

**Why should the foreign creditors of Argentina take  
a greater hit/haircut than the domestic ones:  
On the economic logic, efficiency, fairness and legality of  
“discriminating” between domestic and foreign debt in sovereign debt  
restructurings**

**by**

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**First Draft:  
December 14, 2001**

The opinions expressed in this paper are solely those of the author. The usual disclaimer applies.

## Introduction and Summary

Foreign investors holding sovereign bonds of Argentina are currently seriously concerned, and threatening legal action, at the prospect that the debt restructuring currently undertaken by Argentina will discriminate against them.<sup>1</sup> The argument has been made that better restructuring terms may be offered to the holders of domestically issued debt (that is in a larger proportion held by domestic investors) than those offered on foreign issued debt (that is largely held by foreign investors). The former domestic debt has been restructured (in the first phase of the debt swap currently in place) on terms that cap the coupon rate on the new claims (below current market rates and below the previous coupon rate) while maintain the full face value of the assets at maturity; while the foreign debt may be restructured at much worse terms, for example be subject to an haircut of both coupon and principal/face value.<sup>2</sup> Thus, the overall net present value (NPV) haircut inflicted on the foreign debt could end up being much larger than the one inflicted on domestic debt.<sup>3 4</sup>

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<sup>1</sup> Indeed, a New York-based committee of Argentina's foreign bond holders hired in early December 2001 a law firm to ensure that the losses they suffer in the restructuring will be shared fairly by local investors.

<sup>2</sup> Until recently, the Argentine government was planning to restructure foreign debt on terms that were similar to that of domestic debt, i.e. a cap on coupon but no haircut on principal. But events after December 1, 2001 may eventually lead to a greater haircut of foreign debt.

<sup>3</sup> Such investors' concerns have increased in recent days as Argentina inability to receive the latest \$1.2 billion IMF tranche given its fiscal target slippages may force the country to default on its foreign debt. Minister of the Economy Cavallo indeed obliquely suggested on December 10, 2001 that foreign creditors may suffer a greater haircut than domestic creditors.

<sup>4</sup> Indeed, as reported by Moody's on December 11, 2001, the way the domestic component of the debt swap has been arranged suggests that Argentina may be able to facilitate the discrimination between domestic and foreign bond holders. Specifically, a trust has been established to hold the bonds that local Argentina pension funds and banks tendered as part of the swap. Usually, when investors tender their bonds in sovereign debt swaps, those bonds are extinguished and exchanged for new claims. But in the Argentine transaction, those who participated in the local exchange are retaining their voting rights. This means that local bond holders may be able to turn the bonds held by the foreign bond holders into instruments that are less intrinsically valuable than they are today, via the use of exit consent clauses.

In this paper, I discuss why such “discrimination” may be economically justifiable, efficient, fair and legal.<sup>5</sup> In short, in a situation of insolvency, after domestic agents/workers and domestic holders of financial assets have borne the severe burden of the necessary fiscal and real adjustment that the country is and will undertake, the residual burden can only be borne by foreign investors holding the foreign debt of the country.

In the case of Argentina, these costs borne by domestic agents include of three years of negative growth, increasing unemployment, falling consumption and welfare, cuts in public services, cuts in public wages and pensions, increases in taxes, capital levies, deposit freeze, capital losses on equity and real assets, effective devaluation of the peso, capital levies in the form of increasingly worthless patacones and lecops, seizure of their pension funds, loss of foreign reserves, haircuts on their holdings of public debt and the now unsustainable debt servicing costs on foreign debt. So, residents have already borne a large adjustment burden and would bear the costs of any further fiscal/real adjustment that will be necessary to put the country back on track, even before the foreign debt is treated/reduced. Thus, once the maximum politically feasible internal adjustment has been borne by domestic agents and there is still insolvency, the foreign investors will have to bear the residual costs required to restore medium term debt sustainability.

In the paper, I also discuss why “discrimination” of foreign investors may be more apparent than real once one considers the different features of domestic and foreign debt (degree of legal protection, risk of early treatment, liability to semi-coercive restructuring); I estimate the size of the foreign creditors’ flight in 2001 from Argentina and Turkey that has been financed by official creditors and loss of foreign reserves (over \$36 billion in 2001 alone); I analyze how assess whether a country is insolvent or just unwilling to pay; and I discuss the possibility of self-fulfilling debt crisis driven by an unwarranted increase in sovereign spreads. Finally, I consider the threat of possible litigation and its consequences in the Argentine debt restructuring. I discuss the arguments often heard that this threat is large in the Argentine case and find them to be incorrect or exaggerated. An orderly restructuring and reduction of foreign debt, even at “discriminatory” terms, is not likely to be threatened or disrupted by the legal action or behavior of foreign creditors.<sup>6</sup>

### **Different definitions of “domestic” and “foreign” debt.**

Before we discuss the economic logic, efficiency, fairness and legality of such a “discrimination”, we need to precisely define the terms used in this debate. According to an economic definition (based on a residency principle), foreign debt is only the debt by

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<sup>5</sup> In a separate paper (Roubini (2001b)), I discuss the currency regime options currently available to Argentina (move to a float, dollarization), their pros and cons; and their implications for the amount of necessary debt restructuring/reduction.

<sup>6</sup> For a broader discussion of bail-ins, burden sharing and foreign debt restructurings, see Roubini (2000, 2001a).

non-residents, regardless of whether the debt is in local or foreign currency, whether it is issued at home or abroad. Conversely, domestic debt is debt by residents, regardless of whether the debt is in local or foreign currency, whether it is issued at home or abroad. So a Brady held by an Argentine resident is domestic debt while a Letes held by a foreign investor is foreign debt.

This economic definition of foreign and domestic debt is different from the “legal” definition used in the current debate on Argentina where domestic debt is defined as debt issued according to Argentine law, regardless of whether it is in local or foreign currency and regardless of who, foreign or domestic resident, is holding these claims. Conversely, the “legal” definition of foreign debt is debt issued according to foreign (New York, UK, et cetera) law, regardless of whether it is in local or foreign currency and regardless of who, foreign or domestic resident, is holding these claims.

Since in practice, a larger fraction of the “legally” domestic debt is held by residents than non-residents and a larger fraction of the “legally” foreign debt is held by non-residents, a swap that would discriminate in favor of domestic debt and against foreign debt would hurt more non-resident investors than resident investors.

