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before the
New York State Senate
Standing Committee on Banks

April 23, 2010

Hearing on the Argentine Bond Default and its Impact on New York State

Good afternoon Chairman Foley and distinguished members of this Committee. I am Arturo Porzecanski, a United States naturalized citizen and full-time professor of international finance at American University in Washington, DC. In the 28 years from early 1977 until early 2005, I resided year-round in New York City and worked as an international economist on Wall Street. I started out as a junior sovereign-risk analyst at the venerable JP Morgan Bank, and after a dozen years there I went on to serve as the chief economist for emerging markets at several fairly large financial institutions, the last of which was the European bank ABN AMRO. For the record, let me make clear that I have no financial ties to Argentina; in fact, I have never bought or sold any Argentine government securities, and I have never made any investments in that country.

While I was residing in New York and since then, I have published numerous scholarly articles on sovereign debt issues at the intersection of international finance and international financial law, including two in leading law journals. One of these, published in 2005, is entitled “From Rogue Creditors to Rogue Debtors: Implications of Argentina’s Default,” and it has been widely cited, including in court documents.

This testimony will provide evidence of Argentina’s now ample financial capacity to meet its debt obligations governed largely by New York law, and to pay in full the nearly ten billion dollars' worth of judgments entered against it, mainly by the United States District Court for the Southern District of New York.[1]

During my nearly three decades on Wall Street, I gained considerable first-hand experience in case-by-case workouts with sovereigns experiencing debt-servicing difficulties – including Argentina in the 1980s and 1990s. I represented my employers in debt-restructuring negotiations; investigated the nature of cash-flow problems and assessed the chances of policy improvements; exchanged views with experts at the Federal Reserve, International Monetary Fund and World Bank, as well as with others in-country; and advised my employers and/or their institutional-investor clients as to the extent of debt relief that I thought was appropriate under the specific circumstances, and as to the chances that governments would overcome their financial difficulties.

As you are well aware, there is no international bankruptcy court for sovereigns in financial distress, but ever since our federal government and the European powers abandoned "gunboat diplomacy," a set of constructive practices have developed and become standard in international finance. Whether they represent very poor nations with little upside potential or middle-income countries like Argentina with often bright prospects for a quick turnaround, governments in financial distress usually request and obtain debt relief that bears a relation to the scale of their financial problems and possibilities. They realize that it is in their self-interest not to ruin their reputation as borrowers, and jeopardize their future access to the international capital markets, by delaying a resolution of their problem or by imposing heavy losses on their creditors.

Governments are also mindful of the domestic economic, financial and political fallout from a disorderly or protracted default, because their own banks and corporations are

[1] According to The Republic of Argentina prospectus subject to completion dated January 28, 2010, filed with the U.S. Securities and Exchange Commission under Schedule B of the Securities Act of 1933, pp. 11-12, as of January 19, 2010, judgments totaling approximately $8.6 billion in the United States and €155 million in Germany had been entered against Argentina in actions based on its long-standing default on public debt obligations. In addition, as of the same date, eight awards totaling $913 million had been entered against Argentina as a result of arbitrations under the International Centre for Settlement of Investment Disputes (ICSID).

vulnerable to the consequences of a government default.[2] In return for debt relief from private and official creditors, they adopt constructive prior actions to balance their budgets and shore up their external accounts – in order to be able to meet the new debt-service commitments they enter into. Governments usually negotiate these prior actions in parallel with multilateral agencies like the IMF and World Bank that play a useful mediating and supportive role, and they agree to a monitoring function on their part. In sum, the absence of a supranational sovereign bankruptcy mechanism has not delayed, never mind impeded, numerous sovereign workouts that have taken place in recent decades given enlightened, self-interested good will on everyone's part.[3]

However, as I summarize in Figure 1, in the last decade Argentina has broken with tradition – including its own tradition – and has set a troubling precedent that violates every element of customary or best practice in sovereign debt workouts.

