

## **The Fight to Avoid Default and Devaluation**

By Domingo Cavallo  
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Rumors about default already existed when I took office at the Economy Ministry in March 2001. 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”, the 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 financial support to be paid out through years 2001 and 2002. To avoid default, in addition to meeting these payments, 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.

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 meet its Public Spending and Fiscal Deficit goals that were implied in the “Blindaje” and, as a result, the payments from the international financial organizations would be withheld. Rumors of default restarted and with them, a new outflow of deposits. In this context, José Luis Machinea presented his resignation and was followed by Ricardo López Murphy. 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 coalition 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, we registered the largest monthly deposit drainage in Argentina’s history: 5,543 million of pesos in March 2001. Up to that moment, the biggest deposit outflow had occurred in March 1995, amidst the so called 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.<sup>1</sup>

### **Why was it necessary to avoid 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. But this is not true due to four fundamental reasons:

First, a large segment of government creditors are Argentine savers. Bank deposits of the Argentine consumer are lent by banks in their role as financial intermediaries to the Public Sector in the form of bonds and the loans for the National and Provincial Governments. So when rumors about default are heard, some depositors become scared and withdraw their money from the banks. A High proportion of the contributions of workers to the Social Security System are held in government bonds. In every country in the world, the main assets of the social security system are public debt issues. 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 bond holders 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 companies from the domestic private sector, 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.

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<sup>1</sup> A detailed description on how we solved the Tequila Crisis can be found in my book, *El Peso de la Verdad*, Editorial Planeta, 1997

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.<sup>2</sup>

### **The successive attempts to avoid default.**

Throughout the nine months in which I held the Ministry 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 at the moment I presented my resignation. The governments that came after President de la Rúa formally declared default and devalued the currency. Four months after those decisions, many people, including some of the leaders that proposed the suspension of payments and the end of Convertibility, are beginning to understand that we had good reason to avoid default and devaluation.

### **First attempt: agreement with the IMF in May**

As soon as I took office at the Economy Ministry, I sought to restore the “Blindaje” so as to avoid the interruption of the agreed upon payments. As the goals on Public Spending and Fiscal Deficit for the first trimester of the year had not been fulfilled as had been agreed to in the “Blindaje” accord, 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 goals. 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 trimester so that we could fulfill the original goals of the third and fourth trimesters of 2001.

Second, we had to replace structural reforms related to the Social Security System for other reforms acceptable for the multilateral organizations of credit. These reforms were being held up by the National Congress. Moreover, we had to again demonstrate 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. So that the Executive Power could make all the necessary decisions, we sought from Congress the special powers to be delegated to the Executive Branch as imagined article n° 76 of the National Constitution in times of national crisis.

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 which was intended to receive funding from the collection of the new Financial Transactions Tax.

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<sup>2</sup> All these arguments are described in a document prepared by the Ministry of Finance in August 2001, called “Devaluation and Default in Argentina”.

Anyway, the new tax was passed and it began to be collected in April and helped to fulfill the fiscal goals.

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 administration of tax collections, which were also central to the fulfillment of fiscal goals.

The decision to restructure the public debt, including the debt of the provinces, so as 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. But 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 reductions of the interest rate paid on public debt.

Provincial public debt could not be included in the proposed swap because it was already guaranteed by taxes from Federal Revenue Sharing Agreement (“Coparticipation”) and no holder of this provincial debt would have exchanged it for non-collateralized national bonds.

We could not expect to reduce the interest rate because the absence of special guarantees would have forced us to offer market rates so that national bond holders accepted voluntarily to exchange them. Thus, the so-called Global Bond Exchange had to be designed excluding Provincial Public Debt and be conducted as a market rate-based operation.

