

UNIVERSITY OF LJUBLJANA  
SCHOOL OF ECONOMICS AND BUSINESS

MASTER'S THESIS

**EXTERNAL DEBT DEFAULTS OF EMERGING ECONOMIES:  
THE CASE STUDY OF ARGENTINA**

Ljubljana, December 2022

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## **LIST OF ABBREVIATIONS**

**ARS** – Argentine peso

**BAC** – Bank Advisory Committee

**BCRA** - Banco Central de la República Argentina

**BIS** - Bank for International Settlements

**BRIC** - Brazil, Russia, India, China and South Africa

**CAC** – Collective action clause

**CFB** - Corporation of Foreign Bondholders

**CPI** - Consumer Price Index

**DSA** – Debt Sustainability Analysis

**ECB** – European Central Bank

**EMCA** - Emerging Markets Creditors Association

**EU** – European Union

**FDI** – Foreign Direct Investment

**FED** - Federal Reserve System

**FRED** - Federal Reserve Economic Data

**FTSE Russel** - Financial Times Stock Exchange Russel

**GATT** - General Agreement on Tariffs and Trade

**GATT** - General Agreement on Tariffs and Trade

**GCAB** - Global Committee of Argentine Bondholders

**GDP** – Gross Domestic Product

**HIPC** - Heavily indebted poor countries

**ICMA** - International Capital Markets Association

**ICSID** – International Centre for Settlement of Investment Disputes

**IMF** - International Monetary Fund

**LIBOR** - London Interbank Offered Rate

**LIC** – Low-income country

**MAC** – Market-access country

**MSCI** - Morgan Stanley Capital International

**NAFTA** - North American Free Trade Agreement

**NPV** – Net Present Value

**OECD** - Organisation for Economic Co-operation and Development

**RUFO** - Rights upon future offers

**SDRM** - Sovereign debt restructuring mechanism

**UK** – United Kingdom

**UNCTAD** - United Nations Conference on Trade and Development

**USA** – United State of America

**USD** – United States dollar

**WWI** – World War I





## INTRODUCTION

After the stable post-war period of economic growth, global economy turned into a phase of turmoil characterised by breakdown of Bretton Woods system, cancellation of gold convertibility of the USD and oil price shocks in 1970s. It resulted in internal (high inflation, unemployment) and external imbalances (large current account deficits) all around the world. Commodity prices in developed economies declined due to lower demand which negatively affected emerging economies dependent on commodity exports. Several African and Latin American countries increased their debts because of higher interest rates in the USA that was fighting inflation. Therefore, the 1980s was a decade of debt crises that started in 1982 in Mexico which triggered sovereign defaults worldwide (United Nations, 2017). In only 27 years there were 84 sovereign defaults (Yue, 2005). They played significant role in the history of Latin America. Mexico, Chile, Argentina and Brazil defaulted 14 times during the period between 1870 and 2012 and they spent more than 20% of their time in sovereign debt crises (Boonman, 2013).

Argentina itself defaulted three times in this period when its debt started to accumulate during military dictatorship from 1976 to 1983. In only 7 years, external debt of the country rose by \$40 billion. Huge amounts of bank loans from European and US banks to finance current account and government deficits led to a debt crisis after interest rates skyrocketed due to oil shocks (Öncü, 2014). In 1980 one of the largest Argentina's private banks failed and was followed by liquidation of other 71 financial institutions within next two years (IMF, 1991). By 1982 Argentina defaulted on its foreign bank loans and experienced almost a decade of rising unemployment rate, decreasing wages, slow growth, two hyperinflations and increasing interests on defaulted loans which resulted in external debt of \$63 billion by 1990. The default ended in 1992 with the Brady Plan that changed the form of investments from banking loans that predominated until 1980s to sovereign bonds (Öncü, 2014; Miles, 2000).

The Convertibility regime and radical reforms followed to tackle high inflation. (Öncü, 2014; Frenkel & Rapetti, 2007). Moreover, the government financed its budgetary deficits by borrowing in dollars and other foreign currencies while collecting revenues in pesos. A weak fiscal and political discipline and decrease of export led to economic slowdown and Argentina defaulted on its debt again in 2001. Consequently, Argentina began to restructure its debt under two debt restructuring agreements in 2005 and 2010 (Georgescu, 2015).

The main purpose of this thesis is to get a complete understanding of how an excessive sovereign debt can lead to a country's default. My master thesis explains what it means for a country to get into a default and consequent economic implications especially for developing economies. With an emphasis on Argentina, my research consists of in-depth analysis of two external debt defaults that the country experienced in the 1980s and at the

turn of the 20th and 21st century. I will closely look at the differences in the debt structures, at the management of the defaults by the government and international financial institutions, and I will elaborate on the debt restructuring processes that followed both defaults.

The method used in my research is aimed at developing debt sustainability analysis with focus on Argentina for which I lean on the framework introduced by the IMF. The analysis helps to answer following questions:

- How did the economic slowdown change the level of debt in Argentina?
- Was the level of Argentine debt sustainable prior to the default in 2001?
- How do different scenarios change the level of debt?
- Could have Argentine debt been stabilised? If so, what were the desired measures to achieve sustainable debt level?

Finding answers to these questions is in my master thesis conducted by theoretical and empirical analysis. The initial theoretical framework is based on literature review obtained from secondary data. The relevant literature is collected from reports, working papers and researches published in scientific journals and by international financial institutions or universities and research scholars. To analyse macroeconomic environment of emerging countries, my thesis leans on quantitative data provided by regional organisations such as the Central Bank of Argentina, and data provided by international organisations like the IMF and the World Bank. These data are to compare macroeconomic indicators and used as inputs for graphs and tables to paint a clearer picture of macroeconomic environment. The analysis of Argentina's defaults is based on qualitative data gathered from publications of scientific journals complemented by quantitative data found in world organisations' datasets.

The theoretical analysis is included in the first three chapters. The first chapter focuses on the conceptual framework for external debt, definitions connected to the external debt and different types of external debt. Moreover, it provides an overview of how a country gets indebted and what consequences it must face eventually.

The second chapter starts by defining emerging countries and mentions some of the defaults that they experienced in the past. Further, it describes the process of managing the debt crises and how it changed over the years. Final part of this chapter explains the IMF's framework for debt sustainability analysis and its purpose.

The third chapter provides a comprehensive overview of Argentine sovereign debt defaults by first mentioning the entire default history of the country, and then looks at the 1980's and 2001 defaults. It describes in detail the causes and management of the defaults and how they were resolved. It also explains what implications these defaults had on the

domestic economy and what features distinguish the 1980's defaults from the 2001 default.

The empirical part of my research is conducted in the final chapter, and it links the macroeconomic indicators of Argentina published by regional and international organisations with the theoretical concept of external debt sustainability. The secondary data are gathered for the purpose of conducting quantitative research on debt sustainability analysis. This analysis helps to understand the level of Argentina's debt prior to the default. Using MS Excel, I will apply simplified debt dynamics model to point out whether the country's debt was sustainable or not, and consequently by deriving required permanent primary balance, the result will suggest the amount of primary surplus needed to get Argentina's debt to sustainable level. This will make it clearer whether sustainable level of Argentina's debt was feasible at that time.

## **1 EXTERNAL DEBT OF EMERGING ECONOMIES: MAIN CONCEPTUAL ISSUES AND TRENDS**

### **1.1 Theoretical concept of external debt**

Until 1980s external debt did not play significant role but after it became internationally important topic, there was a need for a definition to enable the users of external debt statistics to assess risks connected to external debt and to find relevant statistics. A wide range of users include banks, officials focused on debt agreements negotiations and economic analysts. Even before excessive external debt occurred, such statistical data had been collected by the Bank for International Settlements (BIS), the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the World Bank, so they started seeking a common definition of external debt. Each of them had different motivation to pursue this goal. The central banks under the BIS were concerned about the stability of international financial system due to participation of commercial banks in international lending. The IMF's reason was to ensure effective international monetary system and avoid problems with balance of payments. The worries about debt stemming from international financial collaboration with emerging economies troubled OECD's industrial countries. The World Bank's interest arose from the need for debt statistics to provide financial aid to developing countries. Therefore, since 1980s the BIS has been collecting data from banking sector, the OECD has been obtaining figures on private export credits and together with the World Bank has been comparing information about loans provided by creditors and debtors. (IMF, 1988) Finally, they defined the external debt as "the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to non-residents to repay principal, with or without interest, or to pay interest, with or without principal." (IMF, 1988, p. 19)

The World Bank's definition states that "total external debt is debt owed to non-residents repayable in foreign currency, goods, or services. It is the sum of public, publicly guaranteed, and private non-guaranteed long-term debt, use of IMF credit, and short-term debt" (World Bank, 2009).

IMF (2003, p. 7) defines gross external debt as "the outstanding amount of actual current liabilities that require payments of principal and/or interest by the debtor at some points in the future and that are owed to non-residents by residents of an economy."

According to the researchers, external debt can be considered as a sum of money that national economy borrowed for more than one year and is due to the foreign creditor in form of payments in foreign currency, or in form of goods and services exported to the creditor (Abuzaid, 2011).

Simply put, external debt starts accumulating when a country borrows money from other countries, foreign banks, or international institutions. This country must then pay interests in the same currency as the loan was provided in, and eventually repay borrowed amount at some point in the future (World Bank, 2009). Theoretical models suggest that external debt flows ought to be countercyclical, meaning that developing countries borrow more during recession. However, according to evidence procyclicality is more noticeable. This might be due to developing countries' inability to access international credit during recession period, and spending pressures in good times. These periods of overborrowing then lead to sovereign defaults that occur after periods of relatively large capital inflows (Panizza, Sturzenegger & Zettelmeyer, 2010; C. Reinhart & V. Reinhart, 2008).

To clarify a sovereign default, it is simply a breach of promise when a payment is missed. According to credit rating agencies, a default occurs when (a) a debtor fails to pay principal or interest within a period defined in the agreement, (b) a financial obligation is reduced by exchange of debt in order to evade a default, (c) a debtor changes original payment terms such as the amount of financial obligation or its maturity or price (Ams, Baqir, Gelpert & Trebesch, 2018).

Since one debtor typically has several creditors, once a debtor approaches a default, he is able to repay only some of them and is forced to default on the others. When it comes to private borrowers, there is a bankruptcy law that regulate which lender is repaid first (creditor seniority). However, if a borrower is a foreign sovereign government, it is difficult to enforce contracts and creditor seniority is more of a custom or agreement. Based on them, governments make decisions on debt markets, which group of creditors is preferred. First on the list is the IMF so it is protected from defaults and can offer financial aid to countries in crisis. Intergovernmental agencies, regional development banks and international financial institutions like the World Bank follows. Then, to protect taxpayers' money, official governmental agencies acting as bilateral creditors are next in line followed by public debtors issuing sovereign bonds on capital markets. Lastly,

private banks and supplier, manufacturers, or exporters are at the end of the list of preferred seniority (Schlegl, Trebesch & Wright, 2019).

Regardless of a creditor group, defaults can have many forms. First, technical default is considered to be a missed payment that is resolved within 3 months without default being even declared. According to the European Banking Authority such a default is a result of an institution's system failure, payment system error, delay in payment reception, or specific factoring issues. Second, contractual defaults are recognized when payments are delayed for more than 30 days, irrespective of creditor group and form of debt, but restructuring process and exchange of debt are not included. Substantive defaults, however, do include restructurings and debt exchanges and bring creditors less favourable terms. Third, repudiation occurs when a country refuses to pay and questions its obligations which is rare nowadays, but it usually happens after a change of political regime when governments denied paying for debts acquired by previous governments. The next form of default depends on debtor's approach toward negotiations. Soft default is characterized by debtor's proactive engagement in restructuring process, information sharing and sound and informal negotiations. An example of such default can be Uruguay's default of 2003. On the other hand, hard defaults are carried out in aggressive restructuring approach when a debtor rejects to cooperate with creditors. Such negotiations result in information asymmetries and lawsuits. Argentina's 2001 and Russia's 2000 defaults fall in this category. Lastly, depending on the amount that a sovereign defaults on, partial or full default is considered. However, here the opinions of authors are not unified on where the boundary is (Ams, Baqir, Gelpern & Trebesch, 2018).

In some cases, default is resolved quietly when missed payment is temporary and debt is eventually repaid. However, if this is not the case, sovereign debt must be restructured. In a legal process of sovereign debt restructuring existing bonds or loans are exchanged for cash or new debt instruments and debt must be guaranteed by the sovereign state government (Das, Papaioannou & Trebesch, 2012).

There are several types of debt restructurings (IMF, 2003):

- Debt rescheduling represents the postponement of payments of the debt and new extended maturities are applied. In this case new terms and conditions are implemented or the debt instrument can be replaced by a new one. The result of debt rescheduling can be reduction of debt present value.
- Debt forgiveness is done voluntarily by the creditor to reduce or completely cancel debt obligations that have already been due and are still to be paid.
- Debt conversion is an arrangement where the creditor exchanges the external debt for a nondebt commitment in domestic currency. The debtor's economic value is used, for example, in development projects, education or wildlife protection in the debtor's country.

- Debt prepayments and buybacks are bilateral agreements on early payment or repurchase of the debt that could also be done on secondary market.

In majority cases restructurings happen after a default (post-default restructurings), but there have also been instances when debt restructurings happened even before default occurred (pre-emptive debt restructurings) (Das, Papaioannou & Trebesch, 2012).

Earlier in the 1970s and 1980s when banks were the main lenders, bank advisory committees were responsible for negotiations. They consisted of representatives of bank creditors. However, in the 1990s bonds became more popular, though there was no supranational legal system to enforce contracts (Panizza, Sturzenegger & Zettelmeyer, 2010; Wright, 2011). Especially, a period between 1995 and 2002 was characterized by excessive borrowing and defaults which made market actors and policymakers to look for a solution. In late 1990s there were two suggestions on the table. The first one was introduced by Anne Krueger, Deputy Director at the IMF, whose idea was to create a bankruptcy court for countries that would be run by the institution. However, this plan was denied as politically unattainable. The second proposal came from the U.S. Department of the Treasury advocating, that sovereign bonds should be designed in a way to give bondholders right to withdraw from restructuring. As opposed to commercial banks, bondholders are dispersed with different interest and therefore they should have option to avoid restructuring and get themselves a better deal. Consequently, collective action clauses (CAC) were introduced. Collective modification clause allowed to accept restructuring by certain percentage of bondholders and the rest of them would have had to undergo this process. Collective acceleration clause forbade bondholders to ask for full repayment after a default. This idea was implemented for the first time in 2003 when Mexico issued its bonds, followed by other countries (Weidemaier & Gulati, 2012).

## **1.2 External debt typology**

As seen from the Figure 4 in Appendix 8, total external debt consists of external loans divided according to length of the loan, issuing authority, receiving authority, provision or purpose of the loan. In terms of issuing authority, external debts can be private and public (Abuzaid, 2011).

Public external debt arises when the creditor is either a government or an international financial institution which provides facilitated loans. These external loans are called bilateral in a case when a creditor is a government or its agency. Governments provide two types of loans. Firstly, commodity loans are offered mainly to developing countries as they lack sufficient food resources. However, commodity loans are provided in a debtor's currency and therefore they are not part of the external public debt. On the other hand, loans in foreign currency that governments lend to a debtor under certain conditions are included in the external public debt. Here, military aid could be mentioned as an external loan taken by developing countries to finance their military bases. Multilateral

external loans are then loans from multilateral and intergovernmental organizations such as the World Bank, the United Nations Agencies, the European Investment Bank, the Regional Development Bank and many more (Abuzaid, 2011).

In case an external loan is acquired from private creditors like private banks, bondholders, manufacturers, suppliers or exporters, then we can talk about private external debt. Foreign banks provide countries with private funds to finance their balance of payments deficits, in other words, to finance their import of inevitable consumables so they can operate their production capacities. Another type of private external loan<sup>1</sup> is in form of bonds issued on capital markets and offered in developed countries. These bonds have certain value that must be repaid with interests when they are due (Abuzaid, 2011). This type of external borrowing became more popular in 1990s when its amount skyrocketed, resulting in 60% increase in the share of private external debt in emerging countries. The reason for this is better financial stability promoted by the private sector since firms tend to use their funds efficiently and have greater monitoring power (Hallak, 2013).

In terms of length of loans, governments of emerging countries issue long-term debt in foreign currency and short-term debt in local and domestic currency. The reason for this is that repayment of debt issued in domestic currency can be avoided by debtor who decides to depreciate its currency or employs high inflation rates to decrease the real debt value. Therefore, risk averse investors rather hold short-term debt or keep their portfolio in dollars. This way it is more difficult for debtors to hurt creditors with their actions. Many authors argue that such structure of sovereign debt makes emerging economies vulnerable and contributes to the occurrence and depth of debt crises. Although, developed countries usually issue long-term debt in their domestic currency, the amount of such debt has significantly risen since the beginning of this century in emerging markets as well (Sturzenegger & Zettelmeyer, 2007).

### **1.3 Reasons for country indebtedness**

With a goal to accelerate economic growth with insufficient capital, external borrowing plays an important role. However, when already accumulated external debt cannot be repaid, additional external capital is needed to service these obligations which creates a problem. Many causes of crises can be determined (Abuzaid, 2011). Kwack and Leipziger (1988) claim that external debt crises of developing countries that occurred in 1980s were just a result of several factors such as high real interest rates, oil shocks and slowdown in growth of industrial countries. Some argues that beside external factors, also internal decisions especially in Latin American countries contributed to the origin of the crises.

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<sup>1</sup> There are also direct private investments as a type of foreign capital imported in developing countries, but these are not part of the developing countries' external debt (Abuzaid, 2011).

### 1.3.1 External reasons for indebtedness in developing countries

External factors that largely impacted economic situation (mainly balance of payments) in developing countries and negatively affected the ability to repay external debt of developing countries were (Abuzaid, 2011):

#### A. Rising real interest rate<sup>2</sup>

Since developing countries obtained their loans in strong U.S. dollar, they had to repay them in U.S. dollars as well. Therefore, high exchange and interest rates were applied. From 1965 to 1983 the average real interest rate was 1.4% and it was the period of accelerated growth in developing countries. However, by 1990s it was 6.5%. This contributed negatively to the volume and price of export of developing countries which made export earnings to drop (Abuzaid, 2011). These earnings could not then cover imports which caused foreign exchange gap (Tiruneh, 2004).

#### B. Changes in the oil prices

In 1973 oil prices began to rise from \$4.5 to \$33 per barrel at the end of the decade. Consequently, imports of oil into developing countries became more expensive which led to extensive budget deficits. At the same time, countries exporting oil experienced budget surpluses which made it possible for those countries to lend money to commercial banks. Commercial banks then used that money to finance oil importing countries deficits (Abuzaid, 2011).

#### C. Worsening international commercial exchange

Conditions of commercial exchange between developing and developed countries deteriorated due to prices inconsistencies. While raw materials produced in developing countries were cheap, needed machinery from developed countries to produce those raw materials were expensive. These circumstances led to rising balance of payments deficits in developing countries (Abuzaid, 2011). Also, if low-income countries wanted to keep access to technology that expands their export sector and brings economic growth, they had to rely on foreign capital (Tiruneh, 2004).

#### D. Economic recession in developed countries

Since developing countries are dependent on developed ones, they are also affected by them. And this was clearly visible in the 1980s when developed economies were experiencing economic downturn, rising unemployment and declining growth rates. It also affected international trade in a way that export from developing to developed

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<sup>2</sup> By real interest rate is meant the difference between inflation rate in the USA and the nominal interest rate (Abuzaid, 2011).



countries decreased by 20% in early 1980s. Moreover, exports from developed to developing countries became more expensive to cover losses (Abuzaid, 2011).

#### E. Debt relief

The problem of high levels of external debt in heavily indebted countries got even worse by the end of 20th century. It all started with a suggestion of nongovernmental organisations to forgive all debt of developing countries at the turn of century called Jubilee 2000. Initially, it was intended to improve employment, education and development of indebted countries. First debt reliefs of \$6 billion to 45 countries occurred between 1977 and 1979 and they were in form of interest payments reduction, new grants and reschedulings. After almost a decade of addressing the problem by the World Bank, in 1988 G-7 summit introduced Toronto terms under which 20% of debt was forgiven, lower interest rates and longer maturities were agreed on. Two years later Trinidad terms increased the amount of forgiven debt to 67% and this amount was gradually increased to 80% by 1996. At the same time, the World Bank and the IMF allowed poor countries to completely abandon rescheduling process and return to normal relations of honouring commitments under condition of improving policies in developing countries. Now, the paradox is that after almost two decades of debt relief, poor countries became even more indebted. Interestingly, between 1989 and 1997 the amount of debt relief in 41 heavily indebted poor countries was \$33 billion, while their net borrowing totalled \$41 billion without any economic growth. It is argued that offering more favourable terms progressively led poor countries to delaying policy reforms and waiting for better deal (Easterly, 2002).

#### F. Increased protectionism

Despite the General Agreement on Tariffs and Trade (GATT) that aims at easing and developing free trade, developed countries increased their protectionist policies. They neglected principles allowing developing countries to protect their domestic producers (Abuzaid, 2011).

### 1.3.2 Internal reasons for indebtedness in developing countries

However, indebted countries themselves are responsible for their insolvency and accumulation of external debts. These are the internal factors that influenced problem with foreign debts (Abuzaid, 2011):

#### A. Foreign funding dependency

Developing countries with their tight national savings could not achieve high economic growth and therefore relied on relatively available foreign loans (Abuzaid, 2011; Tiruneh, 2004). It was based on justification that capital should move from developed countries

with capital surpluses to developing countries with capital deficits. This would be beneficial for both sides since developing countries could finance their investments and developed countries would generate higher returns by moving capital from already exploited to profitable markets (Tiruneh, 2004). Nonetheless, overborrowing did not pay off as international trade and export prices dropped in 1980s. This situation was even worsened due to something that Tiruneh (2004) calls indebtedness driven by poverty where difference between nation's investments and savings creates a vicious circle. The rationale behind this assumption is that poor economies are poor because income is low, consequently savings are low which lead to low investments which is because they are in poverty. Therefore, poor countries are not able to save enough money to finance investments needed for growth. And that is where external borrowing comes into play. Also, the IMF stated that the increase in debt of developing countries was followed by inadequate dealing with poverty in such countries.

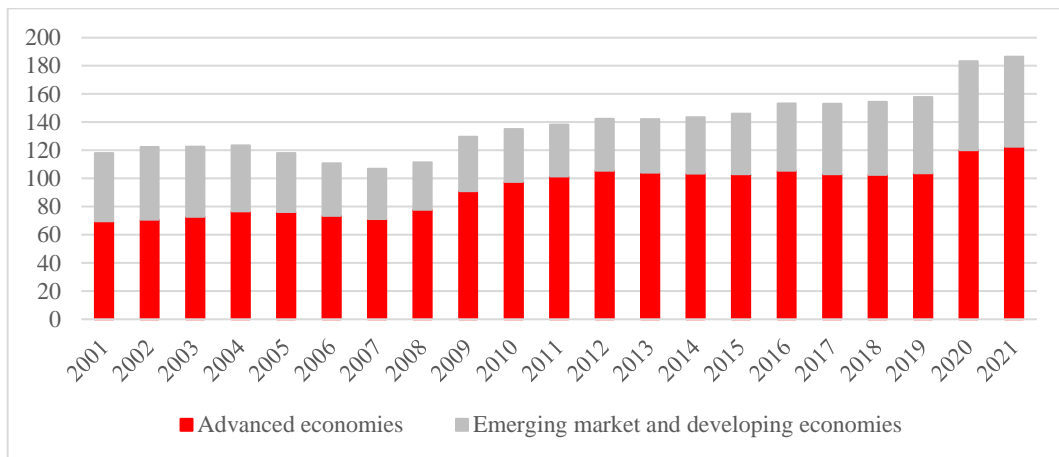
#### B. Insufficient development policies

Developing countries were implementing policies similar to those of developed industrial countries without taking into account political, social and economic conditions which led to investments in unsuitable manufacturing instead of developing agricultural production. As a result, export of agricultural products decreased, food problem aggravated which put a pressure on the balance of payments without any growth (Abuzaid, 2011).

#### C. Debt structure

To measure whether a country is able to repay its obligations, debt-to-GDP ratio is mostly used. This indicator is expected to be worse in developing countries where debt crises occur more often. However, as seen in Figure 1, emerging economies have had actually lower levels of debt than developed countries. For example, external debt of the United States is enormous compared to average emerging economy. There are empirical implications that the external debt levels are not as significant as composition of debt when exploring debt crises in developing countries. Especially, foreign currency and short-term maturity structure has the ability to bring about debt crises. In case of the U.S., it is not about the amount they borrow, but the fact that its debt structure involves long-term debt in U.S. dollars as opposed to borrowing short-term debt in foreign currency in developing countries (Panizza, Sturzenegger & Zettelmeyer, 2010).

Figure 1. General government gross debt (Percent of GDP)



*Adapted from IMF (2021).*

#### D. Capital outflow from developing countries

The movement of capital from developing to developed countries became quite popular in 1970s and early 1980s. There were several motivations behind capital outflow, namely bribery, economic and political instability, administrative corruption and lack of control. This transfer of government revenue from poor to rich represented resources which could have helped developing countries generate employment and increase production. It also could have increased collected tax and created opportunity for domestic banks to provide investments. Instead, transferred funds landed in foreign banks and got back to developing countries in form of loans (Abuzaid, 2011).

#### E. Form of government

Kohlscheen (2007), in his study examining why certain countries like Venezuela and Mexico tend to default on their external debts more often than other countries like Malaysia or India, found out that there is a correlation between likelihood of a default and form of government. With a focus on democratic nations, Kohlscheen's study shows that presidential democracies are almost five times more prone to defaults than parliamentary democracies. The vote of confidence that exists in parliamentary governments ensures that policy decisions on debt are strongly connected to the survival of the parliamentary cabinet. This survival depends on whether a prime minister is or is not unseated, so he or she deliberates more carefully on the effects of external debt. Whereas if a president defaults on external debt, this decision is taken as lost. However, form of government is relevant only when there is an alternative to current government. Results of the study can be found in Appendix 9.

#### F. Domestic inflation

Domestic inflation caused higher import prices and lowered export volumes which had negative effect on balance of payments and increased foreign loans. Moreover, it made domestic currency exchange rates decline and capital to be transferred abroad. Therefore, current account deficits had to be financed with foreign loans (Abuzaid, 2011).

#### G. Mismanagement

Most of the foreign loans taken by developing countries were not invested accurately. Instead, they were wasted on bribes or smuggling and consumption purposes (Abuzaid, 2011).