Figure 1: Argentina's Conduct vs. Best Practice in Distressed Sovereign Finance

	Best Practice	Argentina
Stop incurring debt when you already are -- and claim to be -- overindebted.	Yes	No
Make a good-faith effort to reach a collaborative agreement with creditors.	Yes	No
Seek debt relief appropriate to the nature of your liquidity/solvency problem.	Yes	No
Treat all private creditors in a comparable manner.	Yes	No
Recognize interest arrears, and treat them preferentially vs. past-due principal.	Yes	No
Make a good-will, up-front cash payment -- especially when you have the cash.	Yes	No
Seek the financial support and endorsement of the multilateral agencies.	Yes	No
Aim for 100% creditor participation.	Yes	No

[2] For the latest discussion of the potential motivations why governments would want to avoid or minimize a default, and on the actual, measurable costs of sovereign default, see Eduardo Borensztein and Ugo Panizza, "The Costs of Sovereign Default," IMF Staff Papers, November 2009, pp. 683-741.
[3] See Arturo C. Porzecanski, "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default," Chicago Journal of International Law, Summer 2005, pp. 311-332.

A series of irresponsible, populist governments in Buenos Aires have blamed foreign investors for the country's problems, refusing to cure what has become by far the largest and, in my view, least justified default the world has ever known. Contrary to standard practice, the authorities have not engaged with the relevant multilateral agencies or negotiated an appropriate debt-restructuring deal with a representative committee of bondholders, commercial bankers or even government lenders.[4]

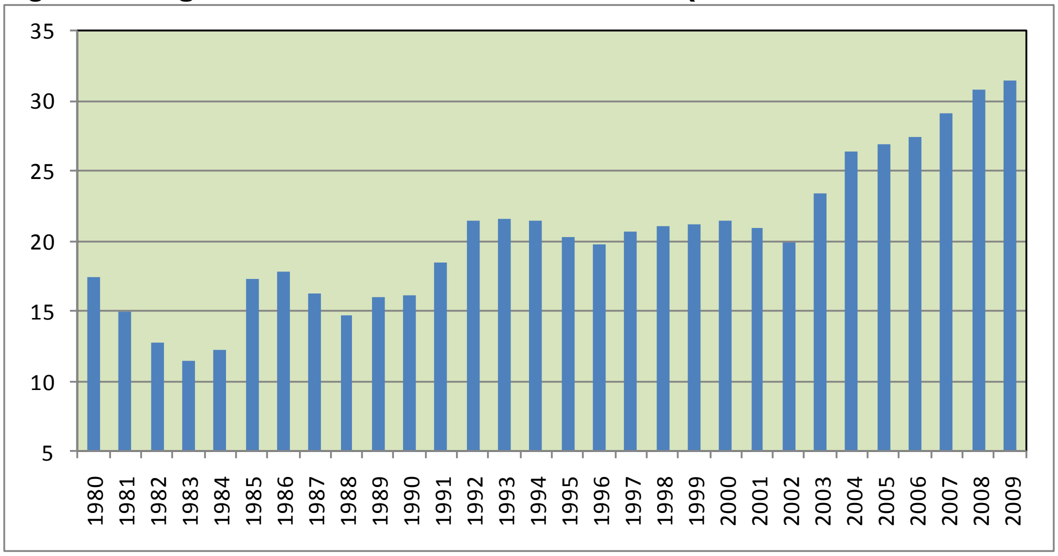
To give but one concrete example, Argentina has treated its official creditors in a highly discriminatory manner. On the one hand, during 2005-2006, and years ahead of schedule, the International Monetary Fund was paid in full the princely sum of $13½ billion. On the other, agencies such as the U.S. Export-Import Bank, and European and other export credit and foreign-aid agencies elsewhere around the world, have not received a dime from Argentina since early 2002 on account of interest or principal due, and are collectively owed $7 billion – most of it (nearly $5½ billion) in arrears.

In the decade since the default, the Argentine economy and in particular its public finances have greatly improved, and yet governmental attitudes toward debt obligations have remained uncompromisingly harsh and downright scornful. Each government in office pleads poverty, but as demonstrated by the following charts prepared solely from official data published by the country's Ministry of Economy, nothing could be further from the truth. To begin with, in contemporary times, the government has never raked in as great a share of the country's Gross Domestic Product (GDP) as in recent years (see Figure 2). This bonanza in genuine revenues (namely, excluding borrowing) is largely the result of booming commodity exports which are taxed directly, plus rapid growth in taxable domestic production, sales and formal employment.[5]

[4] The leading guideline in best practices for sovereign debt workouts is "The Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets," which was agreed upon by a group of sovereign issuers and leaders of private finance in the Fall of 2004, and subsequently welcomed in November 2004 by the Group of 20. It was also welcomed by the Ministers of Finance and Central Bank Governors of the International Monetary and Financial Committee (IMFC) of the Board of Governors of the IMF. The Principles are included, for example, in the Institute of International Finance, "Report on Implementation by the Principles Consultative Group," October 2008, available at www.iif.com/download.php?id=sIEw+cPkyf8=.

