1 peso in the transfers of coparticipable funds produces an increase of 0.3 pesos allocated to education, while an increase of 1 peso in own resources by the province only increases expenditure on education by 0.12 pesos, ceteris paribus. Sanguinetti further shows that an increase of 1% in transfers of coparticipable funds, other things being equal, increases provincial expenditure on education by 52% (significant at 99% confidence level), while a 1% increase in own resources increases their expenditure on education by 19% (significant at 99% level) and a 1% increase in transfers from national government through the programs already discussed, decreases expenditure on education (crowds it out) by 4% (significant at 95%).

From these results, and given the fact that most of the expenditure on education comes from coparticipation funds, we can conclude that any fiscal policy change will have an effect on provincial expenditure on education depending on the degree on which it affects coparticipation funds.

Effect of Public Education Expenditure on Educational Outcomes

Most of the authors surveyed conclude that increased education expenditure had is no significant effect on measurements of quality of education. When comparing the relationship between expenditure per student and test results for all provinces, there is no significant correlation between the two variables. In fact, some provinces with similar test scores show completely different patterns of expenditure on education. The same holds true when comparing number of students per teacher and tests: fewer students per teacher do not mean higher test scores.

Regression analysis in Parandekar, España and Savanti show that factors such not having repeated grades, being in a private school rather than a public one, being a girl student and being in an urban community rather than a rural one, have the most important effects on improving language test scores. Factors such as teacher's years of experience, his degree, or particular issues about teachers have a positive but very small effect on scores. For example, giving children books has a greater effect than all teachers' variables. Also, variables measuring family environment (parents and children working, sibling's attendance to school, etc.) have a significant high effect on scores.

Alternative Solutions and Recommendations

All of the above leads to the following conclusion:

Even with a strategy of further fiscal tightening it seems possible to maintain at least the necessary level of "investment" to provide decent education services. On one hand, fiscal tightening could provide incentives for efficient use of resources by provinces for this purpose and aim to reduce dependence on government direct transfers and government rescue or support for provinces. On the other hand, fiscal tightening would certainly crowd out substantial investment in the sector by the national government, with negative consequences for education improvement, particularly in the long run.

However, if the current scheme actually has no or little effects on improving the quality of education, in other words, if more spending has little effect on quality, then it might be the perfect timing to propose new reforms on the system that could be cheaper than pouring more resources into the actual system. President Kirchner's support from provincial governors and his social popularity may enable him to push through such reforms, especially since there exist severe pressures for tightening fiscal policy.

Some of these changes, as proposed by several authors, might be the transfer of resources from the national to the provincial governments for a specific fund for education within the coparticipations system (as in the case of some other countries like Mexico); or support for other programs that focus more on improving household general conditions or giving incentives for parents to actively participate in the management and financing of schools.

APPENDIX VI. PROVINCIAL DEBT ISSUES BACKGROUND

The problem of provincial governments' debts enters the analysis of the Argentine Debt Crisis in two ways:

A portion of Argentina's current sovereign debts to private creditors, approximately 11 billion pesos, has a provincial origin.

This amount of debts belongs to the Province of Buenos Aires, which was the only province with direct access to international capital markets during the 1990s. After the crisis in 2001, the province became insolvent and was deprived of access to private capital. As a result of complicated bargains between the federal and the province's governments, the federal government nationalized this amount of foreign obligations, making it sovereign debt. This exchange of debt was done through the establishment of the Provincial Development Fund (PDF), by means of which the federal government became responsible for servicing the new securities to foreign creditors. However, this operation is not a federal assumption of liabilities; the Province of Buenos Aires has become indebted to the federal government, pledging part of its entitlements under the revenue-sharing scheme in partial guarantee of this new indebtedness. (For other provinces, the federal government has also issued federal debts for old provincial debts through the PDF.)

More generally, Argentina's recurring proclivity to incur massive public debts is rooted in its fiscal federalism, especially deficiencies in federal-provincial fiscal relations.

Argentina's decentralized fiscal federalism encourages fiscal irresponsibility on the part of provincial governments and the tendency to bailout provincial debts by the federal government. Therefore, Argentina's problem of sovereign debts cannot be analyzed in isolation from the flawed structure of fiscal federalism in which it is embedded. A sustainable solution to Argentina's foreign debt crisis must involve serious institutional reforms aiming at improving federal fiscal solvency as well as federal-provincial fiscal relations.

Given the relationships between sovereign and provincial debts of Argentina, this report has identified three main provincial debt related issues that are crucial to the discussion on Argentina sovereign debt:

- The ability of provinces, especially the Province of Buenos Aires, to service their debts to the federal government (which, in the case of the Province of Buenos Aires, is its biggest creditor) which depends on its ability to increase revenues;
- The institutionalization of provincial fiscal discipline, thus reducing both the dependence on federal transfers and the tendency to incur future debts on the part of provincial governments;
- The ability of the federal government to reform the Coparticipation Scheme in order to reduce its procyclical nature and to encourage a larger reliance on own revenues for provincial governments.

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NOTES

The current tax structure is as follows:

1. The federal government has the exclusive right to tax foreign trade
2. Indirect taxes are both under the domain of federal and the provincial governments
3. Direct taxes are an exclusivity of the provinces. Nevertheless, the Constitution allows the federal government to use these taxes under special circumstances.

Source: Besfamille, Martin & Pablo Sanguinetti, "Formal and Real Fiscal Federalism in Argentina." CSGR Working Paper No.115/03: (May 2003): 5.

The federal fiscal pacts of 1999, 2000 and 2002 committed provincial and federal governments to negotiate a new Coparticipations Scheme. These pacts established broad principles, comprising a "current framework of fiscal reform", to guide the design of a new Coparticipations Law. The main principles included in the 1999-2000 pacts are the following:

1. All federal taxes with the sole exception of those on foreign trade, should be included in a single mass of shared revenues, avoiding precoparticipations and exclusions
2. Provincial governments should have more influence over the primary distribution
3. The new Coparticipations Scheme should have smoothing mechanisms, including the calculation of transfers on the basis of multiannual averages of shared resources.
4. The federal government should cover the deficits of the extant provincial social security systems, which must in their turn be harmonized with national system.
5. Any savings in federal spending arising from a reduction in social security spending should be shared with provincial governments
6. The reform should not reduce transfers to any province
7. Any new criteria for distributing resources among the provinces should apply only to the increment in the total pool of resources sent to the provinces.
8. Provinces should adopt fiscal responsibility laws to control their spending, deficit, and debt. But these should remain areas of provincial autonomy

9. Provinces should strive to harmonize their tax systems and to cooperate on matters of tax administration with each other and with the federal government.
10. The federal fiscal agency called for in the constitution should be set up.

Source: World Bank, "Argentina: Reforming Policies and Institutions for Efficiency and Equity of Public Expenditures" Report No.25991-AR: (September, 10, 2003):