### 1.4 Implications of external debt on a country

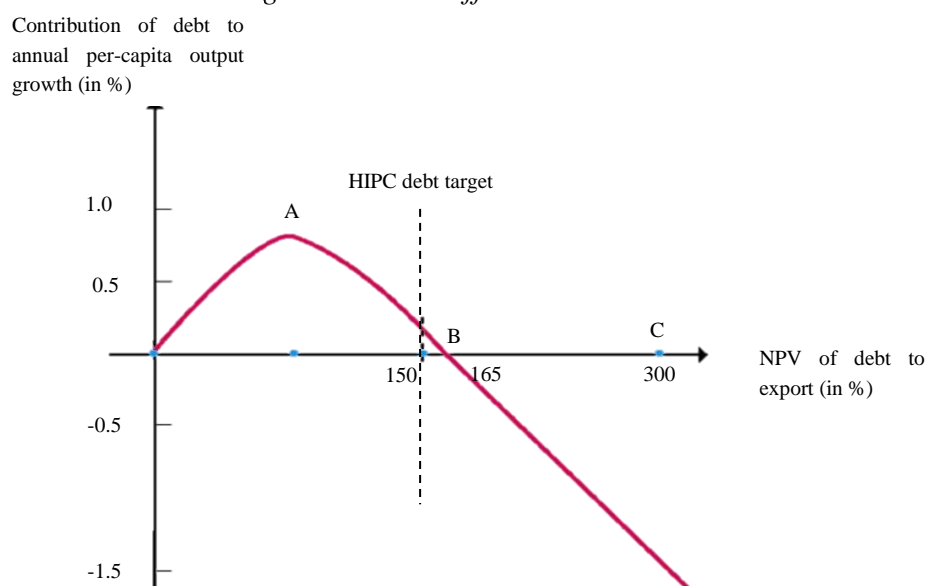
Prevailing interest of all countries is sustainable economic growth because it leads to development of an economy, increase in per capita income, better standards of living and economic progress, especially, in developing countries that struggle with increasing fiscal deficits. (Shabbir, 2013) When domestic resources are not big enough to create savings, these cannot be turned into investments needed to stimulate economic development. External borrowing then becomes a necessity (Uzun, Karakoy, Kabadayi & Emsen 2012). External borrowing initially mitigates fiscal burden and makes economies grow. But inappropriate use of these funds, mainly in developing countries, leads to servicing already acquired external debt with more external debt. Fiscal deficits are then even more profound. This basically means that external debt itself does not have to mean that economic downturn is on the way. It is the failure of a country to finance its obligations that brings weak economic development. When countries are unable to utilize funds from external borrowing to improve employment rates and productivity, then their tax revenues are not sufficient to service debt. Such risky environment finds it harder to lure foreign investments and needs to rely on domestic resources. (Shabbir, 2013)

External debt and its implications on economic growth is a widely discussed topic among economists. The question is whether there is a negative correlation between the two. The neoclassical perspective argues that the relationship is positive, hence capital gained from the external debt supports economic growth. But Krugman's and Kalonji's argument points out that the external debt prevents the economy from growing and if it is excessive, it actually causes poverty. According to these points of view, external borrowing is beneficial up to the point, when capital produces higher rate of return than cost of borrowing. After this point, debtor countries experience negative economic growth. Most of the models work with such nonlinear effect of debt (Iordachi & Ciobu, 2019; Pattillo, Poirson & Ricci, 2011). For example, the results of the study of Pattillo, Poirson & Ricci (2011) show nonlinear correlation between debt and growth. Based on the debt-to-GDP ratio for 93 emerging countries, external debt affects growth negatively. If countries with average levels of debt doubled their debt-to-GDP ratio, their growth would decrease by up to 0.5%. The usual reason for this is a theory called debt overhang (Iordachi & Ciobu,

2019; Pattillo, Poirson & Ricci, 2011) It says that growth eventually declines if there is a probability that in the future external debt level of a country exceeds its ability to repay the debt. Debt overhang then brings uncertainty of what policies will be implemented by the government to meet its obligations. Therefore, foreign and domestic investors are discouraged because current investors will tax away any potential investments in the economy and the economy cannot grow. Not only excessive levels of external debt, but also too high debt service affects growth. Increasing budget deficits and lower public savings lead to higher interest rates or crowd out private investments. (Clements, Bhattacharya & Nguyen, 2003)

However, this theory does not provide information about concrete impact of the external debt on economic growth. Therefore, Debt Laffer Curve is used to show, as seen in Figure 2, the point (A) where debt starts to negatively impact growth. The Debt Laffer Curve depicts the situation when a country opens up and starts accumulating debt. In the beginning, growth is positive, but with rising levels of debt, growth slows down until point (B) when debt ratio is below zero. It is visible that negative effect on growth begins at debt-to-exports level of 160-170% and debt-to-GDP level of 35-40%. (Iordachi & Ciobu, 2019; Pattillo, Poirson & Ricci, 2011).

*Figure 2. Debt Laffer Curve*



*Source: Pattillo, Poirson & Ricci (2011).*

According to a study conducted by Reinhart and Rogoff (2010), that is explained in Appendices 2, 3 and 4, it is possible to set certain thresholds when external debt brings significantly lower growth and higher inflation in developing countries. As seen in Appendix 4, external debt becomes a problem for economic growth when debt-to-GDP ratio exceeds 60%. For the debt to threaten the inflation, its levels need to be above 90%.

Besides several studies arguing that the external debt and economic growth in developing countries have negative correlation, positive relationship has been found as well. One of the factors affecting this relationship is the quality of institutions. In countries with better quality institutions the external debt does not have significant impact on economic growth. Whereas low quality institutions seriously reduce GDP growth of countries. This might suggest that the external debt influences economic growth negatively only in countries with weak institutions (Ahmed, 2017).

## **1.5 Ways of dealing with external debt**

The first default on government obligations was reported in the 4<sup>th</sup> century BC. Historically, the most creditors were private bondholders who formed associations to deal with debtors and occasionally creditors governments intervened. Under the diplomatic protection doctrine governments were allowed to help their citizens collect nonrepaid debt which was usually achieved with gunboat diplomacy. As an example, the attack on Mexican harbour can be mentioned when Spanish, French and the UK military invaded Veracruz 3 months after Mexico stopped servicing its foreign debt in 1861. Consequently, the parties agreed on debt restructuring. Beside such a violent way of debt negotiations, there were other forms of debt rescheduling at that time – face value of bonds and interest rates were reduced, or obligations were cancelled. By the end of 19<sup>th</sup> century, there were efforts to find different ways of dealing with international conflicts. At the Hague conference in 1907 governments agreed to limit the force used to recover their arrears. However, only seven years after that World War I began followed by the economic depression and World War II. After that a lot of restructuring agreements took place so that debtors could repay their obligations while keeping their economic growth. For example, the UK was allowed to postpone its payment and Germany's private and public pre-war external debt and post-war economic aid was settled in a way that allowed for face value reduction. Moreover, western developed countries started financing development programmes in developing economies where in the 1950s debt payment difficulties occurred, especially in Latin America (Cosio-Pascal, 2008).

### **1.5.1 The Paris Club**

To tackle the problem, ten European countries<sup>3</sup> met in Paris in 1956 to come up with rescheduling agreements and formed the Paris Club (Cosio-Pascal, 2008). The Paris Club consists of government creditors that try to resolve payment obstacles that debtor countries face. While such countries conduct reforms to recover and stabilize their economic situation, the Paris Club members provide rescheduling treatment (debt relief by postponement) and debt service reduction during a specified period (Club de Paris,

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<sup>3</sup> The countries that participated at the meeting were Austria, Belgium, Denmark, France, Italy, Norway, the Netherlands, Sweden, Switzerland and the United Kingdom (Cosio-Pascal, 2008). The current Paris Club member states can be found in Appendix 10.

2022). Appendix 5 shows examples of participation of certain Paris Club members in debt restructurings.

Based on the agreement among its members, the Paris Club operates under the principles of (a) solidarity (the Paris Club members deal with a debtor as a group); (b) consensus (creditor countries must reach a consensus in a decision-making); (c) information sharing (information and views on debtor country situation are shared among the members); (d) case-by-case treatment (the Paris Club actions are tailored to each debtor individually); (e) conditionality (negotiations are held only with countries that need debt relief and have implemented reforms to recover financial and economic situation); and (f) comparability (terms of treatment agreed upon with the Paris Club members should be more favourable to the debtor than with other creditors) (Club de Paris, 2022).

Within the next five years after its establishment, the Paris Club invited the IMF and the World Bank to provide technical advice and information; and the UNCTAD to inform the creditors about debtors' situations. Overall, the Paris Club requirement is for debtors to implement stabilization programme which is accepted and monitored by the IMF and its goal is to give debtors enough time to impose economic policies inevitable for recovery (Cosio-Pascal, 2008).

However, the decisions on debt relief by the Paris Club were conducted only by government creditors which was about to change in a way so that external debt negotiations could be handled according to certain international guidelines. The agreement on such guidelines was reached in 1978 and they were adopted in 1980. Although, they do not separate private and public external debt sources, they are the first foreign debt rescheduling guidelines (Cosio-Pascal, 2008).

### 1.5.2 The London Club

While the Paris Club deals with credits provided by governments to private and public borrowers, the London Club resolves disputes between the same borrowers but with commercial banks. The London Club participants are all the banks that provided loans to a debtor country (Rieffel, 1985). The London Club emerged in the mid-1970s, the period when transition from bonds to commercial bank loans started to play a significant role. Before that, commercial banks had not provided enough credit to be involved in rescheduling procedures. Having no permanent secretariat and chairmanship makes the London Club even less formal than the Paris Club. The negotiation process starts with creditor banks forming the Bank Advisory Committee – a communication channel between international banking community and a sovereign debtor - represented by people from major creditors. The Bank Advisory Committee (a) approves all procedures, (b) corroborates presented financial data, (c) examines the amount of debt, (d) considers debtor's recovery plans, (e) negotiates restructuring terms, (f) prepares legal documents, (g) confirms the result of negotiations and informs non-BAC creditors. All creditor banks

must approve the conditions of debt restructuring and sign the agreement (Rahnama-Moghadam, 1998; Viterbo, 2014). Unlike the Paris Club, the London Club negotiations can touch upon new credits, do not involve the IMF in their arrangements and parties need to come up with a legally binding instrument which takes longer and is more costly for debtors. Moreover, the London Club seeks agreements that last longer than two or three years. The Paris Club prefers less than one year consolidation period, plus the BAC members change with each debtor. (Rieffel, 1985; Viterbo, 2014). The examples of when Bank Advisory Committees took place in London Club negotiations can be found in Appendix 6.

### 1.5.3 Collective Action Clauses

The London Club negotiations were dominant until 1990, after that bond issuance became popular again. The group of creditors was much more diverse ranging from supranational institutions like the ECB and international organisations such as the IMF to governments and commercial banks to individuals. Since all the actors had various interests, it complicated negotiations even more (Viterbo, 2014). Increased number and heterogeneity of creditors could lead to collective action problems as coordination of creditors became challenging and it might be more complicated to achieve an agreement during restructuring process. That is why the sovereign debt restructuring mechanism (SDRM) was introduced in 2002 by the IMF. Its objective is to protect creditors' rights and asset values while making restructuring process rapid and predictable long before debt becomes unsustainable. The SDRM is requested by a debtor and used only in case that there are no sustainable macroeconomic policies left to restore its financial situation. The main shortcoming of this mechanism is a hold-out problem. A situation when creditors purposely delay restructuring process in order to get better settlement terms when a default occurs. (Krueger, 2002).

To tackle the hold-out problem, an alternative solution was proposed in 2003 – Collective Action Clauses (CAC). Collective modification clause would enable a certain percentage of creditors to approve a restructuring proposal that would be applicable to all creditors. Collective acceleration clause prohibits creditors from claiming full repayment after a default unless a certain percentage of them agrees to that. The CAC became important term in many bonds issued under New York laws and after Eurozone crisis a standardized Collective Action Clauses have been established and used also in Eurozone bonds with maturity of at least one year (Weidemaier & Gulati, 2014).

The CACs gradually evolved over time and the latest and most used version of them was introduced in 2014 by the International Capital Markets Association<sup>4</sup> (ICMA). This new model offers sovereigns a flexibility when restructuring debts while protecting creditors.

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<sup>4</sup> The ICMA promotes and develops international securities markets and capital markets, innovate principles, rules and recommendations crucial for funding an economic growth (ICMA, 2022).



In order for CACs to apply in different circumstances, a single approach would not be suitable for all situations. Therefore, ICMA extended already existing option (a single series option) by two more (a two-limb option and a single-limb option) and in each scenario defines the percentage that represents majority. A debtor can decide based on the circumstances which one if not all of the options to use in order to achieve comprehensive restructuring (Zandstra, 2014).

#### 1.5.4 Bond exchange offers

An alternative framework to overcome a hold-out problem are bond exchange offers or take-it-or-leave-it offers. While in the case of default CACs change the terms of bonds, exchange offers transfer liquidation rights from delaying creditors to participating bondholders (Hege & Mella-Barral, 2019). Thus, a key intention of exchange offers is to improve bondholders' participation in restructuring process. Once exchange offers are finalized, they are launched, followed by feedback from creditors and mutual corrections. Finally, new bonds are issued, and the old ones are retired (Das, Papaioannou & Trebesch, 2012). Some instances of exchange offers in restructuring processes are depicted in Appendix 7.

### 1.6 Reasons for debt repayment

Even after a long history of external defaults, the enforcement of debt repayment by creditors is still an issue (Bulow, 2015). The threat of nonexisting supranational legal system enforcing bilateral financial contracts could put creditors at bigger risk. Even if a debtor holds assets seizable in foreign jurisdictions, they may not be sufficient to repay the debt. And in case of a sovereign default, according to the absolute doctrine of sovereign immunity, sovereign creditor cannot sue the sovereign debtor without its consent. That is why in the post war period the absolute doctrine was replaced with the restrictive doctrine that does not recognize sovereign immunity in case of commercial activities including debt issuance. When it comes to foreign private creditors, they have no legal remedies (Wright, 2011).

According to economists, debtors' decision to repay the debt is based on the fear of possible economic sanctions and bad reputation that comes with nonrepayment. Even supersanctions used to be imposed on defaulting countries in history. These were sanctions of private creditors that had form of military pressure, financial and political control over borrowers. They were an effective mechanism in the period of golden standard when creditors seized fiscal control over the defaulter, or its ports were barricaded with creditor's gunboats to unable trade (Mitchener & Weidenmier, 2005).

The reputation approach relies on countries' desire to have access to international capital markets which can be denied once a country loses its reputation (Bulow, 2015). Once the

decision to default is made, it is a sign for foreign creditors that their loans in the future will not be profitable and that debtor is not credit worthy (Wright, 2011). Consequently, the debtor's reputation is lost, and it is banned from accessing capital markets. Therefore, the debtor chooses to continue repaying its debt or make a large repayment at a point when a reputation of reliable debtor could be lost. Such approach does not require any political pressure nor international courts which is why this approach is not used widely. The legal enforcement must be implemented in debt repayment contracts as debt renegotiations are in place. Moreover, empirical applications show that direct punishment drives debt limits more than just a reputation aspect (Bulow, 2015).

Therefore, to supplement reputation approach, economic sanctions are used in form of trade restrictions through quotas, tariffs and rejected access to trade credit (Mitchener & Weidenmier, 2005). This so-called punishment approach gives a creditor legal right to threaten debtor not to provide any lending in the future or interfere with debtor's international trade in form of shipments seizures which would lower debtor's gains (Bulow, 2015). Debtor's economy could be affected by steep decline in international trade (Wright, 2011). This decline happens either naturally after default by short-term trade credit reduction or with some help from creditors that aim to punish debtor and prevent another default in the future or even different country from default. This punishment is usually determined in debt renegotiations, so basically debtors fear that the outcome of renegotiations and their negative impact on trade (Rose, 2003). The punishment approach is not without flaws either. Such measures might not only be too expensive to implement, but they also present moral hazard for third parties that trade gains would be affected negatively as well (Bulow, 2015).

## **2 EXTERNAL DEBT DEFAULTS IN EMERGING ECONOMIES**

### **2.1 Characteristics of emerging economies**

When Antoine Van Agtmael studied financial markets in developing countries in late 1970s, he came up with a phrase "emerging markets" for a group of countries with attractive investment return perspectives. This expression was supposed to bring more investors than just a third world market term and hence boost progress and growth to these countries. After couple of years the phrase was changed to "emerging market economies" and later simplified to "emerging economies" (Vercueil, 2016). Although, emerging economies tend to be very different, they still share some common characteristics (Grill, 2020; Vercueil, 2016):

- High economic growth and medium to long-term potential to become developed country,

- High investment returns due to market volatility,
- Maintain their GDP per capita between 10 and 75 per cent of the EU average,
- Unused reserves of workforce,
- High market regulation,
- Stabilizing political and economic environment,
- Open economy with institutional transformation.

Emerging economies do not have to be small markets. The MSCI appointed 24 countries an emerging market status (which can be found in Appendix 11) and their total population is about 70 per cent of global population. These countries have had turbulent histories, but they managed to stabilize their economies by improving investment inflows from developed economies and conducting structural reforms in form of privatisation, deregulation and loosening trade barriers (HSBC, 2018). In case an emerging country overperforms, it can become an advanced economy. In order to achieve that, emerging economies should have young productive workforce, exporting power, low level of government and private debt, growing household income, natural resources and sophisticated fiscal policymaking (Vercueil, 2016; Grill, 2020).

Nowadays, there are no unified criteria that would define emerging economies. There are different groups of countries that form emerging economies, however they differ based on various indicators and such indicators are not the same for every analyst. That is why financial groups such as Goldman Sachs, Financial Times Stock Exchange Russel (FTSE Russel), Morgan Stanley or S&P Dow Jones created groups of emerging countries based on their own criteria (Grill, 2020).

The IMF differentiates two groups of markets based on their export levels, income per capita and integration in global financial system. 39 countries are classified as advanced markets and others are emerging and developing markets. 40 of them are so-called emerging and middle-income markets. Besides their income, emerging markets must be characterized with strong sustainable growth, production of higher value-added goods and are similar to advanced economies in terms of global trade participation and integration in financial markets. The IMF identifies emerging markets by calculating a score for each country that consists of five variables – nominal GDP, population, GDP per capita, share of global trade export and share of global external debt. The result is 20 countries (see Table 1) representing 34 per cent of global nominal GDP in USD (Dutttagupta & Pazarbasioglu, 2021).

*Table 1. Emerging markets based on the IMF's criteria*

| <b>Americas</b> | <b>Europe, Middle East &amp; Africa</b> | <b>Asia</b> |
|-----------------|---|-------------|
| Argentina       | Hungary                                 | China       |
| Brazil          | Poland                                  | India       |
| Chile           | Egypt                                   | Indonesia   |
| Colombia        | Iran                                    | Malaysia    |
| Mexico          | Russia                                  | Philippines |
|                 | Saudi Arabia                            | Thailand    |
|                 | South Africa                            |             |
|                 | Turkey                                  |             |
|                 | United Arab Emirates                    |             |

*Adapted from Duttagupta & Pazarbasioglu (2021).*

## **2.2 Defaults in emerging economies and their management**

Debt crises and sovereign defaults date back to the beginning of sovereign borrowing. During the ancient era they were resolved mostly through inflation and currency devaluation. Debt restructurings started to be applied in 16<sup>th</sup> century with Spain's, France's and Portugal's defaults. By the end of the 18<sup>th</sup> century, Spain and France experienced together 14 defaults which made them leaders in this matter. Number of defaults and debt restructuring increased in the 19<sup>th</sup> century as a result of newly established independent governments in Latin America and evolution of financial markets making it easier to borrow internationally. In the 1820s governments started issuing foreign currency bonds in European financial centres and large scale of sovereign defaults followed. Some of the defaults were just a by-product of lost wars (Austria 1802 and 1868, Russia 1839) and civil conflicts (Spain 1831, China 1921) but most of defaults that appeared since then reflected shocks to domestic economies. These defaults occurred after each of the eight periods of increased international lending described in Appendix 12 (Sturzenegger & Zettelmeyer, 2007; Beers, Jones, Quiviger & Walsh, 2021). For example, the defaults of emerging countries that occurred after the First World War were a result of a general belief that the world war would not happen again, and that global growth and political stability would persist. Plus, another global optimistic thinking was based on low debt and feasible public finances of countries in Latin America and Asia as

they were not destroyed by the war. And similar optimism dominated in 1970s. Bank loan spendings and their repayment was expected to be thoroughly monitored and with increase in commodity prices Latin America seemed to be profitable. However, inflation in developed countries caused lower demand and commodity prices collapsed leading to a series of defaults starting in Mexico. Just when Latin America got out of a decade of defaults, international creditors started pouring funds into this region believing that defaults would not occur again as bonds are safer instrument. They thought that countries would do anything to avoid defaults because renegotiations were almost impossible. Moreover, countries in Latin America became democracies, Mexico was a part of the NAFTA and Argentina fixed its exchange rate to the USD. Again, series of defaults started with Mexico (Reinhart & Rogoff, 2009).

Obviously, not all countries that borrowed during a particular period defaulted. Whether a country defaulted or not depended on several factors such as its indebtedness, the degree of shocks endured, the use of debt or its fiscal and political institutions. Interestingly, several countries that heavily borrowed did not defaulted. For example, the USA, Canada, South Africa, Australia, most Arab and Asian countries. On the other hand, Latin American countries defaulted after every period and some of them repeatedly. Another eye-catching fact is, the number of defaulters after the WWI and 1970s period. It is substantially higher than in other periods which only proves how deep and extend the Great Depression was and that debt crisis of 1980s affected more countries because more countries borrowed, including freshly independent African countries. This period is also unique because only defaults that occurred after the lending period in 1970s impacted bank loans while the rest of them affected sovereign bonds (Sturzenegger & Zettelmeyer, 2007).

Most of the defaults that happened in 19th and 20th century were resolved through some kind of settlement between debtors and creditors. Until 1870 creditors used to form ad hoc committees which did not prove to be efficient. Such approach was characterised with poor creditors coordination, competing committees and insufficient experience. Moreover, negotiations took too long to settle with average duration of fourteen years. The change came with an establishment of the British Corporation of Foreign Bondholders (CFB) in 1868. The representatives of the corporation covered the whole British financial sector (the British Bankers' Association, the London Chamber of Commerce) and significant bondholders and its role was to provide information on debtor countries and to coordinate creditors in case of settlements negotiations. It controlled access of sovereign debtors to the London market by refusing to list their new bonds on the London stock exchange. The corporation was in charge of settlement negotiations with Spain, Greece, Peru, Turkey, Mexico, Portugal, Argentina and Brazil. In only 30 years it managed to reduce the amount of loans in default from £300 million to £25 million and shorten average duration of defaults by eight years. Similar organisations were then established in Belgium and France (1898), Switzerland (1912), Germany

(1927), the USA (1933) and continued to exercise their functions until all post-war defaults were settled in 1950s. During the first half of the 19th century the settlements were generally in form of extended maturity, postponement of payments and capitalisation of interests. In the second half of the century property transfers (transfer of land, customs revenues, tax, right to operate a railway) to the creditors became popular accompanied with lower interest or principal payment. Such settlements were involved in case of Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador and Paraguay. Other settlements that took place until the post-war period included creditors' control over debtors' public finances. This was the case in Tunisia, Morocco, Egypt, Serbia, Liberia or Greece (Sturzenegger & Zettelmeyer, 2007).

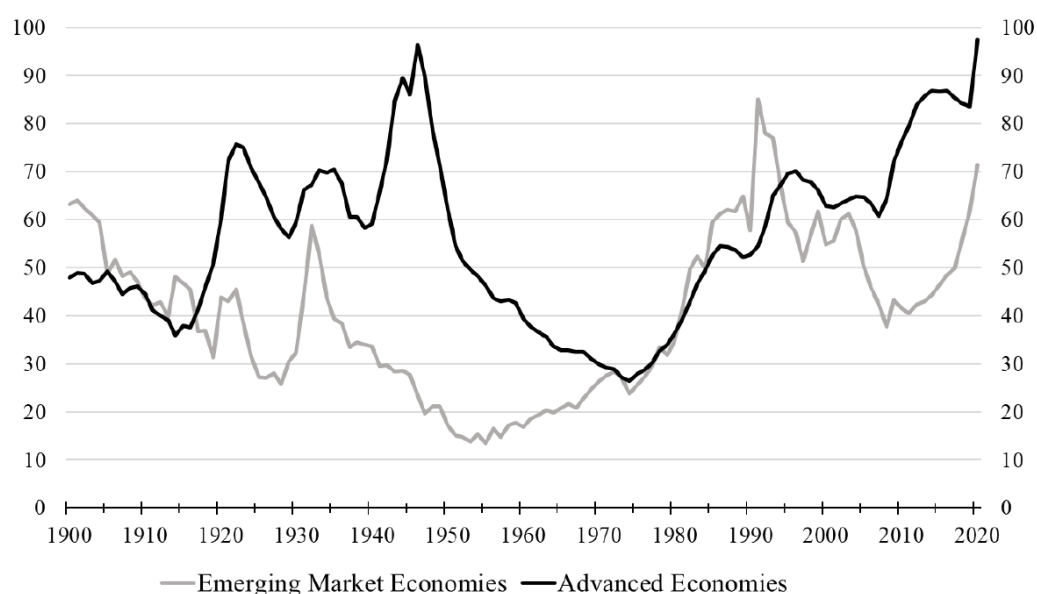
Debt renegotiations began an issue again in 1970s, however, bonds held by many creditors in few countries were replaced by loans issued by many commercial banks. So, when developing countries like Poland, Turkey, Peru, Sudan and Zaire started having problems with their debt servicing, restructuring of debt needed to be coordinated. This is when the London Club's Bank Advisory Committee came into play. At first, there were no formal restructurings. Banks counted on debt refinancing and provided debtors with new loans so that they could service their existing loans. However, later on Poland and Mexico started renegotiating their debts involving new financing to pay interests and rescheduling of their principal. Moreover, the Baker Plan was introduced to help developing countries by combining new financing with structural reforms. After all these attempts failed, with development of secondary market for defaulted debt in 1986 Argentina, Chile, Brazil and Mexico exchanged their bank debt for exit bonds in their debt restructuring deals. Debt buy backs at lower market price and lower face value of the bonds were not sufficient enough neither. Consequently, the Brady Plan was implemented to collateralize principal with U.S. Treasury zero-coupon bonds bought by debtors. This way creditors got back less but payments were safer. For almost a decade BAC implemented the Brady Plan in their negotiations. Even after initial holdout problems, debt negotiations ended up with buy backs, buyouts and in some cases debt was fully repaid. Moreover, not only was it successful, but also very efficient. Debt restructuring under the BAC managed to close the deals in months which is much faster than debt renegotiations under the Brady Plan. With the Brady deals creditors experienced huge losses and the processes lasted for one or two years, except for case of Mexico and Argentina where restructuring took eight and eleven years, respectively (Sturzenegger & Zettelmeyer, 2007).

Debt crises and restructuring of 1990s defaults lasted until 2005 and they were again focused on sovereign bonds. However, this time there was no formal committee similar to the CFB to represent creditors. Even though Emerging Markets Creditors Association (EMCA) was established in 2000, it did not participate in the negotiations, so more of an ad hoc approach was applied in these debt restructurings. Surprisingly, they did not last long and deals were concluded in months, mainly due to a new take-it-or-leave-it attitude.

The negotiations were inspired by the Brady Plan and they were to replace existing bonds with new ones with lower present value. These exchange offers were supposed to reduce principal and interest and extend maturity of the debt (Sturzenegger & Zettelmeyer, 2007).

