The Fight to Avoid Default and Devaluation

By Domingo Cavallo

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I accepted to become the Economic Minister of De la Rúa in the middle of the 2001 crisis. Rumors about default already existed. They had begun the previous October, after the resignation of Vice-president Carlos Alvarez and they had caused a draining of deposits from the Banking System of over 789 million of pesos in October 2000 and over 1,038 million in November 2000.

The then-Economy Minister José Luis Machinea and the Secretary of Finance Daniel Marx had managed to revert that first draining of deposits with the "Blindaje" ("Shield" in English), a financial assistance package from the World Bank and the IMF in late 2000. This package consisted of an economic program for the year 2001 that received support from the IMF, the IDB, the World Bank and the main commercial banks.

The "Blindaje" program foresaw disbursing the financial support through years 2001 and 2002 under a set of conditionality. To avoid default, in addition to receiving these disbursements, it would be necessary for a) the commercial banks to rollover the 10,000 million dollars of Treasury Notes payable due in 2001 and for b) that the market provide fresh funds to pay the capital amortization produced in 2001, estimated at 7,000 million dollars.

The "Blindaje" reverted the deposit withdrawal until March 2001. At the beginning of this month, several signals made it apparent that Argentina would not be able to meets the Public Spending and Fiscal Deficit targets committed as conditionality in the "Blindaje". Consequently, the international financial organizations would very likely withheld the disbursements programmed for April.

Rumors of default restarted and with them, a new outflow of deposits. In this context, José Luis Machinea presented his resignation and Ricardo López Murphy moved from the Defense Ministry to the Economic Ministry. When the new Minister announced his program consisting of a fiscal reduction of 2,000 million pesos for the rest of the year, there were large street protests and several members of the National Cabinet, including key members of the already weakened alliance between the FREPASO and the Radical Party, resigned. All these events emphasized a negative prognosis, both politically and economically.

In this context, I accepted to become the new Economy Minister on March 20, 2001, because I was convinced that it was possible to produce the needed fiscal reduction while reactivating the economy.

While all these political changes were occurring, Argentina suffered the largest monthly deposit drainage in its history: 5,543 million of pesos in March 2001. Up then, the biggest deposit outflow had occurred in March 1995, amidst the Tequila Crisis when the deposit outflow had been 4,622 million pesos.

To revert the expectations of default and thus avoid the continuity of draining of deposits was the toughest duty I had to face, and I confronted the challenge based on our successful handling of the Tequila Crisis. At that time in 1995, from the Economy Ministry and with the collaboration of Roque

Maccarone, then Secretary of Finance, we were able to create an economic program that won the support of international financial organizations and foreign and national commercial banks, allowing us to meet the financial crisis in a sustainable way.[1]

President De la Rúa and I were determined to avoid debt default

Default means the suspension of payments of public sector debt. It implies, without any doubt, a great economic damage to creditors. Some political leaders argued that default is good for the country because it makes the country's debt servicing lighter. However, this is not true due to four fundamental reasons:

First, large segments of government creditors are Argentine savers. In their role as financial intermediaries, banks lend the deposits of the Argentine people to the Public Sector in the form of bonds and loans for the National and Provincial Governments. Therefore, when rumors about default spread, some depositors become scared and withdraw their money from the banks. The social Security System keeps a high proportion of worker's contributions invested in government bonds. Finally, many Argentine savers hold bonds from the National Government or provincial governments.

Second, external creditors do not accept in a passive way the suspension of payments and creditors take actions that restrain the recovery of credit while a state of default remains in place. It is important to bear in mind that since the 1990's, the makeup of external bondholders has moved away from the traditional small number of commercial banks and moved to a larger number of private pension funds, investment funds and individual investors that refuse to buy bonds from a country that stops payments on its debt.

Third, the suspension of payments of the public sector also causes the default of many private companies, leading consequently to the stagnation of the productive system.

Finally, the suspension of payments raises expectations of depreciation of every asset of the country, and this leads to expectations of devaluation of the national currency. These expectations exacerbate recessive tendencies and cause the fall of tax collections further weakening the fiscal situation and increasing the negative expectations.

Summing up, default ends up in devaluation and both of these create real economic and social chaos requiring considerable time from which to recover. Therefore, it was imperative to fight to avoid default. This is what I did as Economy Minister.[2]

The successive attempts to avoid default

Throughout the nine months I was the Minister of Economy, I led three negotiations with the IMF to avoid default and revert the deposit outflow. Two of the negotiations were successful, and the last one remained unfinished when I was forced to resign. The governments that came after President de la Rúa formally declared default and devalued the currency.