But let us assume for the time being, and to simplify the arguments, that all Argentine domestically issued debt is held by residents and all foreign issued debt is held by non-residents.<sup>7</sup>

### **On the logic of treating on “non comparable terms” local currency debt.**

Note first that domestic public debt includes both debt in local currency and debt in foreign currency. One can sensibly argue, regardless of whether such debt is held by residents or non-residents, that domestic debt in local currency should not be restructured on terms comparable to those of external (or domestic) debt in foreign currency. The reason is as follows. Domestic local currency debt is subject to devaluation risk, on top of country risk, and its real value is already significantly reduced (if not wiped out) when a debtor country in crisis experiences a sharp devaluation of its currency (and/or when high unexpected inflation reduces the value of fixed interest rate and/or variable rate domestic currency debt). Thus, the holders of such debt (be it domestic or foreign investors) are already automatically bailed in and subject to a haircut when a devaluation occurs, as it is effectively already the case in Argentina today. While investors are compensated for incurring such currency risk, it does not make sense to restructure such debt on terms comparable to that on foreign currency debt. If the country/default risk is the same for local currency debt and foreign currency debt and, on top of the country risk, the domestic debt has also currency risk, capping to the same rate the coupon on domestic currency and foreign currency debt would be most unfair to holders of domestic currency debt; no rational agent would want to hold domestic currency debt if he/she is not compensated for such a risk. Similarly, when the Argentine authorities decided to cap the interest rate on peso deposits to a rate no higher than that of dollar deposits, the incentive for any depositor in Argentina to hold peso deposit disappeared altogether and effectively

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<sup>7</sup> This assumption is for convenience and to avoid confusing different definitions of domestic and foreign debt. We will relax this assumption later on.

all deposits got dollarized. Thus, domestic currency debt must be treated separately from foreign currency debt.

### **On the economic logic of discriminating between domestic and foreign debt.**

The more complex issue is whether to restructure domestic foreign currency denominated (or foreign currency linked) debt on terms comparable to foreign debt in foreign currency. Assuming, as we did above, that all of the former is held by non-residents and all of the latter is held by non-residents, such discrimination would imply that foreign investors would suffer a greater haircut than domestic investors if the terms of the restructuring are more favorable to domestic debt.

The main economic argument for discriminating between the two debts is as follows. In principle, if one were to follow the logic that both domestic agents (workers and holders of capital/assets) and foreign investors have to share the burden of adjustment when a crisis occurs, one should distinguish between the adjustment effort made by domestic agents and the one made by foreign investors.

Domestic agents bear already a large, and greater, part of the crisis and policy adjustment burden relative to foreign investors. This domestic burden on domestic residents is much larger than that on foreign investors for several reasons.

First, domestic fiscal adjustment during the crisis period already involves a painful increase in taxes and cuts in public spending and services. The tax burden includes not only increases in direct taxes (such as income taxes) and indirect taxes (such as consumption/sales taxes) but also all capital levies on domestically held financial assets including the real reduction of debt via inflation/seignorage, devaluation, forced or semi forced restructurings of domestic public debt and formal and informal capital levies on such assets. The reduction in government spending (including government consumption and reduction in public wages and pensions) implies a reduction in public services to residents and of income to public employees and pensioners.

Second, the domestic cost of adjustment also includes the output, unemployment and consumption costs of a crisis and of the policy adjustment programs that cut domestic demand in order to improve the external and fiscal balance of the country. This cost is mostly borne by residents.

Third, domestic residents also bear a disproportionate share of the losses on the local currency value of real assets, such as equity and real estate assets that occur during a currency and financial crisis when asset values in local currency sharply fall, as they are currently in Argentina. As long as such assets are mostly held by residents – as they are in Argentina, most of such losses are borne by them.

Fourth, the reduction in the real dollar value of local currency assets deriving from a depreciation is also borne by domestic residents, with the caveat that such costs are mostly a redistribution between resident creditors and debtors. And effectively, the peso exchange rate has already started to depreciate in the black market.

Fifth, domestic residents are those who suffer the most from banking deposit freezes, capital controls, raiding of their pension funds, and other restrictions and levies on their assets.

In summary, Argentine residents have already suffered the large costs of three years of negative growth, increasing unemployment, falling consumption and welfare, cuts in public services, cuts in public wages and pensions, increases in taxes, capital levies, deposit freeze, capital losses on equity and real assets, effective devaluation of the peso, capital levies in the form of increasingly worthless patacones and lecops, seizure of their pension funds, loss of foreign reserves, haircuts on their holdings of public debt and the now unsustainable debt servicing costs on foreign debt. So, residents have already borne a large adjustment burden and would bear the costs of any further fiscal/real adjustment that will be necessary to put the country back on track, even before the foreign debt is treated/reduced.

Once this necessary domestic policy adjustment is made (and the distribution of its costs between workers and domestic holders of assets is determined in the domestic political arena), a haircut on foreign residents held debt is then the necessary part of the adjustment when the country is deemed to be insolvent or unable to pay fully and in time its external liabilities.

So, conceptually one should separate the adjustment costs borne by domestic agents from the burden sharing provided by foreign investors. Ideally, one would want to distinguish between the two and decide separately how much pain/adjustment needs to be inflicted on domestic agents as a way to put the country back on a sustainable growth and fiscal path and how much external relief in the form of restructuring of externally held debt and debt reduction should be provided by foreign creditors. Thus, if one were to assume that the foreign currency debt is held by non-resident investors, the logic above of burden sharing would suggest that such debt should be restructured on terms different from those of the domestic debt. Since domestic agents (workers and holders of financial and real assets) suffer a large part of the burden of the crisis and adjustment, it would make sense to discriminate against foreign non-resident holders of debt in the sense of treating separately their claims.

Specifically, if a country is truly insolvent in the sense that it is unable to pay its foreign debt in spite of a significant domestic adjustment of demand and fiscal positions (including whatever levy can be imposed on the domestic holders of public debt), then the residual burden should be fully borne by foreign investors. They have to take the full residual haircut that makes the country's debt sustainable. In this regard, it is important to stress that any haircut on the domestic debt held by residents is just another form of taxation and thus part of the fiscal and real adjustment already imposed on residents (be it workers or domestic owners of assets). If, in spite of this internal adjustment, the country is still insolvent in that sense that the debt owned to non-residents is not sustainable, logically all the remaining burden should and can be borne only by non-residents.

### **Role of official finance in allowing the early exit of foreign creditors**

One should also consider that, in addition to the early costs of adjustment borne by domestic agents and creditors, foreign creditors are favorably “discriminated” (i.e. the discrimination is actually in their favor) because of the existence of official finance (IFIs “bailout” packages) that effectively allow the early exit of foreign creditors unwilling to rollover their lines or rollover maturing bonded debt or exiting any other claim on the

debtor. This capital flight has been massive in the last two IMF bailout episodes, Turkey and Argentina. Based on recent (September 2001) data by the IIF<sup>8</sup>, official flows to Argentina and Turkey in 2001 alone are expected to have been \$26.1 billion dollars while the two countries lost \$10.2 billion of foreign reserves (this figure is actually much higher and closer to \$14 billion as Argentina lost about another \$4b of reserves between September and December 2001). This massive official lending and reserve loss has financed in 2001 a private capital flight of \$36.3 billion. Foreign private creditors (banks and bond holders) reduced their exposure to these countries by \$26.3 billion while private equity investments from abroad to these two countries were a mere \$3.4 billion (down from \$5.5 billion in 2000). Resident lending abroad has increased by \$11.3 billion (this is the domestic component of the capital flight). Thus, out of a capital flight of about \$36.3 billion, about 72% of it (or \$26.3 billion) was flight by foreign investors. And these figures are underestimates of this foreign creditors' flight given the further massive reserve losses in Argentina in the September-December 2001 period.

