

# Argentina and the International Financial Architecture

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## Argentina's saga has raised three fundamental questions for the international financial structure:

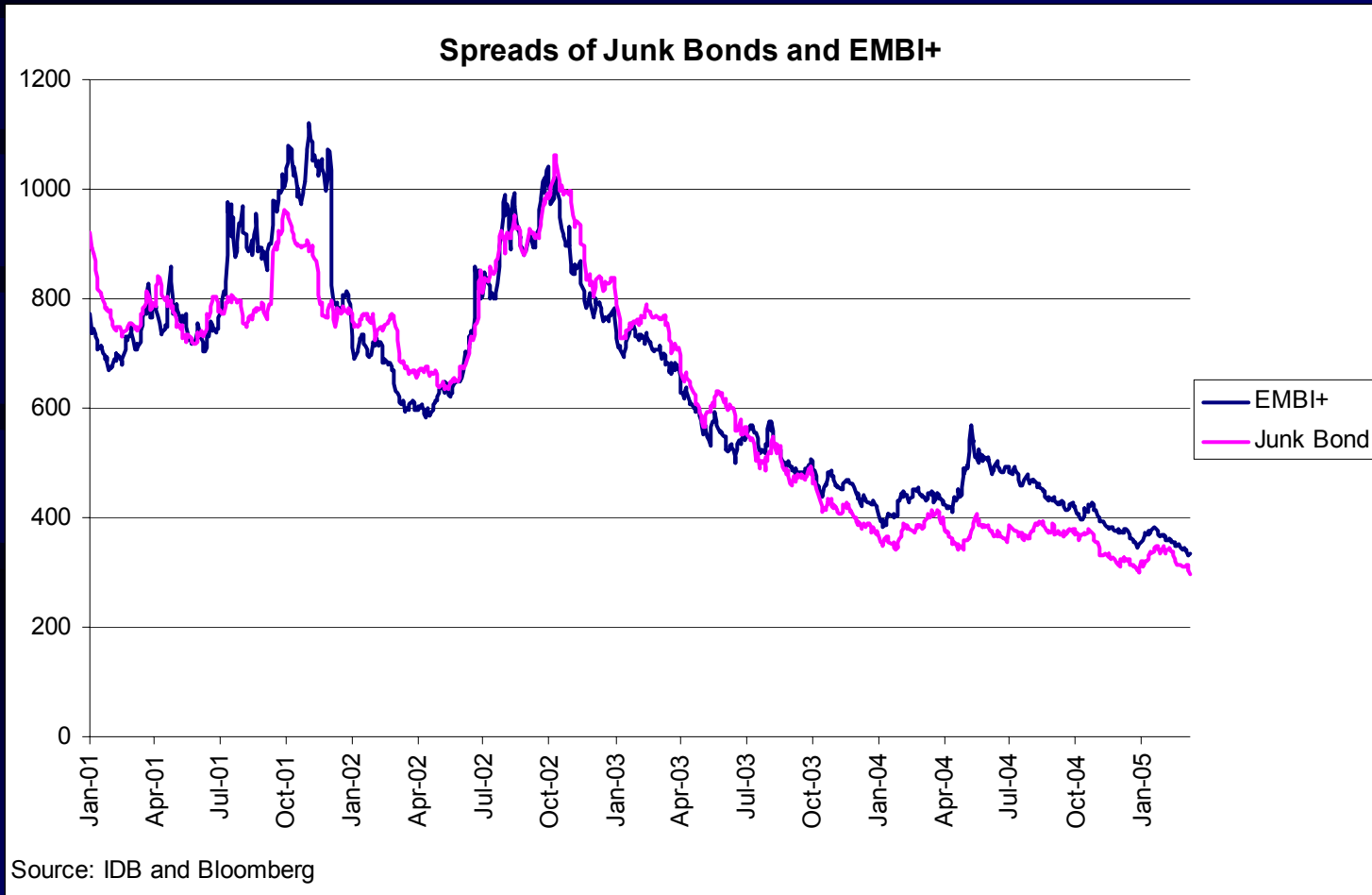
1. Has Argentina's debt restructuring changed the rules of the game in finance negotiations between emerging market countries and their creditors?
2. What major problems in creditors' behavior (IFIs vs. Private sector) towards emerging markets can be identified?
3. Can market-oriented solutions be designed and implemented?