With the rise of global financial crisis in 2007 – 2008 and subsequent fiscal crisis in Greece, global sovereign debt market experienced certain changes and developments. First, sovereign debt problems occurred mainly in advanced economies throughout Europe. Until then, they were viewed as resilient diversified economies with developed institutions and tax resources sufficient enough to resist higher debt levels and prevent defaults. However, debt sustainability in developed countries had been endangered even before that. Long-lasting low growth, aging population as well as high debt levels brought debt/GDP ratios of advanced countries to post-war period levels (Figure 3) (Mitchener & Trebesch, 2021). On the other hand, emerging countries, especially those in Latin America and East Asia entered global financial crisis in better position. Before the crisis they had accumulated enough reserves and reduced their debts so they could conduct countercyclical fiscal policy to tackle lower external demand (Primo Braga & Vincelette, 2011). For example, major Latin American countries had build up stronger balance of payment and switch from fixed exchange rate to more reactive inflation targeting. Both regions were more reliable on domestic demand and local financial markets were less dependent on foreign capital. Also, financial institutions in emerging market were smaller and simpler, so they were not as exposed to toxic assets (García-Herrero, 2021).

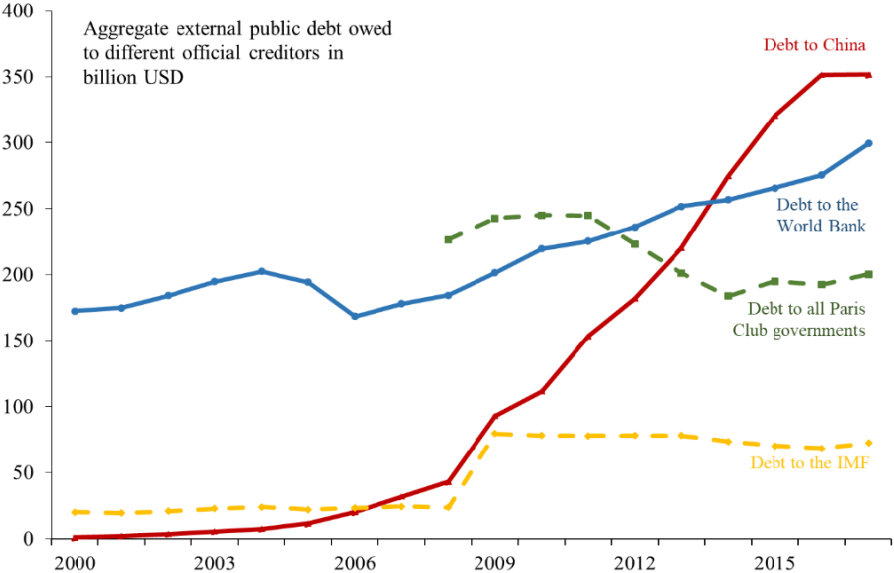
*Figure 3. Government debt to GDP in advanced and emerging economies between 1900 and 2020*



*Source: Mitchener & Trebesch (2021).*

Second, the financial crisis changed also the structure of sovereign debt. Due to all the quantitative easing policies implemented across developed world, holders of sovereign bonds changed from private creditors to central banks which made them a dominant player. Not only that, but also central bank-to-central bank and sovereign-to-sovereign lending through investment and commercial banks became an essential source of government financing in advanced and emerging countries. The main motivations for a sovereign country to lend another one is so-called rescue lending. A creditor fears the existence of adverse implications on its economy as a collateral damage in case of debtor’s default. Over the last twenty years, China has become the biggest lender to emerging economies (Figure 4) and together with Russia, Saudi Arabia and India plays a crucial role in financing these economies (Mitchener & Trebesch, 2021).

*Figure 4. Aggregate public debt to different official creditors for all developing and emerging markets*



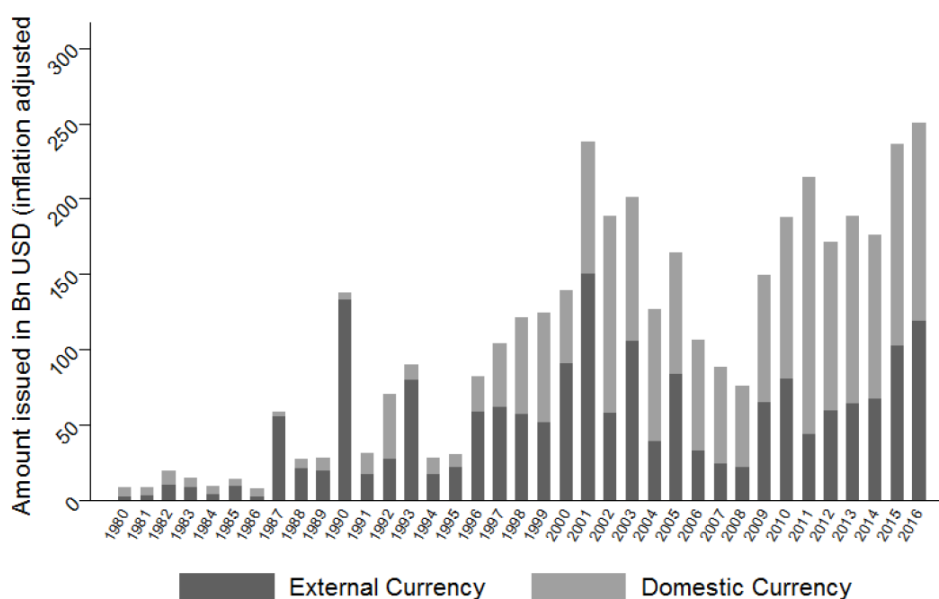
*Source: Mitchener & Trebesch (2021).*

Third, while in 1990s emerging countries issued bonds mostly in foreign currency, since the beginning of this century borrowing in domestic currency and under domestic law has gradually dominated and peaked in 2010s. As seen in Figure 5, foreign currency debt of emerging countries still occurs but it is not as significant as domestic one. It is because bonds issued in domestic currency are less vulnerable to global shocks, real value of the debt can be adjusted through inflation and the resolution of domestic defaults appears to be easier. Bonds issued under domestic law can be changed by a parliament and domestic institutions and banks can be regulated and forced to accept debt exchange offers or to buy domestic sovereign debt (Mitchener & Trebesch, 2021).



Fourth, the resolution of debt has changed. This, however, began earlier with ratification of the Foreign Sovereign Immunities Act in 1976 which allowed creditors to sue defaulting sovereigns in New York and London courts. Lawsuits and litigations have been widely used since 2000s and have become a regular instrument for disputes resolution. Most creditors and debtors prefer to avoid litigations since they are expensive and prohibits debtors from accessing bond markets. Typically, creditors decline debtor’s restructuring offer and demand full repayment. To avoid court litigations, creditors may seize debtor’s foreign assets like central bank assets, commodity exports and even presidential airplanes in exchange for payout which should motivate debtors to cooperate as such restrictions can disrupt international trade, delay the resolution of debt crisis and cause losses to debtor’s economy. Therefore, recent trends have shown that sovereign debt can be enforceable through litigations. Foreign courts can intimidate debtors from defaulting under a threat of denied access to credit markets and legal sanctions (Mitchener & Trebesch, 2021).

Figure 5. Share of external and domestic currency sovereign debt in total public debt in emerging markets



Source: Mitchener & Trebesch (2021).

### 2.3 Discussion about debt sustainability analysis

The public debt is one of essential indicators not only to compare countries, but also for investors who consider the risk of sovereign debt based on its sustainability. A sustainable debt is debt that can be serviced at any time and represents an optimal volume of external debt to help an economy overcome unforeseen external shocks. In order to have this ability, a government needs to be liquid and solvent. A liquid government is able to keep its access to financial markets and to service its short-term arrears. Solvency is, on the

other hand, medium- to long-term concept where net present value of future primary balances at least equals net present value of debt. A government can achieve sustainable level of debt by budgetary and fiscal policies that reduce spending and budget deficits while not increasing indebtedness or tax burden (Teica, 2012).

The IMF's (2021) definition also leans on liquidity and solvency requirements, and it states that sustainable public debt reflects the situation when the primary balance, that at least stabilizes debt, is economically and politically feasible, so that potential growth is not threatened, and rollover risk is not dangerously high. However, if the IMF detects that the sovereign stress is apparent, it does not necessarily mean that debt is unsustainable. Public debt is unsustainable only when no financing or adjustments are left to stabilize debt-to-GDP ratio and debt restructuring is inevitable (IMF, 2021).

Debt sustainability analysis is a concept that has been widely used to prevent and resolve sovereign debt crises by estimating a country's ability to service its debt in the future. In order for a government to pay for its debts, it needs to attain sufficient primary surplus which depends on forecasts for growth, exchange and real interest rates. This, however, makes debt sustainability analysis not always accurate, since such forecasts by governments, markets and international financial institutions differ (Sturzenegger & Zettelmeyer, 2007). Sturzenegger & Zettelmeyer (2007) suggest three ways how to detect unsustainable debt. First, static sustainability analysis pretends that interest rate, the growth of GDP and primary surplus of an economy are constant. It simply proposes future GDP growth and interest rate and determines whether current primary balance is sustainable or not under these circumstances. This rule of thumb approach, however, does not include concerns about future GDP and interest rate fluctuations, and applies only when debt is in domestic currency. Moreover, a result of the analysis may not show a feasible primary surplus which in addition keeps the debt constant. Second model calculates primary surplus as a function of growth, debt, interest rate and other predictable variables using past data to regress primary surpluses of a country. Using past experience helps determine attainability of a particular primary surplus. One disadvantage of this model is that in future a government may not be able to achieve primary surpluses similar to the past ones due to unsustainability of extraordinary fiscal performance. Additionally, this model also counts on estimated variables, therefore it is uncertain. Third approach has been used by governments and international institutions because it relies on simulations of short- and medium-term debt dynamics with alternative growth rates, interest rates and primary surplus, which leads to desired long-term primary surplus. With this model it is possible to determine debt sustainability under current policies assuming the evolution of growth and interest rates in future. If current policies suggest that debt is unsustainable, taking into account a country's economic and political limitations, a realistic way to primary surplus can be found.

The IMF analyses a country's ability to finance its macroeconomic policies and debt servicing in order to prevent the country's instability. To better recognise, resolve or avoid

potential crises, the IMF introduced public and external debt sustainability analyses (DSA) in 2002. This framework's objective is to evaluate present situation in terms of debt, detect debt structure vulnerabilities and assess the effect of policies that would stabilize debt situation if any difficulties emerged or will emerge. In other words, the DSA helps the IMF to determine whether a member state is vulnerable to sovereign stress, and if it is, it tells the Fund whether liquidity support, conventional adjustments or exceptional measures need to be implemented to resolve the stress. Moreover, in the case of debt restructurings, the IMF is able to develop conditions for financing requirements and debt relief. The latest review of the DSA framework was conducted in 2011-2013 to improve imperfections that were revealed during financial crisis and euro area crisis. The DSA framework involves two components - the analysis of total public debt sustainability and the analysis of total external debt sustainability. Both components have a baseline scenario and several stress tests. A baseline scenario presents projections based on macroeconomic policies and stress tests assess sensitivity of the baseline scenario to various assumptions. The DSA framework is not uniform for every country. Since countries face different circumstances, their debt structure and macroeconomic policies vary. Therefore, in addition to the 2002 framework designed for market-access countries (MACs), the IMF also developed a framework for low-income countries (LICs) in 2005 (IMF, 2017). The two frameworks are basically the same, but since low-income countries need to overcome more challenges (i.e., infrastructure gaps), the LIC DSA leans on slightly different data (IMF, 2011; IMF, 2021). Table 2 shows what is included in both frameworks.

Table 2. Composition of DSA for MACs and LICs

| <b>DSA for MACs</b>   | <b>DSA for LICs</b>   |
|---|---|
| <u>A baseline scenario</u><br>A 5-year projection of debt-to-GDP ratio (debt measured in nominal values)  | <u>A baseline scenario</u><br>A 20-year projection of debt-to-GDP ratio (debt measured in present value)  |
| <u>Alternative scenarios</u><br>1) A 10-year average of real GDP growth, real interest rate, primary balance<br>2) First year's projected level of primary balance-to-GDP is constant – no change in fiscal policies  | <u>Alternative scenarios</u><br>1) A 10-year average of real GDP growth, real interest rate, primary balance, debt-to-revenue, debt service-to-revenue<br>2) First year's projected level of primary balance-to-GDP, debt-to-revenue, debt service-to-revenue is constant<br>3) Permanently lower growth  |
| <u>Bound tests</u><br>1) Permanent shocks to real interest rate, real GDP growth rate, primary balance-to-GDP set at ½ of a standard deviation over 10-year period<br>2) Permanent shocks to real interest rate, real GDP growth rate, primary balance-to-GDP combined, set at ¼ of a standard deviation<br>3) 30% permanent exchange rate depreciation<br>4) 10% permanent increase in other debt creating flows | <u>Bound tests</u><br>1) 2-year shocks to real GDP growth rate, primary balance-to-GDP, debt-to-revenue, debt service-to-revenue set at 1 of a standard deviation over 10-year period<br>2) 2-year shocks to real GDP growth rate, primary balance-to-GDP, debt-to-revenue, debt service-to-revenue combined, set at ½ of a standard deviation<br>3) 30% permanent exchange rate depreciation<br>4) 10% permanent increase in other debt creating flows |

*Adapted from IMF (2011).*

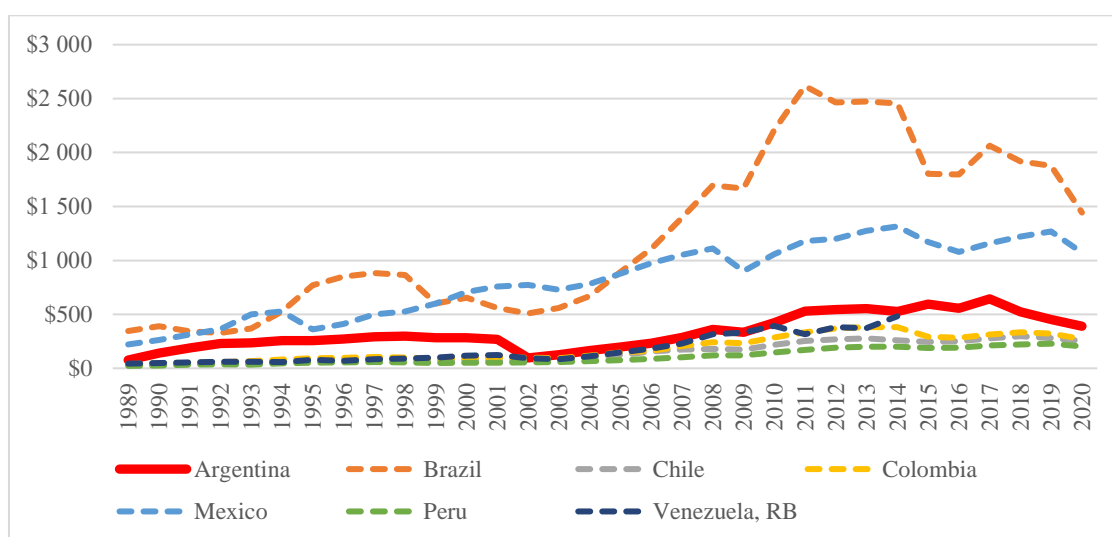
The DSA's first step is to project the debt-to-GDP ratio. To determine whether the path of the ratio is realistic, alternative scenarios and bound tests are conducted as a part of stress testing. Alternative scenarios help to understand how assumptions for the future vary from historical experience and current fiscal situation. Comparing the baseline scenario to alternative scenarios provides the information whether policy actions and commitments are sufficient to change current or past trend. If the assumptions are realistic, the DSA starts examining estimated debt-to-GDP ratio and set certain threshold. The most used ceiling for this ratio is set to 60 percent of GDP. When public debt is expected to overcome this threshold in projected period in the baseline scenario, debt sustainability might be endangered, and further discussion and analyses are needed. This is, however, very country specific. Even lower levels of public debt may raise potential risks, especially in emerging markets, while advanced economies might survive much higher debt-to-GDP ratios. In this case, the IMF suggests conducting in-depth analysis (e.g., debt structure, fiscal risks) in emerging economies where debt distress occurred at

levels of public debt below 60 percent. But in general, higher levels of public debt increase a likelihood of unsustainability, since the higher debt is, the higher primary surplus is needed. In addition to that, higher interest rates are usually in place, which raises desired primary surplus even higher. Therefore, public debt is deemed unsustainable, if fiscal adjustments, needed to bring the primary balance to a level that stabilizes the debt-to-GDP ratio, are not economically and politically feasible (IMF, 2011).

### **3 EXTERNAL DEBT OF ARGENTINA AND ITS DEFAULTS OVER THE HISTORY**

Argentina is a presidential federal republic with rich natural resources. Argentina has been one of the largest economies in South America. As shown in Figure 6, its GDP in 1989 was close to \$77 billion, in 1999 it was more than \$283 billion and in 2020 almost \$390 billion. Argentina is classified as an upper middle-income economy by the World Bank and is considered one of emerging market economies. The country is also a member of the G-20 countries. However, its institutional framework, in which fragile democracy replaces military dictatorship, is one of the essential factors that cause undisciplined spending of public resources. Even though, in the 1990s Argentina established a currency board, restored the financial system, privatised public companies, encouraged trade and debased inflation, it could not avoid economic disaster. Mainly because it was highly dependent on agriculture, the U.S. monetary policy affected the Argentine one and it overvalued the real exchange rate that caused unsustainable performance and high unemployment. Moreover, Argentine economy was hit by the other emerging market crises such as Mexican, Asian, Russian and Brazilian crisis. While Russian and Asian crises were overcome flawlessly, the Mexican crisis restructured Argentine financial system. Thanks to this, the IMF support and the Convertibility Plan, the global financial crisis was managed without a threat of solvency problems. But let's start from the beginning (Ferrandino & Sgro, 2015; Shalolashvili, 2015).

Figure 6. GDP of the largest Latin American economies (in billion \$)



Adapted from World Bank (2022).

### 3.1 History of Argentina's defaults

Argentina with its nine defaults belongs to the group of countries called serial defaulters. The first default occurred only eleven years after becoming independent from Spain. After that by the end of the century Argentina became one of richest countries in the world thanks to its agricultural power. But impulsive behaviour of foreign creditors, easy access to capital and liberal spending caused eight other defaults while the last three of them happened in only two decades (Bartenstein, Maki & Gertz, 2019).

The default of 1827 was the result of quick opening of economy. When Argentina became independent, it issued one £1,000,000 bond on London stock market. The country defaulted on it two years after the Bank of England increased interest rates during the global crisis. The outstanding amount was around £975,000. The negotiations started in 1850s reaching an agreement in 1857. The deal was to pay the principal without reductions and to issue a new bond amounting to £1,641,000 which equalled to unpaid interest (Bartenstein, Maki & Gertz, 2019; Kaminsky & Vega-Garcia, 2014).

When Argentina regained access to international capital markets, it issued its first bond in 1866. While south of Argentina had huge potential in its agriculture (production of commodities such as wheat, grains, fleeces, wool and hides), Buenos Aires was planned to become a cosmopolitan city. Argentina, however, faced limitations in poor roads and insufficient railways. But immigration of European labour force and foreign borrowings from London's Barings Bank helped Argentina achieve growth. Yet by 1880s, Argentina did not have any national currency or central bank. Only depreciated peso notes issued by national and provincial banks and several foreign coins were in circulation. Therefore, by 1883 Argentina joined the Gold Standard and old notes were replaced by new peso

notes convertible into gold. But with the burst of commodities bubble debt repayments were endangered. For example, in 1890 Argentina exported almost 500,000 more tons of wheat than a year before, but revenues dropped by 22 million gold pesos. Subsequent bank run and resignation of Argentine president triggered the second default in 1890. Argentina suspended payments of ten new bonds with £31 million outstanding balance and £244,000 outstanding amount of 1820s bond. During the negotiations it was agreed that Argentina had to issue £7.6 million bond by 1893 to be able to service its defaulted bonds. However, since the government had no access to new borrowings on international capital markets, the agreement was denied and replaced by Romero Agreement. The Romero Agreement included all government bonds in default which increased the total amount to £44 million, but interest rates on defaulted debt were reduced for five years and the sinking fund was put on hold until 1901 (Bartenstein, Maki & Gertz, 2019; Kaminsky & Vega-Garcia, 2014; Ford, 1956).

Argentina began new century in a favourable condition with strong agriculture oriented on export. Foreign capital and inflow of immigrants helped Argentina overcome shortage of both resources. In terms of the population, it increased from the first default to the World War I by more than 4 million helping the country reach 3.5 per cent average annual growth and GDP per capita of 80 per cent of the average for OECD countries. However, Argentina's reliance on agricultural products and foreign capital made its economy vulnerable after the war. Inflow of foreign investments was crucial for the country as domestic savings were not sufficient due to the young population with tendencies to consumption. On the other hand, export of agricultural products was dependent on price developments on commodity markets. Therefore, when foreign capital was attracted to the Wall Street and prices of commodities declined due to increased production in developed countries, Argentina faced recession in 1928. It took the crash of Wall Street and droughts in Australia, Canada and the USA to save Argentina from the recession. Until the World War II industrial sector in Argentina performed well and even during the war export of food to countries in war helped Argentina accumulate foreign currency. But with the closure of European markets a military coup in 1942 brought General Peron to power. After the war he utilized the gains from war period to conduct economic reforms – he nationalised the Central Bank and repaid the debt. When the reserves ran out and agricultural prices stabilised, Argentina's current account deficit reached \$160 million in 1949. While supported by working class, he introduced a strategy that neglected exports via import restrictions (on fertilisers and tractors) while building domestic industry. Since industrialisation needed import of such goods, his strategy contradicted itself and eventually failed leading to unemployment and social and political instability and to another default in 1951. After that Argentina tried to balance the external accounts by increasing agricultural production and devaluation of the peso. With exports on decline and drought that forced Argentina to import wheat, the country continued to struggle with debt payments and defaulted again in 1956 until it restructured the debt through the Paris Club negotiations. Due to foreign investments Argentine economy recovered in 1961

reaching 7 per cent growth rate of GDP (Sørensen, 2001; Ferrandino & Sgro, 2015; Bartenstein, Maki & Gertz, 2019).

After Peron's death inflation problems occurred, foreign capital inflow stagnated and export of meat to Europe suspended. It all worsened the public debt situation. Peron's wife took his place until Lieut. Gen. Jorge Rafael Videla took presidency and led the Dirty War<sup>5</sup> during which he borrowed from British and U.S. banks to finance its infrastructure. It caused foreign debt to rise by \$38 billion. And when the Fed raised interest rates to tackle inflation, commodity prices collapsed and Argentina together with fifteen other Latin American countries had to restructure its debt in 1982. By the end of 1980s inflation climbed up to 3,000 per cent and caused another default in 1989. When Carlos Menem became a president, he managed to record enormous growth by reducing inflation, bringing foreign capital and privatizing companies. On the other hand, he left behind \$100 billion foreign debt leading country to recession, reduced exports, overvalued currency and high unemployment (Bartenstein, Maki & Gertz, 2019; Ferrandino & Sgro, 2015). These two defaults of 1980s are analysed into details in the next chapter.

At the end of the century Argentina found itself in recession again while being incredibly politically unstable. Inability to pay for bonds that were worth \$95 billion resulted in another default in 2001. Argentina negotiated restructuring agreements with creditors in 2005 and 2010, however, holdout creditors demanded full repayment. Since the government did not have access to international capital, Argentina defaulted in 2014 on missed interest payments again. Finally, in 2015 Mauricio Macri was elected president and he brought litigations with holdout creditors to an end in 2016. (Bartenstein, Maki & Gertz, 2019; Nelson, 2020). Chapter 3.3 elaborates on this topic and brings comprehensive overview of 2001 default.

After President Macri managed to resolve long-lasting restructuring disputes of 2001 default, he was determined to address previous failing economic policies through economic reforms. He reduced export taxes and imposed currency controls. Together with increased interest rates to tackle inflation, the economic growth in 2017 was at 2.9 per cent. But with the rise of borrowing costs the government decided to abandon international capital markets and focus on money creation and forcing domestic banks into government bond purchases. In only one and a half year Argentina's external debt increased by \$56 billion, pushing budget deficit to 6.4 per cent of GDP. While such deficit was supposed to be financed by foreign capital, it overvalued peso which led to deepening of current account deficit. Such dependence on foreign capital made Argentina vulnerable to some factors. First, when the Fed rose interest rates, creditors were less interested in Argentine bonds. Second, the Central Bank of Argentina altered its inflations targets, and

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<sup>5</sup> Dirty War characterises the period between 1976 and 1983 when president Peron was deposed and replaced by Lieut. Gen. Jorge Rafael Videla. It is the period of military dictatorship during which left-wing political opponents were hunted down, state and municipal government was under military control, trade unions were banned, the National Congress was closed and censorship was imposed (Britannica, 2020).



lastly, Argentina experienced significant drought which reduced its revenue from agricultural export. To lure investors, Argentina increased interest rates to 40 per cent and introduced fiscal reforms that would deal with budget deficit. Since it did not help, the IMF agreed to provide \$50 billion to Argentina, whose external debt reached \$285 billion in 2019. Despite all the efforts, the peso depreciated even more and the central bank had to raise interest rates to 60 per cent. Moreover, the IMF increased its program by another \$7 billion. Eventually, the budget deficit declined to 2.5 per cent, but the devaluation of peso made it difficult to lower inflation and increased the debt real value to 76 per cent of GDP in 2019. When the peso recorded the all-time lowest value and the country's stock market deteriorated, President Fernandez won primary election in August 2019. He tried to recover the economy by increasing taxes to finance freezing tariff prices of utilities, cutting medicine prices, giving tax allowances and increasing wages. The Fernandez's government also tried to address public debt by talking to the creditors about renegotiating it. However, the coronavirus pandemic exacerbated economic pressures and Argentina defaulted again in 2020 when it failed to pay \$503 million interests on dollar bonds. The negotiations to exchange old bonds for new ones continue. Argentina's restructuring offer would mean reduced principal and interest rates and prolonged maturity. Although, the bondholders are entitled to demand full repayment, according to the IMF accepting Argentina's restructuring offer would restore its debt sustainability (Nelson, 2020).