### **“Discriminatory” debt relief to avoid a debt overhang.**

One should also note that, not providing such a foreign debt relief would cause a “debt overhang” that would worsen the welfare of both residents and non-residents. In other terms, if foreign bondholders had originally claims on a tree producing ten oranges a year and now there are only five oranges per year on the tree, they cannot get more than five oranges. And if they insist on ten oranges and this leads the farmer to stop tending the tree (disinvestments driven by a debt overhang), they may eventually end up with even less than five oranges. Thus, it is mutually beneficial for both the debtor and the creditors to accept a haircut that “discriminates” against foreign creditors.

Thus, one can justify on economic and efficiency terms, the need to discriminate against foreign investors in debt restructuring. Since they do not bear the costs of the domestic policy and demand adjustment, it is not correct to argue that they are “discriminated” against if the terms of the debt restructuring are less favorable to them.

### **Discrimination between domestic- and foreign-issued debt as an approximate way to “discriminate” against foreign investors.**

Of course, the reality is more complicated because it may be hard to distinguish, and treat differently, debt held by domestic residents and debt held by foreign residents. Part of the domestic local and foreign currency debt is held by foreign investors and part of the external debt in foreign currency is held by domestic investors. Also, legal impediments prevent discriminating between domestic and foreign holders of domestic-issued debt and between domestic and foreign holders of foreign-issued debt. Also, attempts to distinguish between the two classes of domestic and foreign debt may lead to distorted incentives in the future, i.e. investors preferring to hold claims subject to less harsh restructuring risk.

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<sup>8</sup> “Capital Flows to Emerging Market Economies”, IIF, September 2001.

But, as long as a larger fraction of the domestic-issued debt is held by residents while a larger relative fraction of the foreign-issued debt is held by non residents, a debt restructuring that “discriminates” against foreign-issued debt and in favor of domestic-issued debt is both fair and economically justifiable on efficiency grounds.

Thus, while it is very hard to discriminate between domestic and foreign holders of foreign debt, one can and should restructure domestic-issued foreign currency debt separately from externally issued foreign currency debt. Fairness among creditors in this case would imply treating equally domestic and foreign holders of such foreign issued debt.

The arguments for restructuring domestic foreign currency debt on terms different, and better, than those of foreign issued debt are as follows.

First, often this debt is mostly held by domestic investors. So, treating it separately may get you close to the principle of separating the overall adjustment burden on domestic agents from how much burden sharing should be provided by foreign creditors.

Second, this debt is subject to a different legal framework than foreign debt and can thus be treated separately; i.e. cross-default and acceleration clauses do not usually apply.

### **On the impossibility to avoid “discrimination” when domestic debt is held by insured domestic banks.**

Third, such domestically issued debt is often held by domestic banks that are in distress, if not bankrupt, and will have to be bailed out by the government anyhow if a crisis worsens and a haircut on domestic debt occurs (as in Ecuador for example). Restructuring domestic bonds held by these financial institutions at “comparable” terms as foreign debt would thus imply that the financial distress of these institutions will be larger and the eventual cost to the government of dealing with their bad assets unchanged: the more these bank-held bonds are restructured the lower is the initial burden for the government but the greater is the burden of bailing them out down the line. So, debt reduction of claims held by deposit-insured banks is conceptually no debt reduction at all for the government; it is just a reshuffling of its liabilities from explicit to implicit ones.<sup>9</sup>

One could argue that, if treating such debts is net wash for the government in terms of eventual fiscal costs of a banking bailout/recapitalization, why not to treat them on comparable terms as foreign debt in the first place? This would avoid the risk that wealthy domestic holders of such claims (and equity owners of the banks) are effectively bailed out (or subject to smaller losses). However, the net fiscal costs may not be unchanged. If a bank is not yet bankrupt, treatment of such claims may make it insolvent with all the additional cost of having to deal with a formal bank bankruptcy and bank

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<sup>9</sup> The same argument holds if the haircut is imposed on the government debt holding of pension funds whose benefits are defined. Unless the government wants and can impose a capital levy on the workers who are entitled to these assets, any haircut on these claims will become another liability for the government.



nationalization. Thus, the potential additional costs of treating such claims together, and on comparable terms, with foreign held debt may be high.

This logic does not mean that such domestic claims should not be treated at all or that domestic debt holders should be treated much more favorably than foreign ones. If fiscal sustainability implies the need to restructure the overall public debt, both the domestic and foreign components of it will have to be treated. The argument here is only that it makes sense to treat such domestic foreign currency claims separately from foreign debt held by non-residents to avoid creating further financial and real disruption deriving by greater distress and real bankruptcy costs imposed on the financial system.

At the more conceptual level, if banks liabilities are fully insured, any losses deriving from a haircut of domestic public debt held by banks are still a burden on the government intertemporal fiscal position as a greater haircut of these claims increases the implicit liabilities of the government deriving from the bigger hole in the assets of the banks. At the end of the day, any capital levy on domestic banks that have deposit insurance cannot be a true capital levy (or source of revenue for the government) as it increases public liabilities (the implicit costs of recapping the banks) by the same amount as the initial levy/haircut on the bank holdings of government debt.

So, for example, suppose that the insolvent government decided to avoid “discrimination” and would try to give a similar haircut on domestic debt held by domestic banks and foreign debt held by foreign investors. Then, the greater the average common haircut, the greater is the liability for an already insolvent government deriving from the hole that the domestic haircut inflicts on deposit-insured banks. Thus, at the end the government would need a further larger proportional haircut on all debt (including the foreign held one) to obtain the resources needed to recapitalize the banks that were rendered insolvent by the initial non-discriminatory haircut. In other terms, if bank liabilities are government liabilities, one cannot logically but discriminate against foreign debt holders as attempts to treat domestic banks and foreign investors comparably in debt restructuring just end up increasing the liabilities of the government and the need for further foreign debt haircuts. So, comparability does not make logical sense.

So, setting aside bankruptcy costs, there is no difference in the amount of eventual effective haircut that foreign investors suffer in the following two alternative scenarios:

- a. foreign investors are discriminated in advance in debt restructuring relative to domestic holders of bonds (banks, pension funds, et cetera);
- b. they are not discriminated in advance but a much higher average haircut is required if a common comparable haircut makes banks insolvent and increases the implicit liabilities of the government.

