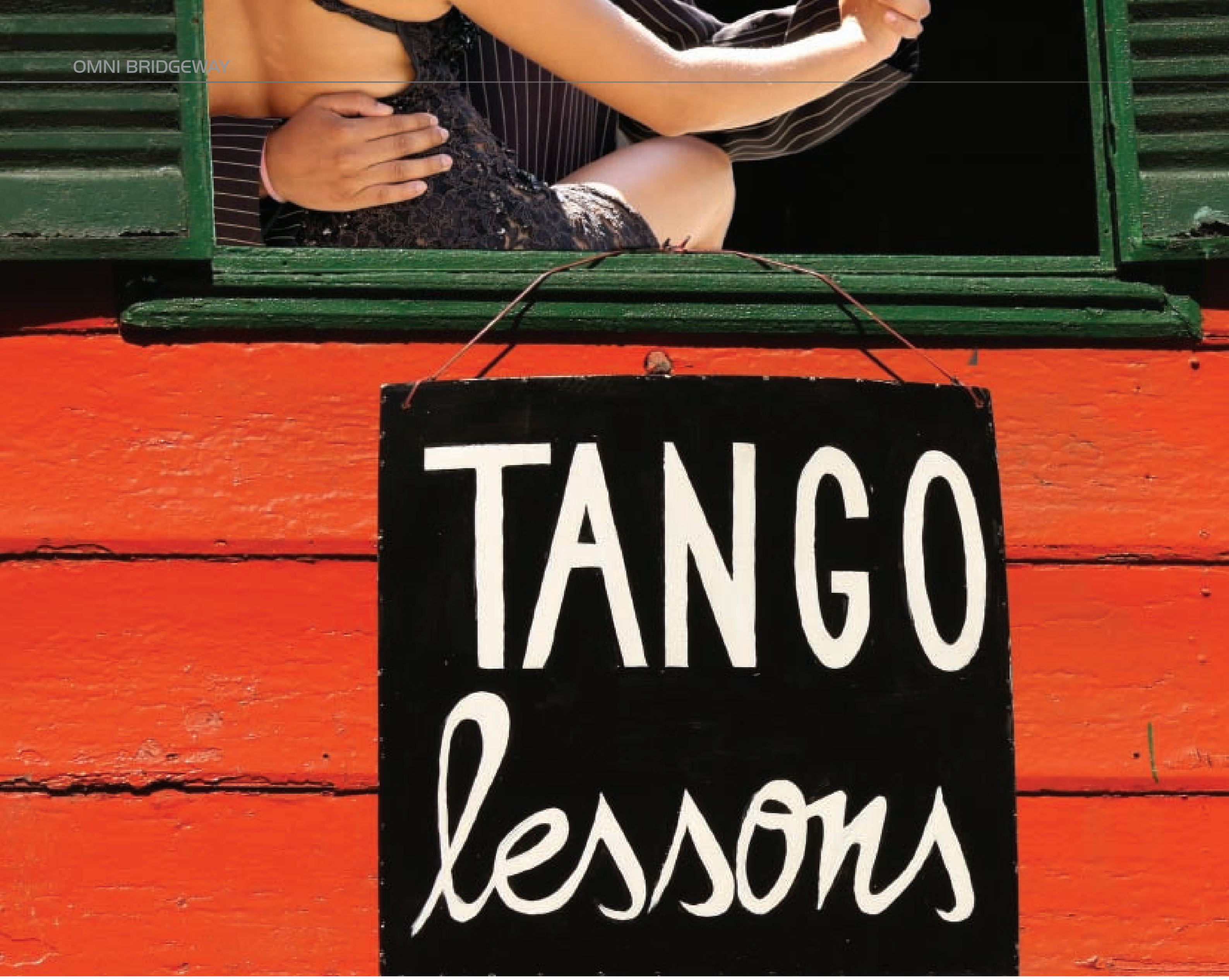

Reversing traditional roles, Europe has been grappling for the last year and a half with the potential consequences of a series of sovereign defaults of its own. As deals are brokered and broken in Athens, Berlin, Brussels, Dublin, Lisbon, Madrid and Rome, EU and International Monetary Fund (IMF) leaders need look no further than Argentina for a reminder of what can happen when a sovereign is allowed to default.