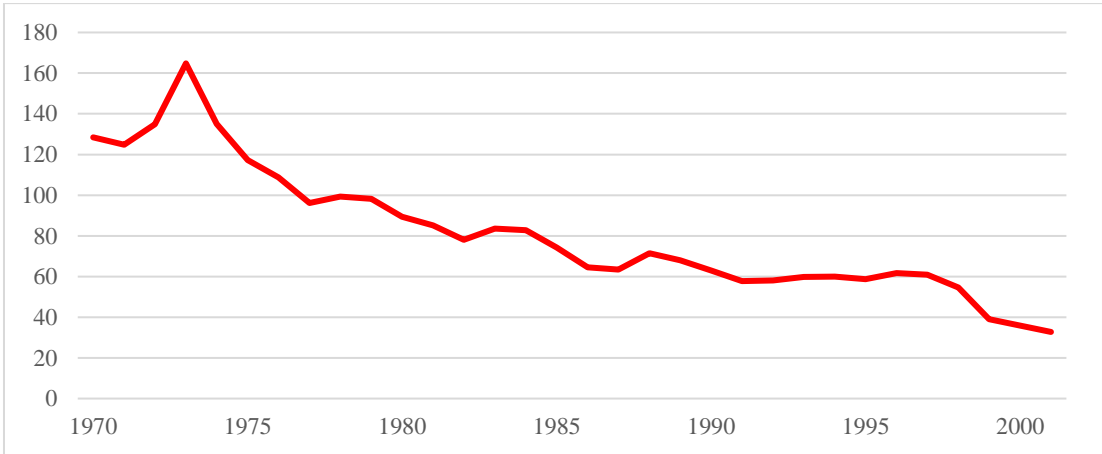
## **3.2 The Argentina's defaults of 1980s**

### **3.2.1 The cause of Argentina's 1982 default and its management**

The 1980s is characterised as a lost decade not only in Argentina, but also in other Latin American countries, Africa and Western Asia. Emerging and developing countries experienced series of defaults as a consequence of economic shocks that occurred in 1970s. In 1971, so-called Bretton Woods system, which allowed the dollar to be convertible into gold and other currencies, collapsed and this was the first shock. The U.S. government decided to suspend this system due to its scarce value of gold reserves compared to its international liabilities associated with increased fiscal deficits to finance the Vietnam War. Together with monetary easing that lowered interest rates in the USA, speculations surrounding capital flight to the UK and France supported this decision which resulted in the dollar devaluation. By 1973, floating rate regime was widely established. That is when the second economic shock happened – oil shock. Prices of oil skyrocketed and with the higher demand for food and global problems with its production, food prices doubled as well. These two shocks caused uncertainty on a stock market which crashed, the growth in developed countries slowed down and with prevailing high inflation and increasing unemployment, developed world found itself in stagflation. Tight fiscal policies and restrictive monetary policies in developed countries were a natural reaction which rose interest rates and restricted credit. That is when the third shock

occurred in the form of global imbalances in trade. Such imbalances led to the promotion of protectionism in developed countries in order to achieve economic growth. This, however, meant that the export of developing countries would be reduced which caused their balance of payments deficits to rise by \$62 billion. Poor domestic fiscal policies accompanied with high inflation and protectionism made developing countries heavily rely on foreign credit. However, after the World War II private and official external financing was lacking. With low rate of savings, protectionism and declining commodity prices (see Figure 7), developing countries did not have sufficient resources to cover their balance of payments deficits. But when the competition among former national banks started to increase, the banks began to provide international financing to Latin America and other developing regions to rebuild international capital market. These smaller banks together with large banks, that aimed to maintain or expand their market share, offered syndicated loans at floating interest rates pegged to LIBOR (London Interbank Offered Rate) so that the risk connected to rate fluctuations was shifted onto debtors. Between 1973 and 1981, only Latin America’s private debt inflow alone represented more than half of all such inflows to developing world (United Nations, 2017).

*Figure 7. Commodity net export price index for Argentina (2012 = 100)*



*Adapted from IMF (2022).*

Therefore, many policymakers and scholars believe these international banks are to blame. Since they were essential creditors at that time, their job was to conduct risk analyses of countries they were about to lend their funds to. However, due to underdeveloped assessment procedures associated with limited information on borrowers’ debts, the analyses were miscalculated. In addition to that, bankers themselves acknowledged that country risk analyses were not even considered when making decisions on providing loans. And under such conditions, loans to developing countries were gradually increasing with the full support of lenders’ governments that intended to expand their exports once the oil shock occurred. While the U.S. banks found their target market in Latin America, West German banks focused on Eastern Europe. At the same time, the IMF’s role, which initially was to support countries in difficult economic

situations, transformed from dealing with trade imbalances to managing the crisis. And in terms of information sharing, banks held discussions with the IMF regarding improvements in this matter, but governments wanted to keep such information confidential to improve market efficiency. Eventually, the IMF ended up publishing the statistics but without further comments or judgement. Additional sources of political and economic situation in debtor countries could be found in publications from the BIS and the World Bank. Although, some information was available, rating agencies completely ignored sovereign borrowers. In 1974 only seven countries were rated by Standard & Poor's, none by Fitch and as of 1980 only 11 countries were rated by Moody's. On the other hand, ranking system was in place but did not provide any new information. It just reflected the conditions under which each borrower obtained a loan. According to these rankings, out of 67 countries, Argentina placed 37 in 1979 and was upgraded to 24<sup>th</sup> place a year later (see Table 3). Interestingly, only two years prior to its default, Argentina's ranking was very close to countries like Spain, Iceland, and Norway which appeared in 21<sup>st</sup>, 19<sup>th</sup>, and 15<sup>th</sup> place respectively. To help banks require better information on their borrowers, the Burns questionnaire, developed by the central banks of G-10 group and the BIS, suggested a set of questions to be asked potential borrowers before providing any kind of financial aid. However, as bankers did not feel the need to be taught how to analyse country risk, the questionnaire was rejected by most banks. Bankers were also convinced that debt rescheduling or defaults were out of the question and even if they had occurred, the IMF would have provided resources necessary to meet debtors' obligations. So, why intervene in free market system that finances development and solves balance of payments problems. Thanks to all of that, countries were able to borrow internationally on good terms while experiencing economic downturn at the end of 1970s. The loans that were provided to developing countries started growing substantially in 1974 and accelerated two years later. But their biggest weakness was floating interest rates and shorter maturities than before. And with higher interest rates it was damaging for them. Especially, when developed countries implemented anti-inflationary policies and the Fed sharply increased interest rates (also known as the Volcker shock) in 1979, commodity prices dropped, protectionism prevailed and developing countries were on the verge of sovereign debt crises. Since most of the loans that were provided in 1970s were contracted at LIBOR, that reached 18.5 per cent in 1981, it was impossible for them to continue service their debts (Altamura & Flores Zendejas, 2016; United Nations, 2017).

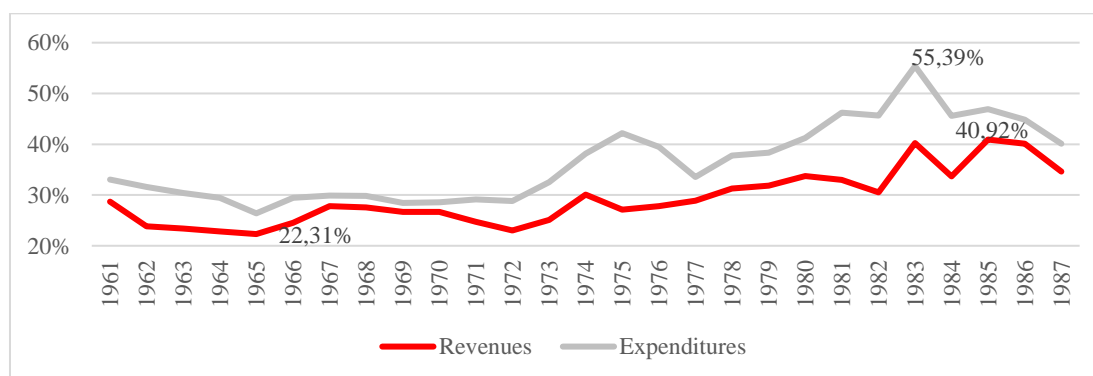
Table 3. Euromoney rankings of 1980s defaulters

| Country     | 1979  | 1980  | 1981  |
|-------------|-------|-------|-------|
| Argentina   | 37    | 24    | 38    |
| Brazil      | 47    | 53    | 62    |
| Chile       | 41    | 38    | 34    |
| Ecuador     | 50    | 42    | 39    |
| Ivory Coast | 67    | 54    | 52    |
| Mexico      | 34    | 13    | 27    |
| Morocco     | 52    | 43    | 53    |
| Nigeria     | 55    | 41    | 43    |
| Panama      | 43    | 52    | 56    |
| Peru        | 64    | 55    | 47    |
| Philippines | 45    | 26    | 37    |
| Romania     | 36    | 30    | 42    |
| Uruguay     | 53    | 36    | 33    |
| Venezuela   | 22    | 51    | 61    |
| Yugoslavia  | 46    | 49    | 58    |
| Average     | 46.13 | 40.47 | 45.47 |

Source: Altamura & Flores Zendejas (2016).

In addition to these external factors, domestic policies contributed to the default as well. As shown in Figure 8, during the period between 1961 and 1989 Argentina had a fiscal deficit every year. That was mainly because distribution of expenditures and revenues in Argentina underwent significant changes. They were transferred from central to local and provincial governments which did not have predefined budget limits. Fiscal revenues show a growing trend from almost 23 per cent in 1965 to less than 41 per cent in 1985. When it comes to expenditures, they grew by around 20 per cent and when they reached 55 per cent in 1983, the government started to pay attention to its spending reduction. Consequently, it dropped by 11 per cent. Even though, fiscal revenues grew, they were constantly below expenditures, so after financing its spending, the government had not enough resources to service interest on its not only external, but also internal debt. The central bank became a borrower of first resort financed by public's deposits in commercial banks. Practically, fiscal deficit was financed from public's deposits that were lent to the central bank. The central bank exploited 80 per cent of the commercial banks' capacity. It resulted in high interest rates and inflation (Rodriguez, 1991).

Figure 8. Total fiscal expenditures and revenues (as % of GDP)



Adapted from Rodriguez (1991).

Moreover, the use of foreign funds in Argentina is questionable. When a foreign debt finances capital flight, servicing problem may occur. As shown in Table 4, between 1979 and 1983, more than 60 per cent of the foreign debt was spent on foreign assets purchases by Argentinians and only less than 40 per cent of the total funds financed current account deficits (Rodriguez, 1990).

*Table 4. Sources and use of funds 1979-1983*

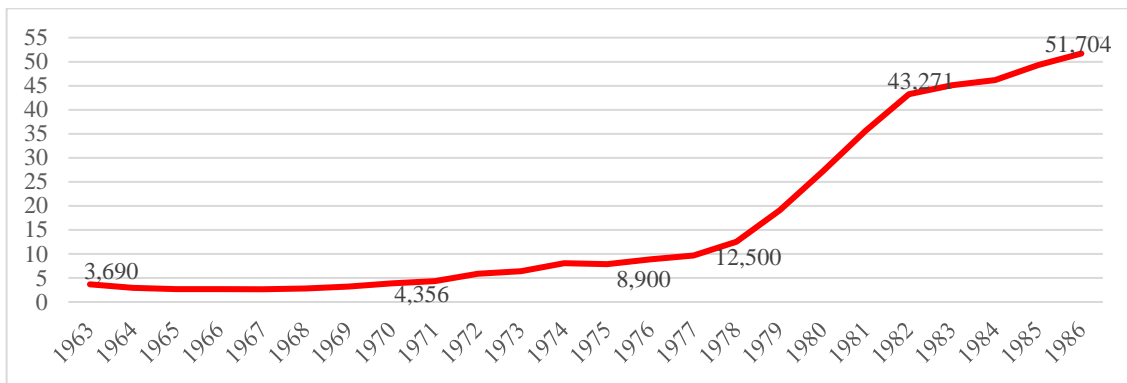
| <b>Sources of funds</b>    |                | <b>Use of funds</b>              |                |
|----------------------------|----------------|----------------------------------|----------------|
| Increase in external debt  | \$32.6 billion | Current account deficits         | \$14.8 billion |
| Decrease in gross reserves | \$2.7 billion  | Increase in gross foreign assets | \$22.9 billion |
| Foreign direct investment  | \$2.4 billion  |                                  |                |
| Total supply               | \$37.7 billion | Total use                        | \$37.7 billion |

*Adapted from Rodriguez (1990).*

Until 1975 Argentine fiscal deficit was covered by money creation. But when the military regime claimed power in the country, Jose Martinez de Hoz (1976-1981) became Minister of Finance. This change was also associated with financial reform that opened Argentine financial market to foreign creditors and deficit started to be financed by taking on debt. Most of the external debt was incurred between 1976 and 1981 (see Figure 9). To tackle the crisis of balance of payments in 1975, Martinez de Hoz's administration relied on devaluation to motivate export and farming production (Figure 10). Consequently, the prices of exportable farming products as well as imported products increased, and real wages declined by 40 per cent. Together with restricted issuance of money, interest rates rose which brought more foreign capital. The Argentine current account of the balance of payments started to recover and by 1978 the country registered a surplus. Compared to one month before de Hoz became the Minister of Finance when annual rate of inflation reached 5,000 per cent with steep GDP decline, after the new program was implemented, GDP stagnated, and annual inflation amounted to 170 per cent, as shown in Figure 11. However, it could not get lower than 150 per cent so, the government bet on expectations approach and decided to announce depreciations ahead. In one-year period, inflation dropped to less than 100 per cent. The situation resulted in a political pressure to reactivate the economy and to increase the real wages. Therefore, the government planned to reduce tariffs to support international competition and fight inflation. Also, the devaluation was to be undertaken at slower pace. However, foreign competition affected only a small part of the economy – agriculture, whose international prices were on the rise. Moreover, economic sectors that were not exposed to foreign competition due to several reasons (costly transportation, perishable goods, problematic packaging, health regulations and so on) experienced continuing price increases. The overall result was even higher inflation, businesses recorded losses and closed their manufacturing plants. Due

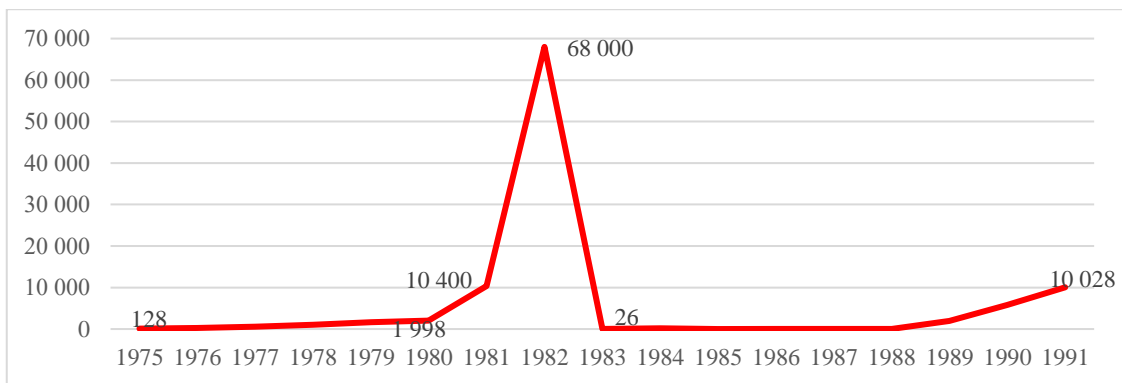
to lower interest rates abroad, foreign borrowings increased. In 1976 the regime of unrestricted capital mobility was introduced which allowed dollar purchases. This facilitated capital flight that amounted to \$23.4 billion between 1978 and 1982. It caused significant fluctuations in exchange rate that is associated with Argentina's macroeconomic policy and subsequent capital flight. Between 1970 and 1979 the average real exchange rate amounted to 73 and in the next three years it reached 108. By 1987 it fell by two thirds. The main channel of this capital flight is higher import than export. And with further increases in import, capital outflow and declining exports, current account of the balance of payments recorded growing deficit which was financed with short-term loans and foreign funds deposited in the peso in Argentine banking system. It helped to accumulate national reserves and enough foreign currency to finance imports and to keep the balance of payments in equilibrium. However, growing external debt remained unnoticed mainly because of delayed publication of relevant statistics by the central bank. Since the accumulated foreign debt between 1976 and 1978 was almost \$1.5 billion, between 1979 and 1981 it was more than \$18.5 billion. As opposed to other countries, this indebtedness was not brought about by oil shocks since Argentina imported no oil. With its high commodity prices this situation was favourable for the economy but increased imports, outflow of capital and tourists and high interest rates contributed not only to the accelerated indebtedness of Argentina during Martinez de Hoz's administration, but also caused a banking crisis that started in 1980 when Banco de Intercambio Regional, one of the largest private banks in Argentina, failed. In the next two years seventy more private financial institutions failed. The banking crisis intensified inflationary problems in the following years as more money had to be created. It was used to finance deposits that were guaranteed by the central bank. Consequent global market closures and protectionism and the rise in global interest rates made it difficult for Argentina to service its debt. The debt that was not incurred to grow but to finance its economic openness with foreign currency which was unlimited and available. To get out of this situation, Argentina would have had to adjust the exchange rate to decrease domestic interest rates, continue to lure foreign investments and maintain reasonable activity level. Instead, existing external debt was financed with new funds provided by domestic banks. In 1980, the central bank started issuing government paper called BONEX which paid LIBOR, had a 10-year maturity and was traded below par value. BONEX became very popular because it represented collateral for loans in interfirm financial market and could be traded in secondary markets for dollars or Australes. Moreover, BONEX rate was determined by changes in global dollar rates and was not affected by expectations about exchange rate. Increasing internal debt raised the real monthly interest rates even higher from 3 per cent to 9 per cent in 1981. In response, Martinez de Hoz just before the end of his term devalued the peso by 10 per cent, raising the monthly interest rates to 16 per cent. Inappropriate management of exchange rate and current account deficit are the main contributors to the debt accumulation. De Hoz's overvaluation was the beginning of massive destruction (Diamond & Naszewski, 1985; Rodriguez, 1991; Dornbusch & de Pablo, 1989; Beckerman, 1992).

Figure 9. Argentina's external debt 1963 – 1986 (millions of USD)



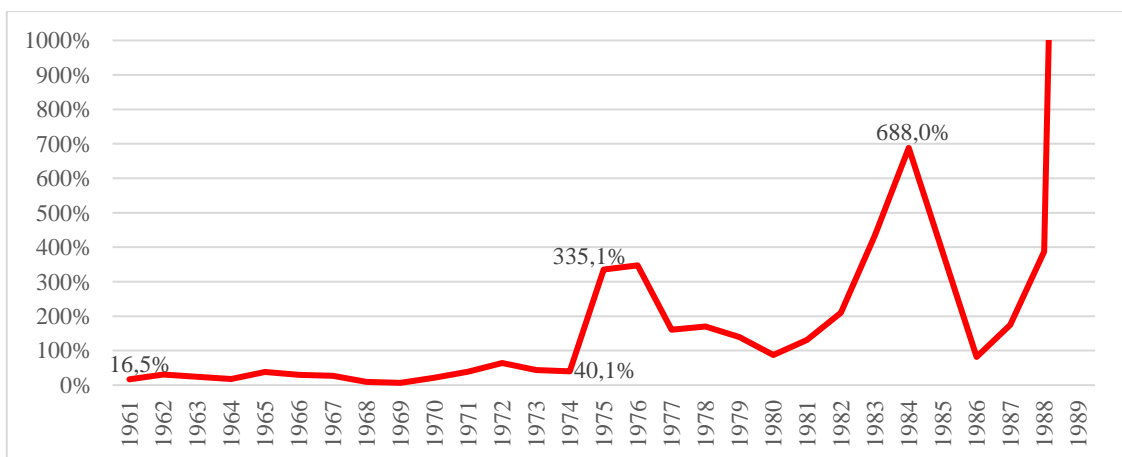
Adapted from Diamond & Naszewski (1985); Rodriguez (1990).

Figure 10. Nominal exchange rate (in 1 USD/ARS)



Adapted from Calniquer (2022).

Figure 11. Annual inflation rate in CPI (1961 – 1989)



Adapted from Rodriguez (1991).

During De Hoz's last months in the office future president announced his commitment to carry on with devaluation which increased capital flight even more. Central bank reserves decreased by over \$5 billion and external debt climbed. When his successor Lorenzo Sigaut (April 1981-December 1981) took over Ministry of Finance, the change in exchange rate predicted the balance of payments problem. Plus, when the global interest rates rose, Argentine export prices fell and international recession was evident, the needed capital was hard to obtain. The peso was devalued again by 30 per cent, import tariffs were reduced and tax refunds for exports were implemented. This, however, doubled the inflation. The peso was then devalued two more times by 30 per cent and inflation rose to 60 per cent while a double parity of the exchange market was introduced. The government established a financial dollar (parallel exchange rate) and a commercial dollar (official exchange rate). The former fluctuated freely and the latter was set. During the next three years inflation rose from almost 100 per cent to 600 per cent. Servicing debt became more problematic due to high interest rates and depreciation, which deepened budget deficit and increased inflation and money creation. The debt crisis eventually became unbearable because of extreme overvaluation, massive capital flight and unfavourable global conditions. (Dornbusch & de Pablo, 1989; Heymann, 1987; Diamond & Naszewski, 1985).

When General Galtieri came to power, he appointed Roberto Alemann (1981-1982) as a new Minister of Finance. He devalued the commercial exchange rate by 30 per cent, increased value-added taxes, froze non-taxable income floor and public sector wages together with pensions and retirement funds, increases in the private sector wages were prevented and the money supply was reduced. Although, the recession exacerbated when domestic consumption declined by more than 10 per cent, the real wages deteriorated, international prices of farm products fell and export decreased, the balance of payments recorded surplus of \$450 million in the first quarter of 1982 mainly due to significant reduction of imports. However, foreign public debt that was to be paid that year reached \$12 - \$15 billion raising concerns about debt refinancing. The talks were postponed when Argentina and the Great Britain got into an armed conflict called the Falklands War which increased public expenditures and eventually even worsened Argentine payment ability, brought the highest external debt in Argentina's history, caused negative current account balance, low wages and high unemployment and put Galtieri's government to an end. After that, Jose Maria Dagnino Pastore (July 1982-August 1982) became the Minister of Finance and Domingo Cavallo the president of the central bank. Their economic policy was aimed at the reactivation of the economy and debt settlements. They started by reducing interest rates of short-term deposits and devalued commercial exchange rate by almost 30 per cent. Savings were used for consumption and reactivated the economy but tempering with commercial and financial exchange rate caused the 75 per cent difference between them and resulted in 15 per cent inflation rate per month. The effect of reactivated economy diminished. When Argentina defaulted on its debt, both officials resigned, and Jorge Wehbe (1982-1983) became a new Minister of Finance who had to



face renegotiations of the external debt as payments were suspended without any negotiation until this point. The negotiations started with the IMF in term of the standby credit provided under three conditions. First, the balance of payments deficit was not allowed to drop below \$5 billion until 1984. Second, public sector deficit and monetary expansion measure were limited until annual inflation is under 160 per cent. Third, Argentina was not allowed to impose new import restrictions and progressively expire existing ones and review its export incentives. Argentina had to maintain a 5 per cent GDP growth in 1983. Consequently, the IMF provided \$2.15 billion standby loan and international banks lent Argentina \$1.1 billion to repay its interest and outstanding debt. After Argentina suspended its payment of interest in March 1982, creditor banks demanded to change Argentine law which considered local lenders equal to foreign ones. When the law was passed, banks wished to renegotiate state-owned Aerolinas Argentinas first as foreign debt of state enterprises represented the biggest portion. After strong disagreements the deal was eventually signed but it was objected by the federal judge Pinto Kramer who forbade the government to proceed in negotiations, nullified already signed agreement and charged the president of the central bank of not fulfilling his official obligations. The lending banks then suspended their credit operations, and the IMF did not provide the third instalment of the standby loan to Argentina. At that time, Argentina's total obligations reached approximately \$21 billion that was due by 1983. In autumn 1983 the situation was still unstable as maturities were paid late and decisions were made in last minute. Also 160 per cent inflation objective was not met when the annual inflation rate recorded 550 per cent in September that year. Neither fiscal deficit condition was not adhered to because of expenditures on unprecedented floods that northeaster Argentina experienced and high inflation negatively affected tax revenues. Nevertheless, the limits that Argentina agreed upon with the IMF were not attainable due to the country's inflation growth rate and available credit was not sufficient. Only half of the country's exports were needed to finance interest on the external debt. Moreover, Argentina had only half of the foreign currency that it needed to import goods that would have supported domestic production (Diamond & Naszewski, 1985).

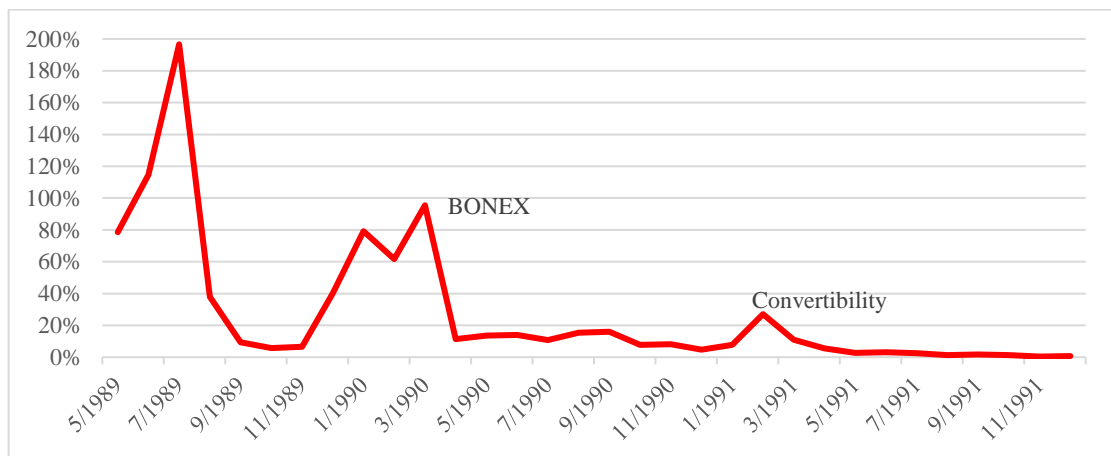
When Raul Alfonsin became the president in 1984, extreme increase in real wages burdened budget and external balance. Debt renegotiations with creditors and the IMF were not successful and the threat of hyperinflation became realistic when annual inflation rate reached 1,500 per cent in 1985. Therefore, in June 1985 Argentina came up with the Austral Plan. The Austral Plan's goal was immediate disinflation through real depreciation, higher public sector prices, import and export taxes, better tax collection and frozen wages and prices. Also, the austral was introduced as a new currency that replaced peso at a rate of 1,000 pesos/austral. At first, the plan worked and brought monthly inflation rate down to 1-2 per cent and budget seemed to be stabilized. But eventually, this plan did not bring price stability as inflation rate was back to 100-200 per cent but reduced from 2,000 per cent without economic slowdown or rise in unemployment (Dornbusch & de Pablo, 1989; Heymann, 1987). By the end of 1986,

Argentina's external debt reached almost \$52 billion, and the current account recorded a surplus of \$1.6 billion. But when the trade surplus declined in 1987 to almost \$0.6 billion and fall of the dollar rolled over unpaid interest, the debt climbed to \$56.5 billion in one year (Rodriguez, 1990). The prices continued rising in 1988 so a stabilization strategy needed to be renewed. That is when the Primavera Plan came to existence. The central bank was simply planning to make profit from unfavourable exchange rate for exporters and importers. The official rate – rate for exporters - was to be devalued by 4 per cent every month while keeping it from 20 to 25 per cent below the rate for importers. The profit made with this plan was meant to lower domestic debt. Also, the prices of public companies were raised to improve their revenues. The Primavera Plan was temporary, and it should have bought some time to prepare extensive tax reform. However, the reform had so many compromises that it failed to increase tax revenues and the profit from foreign exchange did not bring desired results. In early 1989, the central bank had to devalue again, and hyperinflation was evident in the following weeks. The central bank then had to save illiquid banks from deposits withdrawals by releasing their reserves and inaccessible deposits and also allowing overdrafts on their accounts in the central bank (Beckerman, 1992).