Moreover, once one includes the bankruptcy costs of bank defaults, the arguments in favor of discriminating against foreign investors become even stronger as one would want to avoid such real costs if possible.

One could certainly argue that domestic depositors, rather than the government, should bear some of the burden deriving from a capital levy on banks (domestic debt haircuts) that make them less solvent. But depositors are already taking a large hit once considers the previously discussed costs of a crisis and the fiscal adjustment that ensues. Also, as long as the amount of domestic pain that domestic agents (workers, owners of assets) can take is limited to the feasible amount after which the country is still insolvent, the residual burden of an insolvent country (and its aggregately insolvent

government/banks/corporates/households) can be borne only by non residents. If domestic workers will contribute to the country's fiscal adjustment through direct/indirect taxes and capital levies (haircuts on their holding of government debt), what matters is the total fiscal burden they pay and the maximum burden they can feasible/politically take, not its distribution between regular taxes and capital levies. The rest of the burden can be logically borne only by the foreign investors.

### **On distinguishing between true insolvency (inability to pay) from strategic insolvency (unwillingness to pay).**

Also, the argument is sometime made that a country may not be really insolvent (unable to pay) but rather unwilling to pay as a greater domestic and fiscal adjustment would allow it to pay in full its liabilities. This argument does not hold at closer inspection.

First, the debt may be so high that, even under the most optimistic assumptions on growth and fiscal adjustment, the country may be unable to pay.

Second, if the domestic adjustment required to prevent a short run default leads to political unrest (a revolt against further austerity) and a fall in investment that reduces long run growth opportunities, the country is effectively unable to pay as "excessive" domestic adjustment creates political and economic costs that make the debt less sustainable in the medium term.

Third, there are known empirical criteria (various debt ratios to GDP, exports, revenues or estimates of primary gaps and trade balance gaps, i.e. the primary fiscal and trade adjustments required to stabilize debt ratios and prevent them from growing without bounds) that can be used to make an assessment of whether a country is insolvent or just unwilling to pay. While this is not a perfect science, there is a body of literature and criteria that can be used to distinguishing true insolvency from strategic unwillingness to pay.

Fourth, as discussed below there are market mechanisms and punishments to deal with strategic default. Thus, countries do not lightly default on their foreign debt.

### **Self-fulfilling solvency crises and the need for ex-post haircuts.**

Fifth, at some point a solvency crisis takes dimensions that make it self-fulfilling and require an ex-post reduction in debt servicing. I.e., if a crisis originally triggered by fundamental imbalances and a modest degree of insolvency leads to such high spreads that the country cannot not feasibly pay such high interest rates (spreads of over 30% over Treasuries as currently in Argentina) and still remain solvent, then it is efficient and optimal to ex-post to reduce such excessive interest rate burden to restore sustainability and growth. I.e. spreads such as those experienced by Argentina in recent weeks have a component of self-fulfilling arbitrariness that requires an ex-post haircut to restore solvency even if the country was not deemed to be insolvent in the first place.

In assessing solvency, one should thus carefully consider the potentially perverse effects that the interest rate on the country or government debt may impart on the debt

dynamics of a country/government. If foreign/public debt is very high, the market will price the probability that the debt may not be serviced in full and in time. In this case, the level of interest rates and interest spreads on the debt will reflect the possibility that “partial default” (defined as a situation where debts are not promptly serviced in full) may occur. Such a risk of default implies that the risk-adjusted interest rate on the debt will be higher than under no-default risk and higher interest rate will trigger a more rapid accumulation over time of a given stock of debt (given the constancy of other economic factors). Such an increase in spread may trigger a perverse debt dynamics in which, if the country tries to service its debt in full at current high spreads, debt ratios grow even if the country/government is following policies that are sound and is not otherwise insolvent. One may also end up in situations of “self-fulfilling solvency traps”.

For example, suppose that investors exogenously and arbitrarily increase their assessment of the probability of default on a sovereign debtor that would otherwise have a lower objective default probability. Then, the sovereign spread will accordingly increase to reflect that higher subjective probability. In that case, in equilibrium the borrower may be forced to default according to the higher probability even if such an increase in default probability was not justified in the first place. If the borrower does not default, the ex-post real cost of borrowing may become prohibitively high. So, you can get multiple equilibria in which any subjective probability of default is self-justified even if not justified by underlying fundamentals: the higher probability leads to higher sovereign spread and this in turn forces the borrower to default to justify having committed to such high ex-ante premia.

Such perverse dynamics becomes a serious issue for countries, such as Argentina, that are in a crisis and are borderline between being insolvent and illiquid. As there is broad uncertainty about whether there is insolvency (and some investors may also be risk averse), markets will react to any increase in the objective probability of default by increasing the spreads on the country/government debt and thus worsening the debt dynamics of the country/government. An otherwise solvent agent may thus be thrown in an insolvency region if real interest rates on the debt become too high.<sup>10</sup>

Moreover, while it is socially efficient to be in a world in which countries have strong incentives to pay in full their obligations, sovereign spreads reflect the objective probability of default for countries that may be insolvent. Thus, in equilibrium default will on average occur from time to time (for countries/governments that are effectively insolvent) in such a manner that the net of default return to risk-neutral investors will be on average close/equal to the return on a safe asset (say US Treasuries). In equilibrium it does not make sense to have higher sovereign spreads and then expect that every debtor will pay in full in all circumstances/states of the world for every bond. If it did so, the ex-

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<sup>10</sup> Of course, the currently high spread on Argentina debt reflects only the marginal cost of new borrowing, not the average cost of servicing the existing debt that is much lower given the historically lower spreads and coupons on outstanding debt. On the other hand, the proposed capping of coupon rates on domestic and foreign debt does not provide much debt servicing relief since the proposed caps (slightly above 7% coupon rates) are not much lower than the average coupon rate on existing debt, that is slightly above 9%. Thus, a much larger haircut of coupon, and possibly principal, will be necessary to provide more meaningful and sustainable debt relief.

post systematic real cost of borrowing will be extremely high and markets would be mispricing the assets. I.e., if there is a default premium, the asset has to default accordingly in a probabilistic sense. For example, if Russia had paid in full the GKO at a 70% nominal return, the real borrowing costs would have been prohibitive.<sup>11</sup>

The above argument does not imply that every country that is borrowing above the riskless rate should default in proportion to its sovereign spread. One should not favor the idea that countries should default on a regular basis: if obtaining debt relief is too easy, there is a risk of creating incentives for countries not to pay, i.e. debtor moral hazard. What is suggested here is, instead, that sovereign spreads on foreign currency borrowing reflect the probability that the investment will not be paid in full if the country becomes insolvent. If markets are pricing risk correctly, a high spread implies a high risk of default and, in equilibrium, defaults will occur from time to time. Some countries/governments that borrowed ex-ante at high spreads will be able, given the developments in their economies and realization of shocks, to service in full their liabilities; other countries/government will be subject to such negative developments and shocks that insolvency will result and some debt reduction will occur either via a negotiated deal or through outright partial default.