[5] For example, the official urban unemployment rate in Argentina has dropped from over 20% in 1Q2003 to 8.4% in 1Q2009; the latest figure is also 8.4% for 4Q2009.

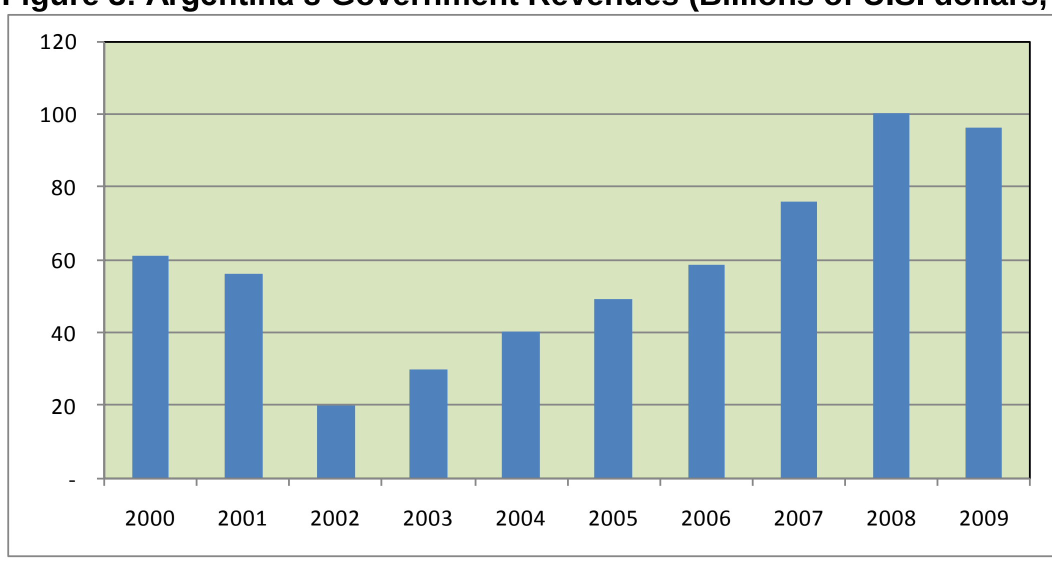
Figure 2: Argentina's Government Revenues (Percent of GDP, 1980-2009)*



*Net of tax rebates and including mandatory pension contributions. *Source: Calculated by the author from data published by Argentina's Ministry of the Economy and Public Finance.*

The revenue windfall is also visible once data in local currency are converted into U.S. dollars, the currency in which more than 40% of the government's debt is presently denominated. Though revenues shrank in 2002 in the wake of the country's major currency devaluation that year, they were well on their way to a full recovery by 2005 (see Figure 3), when the government first demanded that bondholders accept a loss in principal and past-due interest exceeding two-thirds of what they were owed.