This situation helped Carlos Menem to become the president in July 1989 and he immediately enacted a new stabilization plan. He put together executives of Bunge and Born - the Argentine multinational company – therefore the Bunge and Born Plan or the BB Plan. It consisted of extensive devaluation of official exchange rate from 303 to 655 australes/dollar, the prices of public services (fuel, electricity, transport fares, telephone rates) increased and those of private sector had to remain stable until public-sector prices and fixed exchange rate change. The official and parallel exchange rates were fixed and equal. The devaluation was supposed to convince exporters to pay export taxes and eventually reduce public sector deficit. The government submitted legislations to allow authorities to cut or suspend expenditures, to privatize or close public companies, and proposed a new tax reform that eliminated tax collection flaws and increased the value-added tax base. The BB Plan, like other stabilization programs in Argentina, worked initially. Monthly inflation recorded single-digit rates, both exchange rates remained unchanged for four months and international reserves recovered sharply, and monthly interest rate decreased from 15 to 4 per cent. It was enough to negotiate a stand-by program with the IMF, who provided \$233 million in November 1989. However, the parallel exchange rate increased up to 40 per cent and threatening devaluation forced withdrawals of bank deposits. Interest rates increased again to 15 per cent by December and the official exchange rate was devalued from 655 to 1,010 australes/dollar. The devaluation increased public sector prices by 65 per cent, raised public sector wages and export taxes. The government declared a bank holiday for one day but even after that day the parallel exchange rate and interest rates remained the same and by the end of the week the team of executives resigned. A new economic team implemented floating exchange rate, cancelled increases in export tax and price controls. It did not help stabilize the

economy, interest rates continued to increase and austral devalued further to double the inflation level by the end of the month. Beginning from the first day of 1990, the BONEX Plan was introduced to address rising hyperinflation. This plan focused on conversion of deposits in commercial banks into BONEX - a 10-year government bonds denominated in dollars – which confiscated substantial volume (\$3 billion) of assets held privately. It was meant to downsize liquidity and put an end to excessive borrowing by public sector to finance interest obligations to the banking system (Beckerman, 1992). Initially, BONEX was traded at 30 to 40 per cent of par value with interest rate around 100 per cent (Rodriguez, 1991). Consequently, the government bond value dropped, and interest rates rose. Moreover, as Figure 12 shows, inflation did not significantly fell until April 1990. By that time, bank deposits fell by 75 per cent and transferred into dollar purchases or flew the country. Even though, in the second half of 1990 inflation declined, bank runs in early 1991 caused hyperinflation again (Welch, 1991).

*Figure 12. Monthly inflation rate in CPI (1989 – 1991)*

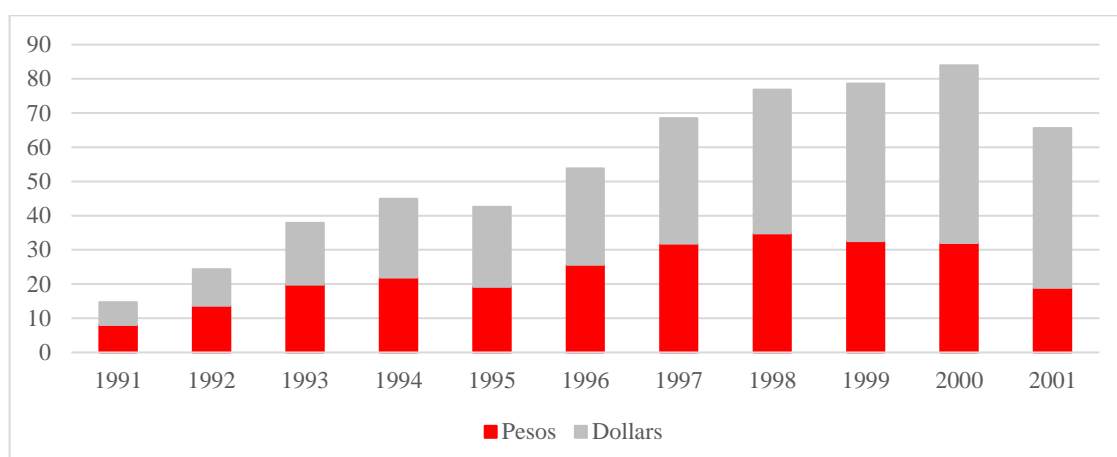


*Adapted from BCRA (2022).*

When Domingo Cavallo became freshly appointed Minister of Finance (1991 – 1994), he introduced a new stabilization program with a set of fiscal reforms. It was a response to higher demand for foreign currency and depreciation of domestic currency that caused hyperinflation in early 1991. Therefore, stabilization of price level was a priority. In April 1991, a series of fiscal reforms were introduced with the Convertibility Plan being the crucial part of it. The austral was replaced by the peso where 1 peso equalled 10,000 australes. The exchange rate was fixed at one peso per dollar backed with international reserves. It also allowed free usage of the peso or the dollar in contracts and payments, and abolished controls of foreign exchange. Moreover, it was prohibited to issue money that was not backed with foreign currency and to alter the exchange rate. Besides, the convertibility liberalized the economy, exposed it to competition and privatized the government’s assets in industries like, telecommunication, aviation, electricity, petroleum, gas, water utility and transportation. In addition to that, tax collection improved, and public expenditures decreased due to freezing of public sector wages and

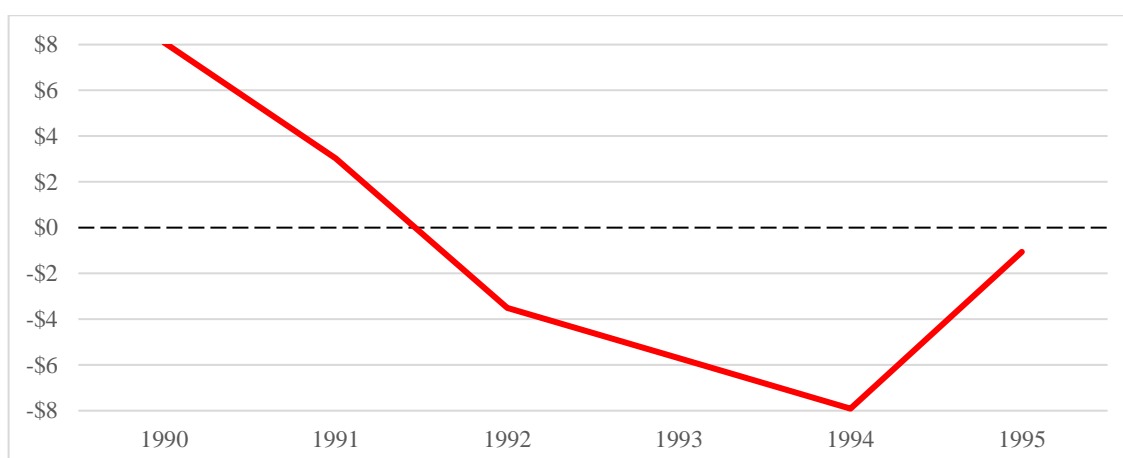
20-per cent reduction of employees in public sector. Consequently, the public finances were improved. The Convertibility Plan was supposed to re-establish the confidence in domestic currency. Cavallo believed that developing economies with poor domestic institutions could have a stable exchange rate only when its fixed, so he was inspired by the period of strict monetary commitments in the beginning of 20<sup>th</sup> century. Cavallo's expectations were to increase foreign capital inflows with the implementation of the convertibility and therefore improve competitiveness and export to service the debt. The public response to the convertibility regime and fiscal reforms was positive at first. It invoked positive signs as price stabilization and real appreciation were really happening. Mainly in terms of expectations about the economy which triggered private spending and boosted real output. On the other hand, dollar deposits and loans increased which was viewed positive because it could have increased investments and induced growth, but any thoughts on ensuring non-repayments in case of negative shocks were lacking. The other thing that was not clear about the convertibility at that time, was how long it would last and what circumstances would make the authorities to abandon the plan. And when stock prices fell in the second half of 1992, financial markets did not have much confidence in the fixed exchange rate because foreign reserves stagnated, interest rates rose, the peso deposits decreased and the dollar deposits rose (as shown in Figure 13). There were doubts whether convertibility would be permanent or just a temporary system to reduce inflation. The policymakers responded by implementing policies to support definite commitment to the fixed exchange rate. Their behaviour and statements about continuous rapid growth, privatization process and economic stability resulted in decreased budget deficits. Initially, the convertibility worked when it comes to inflation levels that dropped below 20 per cent by the end of the year as shown in Figure 12, but appreciation did not have desired impact on trade balance (Figure 14). Although, despite appreciation export increased by 75 per cent by 1995, current account deteriorated and made it impossible to service the debt from export revenues. However, by 1994, the annual growth rate recorded approximately 6 per cent which means that the plan stopped inflation without bringing the country into a recession. Other fiscal reforms that addressed fiscal deficits focused on national savings. These reforms aimed at taxing consumption instead of savings. For example, the social security reform allowed workers to transfer their contributions to private pension funds while the government was still responsible for collecting income taxes and paying out pensions. Even though, international institutions were at first concerned about an exit strategy from the fixed exchange rate, they supported the idea, especially the IMF. The Fund's support convinced other institutions to fund Argentina which eventually helped the country to meet an agreement with creditors in 1992 (Welch, 1991; Galiani, Heymann & Tommasi, 2002; Cavallo & Cottani, 1997; Perez-Caldentey & Vernengo, 2007).

Figure 13. Deposits in the Argentine banking system (in billion \$)



Adapted from BCRA (2022).

Figure 14. Trade balance in billion \$



Adapted from World Bank (2022).

### 3.2.2 The London Club negotiations

Series of sovereign defaults started with Mexico in August 1982. Then, the three phases of debt renegotiation followed. In the first phase until 1985, based on the assumption that this would be a short crisis, domestic policies focused on reducing fiscal deficits by restricted spending, higher taxes and currency devaluations to boost production of export goods. Bank Advisory Committees tried to renegotiate the debts with case-by-case approach. They adopted measures that helped only the USA to prevent a banking crisis but were not appropriate for managing Latin American debt crisis. As a result, nationalizing private external debt in Latin America brought the region into the worst economic crisis in its history, while the U.S. banks were making profits (United Nations, 2017; Ocampo, 2014).

As described in Table 5, Argentina experienced a problem with servicing its external debt since it was not able to generate enough surplus to finance interest on the debt. Basically, the main issue here was not the country's inability to generate surplus, it was just that it could not free any resources to service the debt. Therefore, the government had to find other sources of financing. After insufficient Austral Plan and creditors' unwillingness to refinance interest payments, Argentina proposed new alternatives based on debt repurchases with several domestic assets. Namely, Argentina's syndicated loans were to be repurchased in exchange for exit bonds and debt-equity swaps. The Guaranteed Refinancing Agreement established in 1987 allowed exit bond issuance. The exit bond was a bond denominated in dollar issued by the government to be exchanged for existing debt at par value. The exit bond was issued at 4 per cent annual interest rate and a 25-year maturity with 12-year grace period (a period during which a payment can be delayed without a penalty). By offering exit bonds, Argentina hoped that small banks, that did not participate in debt restructurings by providing new loans, would accept them and sell them in secondary markets with a discount. This would eventually lower country's debt price. However, only four banks out of three hundred were interested. The other banks declined because they were being repaid all of their interest without providing any fresh money. The exit bond initiative ended up as a failure. Second alternative, debt-equity swaps, was characterised by exchange of the debt for equity investments in Argentina's private sector. The government was simply designed to acquire private assets for money that it created or for increased internal debt. The idea was to print money to finance new investments in private sector and then sell the equity in these projects for external debt. Basically, the central bank bought the debt with australes and creditor could use this local currency to buy local assets. The first debt-equity swap regime was approved in 1987 but since no operations were carried out, it failed. It was because of the fact that debt had to be exchanged for australes at the official exchange rate which proved to be less profitable than selling the debt for the dollars on secondary markets and then exchange the dollars for much more australes on the black market. When a free floating financial foreign exchange market was created in late 1987, a new debt-equity swaps allowed to exchange australes at the financial exchange rate. Also, the swaps were offered in form of an auction where investors competed for price offered to exchange the debt for the dollars. The dollars were then exchange for australes at the financial exchange rate. Purchasing of existing assets was prohibited and only purchases of new machinery counted as investment. In the first year of debt-equity swap regime only three auctions took place saving \$323 million of debt's face value (Rodriguez, 1990).

Table 5. Argentina's trade and debt (in millions \$)

| Year | Debt   | Interest due | Current account | Real interest rate |
|------|--------|--------------|-----------------|--------------------|
| 1979 | 19,034 | 1,174        | 624             | -15.4%             |
| 1980 | 27,162 | 2,175        | -2,593          | -1.3%              |
| 1981 | 35,671 | 3,850        | -864            | 13%                |
| 1982 | 43,271 | 4,926        | 2,568           | 19%                |
| 1983 | 45,079 | 5,423        | 2,962           | 14.5%              |
| 1984 | 46,171 | 5,537        | 3,141           | 9.9%               |
| 1985 | 49,326 | 5,132        | 4,179           | 19.6%              |
| 1986 | 51,704 | 4,291        | 1,651           | 24.7%              |

*Adapted from Rodriguez (1990)*

### 3.2.3 The BakerPlan

The next phase was characterised by the Baker Plan whose goal was to stimulate growth through structural programmes like privatisation of state-owned firms, increased trade and seeking foreign investments. It also provided improved lending terms and new credit, debt buybacks, debt swaps and exit bonds (United Nations, 2017; Ocampo, 2014).

In 1985 debtors and creditors met in Korea to discuss rescheduling plan. That is when the Baker Plan originated. It was named after then U.S. Secretary of the Treasury James Baker and his plan consisted of several components (Aremu, 2018):

- interest payments were to be made in time in full,
- principal payments were to be rescheduled,
- commercial banks should have provided new loans to finance interest payments,
- sovereign debtors were about to submit to the IMF's conditionality,
- the international financial institutions had to provide new loans,
- options menu was proposed including exit bonds, debt-equity swaps and debt buybacks.

The Baker Plan basically aimed at strict economic reforms together with new commercial and multilateral loans under intensive supervision. However, the Plan did not bring any results as banks refused to provide new loans out of fear of losing more money. Also, debtor countries were not willing to undergo extended privatisations and economic reforms demanded by the IMF undermined investors' confidence and deteriorated economic growth (Aremu, 2018).

### 3.2.4 The Brady Plan

The following phase under the Brady Plan had similar goal while focusing on debt reduction followed by regained access to external capital. In the first four months of 1992, Argentine officials met in New York with the Bank Advisory Committee consisting of eleven banks to restructure the country's external debt through the Brady Plan. At the time, Argentina's unpaid interest amounted to more than \$8 billion, which was hard to negotiate considering Argentina's limited resources and dispersed creditors after its debt had been traded in previous phases. The goal of these negotiations was to enable Argentina to start paying interests again. Since some of the terms were not agreed upon in New York, the negotiations continued in the Dominican Republic where the parties agreed on the exchange of the external debt principal for par or discount bonds. In terms of a discount bond, it held a 35 per cent discount on principal with annual floating interest rate at 0.8125 per cent above LIBOR. Par bonds were exchanged for 100 per cent principal with a 4 per cent initial interest rate per annum, increased annually up to 6 per cent in the seventh year. Par bonds and discount bonds had the principal backed by U.S. Treasury bonds and were at up to 30-year maturities. However, due to decreasing interest rates, discount bonds were less attractive. Beside monthly interest payments, Argentina had to pay \$70 million every month, \$400 million at closing and \$300 million past-due interest. The financing plan was completed in June 1992 and distributed to more than 800 participants entitled to interest payments. While in the first phase banks made huge profits, under the Brady Plan they suffered debt write-offs. Eventually, the Brady Plan made the bond market the main source of new financing again. By the early 1990s, the debt relief and return of international investors ended the debt crisis with the help of the Washington Consensus. The Washington Consensus represented policy reforms influenced by the World Bank, the IMF and the U.S. Treasury (institutions based in Washington, D.C.) who became leaders in dealing with economic problems in 1980s. For example, the IMF offered financial support in exchange for policy reforms implemented in debtor countries. Such reforms included privatisation, economic deregulation, financial and trade liberalisation (United Nations, 2017; Ocampo, 2014; Olivier, 2010).

## 3.3 The Argentina's default of 2001

### 3.3.1 The cause of Argentina's 2001 default and its management

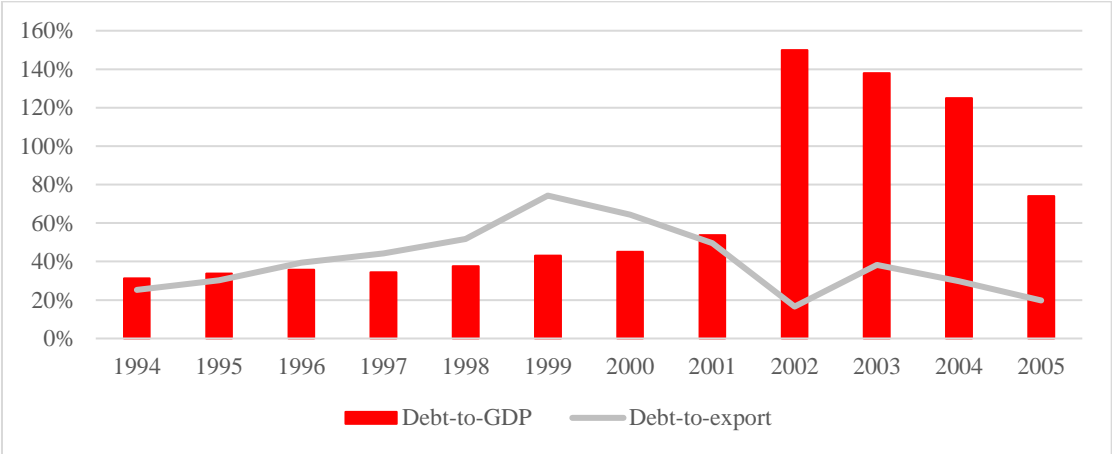
After the process of privatization and trade liberalization, closing the Brady deals and regaining access to foreign capital, Argentina's public debt recorded reasonable levels of 30 per cent of GDP (25 percent in the case of external debt). Argentine economy was on the rise due to increased capital inflows in private sector, diminishing budget deficits and reduced public expenditures by 7 percent of GDP by 1992. Privatisation of state-owned enterprises resulted in \$16 billion in revenues. The country opened to international trade by reducing import tariffs by more than 20 percent and by simplifying bureaucracy.



Capital inflow supported economic growth and was motivated by lower interest rates in the USA between 1991 and 1993. Inflation was no longer a problem because it was one of the lowest in the world. Employment grew annually by 1.8 percent between 1991 and 1994. Export doubled compared to 1980s and its growth exceeded the growth of the world trade. In terms of the convertibility, this regime helped to keep money in the country as in the past dollar deposits induced capital flight, this time depositors could have legally switched their deposits between two currencies within domestic financial system. Even though, dollar deposits grew more than peso deposits, it was more connected to time deposits than to current and savings accounts. On the other hand, the level of domestic savings was Argentina's weakness. The country did not have enough domestic savings to finance increased investments, and therefore relied on external savings instead, meaning increased external debt. Consequently, this debt was not accompanied by improved competitiveness and export in the second half of 1990s which would have financed the growing debt. This situation resulted in growing external debt-to-export ratio as shown in Figure 15. Basically, the country borrowed to finance imports of consumption goods which proved to be unsustainable at the end. By the end of 1994, budget deficits reoccurred and due to rising interest rates and social security reform grew to \$11.5 billion in 2001. While average interest rate of public debt was 5.8 percent in 1996, in 2001 it was 9.4 percent. When Mexico experienced several political assassinations, it caused social unrest and decline in foreign investments. Mexico had to devalue its currency and even when it was saved from default with help from the US, the IMF and official creditors, it had negative implications on Argentine economy. Capital inflows to public sector became significant and remained high which pushed the level of external debt above \$35 billion. Foreign investors became sceptical about emerging markets and, in addition to that, the Fed increased interest rates to tackle inflation. Inflow of capital was disrupted for a moment when the Mexican crisis hit but international financial institutions and domestic fiscal policies helped the country get over it smoothly which attracted more FDIs pushing growth even higher. Consequently, in 1996 weaker dollar and renewed capital inflow picked the economy back up. Although, the elections in 1995 resulted in extended government spending, Argentine debt remained under 40 per cent of GDP (see Figure 15). When Russia defaulted in 1998, debt financing became a problem for most emerging countries plus when Brazil abandoned fixed exchange rate, the Brazilian real devalued a year later, and considering a trade agreement between Argentina and Brazil, not only was Argentine competitiveness threatened, but also its convertibility regime was under pressure. At the same time, dollar was appreciating against the euro and Europe being Argentina's significant trade partner, competitiveness deteriorated. Capital inflows deteriorated, pessimism of domestic businesses reduced investments and subsequent recession had negative impact on government revenues which increased budget deficit. Argentina was not able to depreciate the peso and adjust to external shocks. Quite the opposite, the peso appreciated by 12 percent in 1999 and by 20 percent in last three years. Public debt grew rapidly reaching 45 percent of GDP in 2000 which might not seem much, but the government was not able to lower budget deficit and also the country started

losing access to the international capital as its credit rating downgraded. One of the reasons behind such increase was that the 1980s debt was not reduced during economically successful years and therefore was about to be repaid and fiscal policy struggled to keep up. The second reason was that the growth slowed down at the end of the decade and with rising interest rates the debt rose sharply. (Sturzenegger & Zettelmeyer, 2007; Kiguel, 2002; Jonas, 2002; Damill, Frenkel & Rapetti, 2005).

Figure 15. Argentine debt-to-GDP ratio and debt-to-export ratio



Adapted from Sturzenegger & Zettelmeyer (2007); World Bank (2022).

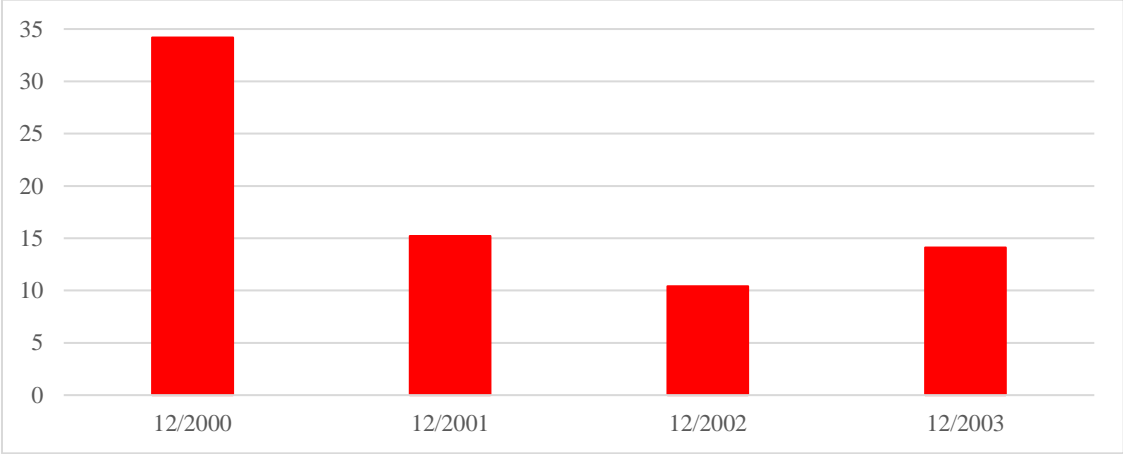
Fernando de la Rúa became the president in December 1999 and even though his primary goal was to maintain fiscal responsibility, he did not manage to uplift confidence in the economy. Quite opposite, expectations about sustainable debt turned negative. Government expenditures and tax increases followed but did not turn fiscal deficit to a surplus, so the blindaje program was introduced to finance the country needs. Within the program, Argentina obtained \$20 billion from the IMF, Spain and the World Bank under a condition of local financial institutions participation. Also, budget limits, that were supposed to help navigate government deficits, were eased. Initially, the program decreased a country risk but those financial needs that local authorities were responsible for, were not covered and total rollover needs in first half of 2001 amounted to \$4 billion. When the statistics for the first quarter of 2001 showed missed targets imposed by the IMF by \$1 billion and a \$3-billion deficit, Ricardo Lopez Murphy became newly appointed Minister of Finance (March 2001) who suggested to reduce government spending by \$2 billion. He lost president’s support and resigned after two weeks (Sturzenegger & Zettelmeyer, 2007).

Domingo Cavallo, who was behind the Convertibility Plan, became Finance Minister again (March 2001 – December 2001) and decided to boost slow growth by lowering some taxes and imposing taxes on financial transactions. The fiscal deficit decreased and the rolled over needs were financed by bonds issued to domestic financial institutions. Moreover, external situation was getting worse. In 2001, world economy recorded a

slowdown and after September 11 investors became more averse towards emerging markets making it impossible for Argentina to acquire additional funds. GDP fell sharply, unemployment rose to 18 percent. But when Cavallo proposed the peso to be pegged to an average of the dollar and the euro (strong dollar weakened Argentine competitiveness in Europe), the convertibility was expected to be abandoned and with resignation of the president of the central bank, confidence in fixed exchange system shattered and interest rates rose. Bond purchases by banking system reduced their international reserves as seen in Figure 16, confidence in recovery was low and foreign debt market became inaccessible for Argentina. Together with deposit withdrawals and dried up liquidity, Argentina seemed to devalue or default soon. In order to avoid that, it needed to extend its debt maturity and reduce short-term financing needs. That is why the \$ 65-billion debt was offered to be swapped voluntarily for bonds with longer maturities (short-term bond maturing in 2006) and debt relief in the first few years. Eventually, the debt of \$29 billion was swapped which reduced first five-year obligations by \$16 billion. However, medium- and long-term obligations became more expensive. Even after the debt swap the economy did not show signs of recovery. Therefore, the competitiveness plan was implemented to stimulate trade balance. Within the plan exporters received subsidies and importers faced additional tariffs. However, it brought very little improvements. Additionally, in July 2001 increasing deficits of provincial governments suggested problems with refinancing since most of the tax collections were used to finance debt and the rest was transferred to the provinces. By that time, the debt of provincial government was too high, so Cavallo introduced the zero-deficit law. The law basically allowed to lower pensions and public wages by 13 percent to balance the budget. But at that time, Argentina was already three years into recession. Immediately after the adjustment, price of sovereign bonds on secondary market fell and Argentine debt began to be massively sold. Argentina had trouble with obtaining new external debt and with significant exposure of banking system to the public sector, deposits started diminishing and flew out of the country. To avoid default, the IMF provided \$4 billion credit to increase the central bank reserves and \$1 billion to the government. When tax collection dropped and provincial expenditures were not reduced, Cavallo looked for debt relief through exchange with local bondholders. Following the announcement, bond prices deteriorated. The exchange offers included bonds to be exchanged for guaranteed loan, the guarantee being financial transaction tax collections. The bondholders were offered three bond options in a way to extend maturities and reduce interest payment. Since the exchange offer was voluntary, to motivate creditors the new instruments were valued at par and in case of mandatory restructuring worse terms would have applied. As a result, almost all debt was exchanged amounting to \$41.7 billion which reduced financing needs by \$26.2 billion in the next five years. However, it only increased nominal value of the debt because new bonds carried interest rates of around 15 percent. Even after these improvements, government deficit did not meet the IMF's criteria of zero deficit and a bank run intensified. Banks were closed and deposits were frozen which made Cavallo and de la Rúa resigned. Within

the next two weeks, Argentina had four presidents (Sturzenegger & Zettelmeyer, 2007; Kiguel, 2002; Jonas, 2002).