### **Historical evidence on ex-post returns on emerging market debt.**

The argument above that ex-post returns on sovereign debt will be close, in equilibrium, to riskless rates of return (if investors are risk-neutral), is confirmed by the ex-post returns on sovereign bonds in the early 20th century default episodes. The ex-post internal rate of return on foreign dollar bonds issues in the 1920s was 4% and on sterling bonds 5%. Instead, ex-ante returns were in the 7-8% range (Eichengreen and Portes (1989)). Lending to 10 major sovereign borrowers gave a real rate of return of 2.1% in 1850-1914 and 3.8% for loans extended in the interwar period, exceeding only by 1% in both cases the domestic safe (sterling or dollar) government bond real return (Lindert and Morton (1990)). Bank lending to sovereign countries between 1970 and 1992 implied an average nominal rate of return of 8% (1.8% below the average Libor) implying an average real rate of 2.1% (Klingen (1995)). Thus, across a long historical sweep, with many defaults and reschedulings and under a variety of different institutional arrangement, the average ex-post real rate of return on lending to sovereigns has remained remarkably similar: about 2-3% not much different from that on “riskless” lending (Eichengreen and Portes (1995)).

Of course, sovereign defaults were usually very messy and often, like after the 1930s, it took decades until the sovereign regained access to capital markets. But 200 years of history show that sovereign defaults are the rule rather than the exception, both under bank and bond financing. As bonds, rather than bank loans, become the norm in capital flows to emerging markets, allowing orderly workouts when necessary would be

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<sup>11</sup> If spreads are that high it is clear that payment in full will not occur; you are likely to be forced to default/devalue to avoid an unsustainable debt dynamics. Investors that bet on 80% returns, as in Russia in 1988, should not have expected to be paid in full in every possible state of the world.

efficient for all. The argument that this will make defaults more likely is not very tight. Since ex-post returns will be approximately equal to riskless rates, creditors will accept defaults whether they like it or not; that is why they require sovereign premia in the first place. It may seem dangerous to pursue policies that accommodate defaults but the alternative, messy workouts that lead to lost decades of growth, is not a good alternative. Like in domestic junk bonds, domestic corporate default and chapter 11 restructuring, investors assess default risk and price firm bonds accordingly under the expectation that defaults will occur and they will not get ex-post the full NPV of the obligation. The same should be the case for sovereign bonds with the caveat that institutions for efficient debt restructurings should be in place.

In the US, debt writedowns under Chapter 11 average 50% while in out-of-court workout processes they average only 20%. The difference is due to the fact that more solvent firms avoid Chapter 11 and do out-of-court workouts. The latter take on average 17 months to conclude while Chapter 11 workouts average 27 months in duration (see Franks and Touros (1994)). If the average Chapter 11 US firm gets a 50% debt writedown, should one expect much less for a sovereign that is seriously distressed?

### **Are sovereign spreads too high given the low frequency of defaults?**

In this regard, Larry Summers (2000) has made the argument that sovereign spreads are often so high that they imply a large probability of default; however, actual defaults/haircuts have been relatively rare events. This would suggest that there is an inconsistency between the price of emerging market bonds and how frequently we observe defaults. One possible explanation is that spreads do not just reflect default probabilities (given some assumptions on recovery rates in states of default) but also the premium that risk averse investors require to hold risky and highly volatile assets such as emerging market debt. Then, spikes in sovereign spread may measure mostly changes in global investors' risk aversion rather than just changes in default probabilities; and the level of the spread may reflect more the degree of risk aversion of investors than the actual probability of a default. Moreover, a combination of risk aversion and uncertainty about the country ability to reform and adjust and about the official sector willingness to support ("bail out") countries in crisis may also be behind the average increase in spreads observed in recent years.

### **Debt restructuring may not provide actual debt relief to the debtor (or the "Bulow-Rogoff" critique of debt buybacks revisited)**

It is often argued that debt restructuring/reduction where a sovereign debtor replaces old bonds with new bonds (that have a different a lower schedule of coupon payments and face value) provide debt "relief" to a sovereign debtor. But, in a variant of the famous "Bulow-Rogoff" critique of debt buybacks, one can argue that debt reduction does not provide any real benefits to the debtor and may actually benefit mostly the creditors.

The “Bulow-Rogoff” argument on the inefficiency of debt buybacks is well known. Debt buybacks are an inefficient use of a country scarce resources (Bulow-Rogoff critique) when they occur at the current average secondary market price of debt (as they should, instead, occur at the lower marginal price of debt). Even, if the buyback were to occur at the lower marginal price of the debt, there is not benefit to the debtor from such buyback as the residual price/value of the remaining outstanding claims would endogenously increase so that the market value of the residual debt is unchanged. I.e., buybacks cannot affect the overall solvency of a country.

The same argument can be made for debt restructuring and debt reduction. If the market value of a sovereign bond has fallen sharply below par, as long as markets are correctly pricing default risk and the ability to pay of the sovereign, the market price reflects the debtor ability to pay. Thus, when the original debt is exchanged with new debt whose face value (and/or coupon payments) is lower than the one of the original bond, the country does not effectively receive any debt relief as long as the price/market value of the new bond is equal to the one of the old bond. If a bond that was a claim on a tree that promised 10 oranges per year was worth 100 (at an interest rate of 10%), but now the tree produces only 5 oranges, the value of that bond/asset is only 50. Thus, writing down the value of this bond to 50 and issuing a new bond with face value of 50 that promises only 5 oranges per year does not provide any relief to the debtor. It represents only the acknowledgement that the asset is now worth less than before. In this debt reduction exercise, the bond exchange occurs at the marginal value of the asset, i.e. 50. Thus, the debtor would obtain no real benefit; the new bond would just formally reflect its lower ability to pay.<sup>12 13</sup>

The above point is important because it is often argued that debt reduction inflicts net present value (NPV) losses on creditors. But this cannot be the case; since bonds are marked-to-market on a continuous basis, their market price reflects, at a first approximation, the default risk and the country’s ability to pay (its degree of “insolvency”). Since a debt exchange where debt “reduction” occurs, always takes place at an exchange price that is at least as high as the one of the old exchanged debt (otherwise, the creditor would not accept the exchange offer), there is not real NPV debt reduction beyond the true value of the original debt as already priced by the market. If anything, since many debt exchanges occur at post-exchange average price rather than pre-exchange marginal price, the debtor loses in the exchange and the creditors increases

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<sup>12</sup> And if the bond is exchanged at the average price, i.e. the post-exchange market price, the debtor actually loses from the exchange as the surplus is transferred to the creditors. And, indeed, in all sovereign bonded debt restructuring in recent years (Russia, Ecuador, Pakistan and Ukraine) creditors obtained mark to market gains as the value of the new bonds exceeded by an average of 20% the value of the old bonds. I.e. the exchange occurred at the less favorable rate for the debtor of the average value of the old bond.