[1] A detailed description on how we solved the Tequila Crisis can be found in my book, El peso de la Verdad, Editorial Planeta, 1997

[2] All these arguments are described in a document prepared by the Ministry of Finance in August 2001, called "Devaluation and Default in Argentina"

First attempt: agreement with the IMF in May

As soon as I took office at the Economy Ministry, I sought to restore the "Blindaje" to avoid the interruption of the agreed disbursements.

As the targets on Public Spending and Fiscal Deficit for the first quarter of the year had not been fulfilled, it was necessary to take strong measures to control spending as well as to increase tax resources so that by the end of the first semester we could meet the agreed upon targets. That is to say, that we could revert the negative performance of the first trimester by improving performance in the second one.

In addition, it was necessary to take those measures in the second quarter so that we could fulfill the original goals of the third and fourth quarters of 2001.

The IMF staff also requested that we replaced structural reforms related to the Social Security System that National Congress would not approve for other reforms of equivalent fiscal effect.

Moreover, we had to demonstrate again to the international community that we would be able to obtain the financing to pay capital amortizations from the Public Debt that would fall due in 2001 and the following years.

The National Constitution states that at time of a National Emergency, Congress can delegate to the President part of its legislative powers, for a limited period.

The National Congress passed these special powers with only one important limitation: it did not authorize the Executive to use tax collections as a guarantee of the Public Debt, although Congress did enact the creation of a Public Credit Trust Fund that would receive the revenue accruing from the new Financial Transactions Tax.

Anyway, Congress created the new tax and the revenue it generated helped to fulfill the fiscal targets.

The special powers allowed us to take measures that led to the encouragement of investments and the recovery of competitiveness, both of these points became structural ingredients of the economic program. We could also take some measures on the reforming the state apparatus and reorganizing the tax administration, which were also central to the fulfillment of the fiscal targets.

The decision to restructure the public debt, including the debt of the provinces, to reduce capital amortization for the next years and to reduce interest payments, was central to the Competitiveness Plan I presented when I took office. However, the limitation imposed by Congress when it granted the special powers preventing the use of taxes as a guarantee precluded the inclusion of provincial debt in the swap offering and made it impossible to get voluntary reductions of the interest rate paid on public debt.

Provincial public debt could not be included in the proposed swap because taxes from Federal Revenue Sharing Agreement ("Coparticipation Federal de Impuestos") already guaranteed provincial debt and its holders would not accept non-collateralized national bonds in exchange.

We could not expect to reduce the interest rate because without special guarantees we had to offer market rates to convince bondholders to participate in the exchange. Thus, the so-called Global Bond Exchange excluded Provincial Public Debt and become a market rate-based operation.

Even though provincial debt would not be included and we could not expect interest cost reduction, it was imperative to go ahead with this limited operation so that the IMF would consider the economic plan we presented to restore the "Blindaje" as financially sound.

Argentina would not have received the approval of IMF on May 21, 2001 if we had not carried out Global Bond Exchange (known as the "Megacanje"). Moreover, the official report of the IMF Executive Committee meeting of May 21, 2001 stated: " The managers praised the efforts of the (Argentine) authorities to interest creditors in a voluntary swap operation directed to reduce the financial requirements of the government during the next three or four years. They emphasized the need to finish this voluntary operation quickly to reduce uncertainties and move towards a sustainable financial scenario in average terms". [3]

While we were drafting the terms of the Global Bond Exchange, I sought to convince the National Congress to allow taxes to be used as a guarantee, especially the newly created Tax on Financial Transactions that was building the Public Credit Trust Fund. That way we could include the Provincial Debt as part of the Global Bond Exchange and, expect lower interest rates. I was able to convince several Peronist governors, who even called President de la Rúa to assure him that they would support my initiative, as long as the governors could get an agreement to restructure Provincial Debts. President de la Rúa answered that he could not send the bill to Congress because he did not have support from the Alliance (the President's political coalition).

These conversations happened on May 16, 2001. The day before, in Brazil, former President Raúl Alfonsín (a member of the Alliance and an influential leader of the Radical Party) had rejected the idea of offering a guarantee.

With the opposition of the President's own party, the idea of the Global Bond Swap including Provincial Debt was frustrated and so was the chance of achieving a reduction of interest costs. So, I suggested to the President to go ahead with the Global Bond Exchange with a limited objective: the decompression of amortizations and maturities for the next three or four years.

That very same day, May 16, we signed Decree 648, which authorized the Global Bond Exchange with those characteristics. Even with that limited objective, the operation was imperative to obtain the approval from the IMF in the following days, and to achieve the rehabilitation of the "Blindaje". The success of Global Bond Exchange would provide in the future a point of departure for a definitive public debt restructuring, with the consequent reduction of interests, as long as the political conditions would made it possible to offer some kind of guarantee.