Figure 16. Argentine international reserves at the end of the year (in billion \$)



Adapted from BCRA (2022).

De la Rúa was replaced by Adolfo Rodríguez Saá who decided to default on all debt straight away. Even on debt on which payments were not missed. Another rare characteristic of this default was that it was perceived as a victory, even though 60 per cent of the debt was domestic. Saá resigned after ten days in the office. His successor Eduardo Duhalde immediately devalued the peso in February 2002 and announced the conversion of dollar-denominated assets and liabilities in the financial sector into the peso. Such loans to the public sector were to be converted at a rate of 1.4 pesos per dollar, and to the private sector at 1 to 1 rate. The exchange rate was sharply depreciating after that and to prevent the banking system from becoming insolvent, time deposits were restructured into 10-year peso- or dollar-denominated bonds indexed to inflation. In terms of domestic government debt, scheduled payments and maturities remained unchanged, but the interest was only 2 per cent, and 3-5 per cent on guaranteed loans. The other option was to exchange guaranteed loans for previously defaulted bonds. However, pension funds that held \$16.3 billion in loans did not accept any option and sued the government, which made their loans to be redollarized in 2003. Banks, on the other hand, did not sue but demanded compensations for their losses. Therefore, the government issued \$9 billion worth Bodens – compensations bonds. After the conversion, creditors lost between 30 to 60 per cent due to interest payment reductions and differences between the market exchange rate and the conversion rate. The conversion of guaranteed loans was followed by litigations against the banking system and the government. The results of such litigations gave depositors the right to demand dollar-denominated deposits from banks at market exchange rate. Consequently, the central bank had to provide liquidity to the banking system and raised interest rates on peso deposits to 100 per cent. In a few months it slowed down deposit outflows, liquidity improved, and withdrawal restrictions were cancelled at the end of 2002. But banks still found providing loans risky and held on to

liquidity in case they were forced to return dollar-denominated deposits, plus they were unsure about the result of external debt restructuring. The collapse of the convertibility regime increased public debt by additional \$28.5 billion. For example, except the pesification, the bank loans of provincial governments were absorbed by the federal government and cost it almost \$10 billion. Cut in pensions and public wages was deemed illegal and made the government issue bonds worth \$873 million to finance them. From the second half of 2002 employment started recovering and capital outflows declined which slowly stimulated the economy. The exchange rate was stabilized at 3.5 peso per dollar and elections in May 2003 were to release tensions and political uncertainty. By the end of 2002, the economy grew, guaranteed loans were serviced, and tax revenues increased while avoiding hyperinflation (Sturzenegger & Zettelmeyer, 2007; Damill, Frenkel & Rapetti, 2005).

### 3.3.2 2005 debt restructuring

The restructuring process began in 2002 in which Argentina together with the IMF tried to find a solution. In 2003 elections, Nestor Kirchner became the president and to restructure the debt worth \$102 billion (\$81.2 billion in face value and \$20.8 in past due interest), he introduced the Dubai guidelines as a debt restructuring strategy (Sturzenegger & Zettelmeyer, 2007). It offered three types of bonds (Guzman, 2016):

- Par bonds without face value reduction, fixed interest rates between 0.5 and 1.5 per cent maturing in 20 to 42 years,
- Discount bonds with 75-per cent face value reduction, increasing interest rates from 1 to 5 per cent and a maturity between 8 and 32 years,
- Quasipar bonds with 30-per cent face value reduction, fixed interest rates from 1 to 2 per cent and the same maturity as discount bonds.

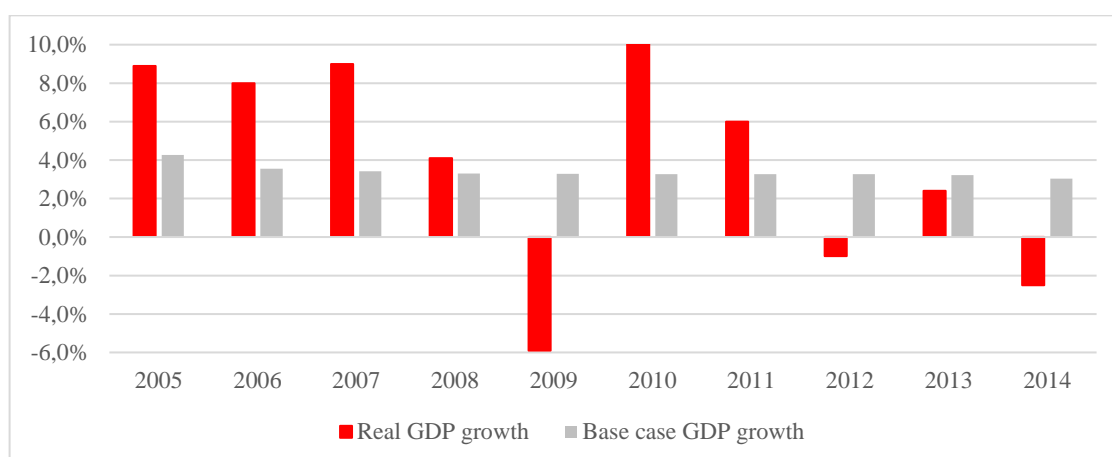
Obviously, creditors could not have agreed to that and took legal actions in New York and Europe. Even though, Argentina lost some of the litigations, enforcement of court rulings was not successful. Therefore, in the beginning of 2004, U.S., Italian, German and Austrian bondholders, and Japanese and Italian banks formed the Global Committee of Argentine Bondholders (GCAB) to claim \$37 billion of defaulted debt. The Argentine government met with the GCAB and other external creditors in April 2004, but no further negotiations followed (Sturzenegger & Zettelmeyer, 2007). Instead, the Buenos Aires guidelines were offered in January 2005 which let creditors choose among three securities (Guzman, 2016):

- Par bonds without face value reduction and increasing interest rates from 1.33 to 5.25 per cent,
- Discount bonds with 66.3-per cent face value reduction and interest rate of 8.25 per cent,

- Quasipar bonds with fixed interest rates of 3.31 per cent.

Both, discount and par bonds were offered in dollars, yens, euros and pesos. Par bonds were offered with 35-year maturity with instalments starting in 2029. Discount bonds included a maturity of 30 years with payments starting in 2024. Quasipar bonds were issued in pesos and were designed mainly for pension funds. They had a 42-year maturity. Instalments for quasipar bonds were proposed to start in 2036. This exchange offer presented some new features that were included in new bonds issued under New York law. The first one was a clause that assured bondholders to get a better deal in next exchange offers than holdouts. Second, collective action clauses allowed corrections in the payment terms with the consent of 75 per cent of bondholders. Third, aggregation clauses allowed for terms to be modified in multiple series of bond issues as long as at least 2/3 of bondholders in each series agrees. Finally, GDP-linked warrants were applied where every year from 2005 to 2034 base case GDP was established. In case that real GDP and GDP growth are higher than the base case GDP, GDP-linked payments were made. As it turned out, it cost Argentina additional \$10 billion between 2005 and 2011 when real GDP growth greatly exceeded (except for 2008 and 2009) base case GDP growth by around 4 - 5 per cent (see Figure 17). In terms of quasipar bonds, \$13.6 billion of debt was exchanged. The rest of debt owed to pension funds was exchanged for Bodens. Even though, proposed exchange offer was protested against and faced lawsuits, they were blocked, and eventually 76 per cent of bondholders participated in the exchange offer of 2005. This means that out of almost \$82 billion debt (past due interest was not addressed), more than \$62-billion worth debt was restructured by issuing new debt in amount of \$35.3 billion. The value of par bonds reached \$15 billion, discount bonds \$11.9 billion and quasipar bonds \$8.3 billion. Interesting fact about this restructuring is, that it was undertaken without the IMF's support. The Fund backed the idea of restoring debt sustainability of Argentina, but it was not supportive of such aggressive approach. Even though, the IMF suspended its support in 2004, Argentina continued repaying its debt towards the Fund until it was completely repaid (\$9.8 billion) before the due date in 2006. After the exchange, the IMF acknowledged that the debt swaps were important, but it advised Argentine government to deal with holdouts and remaining debt (Sturzenegger & Zettelmeyer, 2007). The part of the remaining debt was owed to the countries of the Paris Club. Argentina scheduled to repay its debt toward the Club in 2008 and 2010 but it was postponed (Hornbeck, 2013).

Figure 17. Real GDP growth and base case GDP growth



*Adapted from Guzman (2016); World Bank (2022).*

### 3.3.3 2010 debt restructuring

The participation rate of 76 per cent was relatively low and far from targeted 95 per cent. In order to regain access to international credit markets, second round of restructuring was needed. The exchange offer took place in April 2010 and included (Guzman, 2016):

- Par bonds without face value reduction, interest rate between 0.45 and 2.5 per cent and maturing in 2038,
- Discount bonds with interest rate ranging from 4.33 to 8.28 per cent and the due date in 2033,
- Global bonds that were issued in dollars, fixed interest rate of 8.75 per cent and maturing in 2017.

Out of \$18.3 billion debt, \$13.1-billion worth debt was restructured by issuing new debt in amount of \$7.86 billion. The value of par bonds reached \$2.1 billion, discount bonds \$4.8 billion and global bonds \$957 million. This means that face value was reduced by 40 per cent and that 70 per cent of creditors participated in 2010 restructuring which increased the total participation to 92.4 per cent. Overall, out of \$81.2-billion worth debt, Argentina was managed to exchange \$75.5 billion for \$43.1 billion. The value of creditors' losses reached 73 per cent and the face value was reduced by 43 per cent. However, if we add \$10 billion that Argentina paid due to the GDP-linked warrants, plus \$12 billion to holdout creditors, the total face value reduction drops to 20 per cent (Guzman, 2016). As for the Paris Club, the amount of debt owed by Argentina after the restructurings, was the same as before them - \$6.3 billion (Hornbeck, 2013).

### 3.3.4 A series of litigations

The process of restructuring was accompanied by legal disputes with holdout creditors who amounted to the rest 7.6 per cent of defaulted debt. There were hundreds of thousands of investors involved as plaintiffs in litigations against Argentina. These litigations lasted 14 years until the saga was finally over in 2016. Mostly, it was due to enormous number of lawsuits, huge sums and the fact that the defendant was a state. Moreover, it was a state that was not willing to settle, nor to act in accordance with court's rulings. Most of the holdouts were foreign investors because only around 63 per cent of them participated in restructuring, compared to 95 per cent of domestic creditors. One of the plaintiffs were so-called vulture funds or hedge funds that bought distressed debt at prices lower than face value and then sued debtors for full face value and interest repayment. Vulture funds counted on so-called pari passu clause which was included in bonds. This clause ensured that the government would pay all the bondholders equally, whether they participated in restructuring or not. Since holdouts were not paid, the pari passu clause was violated. In the case of Argentina, NML Capital was the most popular vulture fund. In 2008, it purchased Argentine bonds with face value of \$220 million for \$49 million and when their worth climbed to \$832 million in 2014, the fund decided to file a lawsuit. Other vulture funds created "me too" group, then there was the pari passu group, the ICSID group and European litigants (Guzman, 2016; Swamy, 2014; Porzecanski, 2016; Shalolashvili, 2015). The share of each holdout creditor on non-restructured debt can be seen in Table 6.

*Table 6. The share of holdout creditors on non-restructured debt*

| <b>Holdout creditor</b>      | <b>Percentage of non-restructured debt</b> |
|------------------------------|--|
| "Me too" group               | 2.8  |
| Unknown creditors            | 1.6  |
| ICSID group                  | 1.3  |
| Litigants in other US courts | 1  |
| Pari passu group             | 0.6  |
| European litigants           | 0.3  |
| <b>Total</b>                 | <b>7.6</b>                                 |

*Adapted from Guzman (2016).*

In 2011 alone, 150 individual lawsuits and 18 class action lawsuits were filed in the USA, trying at least to seize Argentine property in the States. In Germany, 460 out of 650 legal disputes were judged against, while other proceedings were in process in Europe and Japan (Porzecanski, 2016). Until November 2012, US courts did not allow holdouts to block the process to promote success of debt swap. Then, while European courts ruled against the plaintiffs, Judge Griesa came with controversial pari passu ruling in the case between Argentina and NML Capital and banned Argentina from making scheduled payments on its external debt under New York law, Argentina's law and other foreign law to restructuring participants until vulture funds are paid in full. Until the ruling was



lifted, Argentina had to issue Bonar 2024 bonds that allowed the country to borrow small amounts from China at 8.75 per cent interest rate. The amount of issued bonds was more than \$1.4 billion. As a consequence of this ruling, in July 2014 Argentina missed interest payments to restructuring participants. Although, the country sent money to its trustee bank in New York, the bank could not send it to the creditors and the event was classified as a default. The reason why Argentina could not pay vulture funds in full was the RUFO clause. This clause stated that if Argentina paid vulture funds before the RUFO clause expires (December 31, 2014), participating bondholders could have asked for the same repayments which would have amounted to \$120 billion, and the country would have defaulted again. Therefore, in 2015, holdouts were offered the same swaps as in 2005 and 2010 but there was no agreement reached. After the election in November that year, Mauricio Macri became the president and started over the negotiations with the holdouts. He offered them \$6.5 billion in cash which was 150 per cent of face value of defaulted bonds. Smaller holdout creditors accepted the offer and when Judge Griesa's ruling was lifted, Argentina issued new bonds worth \$16.5 billion to pay holdouts. Bonds were sold with 10-year maturity and interest rates of 7.5 per cent, which was obviously good enough for investors to overlook the country's history. Finally, in March 2016, the ruling was dropped, and Argentina paid the holdout creditors and regained access to international credit markets (Guzman, 2016; Swamy, 2014; Datz & Corcoran, 2020).

The litigations were resolved differently for each group. For example, the *pari passu* group and the "me too" group were entitled to 70 per cent of the claim, NML Capital received 75 per cent of the claim plus legal fees, and other creditors received 150 per cent of the original bonds' face value (Guzman, 2016).

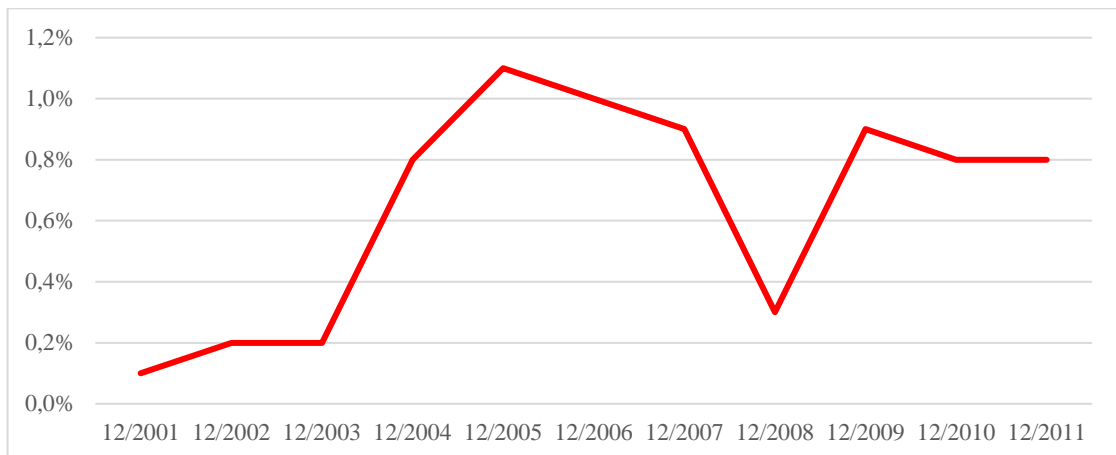
However, the litigations saga did not end. Argentina has faced two more lawsuits since then. First, participating bondholders sued the country for missed interest payments in 2014, and second, Aurelius Capital Master, another hedge fund, filed a lawsuit in 2019 claiming that there was a methodological change in calculation of GDP-linked warrants and Argentina did not pay as much as it should have paid. The first dispute ended in November 2018 when the case was dismissed. When it comes to the second one, Aurelius demands compensation of \$83.7 million and the case has not been closed yet (Guzman, 2016).

### **3.4 Post-default macroeconomic features of Argentina**

For the most part of 2002, economic growth in Argentina stagnated and unemployment reached almost 30 percent. Negative impact of the peso devaluation resulted in so high prices of food, that more than a half of Argentine population found itself below poverty line. Savings were frozen and expenditures were poor. The only positive sign was increased domestic production that managed to meet local demand. It was domestic demand that pushed economic recovery until mid-2004. The demand was created by 80

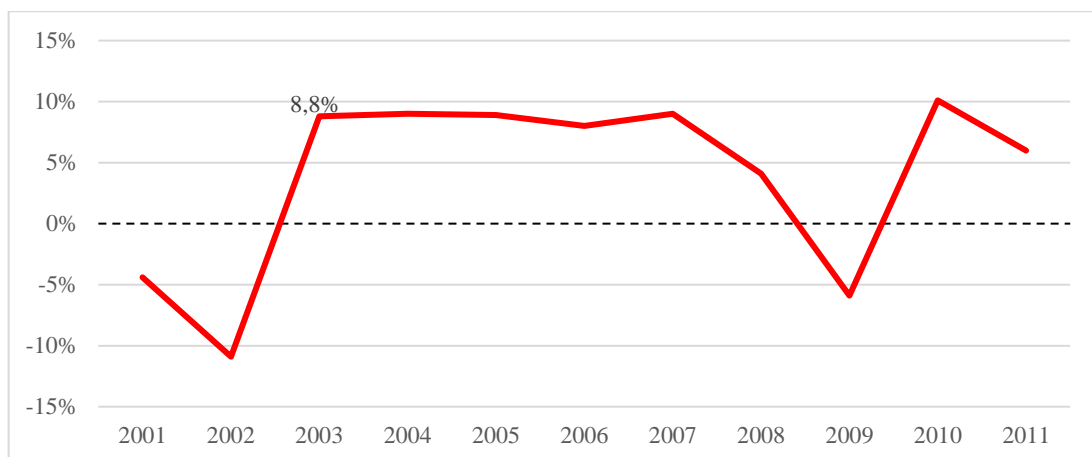
percent of Argentine citizens living and working in cities and towns. Since many imported goods were not available, and export was weak, private sector started producing for domestic demand once prices stabilized. Depreciation of domestic currency led to growth in employment which improved private consumption, generated more jobs and increased income. Already a year after the crisis, conditions improved. Substantial increase in commodity prices had positive effect on trade, inflation stabilized, and GDP growth quickly recovered (see Figure 19) to reach annual rates of 8.8 per cent in 2003 and 9 per cent and 9.2 per cent in 2004 and 2005, respectively. At the end of 2002, real wages showed signs of increase and inflation dropped below 1 percent (see Figure 18). Growing profits of private companies enabled them to increase investments by 40 percent which contributed to 55-percent growth of GDP. Except for outstanding debt, overall situation seemed to be getting better. Between 2003 and 2005, GDP grew on average by 9 percent. The biggest contributor to the growth was financial sector, construction and manufacturing. Especially, manufacturing grew rapidly creating 5 million jobs from 2003 to 2013, mostly supported by demand from regional markets (i.e., Brazilian demand for Argentine automobiles). During the same period, unemployment fell by 19 percent. By 2012, number of citizens below poverty line dropped to 6.5 percent, as well. However, growth in agriculture dropped between 2005 and 2006 by 10 percent. On the other hand, due to consumer demand investments in advertising rose by 26 percent. It was mostly generated by multinational companies like Danone, Johnson & Johnson, Unilever or Proctor & Gamble. By 2006, the level of investments grew to be highest in last 26 years as its growth increased twice as much as GDP itself. High investments generated high consumption and demand pushed economic growth to 8.5 percent in 2007. In the period between 2003 and 2012, Argentine economy grew by around 7 percent. The only reason why it did not reach two-digit level was economic crisis in 2009 and economic slowdown in 2012 when growth amounted to 0.8 percent and 1.9 percent respectively. Between 2003 and 2013 the government nationalised some of the privatised companies in 1990s like postal service, water supply network, oil company and pension system. After 2009, two income policies were implemented to boost demand. First, the government started supporting mothers of underage children and, second, citizens older than 65 years became recipients of monthly income even if they had not contributed to the pension system in the past. Also, trade unions and employers improved wage negotiation system making real wages grow at the highest rate in Latin America between 2005 and 2011. (Cohen, 2011; Olivera & Lazzarini, 2014; Sturzenegger & Zettelmeyer, 2007).

Figure 18. Monthly inflation rate in CPI



Adapted from BCRA (2022)

Figure 19. Real GDP growth after 2001 default



Adapted from World Bank (2022).

Beside domestic demand, external conditions also helped Argentina to grow. The country experienced increased demand for its primary products (especially soy bean) from China that became a member of multilateral trade system, and therefore exploited better trade conditions. At the same time, primary commodities prices rose worldwide and Argentina increased its international and the central bank reserves. Thanks to favourable external conditions Argentina was able to repay the IMF in 2005 and together with growing domestic demand and improved tax collections, 2005 and 2010 restructurings were possible. Even economic crisis in 2008 did not disrupt Argentine economy drastically. Capital outflow did not hit balance of payments because in 2009 Argentina's trade balance recorded surplus of \$16.6 billion (see Figure 20) and foreign reserves in the central bank accumulated to \$47 billion. Therefore, the government did not have to adjust to external conditions. Moreover, gradual devaluation of the peso even during increasing commodity prices helped the country to keep its exchange rate competitive. However,

rapid fall in international demand reduced manufacturing production (automobiles, iron and steel) and between 2008 and 2009 Argentina’s export dropped by 23 percent. This number would have been lower, however, if Argentina had not experienced severe drought that affected its agriculture. During the same period, unemployment rose only by 1 percent. To tackle negative effects of the crisis, the government increased its expenditures to help manufacturing companies save jobs, enacted law to increase pensions three time a year and invested in infrastructure. Consequently, in 2010 and 2011 average economic growth reached 8 percent again. However, even after substantial debt relief after the exchange, Argentina was left with debt at 80 per cent of GDP, bilateral official debt still in default and considerable number of holdouts. (Olivera & Lazzarini, 2014; Sturzenegger & Zettelmeyer, 2007).

Figure 20. Trade balance of goods and services (in billion \$)



Adapted from WITS (2022a); WITS (2022b).

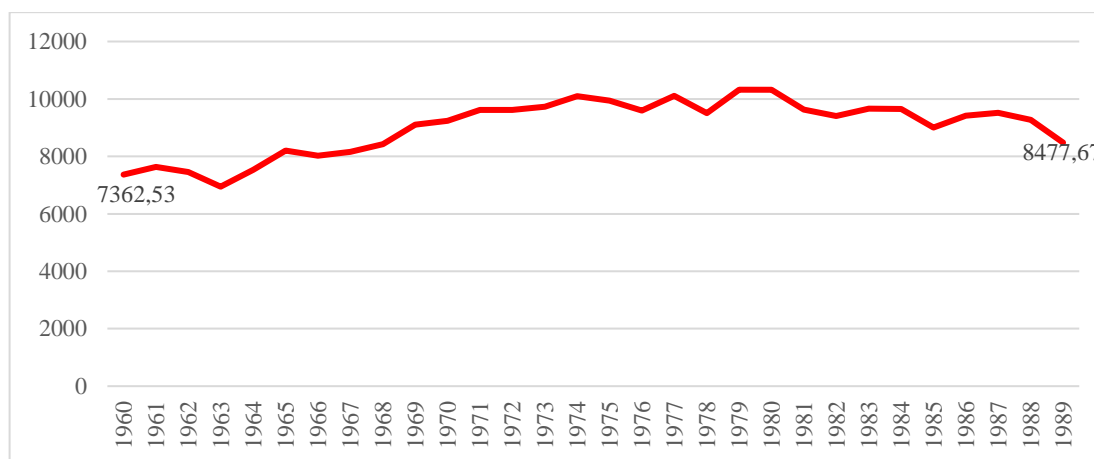
**3.5 Common characteristics and differences between the two defaults**

To compare the 1980s defaults with the 2001 default, Table 7 presents five elements that clarify in what ways Argentine defaults differ. The elements are primary debt instruments, the amount of debt that Argentina defaulted on, external and internal events that preceded defaults, how long restructurings took, and the IMF’s involvement in restructuring processes. Most of these elements were already discussed in previous chapters. Additionally, what was not mentioned, is how differently Argentine external debt accumulated before both defaults.

In 1970s, Argentina experienced a fight for power between two divergent regimes. On one hand, liberals opened to international cooperation and trade, on the other hand national populist promoting autonomous development (Dornbusch & de Pablo, 1989). As seen in the Table 5, between 1979 and 1986 Argentina’s current account surplus did not match service of its interests on debt. This gap had to be financed somehow. The fact that

accumulated amount of current account deficit from 1983 to 1986 represents \$8.45 billion, and that debt increased during the same period by \$8.46 billion suggests that the deficit was financed by foreign debt. However, there is no source to confirm that. Interestingly, between 1979 and 1981, when most of the foreign debt was accumulated, the real interest rates were negative. These favourable conditions contributed to the accumulation of external debt in Argentina. But when the interest rates rose and trade deteriorated, repayment of the debt became a problem. During the time such negative conditions lasted, the real interest rate by 1986 accumulated to 152.5 per cent. If considered a current account, surplus between 1981 and 1983 reached \$4.66 billion and between 1984 and 1986 \$8.97 billion which is a 92 per cent increase. Despite that together with rescheduling efforts, Argentina could not cope with the rate of external debt accumulation (Rodriguez, 1990). During the 1980s the Argentine external debt rose to almost 100 per cent of GDP (\$66 billion). In terms of GDP per capita, the 1989 level is similar to that of 1960 which basically signalizes that the country did not record any growth during this period (Figure 21). After the Second World War Argentina enjoyed 30-year expansion with annual growth of 1.7 per cent. The level of per-capita GDP stagnated and started declining in 1980 and by 1985 it dropped to -1.7 per cent. By 1988 it fell by about 20 per cent while the average annual inflation rate reached 349 per cent. In terms of standard of living, in the beginning of 20<sup>th</sup> century, Argentina was at the level of the United States. Fifty years later Argentina's standard of living was 41 per cent of the U.S. one, and by 1985 it was only 30 per cent. (Dornbusch & de Pablo, 1989; Rodriguez, 1991).