Figure 3: Argentina's Government Revenues (Billions of U.S. dollars, 2000-2009)*

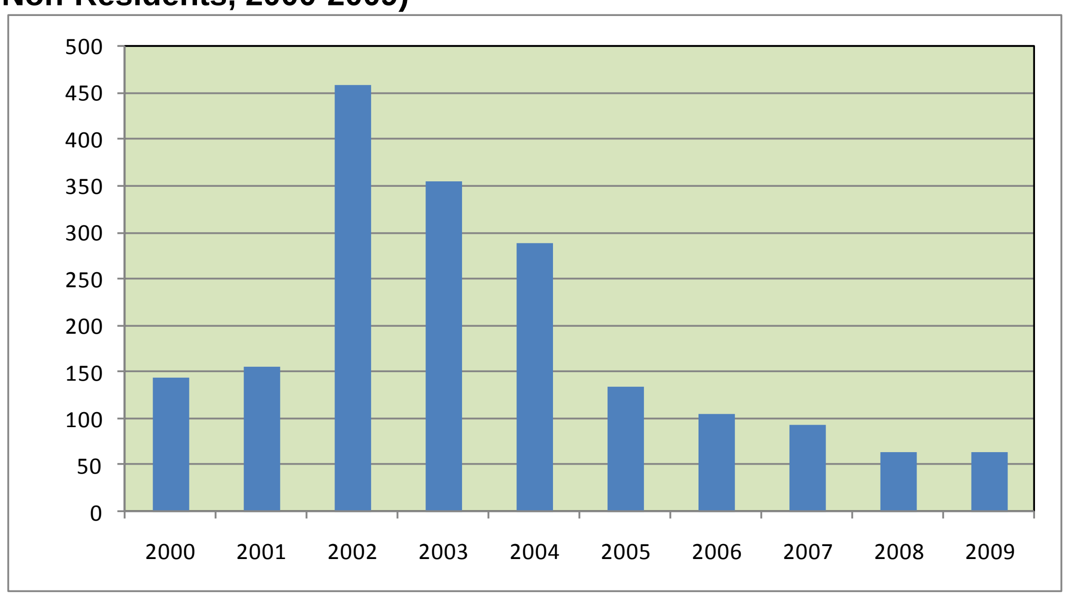


*Net of tax rebates and including mandatory pension contributions. *Source: Calculated by the author from data published by Argentina's Ministry of the Economy and Public Finance.*

The extent of the government's revenue bonanza is also clear when comparing said revenues to the stock of its indebtedness to foreign bondholders and lenders. As can be observed in Figure 4, in the crisis year of 2002, the debt burden tripled in relation to the flow of annual revenues, from about 150% to around 460%. In other words, because of the country's major recession and currency devaluation, the stock of debt to foreign creditors skyrocketed from the equivalent of 18 months to 55 months' worth of government revenues. At that point, there is no doubt, Argentina had a major financial problem and needed time for the economy and its currency to recover.

Since those days, however, the burden of indebtedness has shrunk to the equivalent of less than 65% of national revenues – namely, it could all be paid off with the equivalent of eight months of revenues. This extraordinary lightening of debt burden is the result of both much higher revenues measured in dollars and a significantly lower stock of foreign debt – largely thanks to the forgiveness of claims granted by the three-quarters of bondholders who, in 2005, were intimidated into acceding to Argentina's demand that it be treated as if it were some destitute, war-torn "basket case."[6]

Figure 4: Argentina's Government Revenues (Percent of Government Debt to Non-Residents, 2000-2009)*



*Net of tax rebates and including mandatory pension contributions. The government debt to non-residents includes all estimated past-due amounts. *Source: Calculated by the author from data published by Argentina's Ministry of the Economy and Public Finance.*

[6] The government estimates that its indebtedness to foreigners has dropped from a peak of $116 billion in 2004 to $62 billion by the end of 2009.

In addition to its very ample fiscal resources, mention should be made of supplementary financial resources held by Argentina's central bank, which constitute a second well that may be tapped to pay bondholders, just as it was used to the pay the IMF back in full in January 2006. Earlier this year, the government ordered the central bank president to hand over $6.6 billion of hard-currency reserves supposedly to pay debt obligations falling due, and when he refused because according to his legal counsel the legislature had to approve said transfer, he was promptly fired for insubordination.[7] The government then appointed a new head of the central bank that was already part of the current administration, and she was quick to write the check.

Normally, the foreign assets of a monetary authority are not available for a government to use as it pleases, but in Argentina the central bank has been losing all of its autonomy, and it has become a source of extraordinary financing for the government. A decade ago, it was legally prevented from lending local or foreign currency to the government, but now it is not. The relationship between the central government and the central bank has become so intertwined that recently Judge Thomas Grisea, of the U.S. District Court for the Southern District of New York, ruled that the latter has become the "alter ego" of the former – and thus to satisfy an outstanding judgment against Argentina, he authorized the attachment of $105 million of Argentina's central bank funds left on deposit years ago at the Federal Reserve Bank of New York.[8]

As can be seen in Figure 5, and as it true about its fiscal revenues, Argentina's official international reserves have likewise reached their highest point in contemporary history, averaging in excess of $45 billion during the past three years. During the crisis years of 2001-2003, these reserves had dropped to less than $15 billion, but since then they have tripled – despite the sizeable, aforementioned payments made to the IMF. In those difficult days, the central bank's reserves were equivalent to less than 20% of the stock of obligations to foreign creditors. But as of the end of last year, as per Figure 6, these reserves had grown to the point where they were equivalent to almost 80% of

[7] See Chloe Hayward and Sudip Roy, "Inside Redrado's Battle for Argentina's Central Bank," Euromoney, March 2010. The dismissed head of Argentina's central bank was Martín Redrado; his replacement is Mercedes Marcó del Pont, and the event described took place in late January and early February of this year.
[8] See EM and NML Capital vs. Argentina, 2010 U.S. Dist. LEXIS 34613, April 7, 2010.

what non-residents of Argentina were owed – including unpaid amounts of interest and principal. All things considered, therefore, one cannot justify Argentina's long-standing attitude and behavior towards most of its private and official creditors on the basis of any national economic emergency or binding financial impairment.