[3] See "IMF Country Report No 01/90" and "Summing Up by the Chairmain. Argentina, Third Review Under the Stand By Arrangement, Executive Board Meeting 01/53, May 21, 2001". See also "IMF News Brief No 01/44, May 21, 2001" and "IMF, Argentina, An Assessment of the Debt Exchange Operation, June 29, 2001"

The "Road Shows" designed to convince bondholders to take part in the Global Bond Exchange, were transformed into an opportunity to make the government's Competitiveness Plan known and to show the world that Argentina still had enough political cohesion to find solutions for its crisis. Not only did officials from the Ministry of Finance, agents from underwriting banks and officials from the IMF take part in the "Road Shows", but also Peronist governors José Manuel de la Sota and Carlos Reuteman, as well as governor Angel Rozas, an important Radical leader, took part as a show of support and a show of consensus. Governor Carlos Ruckauf had visited me at the Ministry of Finance a couple of days before, and had asked for a press conference to offer his implicit support to the Global Bond Exchange. [4]

The Competitiveness Plan, including the Global Bond Exchange, was successful in reverting the bank deposit outflow and it even allowed a significant fiscal recovery during April, May and June of 2001. In this way, the severe deposit outflow in March was followed by an increase in deposits that rose up to 184 million in April, 828 million in May and 562 million in June. The fiscal deficit of the National Public Sector, which had registered 3,018 million in the first quarter, fell to 2,192 million in the second quarter.

Bank Deposit´s Monthly Variation	
Month	Variation in millions of pesos
January	910
February	771
March	-5.543
April	184
May	828
June	562
July	-5.268
August	-2.091
September	-69
October	6
November	-2.917
December	-2.546

Second attempt: agreement with the IMF in August

In the first week of July, the province of Buenos Aires and other provinces that had gone deeply into debt declared that they needed no less than 3,000 million dollars to meet their needs for the second quarter and they requested support from the National Government to obtain 300 million during that week. Despite the support offered by the Economy Ministry and the Chief of Cabinet, it was impossible

[4] See document called "Argentina, Mayo 2001" used for the "Road Shows" presentations.

to obtain that figure in the market and the Argentine National Bank extended a loan without true fund backup.

The following week, the government sold 180-day Treasury notes at an average annual rate set at 16%. These two facts convinced us that we could not count on new credit, neither for the provinces, nor for the Nation.

This left us with only one choice, to press ahead with the Zero Deficit ("Deficit Cero") regulation established in the Fiscal Responsibility Law. This law set the zero deficit for 2003. The disappearance of credit obliged us to set that target beginning the second semester of 2001.

The instrument to reassure the new zero deficit target was a modification of the Financial Administration Law authorizing the executive to reduce primary expenditure, including public sector salaries and pensions. Despite the announcements of the policy and its approval in Congress after the unanimous support of the provincial governors, doubts on Argentina's capacity for paying capital amortization of the Provincial Debt, as well as the non-deferred National Debt raised again. These doubts, along with a great number of unfavorable comments on the interruption of the service of the debt and the abandonment of Convertibility, caused a new draining of bank deposits that climbed to 5,268 million pesos in July and 2,091 million pesos in August.

The new confidence crisis in July required a new negotiation with the IMF to get external support that would allow us to stop the draining of reserves from the Central Bank and the Financial System. This negotiation would include not only the Zero Deficit program but also the completion of the debt restructuring of the National and Provincial Debt. The debt restructuring would allow us to lower the interest costs from the 14,000 million dollars we paid in 2001 (11,000 from the Nation and 3,000 from the provinces) to no more than 7,000 million dollars (5,500 from the Nation and 1,500 from the provinces).

These negotiations were very complex and resulted in the approval of a new IMF loan consisting of 8,000 million dollars; The IMF disbursed 5,000 million on September 10, to strengthen the Central Bank and the Financial System's liquidity, and 3,000 million were reserved for disbursing between November 2001 and March 2002, in support of the ongoing debt restructuring. On top of these additional funds, the quarterly disbursements of the "Blindaje" were pending.

The new agreement with the IMF stopped the draining of deposits during September and October, but the presentation of the debt restructuring had to be postponed for political reasons until November 1, due to the mid-term congressional election on October 14, in which many candidates were recklessly campaigning in favor of default. We needed the authorization to use taxes, especially the Public Credit Fund, as guarantees of payment to go ahead with the debt restructuring. After the elections in October, President Fernando de la Rúa determined that the conditions were such that he could decree a National and Provincial Public Debt restructuring with the inclusion of tax guarantees using the power granted to the President in the National Constitution. Thus, on November 1, De la Rúa signed the Executive Order 1387 and this allowed us to carry out immediately the swap of National and Provincial Public Debt for loans guaranteed by federal taxes. This was going to be Phase 1 of an integral swap of the National and Provincial Public Debt. With the IMF and other multilateral credit organizations' consent, and the domestic swap completed we could then carry out Phase 2 and exchange every bond from external holders.