*Figure 21. GDP per capita (in 2010 U.S. dollars)*

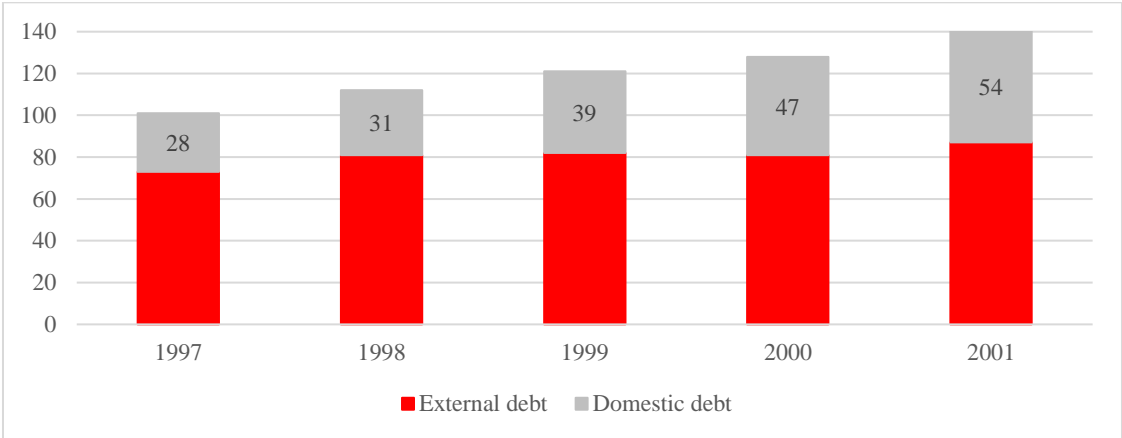


*Adapted from FRED (2022).*

When it comes to debt accumulation in 1990s, after the Brady Plan, Argentine debt was not composed of loans from international banking system anymore. Sovereign medium- and long-term bonds became primary source of funds. Creditors were unknown bondholders and most of them were domestic. However, some part of sovereign debt was contracted with international banking institutions like the World Bank or the IMF. For

example, as of 2001, almost 68 per cent of public debt consisted of bonds, 24 per cent consisted of loans from international organisations and only 3 per cent from official bilateral creditors like the Paris Club. Interestingly, since the public debt grew by around 40 per cent between 1997 and 2001, 64 per cent of it was contracted domestically and in dollars (see Figure 22). Argentine debt grew more in the 1990s than in the previous decade, even though, its economy grew by 15 per cent and the country recorded significant income from privatisation and 559-percent increase in FDI stock during the decade. As a matter of fact, public debt to GDP ratio was even lower than that of Japan or the EU. One of the problems was Argentina’s debt to export ratio (see Figure 15) which was too high due to high interest rates associated with increasing country risk. Between 1993 and 1999 interest payments as a share of export grew by 18 percent. Moreover, substantial inflow of funds from the IMF and reduced capital inflow caused by the Russian crisis contributed to the debt servicing problem. All these external factors combined with increasing domestic debt to cover gap created by falling tax revenues and late abandonment of the Convertibility regime led the country to default. Actually, many studies refer to the convertibility as a factor that contributed to the default. Even though, Argentina benefited from the regime initially, from the long-term perspective it hurt its competitiveness. Argentine peso was not pegged to the right currency as only 10 percent of Argentina’s export goes to the USA. More significant number goes to Europe so when the dollar appreciated against the euro, Argentina’s trade was negatively affected. Secondly, the U.S. economy in the late 1990s grew so fast that restrictive monetary policy had to be implemented. On the contrary, Argentina was experiencing recession due to external shocks and needed expansionary policies. (Lischinsky, 2003; Jonas, 2002).

Figure 22. Composition of public debt 1997 - September 2001 (in billion \$)



Adapted from Lischinsky (2003).

Table 7. Comparison of certain elements of Argentine defaults

|                          | 1982  | 1989   | 2001   |
|--------------------------|---|--|--|
| Primary debt instrument  | Bank loans  |  | Sovereign bonds  |
| Amount of defaulted debt | \$45 billion  | \$56 billion   | \$102 billion  |
| Causes of default        | <p>External:</p> <ul style="list-style-type: none"> <li>• 1<sup>st</sup> oil shock</li> <li>• The Volcker shock</li> <li>• Recession in developed countries</li> <li>• U.S. dollar appreciation</li> </ul> <p>Internal:</p> <ul style="list-style-type: none"> <li>• Rapid money creation</li> <li>• Inflation</li> <li>• Loss of international competitiveness</li> <li>• Balance of payments deficit</li> <li>• The Falklands war</li> <li>• Political instability</li> </ul> | <p>External:</p> <ul style="list-style-type: none"> <li>• No access to foreign capital</li> </ul> <p>Internal:</p> <ul style="list-style-type: none"> <li>• Hyperinflation</li> <li>• Capital outflow</li> <li>• Low tax revenues</li> <li>• Deposits withdrawals</li> </ul> | <p>External:</p> <ul style="list-style-type: none"> <li>• Rising interest rates</li> <li>• Anti-inflationary policies in the U.S.</li> <li>• Emerging countries defaults</li> <li>• Devaluation of Brazilian real</li> <li>• Global economic slowdown</li> </ul> <p>Internal:</p> <ul style="list-style-type: none"> <li>• Insufficient domestic savings</li> <li>• Fiscal reforms</li> <li>• The Convertibility regime</li> </ul> |
| Time to restructure      | 10 years  | 3 years  | 9 years<br>(15 years including holdouts)   |
| Restructuring process    | Led by the IMF as a mediator  |  | Take-it-or-leave-it approach   |

Source: Own work

#### 4 DEBT SUSTAINABILITY ANALYSIS OF ARGENTINA

Since this Master's thesis is focused on two specific external debt defaults that Argentina experienced in the late 20<sup>th</sup> century, the analysis in this section is aimed to examine the country's debt sustainability in this point of time as well. However, due to lack of data and different natures of the two defaults as described in Table 7, the debt sustainability analysis explores Argentina's macroeconomic situation at the doorstep of 2001 default.

There are two debt sustainability analyses conducted – the first one is calculated in the beginning of recession that hit emerging markets in 1998, the second one in 2001 when the recession was at its peak. This way government's economic decisions can be emphasized and reviewed better.

#### 4.1 Research method

This debt sustainability analysis follows the IMF's guideline explained in subchapter 2.3. Therefore, the analysis is divided into two parts. In the first part, baseline scenario is projected, and stress tests need to be conducted. In order to do that, the evolution of debt-to-GDP ratio is based on following logic:

$$D_t = D_{t-1} * (1 + i_t) - PB_t \quad (1)$$

Where  $D_t$  is nominal debt stock in Argentine pesos in current year;  $D_{t-1}$  is nominal debt stock in Argentine pesos in the past;  $i_t$  refers to paid interest in current year and  $PB_t$  is primary balance in current year.

Considering inflation rate in current year  $\pi_t$  and decomposition of nominal interest rate  $i_t$  to real interest rate  $r_t$  in current year, equation resolves to:

$$D_t = D_{t-1} * (1 + r_t) * (1 + \pi_t) - PB_t \quad (2)$$

Dividing by nominal GDP in current year and nominal GDP in the past year increased by current year growth rate  $g_t$  and inflation rate  $\pi_t$  yields:

$$\frac{D_t}{GDP_t} = \frac{D_{t-1} * (1 + r_t) * (1 + \pi_t)}{GDP_{t-1} * (1 + g_t) * (1 + \pi_t)} - \frac{PB_t}{GDP_t} \quad (3)$$

Showing lower case letters as proportions to GDP gives:

$$d_t = d_{t-1} * \left( \frac{1 + r_t}{1 + g_t} \right) - pb_t \quad (4)$$

The equation of current year debt-to-GDP ratio can be further rearranged to:

$$d_t = d_{t-1} * \left( 1 + \frac{r_t - g_t}{1 + g_t} \right) - pb_t \quad (5)$$

To determine the debt-to-GDP ratio in any given year  $d_{t+N}$ , equation 5 can be generalized considering constant real interest rate  $r$ , growth rate  $g$  and primary balance  $pb$ :

$$d_{t+N} = d_{t+N-1} * \left( 1 + \frac{r-g}{1+g} \right) - pb \quad (6)$$

If the first part of the analysis clearly shows that debt sustainability is threatened, stabilization measures need to be undertaken. Therefore, the second part focuses on



calculating required permanent primary balance that lowers debt-to-GDP ratio to desired level:

$$pb = \frac{d_t * \left(\frac{1+r}{1+g}\right)^N - d_{t+N}}{\sum_{j=0}^{N-1} \left(\frac{1+r}{1+g}\right)^j} \quad (7)$$

Where  $pb$  is required permanent primary balance and  $d_{t+N}$  is target level of debt-to-GDP ratio in period N.

## 4.2 Data for the empirical work

Debt sustainability for Argentina is assessed by using data on  $D_t$ ,  $i_t$ ,  $r_t$ ,  $\pi_t$ ,  $g_t$ ,  $PB_t$  and  $GDP_t$  for the period of 1989-2001 and can be found in Appendix 13.

$D_t$  is obtained for years 1992 – 2001 from Passport – Euromonitor International’s market research database.

$i_t$  is defined as interest payments in current year divided by debt stock at the end of previous year, where interest payments are obtained for years 1992 – 2001 from the IMF database.

$r_t$  is calculated for years 1993 - 2001 based on the Fisher equation  $r_t = \left(\frac{1+i_t}{1+\pi_t}\right) - 1$ .

$\pi_t$  is obtained for years 1989 - 2001 from the World Bank database.

$g_t$  is obtained for years 1989 – 2001 from the World Bank database.

$PB_t$  is calculated for years 1990 – 2001 as  $PB_t = \text{Government revenue} - (\text{Government expenditures} - \text{Interest payments})$ , where Government revenue and Government expenditures are obtained from the IMF database.

$GDP_t$  is obtained for years 1989 – 2001 from the World Bank database.

## 4.3 Debt sustainability analysis

### 4.3.1 Simplified debt dynamics

In the beginning of debt dynamics assessment, debt-to-GDP ratio in current year is determined using Equation 5:

$$d_t = d_{t-1} * \left(1 + \frac{r_t - g_t}{1 + g_t}\right) - pb_t \quad (5)$$

Since there are two debt sustainability analyses conducted in this thesis, current year for the analysis conducted in the beginning of the recession refers to 1998 (Analysis 1); while current year at the peak of the recession is meant to be 2001 (Analysis 2). The result of Equation 5 after calculating for debt-to-GDP ratio in 1998 equals to 34.41%. In case of debt-to-GDP ratio in 2001 it is 49.18%. These debt-to-GDP ratios are then used in Equation 6 as  $d_{t+N-1}$  forming baseline scenario that projects debt-to-GDP evolution in the next 5 years because Argentina is considered a market-access country. For the first analysis these years are 1999 – 2003; the second analysis projects debt-to-GDP ratio for years 2002 – 2006.

$$d_{t+N} = d_{t+N-1} * \left(1 + \frac{r-g}{1+g}\right) - pb \quad (6)$$

Based on the Equation 6, 5-year projections of debt-to-GDP ratios for both analysis yields results presented in Table 8 and 9.

Table 8. Baseline scenario, Analysis 1

|      | <b>Analysis 1</b> |
|------|-------------------|
| 1999 | 33.92%            |
| 2000 | 33.46%            |
| 2001 | 32.98%            |
| 2002 | 32.46%            |
| 2003 | 31.92%            |

Source: Own work

Table 9. Baseline scenario, Analysis 2

|      | <b>Analysis 2</b> |
|------|-------------------|
| 2002 | 52.09%            |
| 2003 | 57.61%            |
| 2004 | 62.75%            |
| 2005 | 68.60%            |
| 2006 | 75.26%            |

Source: Own work

The next step is to compare baseline projections of the debt-to-GDP ratio to its evolution in different scenarios by implementing shocks to the debt dynamics components. The stress testing in these analyses consists of one alternative scenario. This thesis leans only on the first of the two alternative scenarios mentioned by the IMF because it sufficiently shows how assumptions for the future differ from historical macroeconomic experience and whether policy actions are satisfactory. Therefore, Equation 6 is then used for calculating alternative scenario as well, because  $r$ ,  $g$  and  $pb$  are deemed to be constant representing their 10-year historical averages. In the first analysis 10-year averages of  $r$ ,  $g$  and  $pb$  are calculated for years 1989 – 1998. As a result, average real interest rate reaches 4.98%, average growth rate 3.61% and average primary balance-to-GDP yields 1.87%. The second analysis uses average data for years 1992 – 2001. In this case, average real interest rate is 6.04%, average growth rate 2.80% and average primary balance-to-GDP reaches 2.29%. After using these numbers in Equation 6, alternative scenarios are formed. Results are shown in Table 10 and 11.

Table 10. Alternative scenario, Analysis 1

|      | <b>Analysis 1</b> |
|------|-------------------|
| 1999 | 32.99%            |
| 2000 | 31.55%            |
| 2001 | 30.10%            |
| 2002 | 28.62%            |
| 2003 | 27.13%            |

Source: Own work

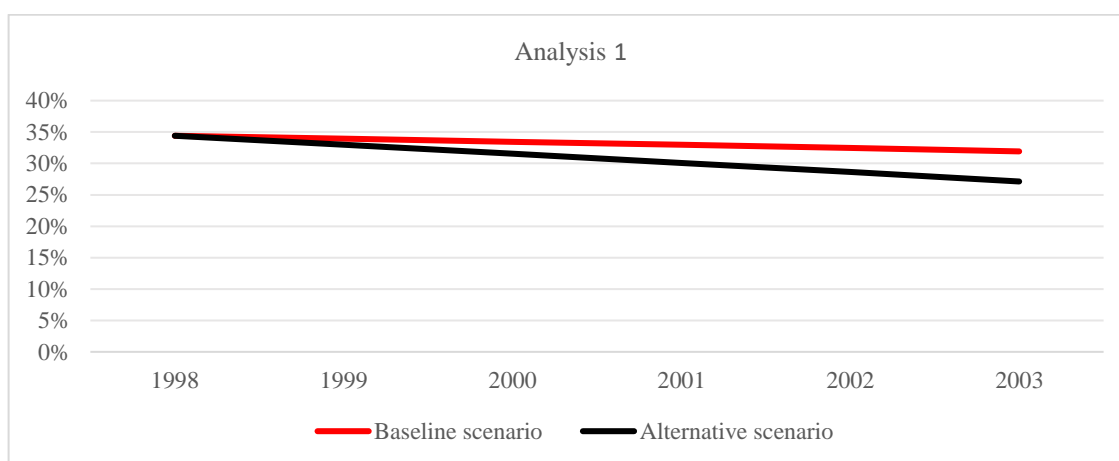
Table 11. Alternative scenario, Analysis 2

|      | <b>Analysis 2</b> |
|------|-------------------|
| 2002 | 48.43%            |
| 2003 | 47.67%            |
| 2004 | 46.88%            |
| 2005 | 46.07%            |
| 2006 | 45.23%            |

Source: Own work

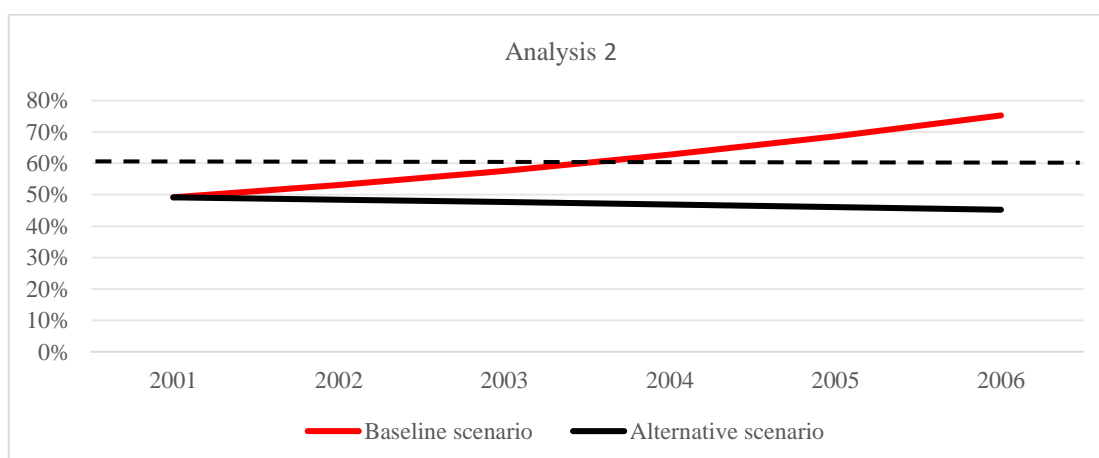
Finally, debt-to-GDP ratios calculated in baseline scenario and alternative scenario are compared to debt threshold defined by the IMF at 60%.

Figure 23. Projected debt-to-GDP ratio, 1999 - 2003



Source: Own work

Figure 24. Projected debt-to-GDP ratio, 2002 - 2006



Source: Own work

### 4.3.2 Required permanent primary balance

Projected debt-to-GDP ratio that exceeds 60% threshold threatens debt sustainability. To stabilize debt-to-GDP ratio, Equation 7 is used to calculate required permanent primary balance that would keep debt-to-GDP ratio at 60% in projected period N, which is 5 years. Therefore,  $d_{t+N}$  is set to 0.6. Since projected debt-to-GDP exceeds 60% threshold only in Analysis 2, required permanent primary balance is calculated only for this period.

$$pb = \frac{d_t * \left(\frac{1+r}{1+g}\right)^N - d_{t+N}}{\sum_{j=0}^{N-1} \left(\frac{1+r}{1+g}\right)^j} \quad (7)$$

In Equation 7,  $r$ ,  $g$  and  $d$  represent data for year 2001 which is current year in this case. Therefore,  $r$  is 8.96%,  $g$  is -4.41% and  $d$  is 49.18%. Equation 7 then says that if Argentina wants to keep its debt-to-GDP ratio at 60% in the next 5 years, its required permanent primary balance needs to be at 34.63%.

## 4.4 Results

The results for simplified debt dynamics are shown in Figure 23 and 24. The baseline scenario in Analysis 1 projects very slight decrease in the debt-to-GDP ratio during the next 5 years. This is due to the fact that real interest rate in 1998 was higher than growth rate by almost 5%. The level of real interest rate mirrors the consequences of increased interest rates in the USA that fought inflation around that time. As for lower growth rate, social distress in Mexico and devaluation of its currency affected capital inflows and domestic investments negatively. Therefore, Argentine growth was slowed down and could not be boosted by devaluation of the peso. Compared to alternative scenario that takes into account historical averages, baseline scenario is a little bit more pessimistic. That is because the previous 10 years were successful enough for Argentina to reach the difference between real interest rate and growth rate at only slightly above 1%. If the debt-to-GDP ratio in baseline scenario was lower than that in alternative scenario, baseline scenario assumptions would be overoptimistic, and, therefore, non-realistic. Therefore, in all the tests conducted in Analysis 1, the debt-to-GDP ratio is stable well below the debt threshold level of 60% determined by the IMF.

When it comes to the second analysis, the projection path is completely different. The projection of baseline scenario indicates almost 30% increase in debt-to-GDP ratio within the next 5 years. In 2001 the difference between real interest rate and growth rate was more than 13% which drove the debt-to-GDP ratio higher and higher. It was the result of worsening economic situation during the previous 3 years. Interest rate kept rising plus lack of international capital and global slowdown caused a gap between these two indicators. Despite the government efforts, fiscal action did not manage to keep up which led to negative growth rate for 3 years in a row. Too high real interest rate and negative

growth rate significantly changed historical averages and pushed alternative scenario line up by approximately 15%. However, the debt-to-GDP ratio is on very small decline because the difference between historical averages of real interest rate and growth rate is still positive at around 3%. Moreover, the debt-to-GDP ratio managed to stay below baseline scenario which indicates realistic assumptions for the future. As Figure 24 shows, the debt-to-GDP ratio is expected to overcome 60% threshold in 2004 and reach level of 75% two years later. Therefore, in order to keep the debt-to-GDP ratio at stable level of 60%, required permanent primary balance within the next 5 years should be at almost 35%.

#### **4.5 Perspective of Argentina's debt sustainability**

Based on the analysis conducted in previous section, initially Argentina's debt did not pose any risk keeping the level of debt stable below 40% of GDP. Three years later, Argentina faced a serious problem with its debt sustainability. It all may have started with Russian default and high inflation in the USA, but the fundamental issues that accelerated increase in Argentine debt were insufficient domestic savings and external debt accumulated from 1980s that Argentina did not get rid of during thriving years. Consequently, increased interest rates and decreased capital inflow made Argentina's public debt too expensive to service with its own resources. Moreover, the fact that changes in fiscal policy were made almost one and a half year into the recession, Argentina found itself in the point of no return. Not only was the intervention too late, but it also contradicted the situation the country was in. To find resources to service its debt, the government decided to pursue restrictive fiscal policy by cutting its spending and raising taxes, whereas expansionary policy would have been more desirable to tackle economic slowdown. Obviously, the fiscal policy did not work, and public debt would have kept on climbing as the analysis suggests. At this point, the government should try to bring its debt to sustainable level. First assumption would be to change the performance of Argentina's primary balance by implementing significant fiscal reforms. Specifically, a tax reform and a reform of revenues and expenditures of provincial governments that would help achieve sufficient primary surplus. Based on the analysis, this primary surplus would have to reach 35% which would be very difficult for Argentina considering its potential to find resources. Therefore, the second step would be to undergo a substantial debt restructuring to cut interest payments and reduce current account deficit. Also, a stable appreciation of real exchange rate would help to lower Argentina's debt-to-GDP ratio.

## **CONCLUSION**

Since its independence, Argentina has been an unstable country from both political and economic point of view. Throughout its history, this emerging country experienced nine

debt defaults and as much as five of them happened in the last forty years. After a successful pre- and war period, overdependence on export of agricultural products and capital inflow started to be problematic for the country. With foreign capital being redirected to the Wall Street, declining commodity prices and financing the Dirty War Argentina had to cover its needs with bank loans. Increasing interest rates threatened balance of payments that the government tried to solve by the peso devaluation. Moreover, the deficit was financed with the money creation. This eventually led to enormous inflation rates that did not drop significantly despite the government efforts to reduce it. The situation intensified even more when banking crisis occurred in Argentina and debt restructuring was inevitable. With the IMF support and mentorship, Argentina's restructuring process consisted of the London Club negotiations, the Baker Plan and the Brady Plan. Despite restructuring efforts, debt and inflation grew for the next ten years until the Convertibility Plan was introduced. The inflation was finally stabilized giving Argentina room for economic growth. However, the situation on global markets changed with Russian default and raising U.S. inflation which placed Argentina in difficult place once again. When recession hit, the government waited too long to intervene and was not able to avoid another default. This research emphasises how significant it was for the country to not take any actions while it still had a chance to mitigate negative effects of recession. Consequently, debt restructuring took place again, although this time without the IMF intervention. Since the first round of restructuring process in 2005 did not bring desired participation, Argentina had to undergo second round in 2010 where almost all debt was restructured. As for the rest of it, the country has faced numerous litigations from holdout creditors, while some of them still have not been resolved.

In the case of Argentina, it is visible that excessive external debt and fixed exchange rate regime play to the country's disadvantage. Depending on foreign capital to such extent may be very dangerous especially when borrowing only in dollars and in long term. Also, floating exchange rate in Argentina could have prevented the country from overvaluation of the currency and subsequent default. Plus, external shocks like interest rates and foreign trade affect small open economy like Argentina significantly, therefore, floating exchange rate helps the country to adjust to these shocks by regulating prices. This, however, would be applicable if Argentina did not have to fight extremely high inflation rates. To stabilise the situation, the convertibility regime was implemented and, therefore, fixed exchange rate prevailed for the next decade.

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## **APPENDICES**





## **Appendix 1: Povzetek (Summary in Slovene language)**

Po stabilnem obdobju gospodarske rasti po II. svetovni vojni je svetovno gospodarstvo prešlo v fazo pretresov, ki so jo zaznamovali zlom brettonwoodskega sistema, odpoved konvertibilnosti ameriškega dolarja v zlato in šoki cen nafte v sedemdesetih letih prejšnjega stoletja. To je povzročilo notranja (visoka inflacija, brezposelnost) in zunanja neravnovesja (velika neravnotežja v tekočem računu plačilne bilance) po vsem svetu. Cene surovin v razvitih gospodarstvih so se znižale zaradi manjšega povpraševanja, kar je negativno vplivalo na gospodarstva v vzponu, odvisna od izvoza surovin. Več afriških in latinskoameriških držav se je zadolžilo zaradi višjih obrestnih mer v ZDA, ki so se borile proti inflaciji. Zato so bila osemdeseta leta desetletje dolžniške krize, ki se je začela leta 1982 v Mehiki, in se razširila na številne države po vsem svetu (Združeni narodi, 2017). V samo 27 letih je bilo kar 84 držav plačilno nezmožnih (Yue, 2005).

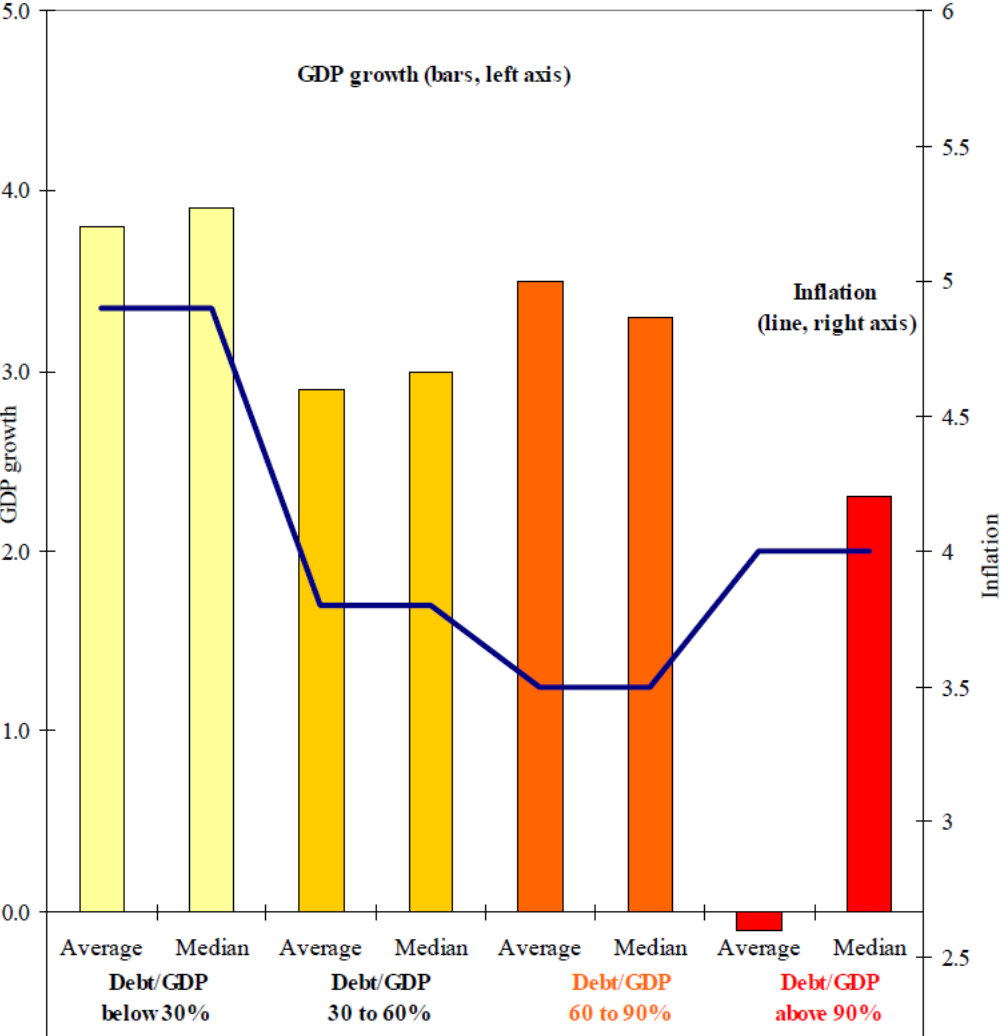
Pomembno vlogo v zgodovini zadolženosti držav v razvoju so imele države Latinske Amerike. Mehika, Čile, Argentina in Brazilija so v obdobju med letoma 1870 in 2012 kar 14 krat razglasile plačilno nesposobnost in so več kot petino tega obdobja preživele v krizah državnega dolga (Boonman, 2013). Sama Argentina je v obdobju zadnjih desetletij bankrotirala trikrat in to pot posledica kopičenja dolga v času vojaške diktature od 1976 do 1983. V samo 7 letih se je zunanji dolg države povečal za 40 milijard dolarjev. Ogromni zneski bančnih posojil evropskih in ameriških bank za financiranje primanjkljaja tekočega računa in državnega primanjkljaja so privedli do dolžniške krize, potem ko so obrestne mere skokovito narasle zaradi naftnih šokov (Öncü, 2014). Leta 1980 je propadla ena največjih argentinskih zasebnih bank, čemur je v naslednjih dveh letih sledil propad še 71 finančnih institucij (IMF, 1991). Od tedaj dalje in skozi celotno obdobje osemdesetih let prejšnjega stoletja je Argentina zamujala z odplačevanjem posojil tujim bankam, to pa je bilo tudi obdobje naraščajoče stopnje brezposelnosti, padanja plač, počasne gospodarske rasti in hiperinflacije. Obdobje neplačevanja se je končalo leta 1992 z Bradyjevim načrt, kateri je spremenil bančna posojila, ki so bila prevladujoča oblika zadolževanja do osemdesetih let prejšnjega stoletja, v državne obveznice (Öncü, 2014; Miles, 2000).