<sup>13</sup> One can conjure up arguments why debt buybacks or debt reductions at marginal prices may be marginally beneficial to the debtor; see the classic debate between Sachs and Bulow-Rogoff on the “debt buyback boondoggle” for this. Also, mispricings between Eurobonds and Bradies may lead to marginal benefits to a debtor buying back its Bradies and issuing new Eurobonds. But the substance of Bulow-Rogoff critique still holds.

the NPV of its claims. So, debt exchanges that “reduce” debt actually benefit creditors and hurt debtors.

Of course, there is always the risk that the current market price of the old debt and its related sovereign spread (above riskless assets) may not truly reflect the actual value of the asset and the country’s ability to pay. A country could talk down the market value of its debt with credible threats of default (even if it is not formally “insolvent”) and then engineer a debt exchange at the depressed current market price. In this case, the debt exchange would lead to some “true” debt reduction for the debtor and could be considered as being unfair. But over time, if market can reassess the true value of the new claims based on the true ability to pay of the debtor, the market price would increase and the new debt price would again reflect its true value.

In a variant of this argument, even if the debtor does not actively manipulate downward the price of the old debt by talking it down, in situation of extreme macro and policy uncertainty and with high degree of investors’ risk aversion, the market price of the old debt may fall and the bond spread increase well beyond what may be warranted by economic fundamentals. Again, debt restructuring under such distressed conditions may imply some true NPV reduction in the debt burden of the debtor, certainly a temporary one, and possible a more permanent one.

But apart from these extreme cases, in general the process of debt restructuring and reduction does not provide any true relief to the debtor; it just acknowledges the fact that its ability to pay is now reduced. The above discussion also suggests that the term debt “reduction” may be a misnomer. In such debt “reduction” episodes, most of the benefits of the exchange may go to the creditors with little of the surplus left for the debtor. The debt “reduction” just acknowledges the reality that the debtor ability to pay is now lower than before.

### **On the legality of discriminating between domestic and foreign debt.**

Important aspects of the current debate on the Argentine debt restructuring and the possible discrimination between domestic and foreign bondholders include the legal issues associated with the restructuring, including the risk of litigation. These are complex legal issues that cannot be fully settled in the present paper. But some general observations can be made.

First, even if Argentina were to discriminate between domestic and foreign components of the debt swap, that does not represent a discrimination against foreign investors. Since part of the domestically-issued debt is held by non residents and part of the foreign-issued debt is held by residents, both some domestic and foreign residents are hit to a greater extent when foreign issued bonds are treated less favorably in an exchange. Of course, if a larger fraction of foreign-issued debt is held by non-residents and a greater fraction of domestic-issued debt is held by locals, this discrimination between the two types of debts amounts to foreigners taking on average a greater hit/haircut in the exchange than domestic residents. But formally, the discrimination is between types of debt (distinguished by the local or foreign jurisdiction over the bond contract), not between domestic and foreign bond holders.

Second, as long as domestically issued debt and foreign issued debt are subject to different jurisdictions, and as long as there are no cross-default clauses from domestic debt to foreign debt or vice versa, Argentina can in principle treat differently domestic issued debt from foreign issued debt without holders of the foreign debt having a legal argument to challenge such a different treatment. Indeed, Russia defaulted in 1998 on its domestic debt (GKOs) and on the Soviet era Eurobonds while it serviced fully the new Eurobonds of the Russian Federation (post 1991 Euros). It was able to discriminate between different types of bonds as they were subject to different legal jurisdiction, represented liabilities of a different sovereign (the former Soviet Union and the Russian Federation) and were not subject to cross-default clauses. Conversely, when Ecuador tried to treat differently different categories of its foreign issued debt (different types of Bradies and Eurobonds), cross-default applied and creditors accelerated their claims (even if, interestingly enough, they did not next take legal action to enforce the acceleration and their claims).

The discussion above suggests that Argentina may have a strong legal argument to treat separately domestic debt from foreign debt and a legal case for foreign creditors to prevent such “discrimination” may not exist.

Third, there are good arguments why the apparent different treatment of domestic and foreign debt may be legal and fair. Considering all the dimensions of a debt restructuring, it is not obvious that foreign debt would be effectively discriminated against. Note first that domestically issued debt does not give creditors the same potential legal rights and litigation advantages of foreign issued debt.

While litigation is costly, partial sovereign immunity an obstacle and litigation outcomes uncertain, holders of foreign issued debt can more easily threaten litigation, use the jurisdiction of foreign courts and legal systems (New York, UK, et cetera depending on where the bond was issued) to try to seize the assets of the sovereign and enforce their rights. Indeed, the recent Peru-Elliott case suggests that aggressive foreign creditors may successfully use the courts to enforce their rights. Conversely, legal protection and substantial rights of creditors with claims to domestic-issued debt are much weaker. As the recent experience of Argentina shows, such creditors can be more easily threatened, bullied, forced or convinced with “moral” (or immoral?) suasion to accept new claims with worse terms with little effective ability to legally challenge such actions. The fact that foreign issued debt has more legal protection than domestic issued debt thus suggests that discrimination between the two in debt restructuring may be not only legal but also economically efficient.

I.e., foreign debt may be threatened with a greater haircut than domestic debt but, in the bargaining between creditors and the sovereign debtor, creditors have better access to litigation to enforce their claims. Conversely, domestic debt is legally less protected and it may thus be fair that it should be treated more favorably (at least in financial terms) than foreign debt. And, once we notice that domestic debt is more liable to forced restructuring, freezing or delay in payments and other semi-coercive pressures to comply with restructuring, it is not obvious that such debt receives on average better “treatment” than foreign debt in restructuring. I.e. “comparability” of restructuring does not include only the financial terms of domestic and foreign debt swaps but the entire set of features of such claims (including different degrees of legal protection, different risk of early seizure and forced restructurings).



For example, it was announced on December 12, 2001 that Argentina will postpone for three months a \$700 million payment of Treasury bills due Friday after agreeing with holders of the debt to pay 9.5 percent interest during that period. Note that Argentina's pension funds and largest banks are the main holders of these Treasury bills.<sup>14</sup> Or, throughout 2001, Argentina restructured its sovereign bonds by “forcing” holders of domestic debt to accept earlier restructurings of these claims and to accept semi-coercive lengthening of their maturities, and proceeded with restructurings of domestic debt before foreign debt was being treated.