## First, some stylized facts:

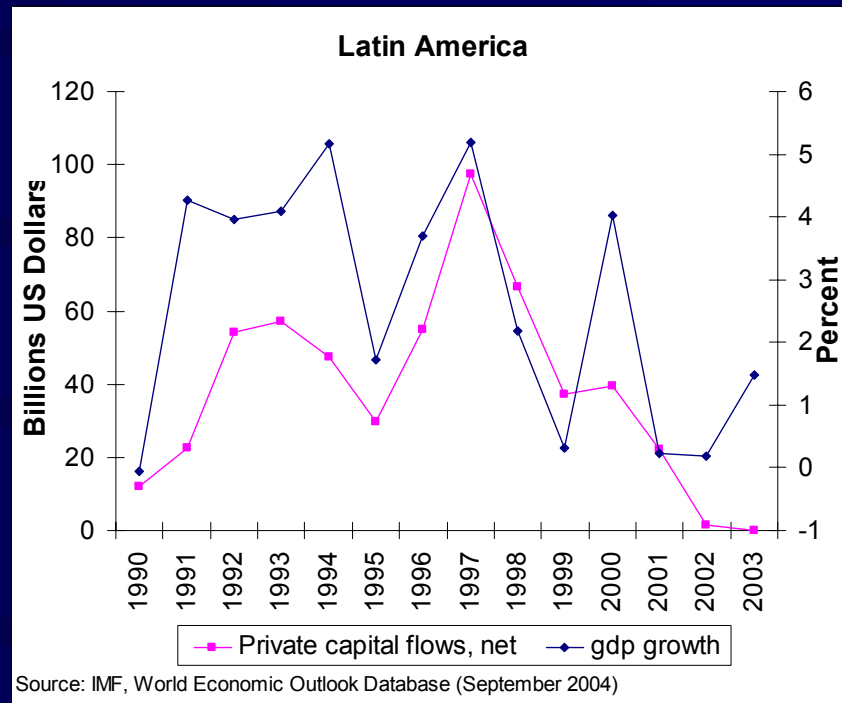
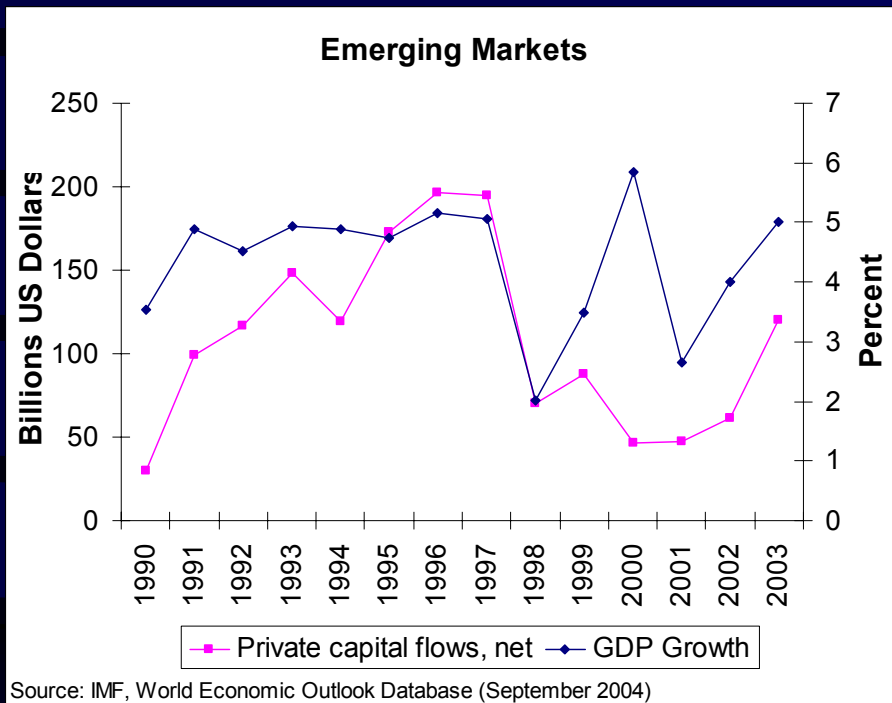
1. Among different classes of portfolio investment, emerging market sovereign debt can be classified as:
  - high risk
  - losing liquidity at first sign of problems

These two features are also present in so-called “junk bonds”.