Figure 5: Official International Reserves (Billions of U.S. Dollars, 1980-2009)

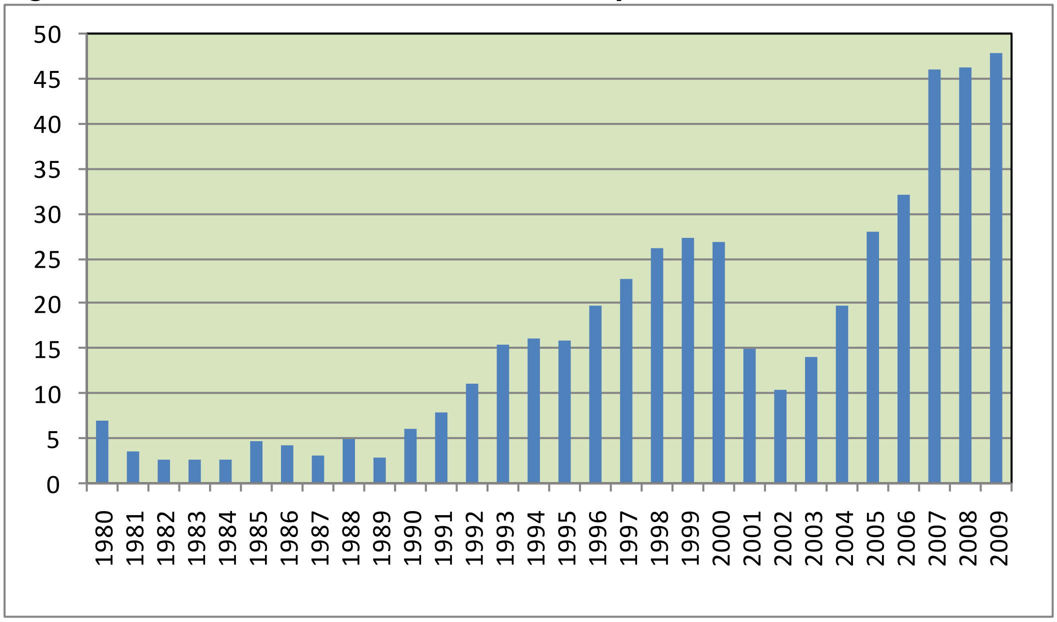
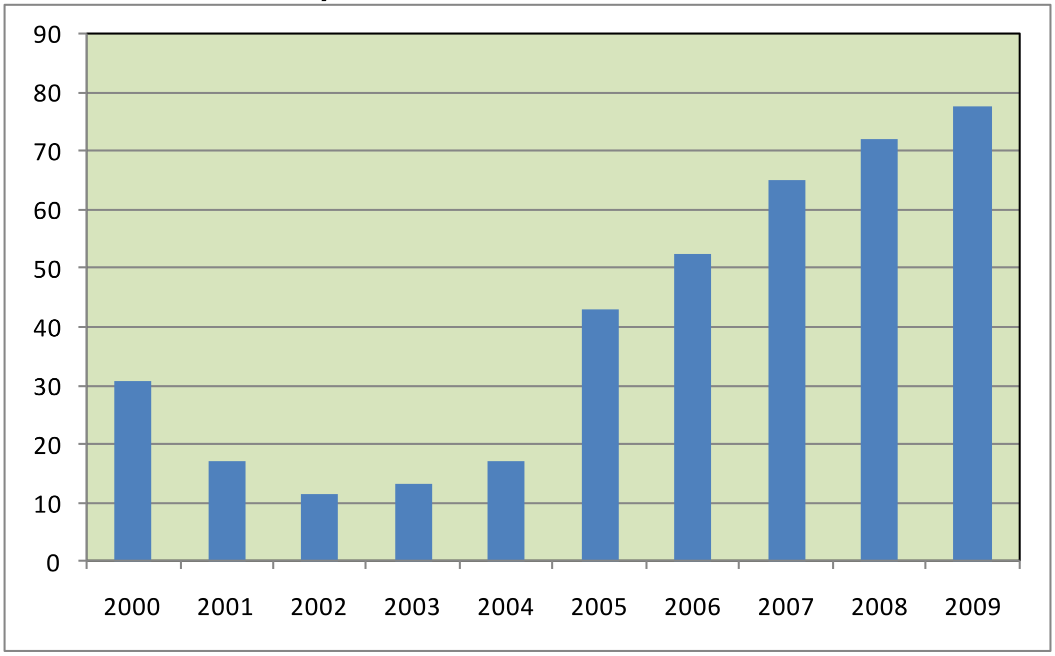


Figure 6: Official International Reserves (Percent of Government Debt to Non-Residents, 2000-2009)



Source: Calculated by the author from data published by Argentina's Ministry of the Economy and Public Finance.

