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Argentina is in checkmate and must negotiate a way out

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Recent moves, countermoves and judicial decisions have brought the government of Argentina perilously close to a checkmate situation. As a result, the endgame in the litigation saga pitting holdout investors against a "uniquely recalcitrant debtor" is now within sight. If the authorities in Buenos Aires were to set aside their confrontational rhetoric and do what is best for their own political survival, they would agree to a negotiated settlement sooner rather than later.

First, a recap of what has transpired. For a number of months, Axel Kicillof, Argentina's economy minister, has had his eye on the looming redemption of over $6bn in dollar-denominated bonds issued under Argentine law, a series known as the Boden 2015. The issue matures in early October, three weeks before national elections to be held on the 25th of that month, such that it represents a significant payment or rollover challenge during a period of likely election-related volatility.

Back in December, the minister decided to get ahead of the potential problem by offering to buy back the Boden at a discount to par and to sell dollar-denominated Bonar 2024s, and he took pride in the fact that no underwriters would be hired to handle the transaction. While the entire $6.3bn outstanding were available for purchase or exchange, the hope was that about $3bn would be tendered. But poor market timing combined with inflexible pricing resulted in a transaction which yielded fewer than $200m in Boden bought and less than $300m in Bonar sold. And yet, Minister Kicillof, a spin master in the best Peronist tradition, declared the whole operation a huge success, arguing that investors had not wanted to part with their Boden bonds because they had confidence in Argentina.

Internalizing the criticism that he should have hired professional underwriters, especially when targeting overseas investors, in late February Kicillof encouraged JP Morgan Chase and Deutsche Bank in London to drum up orders for a private placement of at least $2bn of the Bonar 2024 bonds. When rumours of an imminent transaction surfaced, the leading-edge holdout creditors (NML Capital and others) obtained a subpoena to have the banks disclose what they were up to. When they were not forthcoming with information, US District Judge Thomas Griesa ordered Morgan and Deutsche to appear before him, and within hours the banks let it be known that their involvement in the transaction had ended. The incident was a warning shot: even though the intended issue involved Argentine-law bonds placed outside of the US, the holdouts could have persuaded Judge Griesa to order the attachment of any funds raised on Argentina's behalf before they got delivered.

And then, earlier this month, there was a renewed request to Judge Griesa by Citibank for its subsidiary in Argentina, which acts as a securities custodian, to be allowed to process payments to domestic and foreign holders of Argentine local-law bonds. (The bank had been allowed to handle three coupon payments last year, but on an exceptional basis.) Citibank argued that the bonds in question should not be covered by the court's orders, and pleaded because the authorities in Buenos Aires threatened its license and employees if it obeyed the US court order not to process any payments.

The matter was fully argued in court, after which Judge Griesa prohibited Citibank from making further payments, taking a very expansive view of who is covered by his earlier rulings – "any entity that participates with or assists the Republic" – and of what securities are covered – any and all (new) bonds issued to investors in 2005 or 2010 in exchange for (old) defaulted bonds, regardless of the jurisdiction under which they were issued. The sole exceptions still standing are bonds denominated in Argentine pesos.

Subsequent to this ruling, Citibank and NML Capital (and its related holdout creditors) reached an interesting compromise late last week which has been approved by Judge Griesa. In return for Citibank pledging not to appeal the court's decision and to withdraw from the custody business in Argentina in the months to come, it is allowed to process the March 31 and even the June 30 coupon payments on Argentine debt – for the last time. This compromise gives Citibank the chance to comply with its responsibilities as an Argentine-chartered custodian while at the same time extracting itself from such an intermediary role now thwarted by the US courts. It also means that Judge Griesa's interpretations and judgements are likely to stand.

The noose tightened further on Wednesday, when Judge Griesa entered an order that Brussels-headquartered Euroclear shall not process any Argentina-related payments received from any source, including from Nación Fideicomisos and Caja de Valores. The former is the securitization unit of the government-owned Banco de la Nación Argentina, in which the government last September opened a trust account to hold the coupon payments it could no longer make via BNY Mellon. Caja de Valores is the country's central depository for both government and corporate securities.

The implication of these developments is that Argentina has been blocked in its attempts to raise new funds from the international capital markets, and it cannot make payments on its existing obligations abroad – unless it is ready to stop discriminating among its bondholders, paying some but not others, as it was doing until the middle of last year. Indeed, opinions by expert attorneys quoted by Bloomberg News have stated that the existing rulings effectively impede Argentina from issuing new foreign-currency debt in any jurisdiction, or else that motions which could be made to that effect by holdout creditors might easily lead to that result, given the expansive judicial interpretations now on record.

And this brings us back to the Boden 2015s. To be sure, when October rolls around, the government could order the central bank (BCRA) in Argentina to transfer the needed $6bn out of its official international reserves, currently valued at $31bn, in return for a special-issue, long-term bond paying hardly any interest. The authorities have done this often in recent years, so that the BCRA is by now stuffed with such government bonds: whereas at the end of 2007 the BCRA had $46bn in foreign currency reserves representing nearly two thirds of the bank's assets, the current level of reserves accounts for a mere quarter of its (dubious quality) assets.

However, raiding the central bank will not ensure that the Boden proceeds will actually reach the hands of bondholders. Given the judicial latitude that the leading holdout creditors have gained in the past nine months in New York and well beyond, chances are that the Boden redemption payments will come to be blocked by court order, causing the scope of Argentina's default to expand further. The timing of such a payment disruption could not be worse for the election climate, and especially for Peronist candidates, never mind for any candidate supported by the outgoing administration of President Cristina Kirchner.

It is a matter of when, not if, a government in Argentina will enter into negotiations to settle their obligations to holdout creditors. This conviction is what explains the high prices and relatively low spreads (of around 600 basis points over US Treasuries for the JP Morgan EMBIG Diversified Argentina index) of the country's defaulted bonds, when compared with the average spreads for bonds issued by non-defaulting Ecuador (850 bp) and Venezuela (3,000 bp). If the authorities in Buenos Aires were to become realistic, especially about what is best for their own party in the October elections, they would set aside their confrontational rhetoric and sit down to negotiate a settlement ahead of the October Boden crunch.

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