Since its 2001 default, Argentina's leaders have arranged two rounds of deals with its debt-holders. Now, it is about to enter a third round, this time with the Paris Club, an informal association of creditor nations. What are the implications of this Paris Club deal for debt-holders and those investing in and trading with Argentina? Has Argentina really turned the page on its rollercoaster history in the capital markets?

To say Argentina holds the IMF accountable for its default and subsequent social turmoil is to put it mildly. The precise reasons for the Argentinean default are best gleaned elsewhere, but famed for making sovereigns punish private creditors, the IMF made Argentina do precisely that in early 2001 in a combination of a 'megaswap' and a rollover.

The IMF nevertheless issued Argentina a secured loan later in 2001, despite failing to secure a second standby arrangement detailing the revised fiscal conditions. Furthermore, the IMF made the fatal error of significantly overestimating the political will and ability to see through its package of gruelling austerity measures. The late President Néstor Kirchner eventually paid-off the country's debt to the IMF in 2006, and Argentina has since refused to submit its economic data to the organisation. Tensions between the two remain fraught.

Haircut 100

The history of how Argentina has survived and dealt with almost $100bn of defaulted debt is a lesson in astute politicking from a bygone era. In March 2005, Kirchner's administration persuaded 76% of creditors to agree to two separate debt swaps that saw the value of their bond-holdings drop by almost two-thirds.

In June 2010, Kirchner's wife and presidential successor, Cristina Fernández de Kirchner, oversaw a second round of restructuring that offered creditors about 33 cents in the dollar, which left only 7.4% of the original bad debt outstanding. That 7.4%, which stands between Argentina and it achieving a clean slate in the capital markets, is comprised of two groups: Paris Club creditors and hold-out investors.

The latter, which holds between $4bn and $4.5bn – or 8% of the defaulted 2001 debt, rejected both the 2005 and 2010 work-outs in the hope of securing a better payout – or rather less of a haircut – than the other bondholders. Examples of such investors include NML, a subsidiary of Elliott Associates, which holds about $2bn of Argentine debt; and

Omni Bridgeway examines the prospects of a successful Paris Club deal for Argentina

EM, which represents the interests of investor Kenneth Dart.

These investors have pursued a multi-pronged legal strategy to persuade Argentina to pay their debt, largely using the US courts. Other investors, such as a group of Italian retail creditors, have pursued an International Centre for Settlement of Investment Disputes (ICSID) arbitration claim to obtain payment for its $1.3bn in defaulted Argentine debt, in addition to filing in a New York court as a back-up. Such claims will linger, regardless of any deal with Paris Club creditors.

By chance, the Paris Club first met in 1956 to help Argentina's debt problems. Fast forward 55 years and Argentina owes most of its Paris Club debt to Germany and Japan, which together hold 60% of the debt, and Italy, the Netherlands and the US, holding less than 10% each. There was much domestic posturing over the sums and repayment terms that Argentina's Economy Minister, Amado Boudou, would negotiate for, in addition to speculation over what the debt would rise to should punitive interest charges be included.

After a couple of postponements from the initial January 2011 date, Paris Club negotiations chave yet to commence fully. However, it is thought the agreed sum will be $8.47bn, with Argentina offering a small initial down-payment and paying the balance back over six years, and faster repayment linked to GDP growth.

One sticking point is expected to be IMF oversight, which Argentina rejects out of hand, but which the Paris Club's principles and rules require for such a transaction. Club members reason that a lack of IMF supervision should translate into a larger initial payment and a shorter repayment period. Regardless of the hold-out investors, whose legal strategies could yet cause Argentina some problems, a Paris Club deal will be a game-changer.

Argentina's key creditors within the Paris Club have important export credit agencies (ECAs), such as Atradius and Sace. Many of these agencies have internal guidelines that prohibit them from extending loans or guarantees for projects in countries with debt arrears. In addition, the political risk insurance that such ECAs and others in the market might offer to companies from their respective countries in the wake of a Paris Club deal would greatly boost Argentina. A deal would remove a key obstacle to securing international investors for the large, long-term projects in energy, infrastructure and mining that Argentina requires.

Three key questions

But is it as easy as this? Three key questions surround Argentina's tentative Paris Club deal: first, the implications of how the Argentine government will find the funds; second, Argentina's future funding requirements; and third, Argentina's strategy regarding accessing the capital markets.