# Not surprisingly, spreads of “junk bonds” and emerging market sovereign debt move together



## 2. Features of emerging market sovereign bonds also result in pro-cyclical capital flows



Heightened risk, especially fears of “liquidity loss”, induce private sector creditors to withdraw from the markets when economic slowdowns occur.

Investors search for *liquidity* in Emerging Markets might, at times, conflict with IFIs search for *solvency*

## IFIs

- Assessment of debt solvency is based on intertemporal budget constraints, largely assuming that “sudden stops” of capital inflows will not occur during the period analyzed.

## Markets:

- Rules regarding the adoption of Value at Risk Methodology which, in general, assesses risks in terms of *net risk*, not *gross risk* positions,

combined with:

- Traders’ reporting system of “end-of-day bottom line”

...induce a market focus on liquidity and might generate **contagion.**

## Two very different examples of market responses: Mexico after Russia and Argentina

### Mexico:

- Attracted by high yield and expectations of IMF support for financing needs, investors went long on Russian securities.
- The need to “cover for liquidity risk” led investors to also buy Mexican and other of the most liquid emerging markets sovereign paper.
- When Russia defaulted, investors sold Mexican, Brazilian and other liquid paper to minimize end-of-the-day losses.

## Argentina:

- The large stock of Argentina's foreign exchange reserves and long period of IFI support for the country's overall financing needs allowed major investment firms to unload their holdings of Argentina's bonds before the bonds became illiquid.
- This prevented contagion to other large emerging markets.
- Because of the above, and in contrast to the Russian default, Argentina's default did not create a *systemic* problem.

If liquidity is at center stage for market decisions on sovereign bonds, then what affects liquidity?

### Improves availability of Liquidity:

- Large foreign exchange reserves (even in flexible exchange rate systems).
- IFIs liquidity support.
- Private sector contingent credit lines (less important).

### Deteriorates availability of Liquidity:

- Large overall government financing needs.
- Large debt amortization and interest payments due in the short run.

Going back to the original questions:

1. **Has Argentina's debt restructuring changed the rules of the game in financing negotiations between emerging market countries and their creditors?**

The short answer is NO.

- Lack of G-7/IFIs financial support for debt restructuring (or bail outs) is consistent with Argentina not being a **systemic problem**. No major difficulties developed in the international capital markets following Argentina's default.

- A major lesson for emerging markets is not that it is now “easier” to default and get a “good deal” from their creditors. That conclusion would ignore:
  - a) The favorable overall financial environment for emerging markets over the last two years, including the abundance of liquidity.
  - b) The painful default years for Argentina and the long stream of failed negotiations.
  - c) The difficult problems lying ahead for Argentina now that installed capacity is reaching its limits.

## 2. What is a major problem in creditors' behavior towards emerging markets?

- In assessing countries' performance and designing "programs", the IFIs' methodology for estimating debt sustainability does not differ from that used in industrial countries, i.e., it is based on fiscal intertemporal analysis without considering the likelihood of sudden liquidity constraints.
- In contrast, in market assessments, *liquidity rules*. This partly reflects current rules and practices for the functioning of markets.

These differences in approach can, and certainly have, hurt emerging markets

### 3. Can market-oriented solutions be designed and implemented?

YES. The solution lies in “aligning” market objectives with IFIs’ / countries’ objectives.

And recommendations go to all parties involved:

- In assessing a country’s performance, IFIs need to “price right” liquidity risks arising from market behavior.
- Countries need to be aware of the consequences of having their debt being treated as junk bonds. For example, has anybody examined the potential consequences of Sarbanes-Oxley accounting reforms on emerging market debt? These reforms are currently affecting US junk bonds issuance.

- It is in the interest of policy makers in industrial countries to revise the “undesired consequences” of some financial regulations, as they might contribute to, rather than prevent systemic problems.

Two prominent examples of potentially distortionary regulations are:

- Assessing market risk in net rather than gross terms.
- Some components of Basel II that increase incentives for short-term lending to emerging markets.

Finally, reforms to the process of restructuring international sovereign debt, through “debt restructuring mechanisms” (à la SDRM) and/or innovations in collective action clauses (CACs), are essential.

*However, they can only be effective if measures to discourage countries from overborrowing and creditors from overlending are in place.*

**Pricing “liquidity risk” right can go a long way towards that objective**