Sledili so režim konvertibilnosti in korenite reforme za boj proti visoki inflaciji. (Öncü, 2014; Frenkel & Rapetti, 2007). Poleg tega je vlada financirala svoje proračunske primanjkljaje z zadolževanjem v dolarjih in drugih tujih valutah, medtem ko je zbirala prihodke v pesosih. Šibka fiskalna in politična disciplina ter zmanjšanje izvoza so pripeljali do gospodarske upočasnitve in Argentina je leta 2001 ponovno prišla v dolžniško krizo. Posledično je Argentina začela prestrukturirati svoj dolg v skladu z dvema sporazumoma o prestrukturiranju dolga v letih 2005 in 2010 (Georgescu, 2015).

**Appendix 2: Government debt and GDP growth in selected developed countries**

Reinhart & Rogoff (2010) looked at how external debt affects inflation and economic growth in 20 developed and 24 developing countries, respectively. Developed countries experienced, in the short run, significantly lower GDP growth that occurred with external debt levels above 90%, which is also visible in Figure 1. However, inflation rates were not affected in such countries. The results for the long run are similar with GDP growth being slightly higher when external debt is above 90%.

*Figure 1. Government debt and GDP growth in selected developed countries*

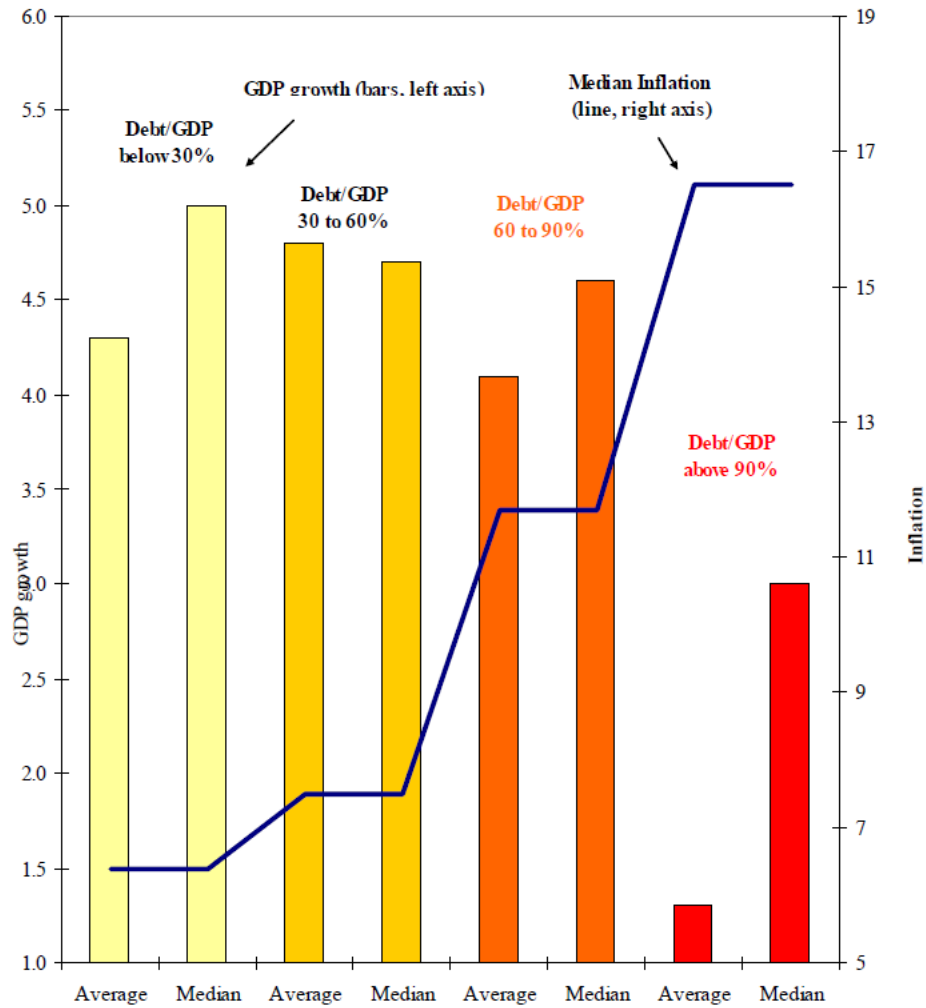


*Source: Reinhart & Rogoff (2010).*

### Appendix 3: Government debt and GDP growth in selected developing countries

Surprisingly, the relationship between debt and growth are similar for the developing countries, but when we look at the inflation in Figure 2, it shows that the inflation in developing countries is strongly affected by government debt (Reinhart & Rogoff, 2010).

Figure 2. Government debt and GDP growth in selected developing countries

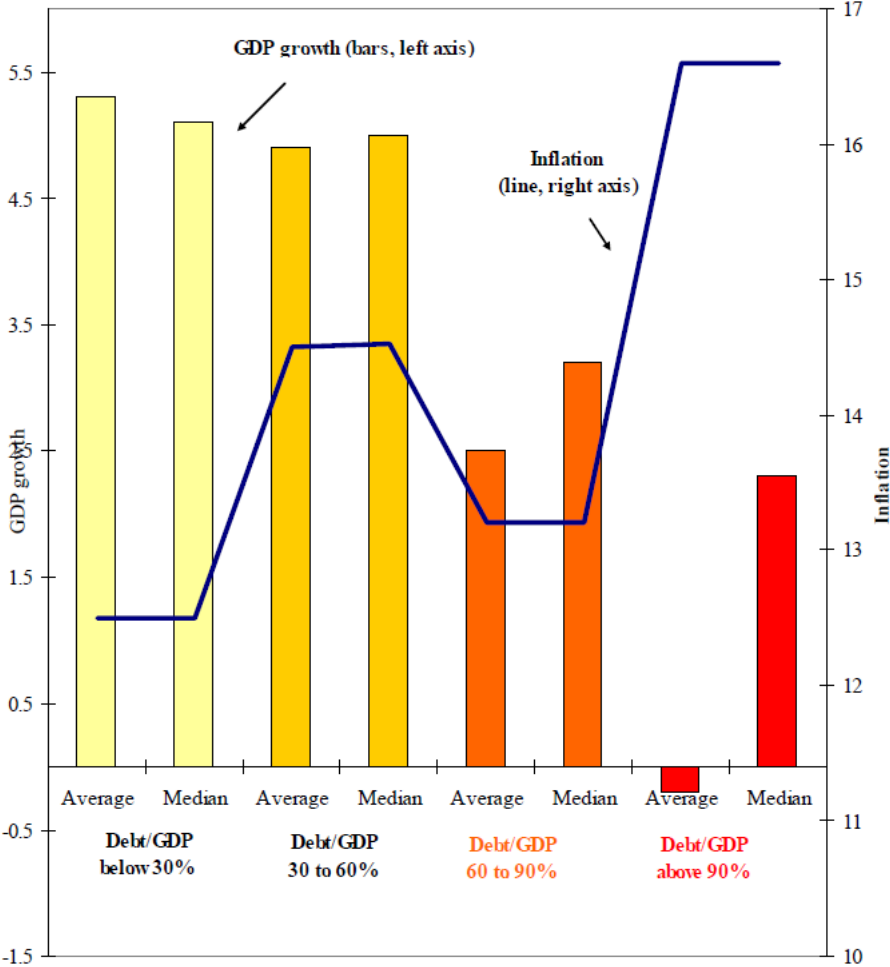


Source: Reinhart & Rogoff (2010).

**Appendix 4: Growth and inflation thresholds for external debt in developing countries**

Thanks to the data used in this study, it is possible to set certain thresholds when external debt brings significantly lower growth and higher inflation in developing countries. As seen in Figure 3, external debt becomes a problem for economic growth when debt-to-GDP ratio exceeds 60%. For the debt to threaten the inflation, its levels need to be above 90%. (Reinhart & Rogoff, 2010)

*Figure 3. Growth and inflation thresholds for external debt in developing countries*



*Source: Reinhart & Rogoff (2010).*

## Appendix 5: Paris Club creditors in selected restructurings

*Table 1. Paris Club creditors in selected restructurings*

| Country     | Agreement Years        | Participating Creditor Governments  |
|-------------|------------------------|---|
| Afghanistan | 2006, 2007, 2010       | Germany, Russian Federation, USA  |
| Algeria     | 1994, 1995             | Australia, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK, USA                       |
| Brazil      | 1992                   | Austria, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, UK, USA   |
| Iraq        | 2004                   | Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Korea (Rep. of), Netherlands, Russian Fed., Spain, Sweden, Switzerland, UK, USA |
| Pakistan    | 1999, 01/2001, 12/2001 | Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Korea (Rep. of), Netherlands, Russian Fed., Spain, Sweden, Switzerland, UK, USA            |
| Russia      | 1999                   | Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Portugal, Spain, Sweden, Switzerland, UK, USA                      |
| Seychelles  | 2009                   | Belgium, Germany, Italy, Japan, Russian Federation, South Africa, Spain, UK   |

*Source: Das, Papaioannou & Trebesch (2012).*

## Appendix 6: Selected BACs in London Club processes

Table 2. Selected BACs in London Club processes

| Country   | Period            | Total Number of Banks (approx.) | Size of Banking Committee | Head of Committee                   | Bank Committee Members (by Country)   |  |                            |  |   |                           |                            |  |
|-----------|-------------------|---------------------------------|---------------------------|-------------------------------------|---|--|----------------------------|--|---|---------------------------|----------------------------|--|
|           |                   |                                 |                           |                                     | US  | Japan  | UK                         | France                                     | Germany   | Switzerland               | Canada                     | Other  |
| Albania   | 1991-1995         | 45                              | 5                         | Creditanstalt-Bankverein (Austria)  |   |  |                            | Credit Lyonnais                            | Berliner Handels- und Frankfurter Bank                          | Union Bank of Switzerland |                            | Banca Nazionale del Lavoro, Creditanstalt-Bankverein     |
| Algeria   | 1990-1992         | 240                             | 8                         | Credit Lyonnais (France)            | Chase Manhattan   | Mitsui-Taiyo Kobe, Long-Term Credit Bank, Industrial Bank of Japan |                            | Credit Lyonnais, Banque Nationale de Paris |   |                           |                            | Arab Banking Corp. Union de Banques Arabes et Francaises |
| Argentina | 1980s debt crisis | 300-350                         | 11                        | Citibank (US)                       | Bank of America, Citibank, Chase Manhattan, Manufacturers Hanover, Morgan Guarantee                               | Bank of Tokyo  | Lloyds Bank                | Credit Lyonnais                            | Dresdner Bank   | Credit Suisse             | Royal Bank of Canada       |  |
| Brazil    | 1980s debt crisis | 750-800                         | 14                        | Citibank (US)                       | Bank of America, Bankers Trust, Chase Manhattan, Chemical Bank, Citibank, Manufacturers Hanover, J.P. Morgan      | Bank of Tokyo  | Lloyds Bank                | Credit Lyonnais                            | Deutsche Bank   | UBS                       | Bank of Montreal           | Arab Banking Corp.                                       |
| Mexico    | 1980s debt crisis | 500                             | 13                        | Citibank (US), Bank of America (US) | Bank of America, Manufacturers Hanover, Morgan Guaranty, Bankers Trust, Chase Manhattan, Chemical Bank, Citibank, | Bank of Tokyo  | Lloyds Bank                | Societe Generale                           | Deutsche Bank   | Swiss Bank                | Bank of Montreal           |  |
| Poland    | 1980s debt crisis | 500                             | 8                         | Creditanstalt-Bankverein (Austria)  | Bank of America and Citibank  |  | Lloyds Bank, Barclays Bank | Banque Nationale de Paris                  | Dresdner Bank of West Germany, Dresdner's Luxembourg subsidiary |                           |                            | Creditanstalt-Bankverein                                 |
| Russia    | 1998-2000         | 2000                            | 12                        | Deutsche Bank (Germany)             | Bank of America   | Bank of Tokyo, Dai-ichi Kangyo Bank, Industrial Bank of Japan      | Midland Bank               | Banque National de Paris, Credit Lyonnais  | Deutsche Bank, Dresdner Bank, Commerzbank                       |                           | Banca Commerciale Italiana | Creditanstalt-Bankverein.                                |

Source: Das, Papaioannou & Trebesch (2012).

## Appendix 7: Selected exchange offer restructurings and their participation rate

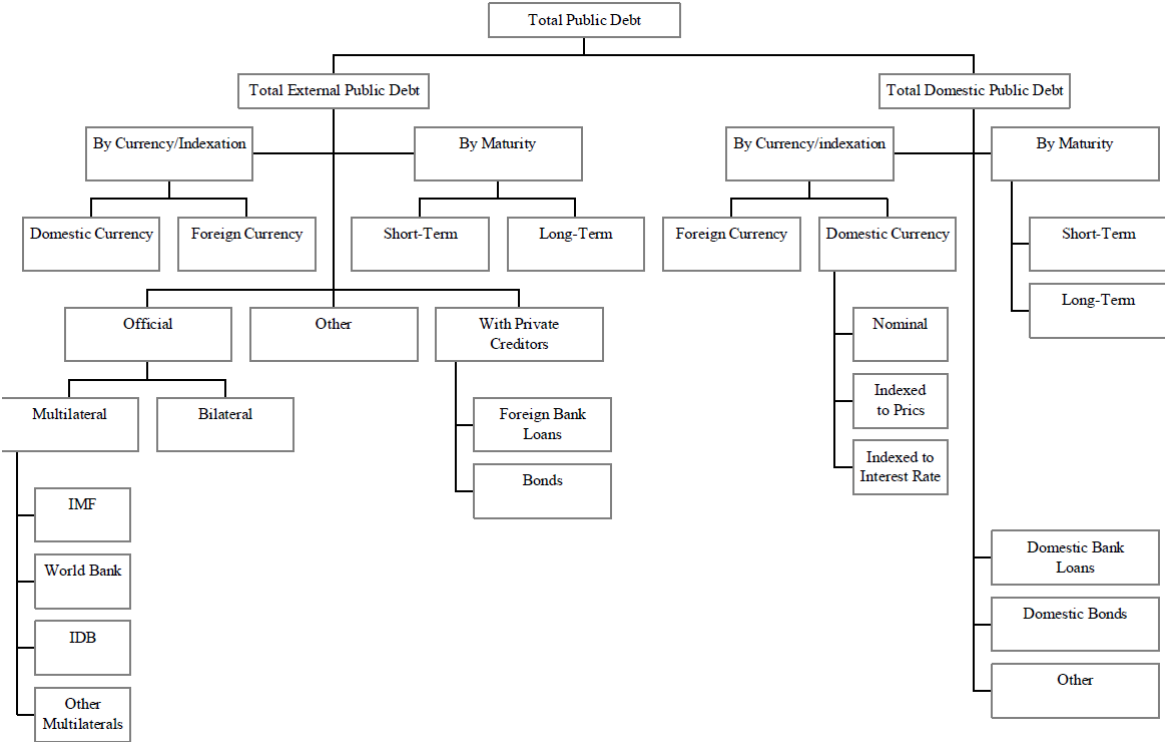
Table 3. Selected exchange offer restructurings and their participation rate

|                    |      | Creditor Structure   | Creditor Representation  | Negotiations with Creditors   | Participation Rate |
|--------------------|------|--|--|---|--------------------|
| Argentina          | 2005 | Very fragmented. Of Argentina's external bonds, 56.5% were held by institutional investors and 43.5% by retail investors. Country distribution: Argentina 38.4%, Italy 15.6%, Switzerland 10.3%, US 9.1%, Germany 5.1%, Japan 3.1%. Approximately 600,000 retail investors affected (450,000 Italians, 35,000 Japanese and 150,000 Germans and Central Europeans)  | Several groups formed. In Dec. 2003 creation of the GCAB, representing about 50% of outstanding foreign private sector debt. No group recognized by government (see footnotes)                                     | No regular negotiations. Some informal contacts in 2002; Some meetings in 2003, 2004, 2005  | 76%                |
| Belize             | 2007 | Rather concentrated. Mostly institutional investors from the region, in particular from Trinidad and Tobago but also from Barbados and Jamaica   | Creditor Committee composed of 13 financial institutions from the Caribbean, representing more than 50% of outstanding debt (see footnotes)  | The government announced a preemptive restructuring and asked creditors to form a committee in August of 2006. Until early 2007 extensive interactions with creditors   | 98%                |
| Dominica           | 2004 | Very dispersed creditor group with many small bondholders. The majority of bonds were held by domestic and Caribbean creditors, in particular the Dominica Social Security and the National Bank of Dominica who account for over 50% of eligible debt. Only a handful of external private creditors, including the Kuwait Fund for Arab Economic Development, the Royal Bank of Trinidad and Tobago (RBTT) and the Exim bank from Taiwan Province of China, who together held approximately 20% of eligible debt. | No committee formed  | Numerous contacts (1-on-1 and towards groups). Roadshow in Jan 2004 in Barbados, St. Lucia, and Trinidad and Tobago to meet with the wide spectrum of creditors (including domestic).   | 72%                |
| Dominican Republic | 2005 | Bonds were widely held by institutional investors exposed to emerging market countries, in particular in New York and London.  | Unsuccessful. Attempt to form a committee failed due to lack of support (less than 25% of outstanding debt) and because authorities refused to recognize it  | Frequent contacts with bondholders (1 on 1 and towards groups). The authorities held a roadshow with their advisors in New York and London during December 2004, conducting over a dozen meetings with investors that held approximately 60 percent of outstanding principal.                         | 97%                |
| Ecuador            | 2000 | Bonds were widely held by institutional investors, in particular in New York and London.   | No recognized bondholder committee. A minority of creditors form the Ecuador Creditors Advisory Group, headed by Gramercy Advisors, which, however, had limited influence and was not recognized by the government | The authorities established a so-called Consultative Group, which consisted of eight representative institutional bondholders with large exposures. However, only two meetings were held and authorities resisted calls for full-fledged negotiations or the establishment of a bondholder committee. | 98%                |

Source: Das, Papaioannou & Trebesch (2012).

**Appendix 8: Classification of total external debt**

Figure 4. Classification of total public debt



*Source: Cowan, Levy-Yeyati, Panizza & Sturzenegger (2006).*



**Appendix 9: Share of defaulters in presidential and parliamentary democracies**

*Table 4. Share of defaulters in presidential and parliamentary democracies 1970 - 2000*

|               | Defaulters  | Compliers   |
|---------------|---|---|
| Presidential  | 81.8%<br>Morocco 85-88<br>Philippines 86-89<br>Costa Rica 87-90<br>Bolivia 88-91<br>Panama 89-92<br>Jordan 91-94<br>Albania 92-95<br>Bulgaria 92-95<br>Russia 99-02 | 18.1%<br>South Korea 85-88<br>Egypt 87-90                                   |
| Parliamentary | 20%<br>Jamaica 90-93  | 80%<br>Botswana 76-79<br>Malaysia 86-89<br>Papua NG 92-95<br>Thailand 98-01 |

*Source: Kohlscheen (2007).*

## Appendix 10: The Paris Club members

*Table 5. The Paris Club members*

| <b>Permanent members</b> | <b>Ad hoc members</b> |
|--------------------------|-----------------------|
| Australia                | Abu Dhabi             |
| Austria                  | Argentina             |
| Belgium                  | China                 |
| Brazil                   | Czech Republic        |
| Canada                   | India                 |
| Denmark                  | Kuwait                |
| Finland                  | Mexico                |
| France                   | Morocco               |
| Germany                  | New Zealand           |
| Ireland                  | Portugal              |
| Israel                   | Saudi Arabia          |
| Italy                    | South Africa          |
| Japan                    | Trinidad and Tobago   |
| Korea                    | Turkey                |
| Netherlands              |                       |
| Norway                   |                       |
| Russian Federation       |                       |
| Spain                    |                       |
| Sweden                   |                       |
| Switzerland              |                       |
| United Kingdom           |                       |
| United States of America |                       |

*Adapted from Club de Paris (2022).*

## Appendix 11: MSCI Emerging market index allocation

Table 6. MSCI Emerging market index allocation

| Emerging markets |                              |             |
|------------------|------------------------------|-------------|
| Americas         | Europe, Middle East & Africa | Asia        |
| Brazil           | Czech Republic               | China       |
| Chile            | Egypt                        | India       |
| Colombia         | Greece                       | Indonesia   |
| Mexico           | Hungary                      | Korea       |
| Peru             | Poland                       | Malaysia    |
|                  | Qatar                        | Pakistan    |
|                  | Russia                       | Philippines |
|                  | South Africa                 | Taiwan      |
|                  | Turkey                       | Thailand    |
|                  | United Arab Emirates         |             |

*Adapted from HSBC (2018)*

## Appendix 12: International lending cycles in history

Table 7. International lending cycles in history

| Period      | Providers of international capital | Recipients of international capital                                   | Causes of the start of the period   | Causes of the end of the period  | Defaults associated with the period  |
|-------------|------------------------------------|---|---|--|--|
| Early 1820s | The United Kingdom, France         | Latin America, European countries                                     | End of the Napoleonic wars in Europe, newly formed independent Latin American countries |  | Spain, Portugal, Greece, all except seven of Latin American countries        |
| 1830s       |                                    | The USA, Spain, Portugal  | Infrastructure investments - railways, export of commodities                            | Drop in cotton prices reduced export revenues of the U.S. states, outflow of gold, lower prices, higher real debt levels   | No defaults on national level, only southern U.S. states                     |
| 1860-1875   |                                    | Latin America, The USA, European countries, Egypt, the Ottoman Empire |   | Rise of artificial fertilizers reduced guano prices  | Austria, Spain, Egypt, Liberia, all except seven of Latin American countries |
| 1885-1889   |                                    | The USA, Australia Latin America                                      |   | Immediate end of Latin America financing after Argentina's macroeconomic sustainability was endangered which led to a bankruptcy of a London bank that had underwritten its bond | Greece, Portugal, Yugoslavia, all except ten of Latin American countries     |

|           |   |  |  |  |  |
|-----------|---|--|--|--|--|
| 1900-1914 | The United Kingdom, France, the USA, the Netherlands, Germany | Australia, South Africa, Canada, Russia, Balkan countries, Latin America, the Ottoman Empire |  | World War I  | Austria, Bulgaria, Romania, Russia, Turkey, Liberia, all except eleven of Latin American countries   |
| 1920s     | The USA, the United Kingdom                                   | Germany, Australia, Japan, Canada, Cuba, Brazil, Argentina                                   | The end of the WWI, rebuilding Germany   | Fall of commodity prices, the Great Depression in the USA  | Most European countries, all except four of Latin American countries   |
| 1970s     | The USA, western Europe                                       | Latin America, Spain, Romania, Turkey, Yugoslavia, Poland, Indonesia, some African countries | Decolonization and independence of Africa, U.S. bank loans to developing countries after they lost domestic business to corporate debt markets | Overlending triggered higher interest rates and debt crisis in the USA                             | Poland, Romania, Yugoslavia, Turkey, Jordan, Philippines, Pakistan, Vietnam, most African countries, all except five of Latin American countries |
| 1990s     | The USA, western Europe, Japan                                | former Communist countries in eastern Europe, Asian countries, Latin America                 | The collapse of Communism, economic reforms of debtor countries predicted economic growth  | Low oil prices complicated Russian debt servicing, increased borrowing costs in emerging countries | Moldova, Russia, Ukraine, Argentina, Dominica, Ecuador, Grenada, Paraguay, Uruguay, Indonesia, Pakistan, few African countries                   |

*Adapted from Sturzenegger & Zettelmeyer (2007).*

### Appendix 13: Data used in simplified debt dynamics calculations

Table 7. Data used in simplified debt dynamics calculations

|      | General government revenue (bil. ARS) | General government expenditures (bil. ARS) | Interest payment (bil. ARS) | Total public debt (bil. ARS) | Nominal interest rate (%) | Primary balance (bil. ARS) | Inflation rate (%) | Real interest rate (%) | GDP (bil. ARS) | Growth rate (%) |
|------|---------------------------------------|--|-----------------------------|------------------------------|---------------------------|----------------------------|--------------------|------------------------|----------------|-----------------|
| 1997 | 21,43                                 | 20,66                                      | 5,60                        | 103,72                       | 5,66                      | 6,37                       | -0,5               | 6,15                   | 292,86         | 8,11            |
| 1998 | 22,82                                 | 21,96                                      | 6,51                        | 114,13                       | 6,28                      | 7,37                       | -1,70              | 8,12                   | 298,95         | 3,85            |
| 1999 | 22,52                                 | 24,10                                      | 8,13                        | 123,37                       | 7,12                      | 6,55                       | -1,80              | 9,12                   | 283,52         | -3,39           |
| 2000 | 22,73                                 | 24,78                                      | 9,57                        | 129,75                       | 7,76                      | 7,52                       | 1,00               | 6,65                   | 284,20         | -0,79           |
| 2001 | 21,55                                 | 23,94                                      | 10,08                       | 144,22                       | 7,77                      | 7,70                       | -1,10              | 8,96                   | 268,70         | -4,41           |

[1] Nominal interest rate is defined as interest payments divided by debt stock at the end of previous year.

[2] Primary balance is calculated as a difference between general government revenue and expenditures without interest payments.

[3] The GDP deflator is used as a measure of inflation rate.

[4] Real interest rate calculations are based on the Fisher equation:  $\text{Real Interest Rate} = ((1 + \text{Nominal Interest Rate}) / (1 + \text{Inflation Rate})) - 1$

*Adapted from Passport (2022); IMF (2022); World Bank (2022)*