To achieve the first and second round of deals with its debt-holders, Argentina employed internal financing strategies that were certainly innovative. For example, as part of last year's deal to pay-off bondholders, President Fernández fought and won a battle against the then central bank governor Martín Redrado over using $6.6bn of foreign exchange reserves. Despite opposition lawsuits over this and the controversial use of reserves, bondholders reacted positively and Argentina's government bonds rallied in the markets. Fernández's preparations for financing this third round have been no less innovative or controversial.

In June this year, the board of Argentina's central bank approved a ten-year loan to the economy ministry of $7.5bn of foreign exchange reserves (to be repaid at the same rate the central bank earns on its reserves – but not exceeding one-year Libor), for the purposes of repaying private creditors. Fernández has also used central bank reserves to finance government programmes and has borrowed from the social security agency Anses.

The viability of using reserves depends on both Argentina's future funding requirements and how it chooses to approach the capital markets. One argument used by hold-out investors is that Argentina is flush with cash. To some extent this is true. Argentina's foreign exchange reserves rose to

$52bn in November 2010, in part boosted by bumper soya bean and grain harvests, and by tax collections in the first 11 months of 2010 coming in $13bn higher than expected.

The composition of Argentina's national debt of $164bn puts the government in a comfortable position – 47% is owed to domestic public sector entities and 38.5% is in the hands of private creditors. The maturities of this debt are also favourable: Argentina estimates total debt servicing costs averaging 2.8% of GDP each year through to 2015 – with private creditors accounting for 1.5% of GDP. This amounts to $17.2bn, while Argentina has potential financing sources of $21.4bn – in addition to its reserves.

Argentina's Finance Secretary, Hernan Lorenzino, stated at the end of 2010 that the country's financing needs for 2011 could be entirely covered by internal financing sources. As part of the second restructuring last year, Fernández postponed plans to sell up to $1bn of 2017 bonds, and Argentina's approach to the capital markets since has been aloof. While other emerging markets rushed to raise $80bn of bonds in 2010, Argentina refrained – and thus missed the opportunity to benefit from raising capital at yields of as low as 7.5%, which have since risen.

Given its dipping into reserves and restraint – for the time being – in accessing the capital markets, if the Paris Club deal did not come to pass and if commodities prices should fall, then Fernández would have to take some (further) bold domestic steps in the short to medium-term. Provision for paying off its outstanding Paris Club debt was included in the 2011 budget.

However, a delay in Congress saw Fernández sign an emergency decree allowing her to carry this over and extend this year's budget. The original 2011 budget, though, was based on GDP and inflation figures which have since decreased and increased respectively – causing further headaches in Congress given the already strong mistrust of government statistics.

Furthermore, if the government wanted to tap reserves again, it would have to pass a law or issue a further decree. Given the likely unpopularity of both approaches in a year when Fernández will be running for a second term in October's presidential election, a lot hangs on the success of a deal with the Paris Club.

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Alternative funding

Short of changing laws or illegally tapping reserves, if the Paris Club does not work out, are there other sources of funding available to Argentina? Beijing may be the answer. Perhaps inspired by the fact that other 'pariah' nations in South America, such as Ecuador and Venezuela, have established lines of credit with Beijing, Buenos Aires has come a step closer given recent Chinese foreign direct investment (FDI).

Between June 2010 and May 2011, China increased its investments in Latin America by 286% compared to the previous 12 months. This $15.6bn accounted for nearly one-third of China's total FDI in the period – and Argentina alone earned 41% of this $15.6bn, second only to Brazil in the region. Since 2008, China has bought key assets in the banking, manufacturing and oil sectors. Another high profile example of FDI is the $100m investment in a new racetrack and hotels complex in Zarate, north of the capital, which could see Argentina back on the Formula-1 racing circuit for the first time since 1998.

Such FDI comes despite The Heritage Foundation recently ranking Argentina 138th out of 179 countries in its annual classification of economic freedom – sandwiching the country between Guinea-Conakry and Vietnam. FDI also continues despite Argentina's poor record of honouring international investment arbitration agreements.

Of ICSID's entire pending case-load, one-fifth relate to Argentina – and 26 of these 27 cases relate to the 2001 crisis. Two other crisis-related claims are being arbitrated under United Nations Commission on International Trade Law (UNCITRAL) rules and two further UNCITRAL claims, brought by National Grid and BG Group, have been fully arbitrated.