In view of the above-detailed economic facts and trends, I conclude that Argentina's behavior during the past many years represents a blatant case of unwillingness, rather than inability, to pay. A succession of populist governments in Buenos Aires have had access to increasingly ample fiscal and central bank resources, but they have decided not to use them to meet their lawful obligations to their creditors, or to pay the many judgments entered against them by courts and arbitration panels in the United States and Europe. As Judge Grisea recently wrote in one of his rulings, when in the 1990s the country sold tens of billions of dollars of bonds to foreign investors under New York law, Argentina agreed to legal provisions that gave "all the appearances of good faith. Unfortunately, the Republic has turned these assurances into a dead letter. The good faith was in the words but not in the deeds."[9]

At the present time, Argentina is about to give its holdout creditors another chance to give up their original claims, and although the terms have not yet been formalized in an SEC-approved prospectus, it appears that they will be at least as harsh as those offered back in 2005. According to the news out of Buenos Aires, small-scale bondholders (mostly in Italy and Germany) who refused the 2005 settlement offer will be given another opportunity to tender their existing defaulted bonds for new ones maturing in 2038. They will have a low coupon but these retail investors will not have to suffer a "haircut" on principal, and they will be paid in cash for interest accrued since 2003. In sharp contrast, institutional investors, who account for the bulk of the nearly $20 billion in principal plus about $10 billion in past-due interest, will be asked once again to renounce to two-thirds of their principal claim in exchange for new bonds maturing in 2033 that will carry a higher but still below-market coupon. They will not be paid for interest accrued since 2003 in cash but, rather, with yet another bond maturing in 2017.

Various Wall Street firms have performed tentative valuations of the upcoming transaction in light of current yields and other relevant factors and have concluded that, on a net present-value basis, large investors in fact are being offered an even worse settlement than in 2005 – about 15% lower.[10] I tend to concur. Evidently, the country's

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[9] EM and NML Capital vs. Argentina, 2010 U.S. Dist. LEXIS 34613, op. cit., p. 7.

[10] See Credit Suisse, "Argentina's Debt Swap Offer: Good Enough," Fixed Income Research, April 15, 2010; Royal Bank of Scotland, "Argentina: Terms on Debt Re-Offer," Emerging Markets Latin America,

very much improved economic and fiscal condition is once again not being reflected in the government's treatment of its creditors, confirming my conclusion that Argentina is unwilling to pay its creditors what it owes them despite its greatly enhanced ability to do so.

I believe that most retail investors in Italy and Germany will capitulate and agree to the new terms on offer, and that most institutional investors in Europe who chose not to litigate will likewise accept the new, severely discounted bonds that Argentina offers to issue and says it will honor in the future. In addition, professional investors who bought Argentine debt obligations at fire-sale prices years ago will probably also take their profits now. The question is what will be the attitude of the (mainly New York-based) bondholders who have litigated and won judgments in their favor. Unless they too agree to the new terms, Argentina's default will not be cured by the upcoming transaction, and any future attempt on the country's part to raise fresh funds here or in Europe is likely to be thwarted by court-issued attachment orders.

What I find personally objectionable is that, under present rules, there is nothing to stop a rogue sovereign debtor like Argentina, which has made a mockery of New York laws and our courts, from attempting to raise new funds in this country before it has met its outstanding financial obligations – especially the many judgments against it. Imagine if someone accused, tried and convicted of committing fraud managed to escape from the courthouse just after sentencing and board a flight to a foreign country. It is inconceivable that if that convict were to come back to the United States he would be allowed to roam freely, possibly to commit another fraud – instead of being arrested on the spot at the airport. And yet, our capital market doors remain open to a deadbeat like Argentina.

April 19, 2010; and Bank of America Merrill Lynch, "Guide to Evaluating the Upcoming Argentina Exchange," Quant EM FX and Debt Trader, April 5, 2010.