Fourth, experience from previous sovereign bonded debt restructurings suggests that litigation risk may be limited. Even in cases of outright default, litigation did not occur. Ecuador's creditors accelerated but did not start litigation. Holders of Russian bonds under default did not pursue legal action. Moreover, as the cases of Ukraine and Pakistan suggest, litigation risk can be further minimized if the country does not enter technically into default at the time of the offered debt exchange. I.e., as long as the country has enough resources to avoid a suspension of payments of principal and interest (i.e. the country stays current on its debt servicing payments on its foreign debt, including any grace period before a formal default event occurs) and goes ahead with an exchange offer, creditors do not have a right to sue as there is no formal default event. Of course, holdouts in an exchange offer may sue the country after the exchange offer has been completed if the country stops paying their old claims. But, as long as the country is current in its debt payment before and during the exchange offer, no default event has occurred and the risk that litigation may disrupt an orderly debt exchange is minimized, if not altogether eliminated.

In other terms, it may be better for Argentina (if it has enough reserves) not to enter into technical default on its foreign debt if it is attempting a foreign debt swap and wants to avoid litigation risk. Of course, for the exchange offer to be credible and accepted by bond holders, there must be a credible threat that holdouts would be treated less favorably than those who accept the offer; otherwise the incentive to go into the offer would be reduced for those creditors who are willing to accept the new claims. But the precedents of Ecuador and Russia, where formal default occurred, have been useful in building such reputation for emerging markets in distress and suggest that a country like Argentina may credibly make such threats of treating less favorably holdouts in an exchange offer. So, avoiding technical default prevents litigation from occurring during an exchange offer.

### **Arguments why litigation risk may be great in Argentina.**

Finally, there is the question of how great is litigation risk in the case of Argentina if a foreign debt swap via an exchange offer is attempted. Some people argue that such a risk is greater in Argentina than in the previous bonded debt restructuring episodes (Ecuador, Russia, Pakistan, Ukraine). Their arguments are as follows:

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<sup>14</sup> Argentina's government also announced on the same day they would defer payments of pensions for a week for 1.4 million retirees, another form of early and severe burden imposed on domestic asset holders.

1. Even if Argentina is able to avoid a technical default (that could trigger litigation), many more creditors are now willing to refuse the offer, remain as holdouts and then litigate after the offer is concluded. Worse, if, as possible, Argentina goes into technical default, the ability and incentives to litigate would be greater.
2. Ecuador was small fish while the stakes are much higher in Argentina that is the dominant issuer of sovereign debt. Creditors are in a fighting mood and the creation of EMCA (Emerging Markets Creditors Association) indicates the more aggressive and confrontational nature of creditors in trying to enforce their rights. Argentina may be used to teach a lesson to emerging market debtors who try to default or restructure on unfair terms.
3. The Peru-Elliott case has tipped the balance in favor of successful litigation and enforcement of creditor rights.
4. Unlike other cases where only four (or a small number of) bond contracts were at stake (as in Pakistan and Ecuador), in the case of Argentina we have about 64 separate bonds, each with its different covenants, jurisdiction and terms. It will be easy to find one or more of these bonds where litigation can be started and successfully pursued.
5. The mega swap in June 2001 has reduced the outstanding stock of previously large issues of debt. A bond with an original issues of \$3 billion of face value may now, after the swap, have an outstanding float of only \$500 million left in the hand of investors and its market price is even lower than par. Thus, it takes much less for a single investor to take a controlling interest in the outstanding stock of a bond and trigger acceleration (usually requiring a 25% vote) or block changes (“exit consents”) in the terms of the bond that do required a 50% or other qualified majority. And, indeed there is circumstantial evidence that some vulture funds or other aggressive investors have pursued this tactic to enforce their holdout rights once they refuse an exchange offer.
6. Foreign investors may hold out and try to use litigation to force a re-opening of the domestic debt swap to force Argentina to impose a greater haircut on domestic debt and thus reduce the needed haircut on foreign debt. It may be strategically worth holding out in this strategic bargaining game.
7. It has been argued that, in the case of Argentina, there is a very large base of retail (often European) investors (the thousands of small bondholders such as “Italian grandmothers” and “Belgian/German dentists”) that are hard to locate and less willing to accept an exchange offer. Thus, this collective action problem reduces the probability of a successful exchange offer.
8. Most of these bonds have been issued according to New York law, they do not contain collective action clauses and require unanimity to change their terms. Thus, restructuring them is very hard.

## **Counter-arguments suggesting the limits of litigation risk.**

Many of the above arguments are exaggerated or faulty at a closer examination.

First, note that as long as the price/value of the new claims/bonds offered in the exchange offer is, at least as high as that of the old bonds that are exchanged, it is in the interest of mark-to-market bond holders to accept such an offer rather than hold out. This is the most important and strongest incentive to participate; and, indeed, in the previous four bonded debt restructurings (Ecuador, Russia, Pakistan, Ecuador), the terms offered on the new bonds implied no mark-to-market losses (relative to the price of the old bonds) and participation rates ended up being above 97%. So, almost all investors accepted the exchange offer.

Second, in the previous four episodes of bonded debt exchange, the holders of the new bonds actually enjoyed major mark-to-market gains in the exchange as the value of the new bonds turned out to be much higher than that of the old exchanged bonds. Such gains were equivalent to over 20% for Ukraine, 32% for Russian Prins and 18% for Russian Ians, 3.5% for Pakistani bonds and averaging over 30% (based on the jump in the price of Bradies, PDIs and Euros after the deal was announced) for the case of Ecuador. Such mark-to-market gains were the result of the relatively generous financial and non financial terms offered to the holders of the new claims.

Third, the generous terms of recent exchange offers, together with the sweeteners of significant upfront cash (Pakistan, Ukraine), release of collateral (Ecuador) or seniority upgrade (Russia) effectively helped to bribe possible holdouts.

Fourth, we have by now learned that the lack of collective action clauses and the need for unanimity to change the financial terms of the old bonds can be altogether bypassed with the use of “exchange offers” as it was done in all four episodes of bonded debt restructuring. In all these episodes CACs were not used ex-ante (even when available as in Pakistan) and the benefits of their existence was mostly the ex-post ability to “cram down” new terms on the holdouts (as in Ukraine) or threaten their use (as in Pakistan).

Fifth, even in the case of Ecuador, where there were no formal CACs in the restructured instruments, the legal advisor found legal ways to “cram down” new terms on the holdouts via the use of “exit consents” to make the old bonds less appealing to the holdouts. Note that while Ecuador’s bonds (and most bonds issued under New York law) require unanimity to change payments terms, only a simple majority of 51% is required to change non-financial terms. Thus, “exit consent” clauses for those who accepted the deal were used to change the terms of the old bonds and make them less appealing to potential holdouts. Thus, exit consents are still a powerful tool that could be used again in Argentina to reduce the rights of possible holdouts.<sup>15</sup>

Sixth, there are many creditors that are willing to accept a “fair” deal that provides them with mark-to-market gains and they can induce/bribe possible holdouts to prevent them from disrupting an orderly restructuring. These investors include large institutional investors who may be happy to settle as long as there is a mark to market

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<sup>15</sup> Such tools may not be successfully used if an individual “vulture” or a group of them hold a 51% stake in a bond issue (as claimed to be the case in some Argentine bonds) and can thus prevent such dilution of their rights.

gains bottom-fishers such as hedge funds or vulture funds who bought at low prices and would gain from any deal that provides a substantial mark-to-market gain, large investment and commercial banks that have extensive commercial and investment banking operations in Argentina with a long run franchise value and thus are willing to settle at sensible terms rather than litigate. Also, such large investors may have an incentive to bribe possible holdouts so as to avoid the disruption of a beneficial exchange.