Argentina has yet to pay $430m (plus interest) relating to arbitral awards rendered against it, and Argentina is in no hurry to write cheques to successful claimants such as BG, CMS Gas Transmission Group, Continental Casualty and National Grid. This figure looks set to rise, with decisions expected in cases brought by Daimler Financial Services, EDF, El Paso, Mobil and SAUR.

Positive prognosis

Does such new FDI and the likely Paris Club deal auger a bright future for investors in Argentina? Short-term problems will always be around: whether man-made, like the current trade disputes with Brazil and Uruguay over Argentina's plan to restrict some imports to boost local industry, or natural, like Chile's Puyehue volcanic ash dump in Patagonia causing a $40m drop in wool production and a $40m drop in lamb sales this year.

Nevertheless, in the medium- to long-term analyses – from the IMF down – are optimistic about Argentina's growth rate, low unemployment and entrepreneurial potential. Despite warning signs of overheating, unsustainable subsidies, inflation of 30% this year, and alarming levels of capital flight ahead of the presidential election, analysts not only view Argentina as not being in danger of default but of even being a frontier market risk worth taking.

Such prognoses, however, are largely founded upon the assumption of a successful Paris Club deal, high commodity prices in the long term, and an eventual return to the capital markets. The extent to which these come true will lie less in Argentina's economics and more in its politics.

We invite holders of defaulted trade debts and rendered arbitral awards relating to Argentina to contact us for advice.

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Emerging market debt pricing

Latin America and Caribbean Hyper-Exotics

Country / Issue	Price Range		
Cuba / Trade	2.000%	4.000%	
Cuba / Loans	5.000%	10.000%	
Suriname / Loans, Trade	14.000%	18.000%	

Eastern Europe Hyper-Exotics

Country / Issue	Price Range		
Azerbaijan / Trade	18.000%	23.000%	
Bosnia / Trade	36.000%	41.000%	
Georgia / Trade	11.000%	15.000%	
Serbia / Trade	44.000%	54.000%	
Turkmenistan / Trade	23.000%	33.000%	↑
Ukraine / Trade	18.000%	25.000%	
Uzbekistan / Trade	20.000%	24.000%	

Asia Hyper-Exotics

Country / Issue	Price Range		
Mongolia / Trade	22.000%	30.000%	
North Korea / Loans, Certificates	9.000%	12.000%	

Africa Hyper-Exotics

Country / Issue	Price Range		
Angola / Trade	50.000%	55.000%	
Angola / Loans	55.000%	59.000%	
Cameroon / Trade (non-HIPC)	14.000%	20.000%	
Congo / Trade (non-HIPC)	22.000%	26.000%	
DR Congo / Loans, Trade (non-HIPC)	16.000%	20.000%	
Ghana / Trade (non-HIPC)	78.000%	82.000%	
Kenya / Trade	39.000%	49.000%	
Mozambique / Trade (non-HIPC)	20.000%	26.000%	
Senegal / Loans, Trade (non-HIPC)	12.000%	16.000%	
Sudan / Loans (non-HIPC)	11.000%	14.000%	
Tanzania / Loans, Trade (non-HIPC)	10.000%	13.000%	
Uganda / Trade (non-HIPC)	14.000%	16.000%	
Zambia / Loans, Trade (non-HIPC)	13.000%	20.000%	
Zimbabwe / Trade	1.000%	4.000%	↑

Middle East Hyper-Exotics

Country / Issue	Price Range		
Egypt Trade	65.000%	75.000%	
Iraq / Paris Club	84.000%	89.000%	↓
Iraq / Bonds	91.000%	92.000%	↓
Libya / Trade	25.000%	35.000%	
Syria / Trade	6.000%	11.000%	

Trade : Trade Debt Instruments
Loans: Loan Agreements
PDI: Past Due Interest
Pns: Promissory Notes
Pars: Brady Par Bonds
↓↑: Changes compared to last edition

Prices are a percentage of principal only, however assuming inclusion of an average amount of PDI for the specific debt instrument and the specific debtor. Trade debts and their documentation differ from case to case and price ranges should therefore be considered as benchmark only.

Price ranges are based on a monthly compilation of sources and analytics. Liquidity on most instruments is very limited and trading may not have taken place for some time.

Prices of debts of other countries and/or other classes are available on request.

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Figures correct as of 1 July 2011