We carried out Phase 1 of the integral debt restructuring between November 1 and December 15 and when it was finished a total of 55,000 million dollars of debt had been exchanged with an annual interest rate not higher than 7%. For the Nation and the provinces, this successful transaction meant a reduction of more than 4,000 million dollars on annual interest payments and the deferral of all amortization payments until after 2005.

Six months after the Global Bond Exchange was completed, it is clear that it was the tax guarantee that was the mechanism capable of producing the voluntary interest reduction.

Bondholders from the Global Bond Exchange decided to exchange them for collateralized loans with a 7 % annual interest rate and three additional years of amortization deferral. That showed that the high market rate demanded during the Global Bond Exchange auction reflected the market's distrust generated by so many demands of default and the denial of the National Congress to offer taxes as a guarantee. The situation of bonds from the Global Bond Exchange when I left the Ministry of Finance is shown in the following chart:

State of new bonds that emerged following the Global Bond Exchange for collateralized loans

	Market value as of Nov. 6, 2001	Amounts swapped for collateralized loans	Bond issues currently in circulation following the bond swap
Promissory note	2,107	2,103	4
Global 08	11,095	9,050	2,045
Global 18	7,060	6,154	906
Global 31	9,029	8,553	476
R. A $ 08	930	330	600
Total	30,221	26,190	4,031

As shown in the previous chart, 4,031 million dollars in bonds remained in circulation after the Global Bond Exchange; from 30,221 million dollars in circulation on November 6, 2001, 26,190 million dollars accepted to turn into collateralized loans. Argentine Law rules collateralized loans. This demonstrates that creditors seek assurances that they will be repaid and not the resignation of Argentine sovereignty. Bondholders are only interested in this last point when political forces show the no indication of the willingness to pay as occurred in March 2001 when the National Congress refused to offer taxes as a guarantee.

Third attempt: Negotiation with the IMF to launch Phase 2 of the integral debt restructuring

When we launched Phase 1 of the debt restructuring, local banks began to point out that the lack of liquidity of collateralized loans could create cash problems for them. Analysts indicated that banks that had extended loans to the provinces would be prone to face difficulties and this fact caused a new draining of capital from the Banking System.

While in September and October, the level of deposits had been stable, during November an there was an outflow of 2,917 million dollars, mainly during the last week of November, the moment in which rumors became louder and banks had to decide if they would participate or not the Phase 1 of the Global Bond Exchange.

We had no choice but to finish the National and Provincial Public Debt restructuring s successfully, as soon as possible, to stop a new draining of deposits. In this context, I began a new negotiation with the IMF to obtain the payments from the “Blindaje” and the 3,000 million dollars that had already been approved in August, to support the debt restructuring. The only requirement from the IMF was that Congress should approve the national Budget Bill for year 2002 and the Senate should start discussing a new Federal Tax Revenue Sharing for approval before September 2002.

In a meeting with the governors summoned by Senator Ramón Puerta, we settled an agreement that the bill regarding Federal Tax Revenue Sharing would enter Congress before the end of the year.

In the bill presented by the Executive, a 5,500 million dollars financial allotment had been included to cover interests (exactly half the amount budgeted for 2001) because of the interest cost reduction we expected from the debt-restructuring program. After implementing Phase 2 through the swap of the 40,000 dollars in bonds not included in Phase 1, the interest cost figure what amount no more than 5,500 million dollars.

The House of Representatives had to create new Budget Committee on December 10 after the new deputies had sworn in. We expected the Committee would discuss the draft budget law with the participation of the Secretary of Finance, Jorge Baldrich on December 19. With the budget approved by the second week of January, the IMF and other international credit organizations would support Phase 2 of the restructuring, which we had planned to launch on January 15, 2002 and complete in one month.

We were only two months away from reassuring the complete fiscal equilibrium and the restoration of financial trust through a transaction that would reduce by half the annual interest cost of the National and Provincial Public Debt and would relieve the government of capital maturities for the following three years.

The restoration of financial confidence was key to eliminate the restrictions to withdraw cash from the banks and to make financial transfers abroad imposed on December 1, to stop the run against the banks. These restrictions had forced most payments using bank money but they had not prevented payments with money deposited in the banks, nor had they changed in any sense the original currency of the deposit. Therefore, once banks recovered liquidity for their assets, which would have happened after the completion of the debt restructuring, the restrictions could have been removed. The so-called “corralito” would have lasted only 90 days, as originally promised.

The institutional coup that transpired from December 19 to December 30, 2001 prevented us from accomplishing these important objectives. On the contrary, it paved the way for an institutional rupture of no precedent in Argentine history. Default and devaluation, long praised by the coup conspirators and their allies, were brought about and chaos fell upon the Argentine economy.