Indeed, in the 1980s similar collective action problems were also serious given the free-riding incentives of smaller creditor banks: but the largest commercial banks successfully bribed the smaller banks and were able to ensure orderly restructurings of syndicated loans. And today the same large actors have the power, resources and incentives to induce similar good behavior of possible holdouts.

Seventh, the small retail investors (the “Belgian/German dentists and Italian grandmothers”) are the least that Argentina or any sovereign debtor should worry about. In the case of Ukraine, there were hundreds of thousands of such dentists and grandmothers and this did not prevent a successful (99% participation rate) exchange offer. Small investors have no effective power or the resources to litigate and will follow the advice of the same financial advisors and banks that lured them in the first place into buying junky emerging market bonds via the promise of high dollar returns. And financial advisors and managers of the new bond issues have all the financial incentives (commission and fees) to convince thousands of retail investors to participate in a deal, as the successful case of Ukraine proves.

### **On the actual risks of greater litigation in Argentina.**

Finally, it is arguably true that a host of factors make the risk of litigation greater in the case of Argentina. But the real issue is whether such a threat will disrupt an orderly debt restructuring. Argentina may prevent litigation during the exchange offer by not going into default and then decide how to deal with holdouts after the exchange offer has been successfully concluded. Even if technical default occurs and some creditors successfully accelerate their claims and start litigation, it is not obvious that this will jeopardize the conclusion of an exchange offer. Litigation would take years, and unless a litigant creditor can get in advance an injunction to stop the restructuring from being concluded (an highly unlikely scenarios given legal precedents), the debt exchange could go ahead in the meanwhile. Then later the consequence of such litigation will have to be addressed; the debtor could punt and settle or pursue its legal options. If a litigant creditor could credibly show its ability to freeze payments to the holders of the news bonds after an exchange, there would be some risk that the exchange offer would be jeopardized in the first place. But the legal precedents suggest that this risk is still very small. Complex legal issues regarding “pari passu” and “negative pledge clauses” would have to be settled before such disruption of an orderly exchange could be successfully accomplished.

Also, most investors have an incentive to settle, if the exchange offer is generous enough, and have an incentive to bribe possible holdouts. Exit consent clauses can again be appropriately used. And the Peru-Elliott case does not set a clear precedent as the legal issues involved in this case were never adjudicated once Peru decided to settle rather than challenge in court the claims of Elliott. But it is possible that, in the case of Argentina,

creditors that would benefit from accepting an exchange offer, would instead hold out this time and threaten legal action. The reason may be that, holding out, may lead Argentina to re-open the domestic swap and treat more “comparably” or “fairly” domestic and foreign bondholders.

**Risks of destructive and disorderly workouts and ways to prevent them.  
Responsibility of the private sector and foreign investors to constructively contribute to the resolution of Argentina’s unsustainable debt burden.**

But, given the discussion above on whether foreign debt is really discriminated against and given the arguments that an insolvent country is unable to pay more than what is available on the table, this strategy of delaying a deal and trying to get better terms via a new and greater hit/haircut on domestic agents, may not eventually work and it may actually backfire. If Argentina is insolvent in the sense that the political constraints and squeeze of domestic incomes does not allow it to adjust and save more than it is feasible from a political economy point of view, it is in no one’s interest to delay an orderly restructuring that may eventually inflict greater output and growth costs and reduce even further the resources available to pay the foreign holders of Argentine’s debt. Economic rationality may suggest to creditors that it is better to settle rather than fight, even if at the level of individual investors the incentive to hold out and free ride on the other creditors may be very large.

And since the Argentine masses have already suffered the increasing costs of three years of negative growth, increasing unemployment, falling consumption and welfare, cuts in public services, cuts in public wages and pensions, increases in taxes, capital levies, deposit freeze, capital losses on equity and real assets, effective devaluation of the peso, capital levies in the form of increasingly worthless patacones and lecops, seizure of their pension funds, loss of foreign reserves, haircuts on their holdings of public debt, unsustainable debt servicing costs on foreign debt given the explosion of country spreads, their political ability to take and accept further austerity and real losses in order to service in full the foreign debt may be exhausted at this point.

More domestic adjustment may occur and should occur given that Argentina has serious macro, fiscal and structural problems to resolve. But politically, such painful reforms are more likely to occur if some meaningful foreign debt relief is granted. Disruptive litigation may threaten the ability to perform a mutually beneficial orderly restructuring and reduction of the foreign debt. Such debt reduction may be beneficial to both Argentina and its creditors, even if its terms are “discriminatory” and require a greater haircut of foreign claims than of domestic claims. It is beneficial to both parts as a country unable to pay has, by definition, to pass along the residual insolvency burden on foreign creditors; while attempts of creditors to prevent that via litigation and disorderly workouts may just end up increasing the costs for the country, lead it into a debt overhang trap and eventually reduce even further its ability to service the residual claims of foreign bond holders. Thus, disorderly workouts and litigation is likely to end up giving to foreign creditors even less than they would in an orderly workout.

The arguments above should not be taken as a green light for emerging market debtors to default on their foreign liabilities. Default implies a very large set of current and future costs (output fall, painful adjustment, loss of reputation, cutoff from international lending for a while, increases in country spread once market access is regained, bankruptcy costs, risks to the ability to trade, et cetera) and this is why sovereign debtors do not take such decisions lightly in spite of the right of a sovereign to default on its debts without the consequences that a lack of sovereign immunity would entail.

These potential punishments are part of the system and contribute to ensure that “strategic default” by otherwise solvent but unwilling-to-pay debtors is limited to a minimum. And the official sector (IFIs and creditor governments) do not condone sovereign defaults nor wants them to occur more frequently; defaults, debt restructurings and reductions should be implemented only when necessary and unavoidable.

But if foreign debt is unsustainable and needs to be restructured or reduced, foreign bondholders have no choice but to accept such reality, even if it implies some degree of alleged “discrimination” against their claims. Such orderly restructuring is feasible in the current system even without the creation of new institutions, such as an international bankruptcy court, that would ensure even more orderly, rather than disorderly and costly, debt restructurings/reductions.

The wiser minds in the private international financial community realize that a sensible and orderly debt reduction of Argentina’s foreign debt is necessary; and it is up to them to rein in, as possible, disruptive holdouts that would jeopardize the interests of both the debtor and the creditors.

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