Even though provincial debt would not be included and interest rate reductions could not be expected, 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 21st, 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 21st, 2001 states: “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 so as to reduce uncertainties and move towards a sustainable financial scenario in average terms”.<sup>3</sup>

While we drew up 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, and in that

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<sup>3</sup> 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”.

way 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 on including tax guarantees, as long as the governors could get an agreement to restructure the Provincial Debt. 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 16th, 2001. The day before, in Brazil, former President Raúl Alfonsín (a member of the Alliance and an influential leader of the Radical party) had stated that he was not in agreement that the new bonds should be guaranteed with fiscal tax collection. He stated: "this kind of guarantee must not be passed by Congress, if it is able to reach there".<sup>4</sup>

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 strong reduction of interest rates. 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 16th, 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 definitive public debt restructuring, with the consequent reduction of interests, as long as the political conditions that offered this payment guarantees were provided.

The "Road Shows" designed to convince bond holders 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.<sup>5</sup>

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 trimester of the year fell to 2,192 million in the second trimester.

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<sup>4</sup> Article published in *Diario Clarín*, Wednesday, May 16th 2001, Page 9.

<sup>5</sup> See document called "Argentina, Mayo 2001" used for the "Road Shows" presentations.

<b>Bank Deposits' Monthly Variation</b>	
<b>Month</b>	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 trimester 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 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 target 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 were raised again on Argentina’s capacity for paying capital amortization of the Provincial Debt, as well as part of the National Debt that had not yet been deferred. These doubts, along with a great number of unfavorable comments on the interruption of the debt-serving and the abandonment of Convertibility, caused a new draining of bank deposits that climbed to 5,268 million pesos in July, 2001 and 2,091 million pesos in August, 2001.

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 complete the debt restructuring of the National and Provincial Debt that would allow us to lower the interest rates from the level we had paid in 2001, that is 14,000 million dollars (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, 5,000 million were paid on September 10th, 2001, so as to strengthen the Central Bank and the Financial System's liquidity, and 3,000 million were to be paid in November 2001 and March 2002 in support of the ongoing debt restructuring. On top of this additional funds, the payments for 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 1st due to the mid-term congressional election on October 14th in which many candidates were recklessly campaigning in favor of default. We needed the authorization to use taxes, specially 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 1st, the Executive Order (decree) 1387 was signed, 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.

Phase 1 of the integral debt restructuring was carried out between November 1st and December 15th 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. When bond holders from Global Bond Exchange decided to exchange them for collateralized loans with an annual interest rate not higher than 7% and three additional years of amortization deferral, it showed that the high market rate demanded during the Global Bond Exchange auction process reflected the market's distrust generated by so many advocations 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 6th, 2001. 26,190 million dollars were turned in collateralized loans. It should be noted that Argentine law rules collateralized loans, this demonstrates that creditors seek assurances that they will be repaid and not, as some Argentine politicians charge, 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 Phase 1 of the debt restructuring was launched, local banks began to point out that the lack of liquidity of collateralized loans could create cash problems for them. The press 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 outflow of 2,917 million dollars was produced, 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 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 a bill regarding Federal Tax

Revenue Sharing should be presented to the Senate and that the National Budget Bill for the 2002 fiscal year be passed. In a meeting with the governors summoned by Senator Ramón Puerta we had settled an agreement that the bill regarding Federal Tax Revenue Share should be sent to 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) as a result of the positive effects we expected from the debt restructuring program. That would be the interest payment figure, once Phase 2 was implemented through the swap of the 40,000 dollars in bonds not included in Phase 1.

The new Budget Committee from the Chamber of Deputies had to be created on December 19th after the new deputies had been sworn in, so that the issue could be discussed on December 20th, with the participation of the Secretary of Finance, Dr. Jorge Baldrich. If the budget could be approved by the second week of January, the IMF and other international credit organizations would support Phase 2 of the restructuring, which was to be launched on January 15th 2002 and completed before February 15th, the same year.

Two months were left to reassure the complete fiscal equilibrium and the restoration of financial confidence through a transaction that would reduce by half the National and Provincial Public Debt annual payments and that 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 that had been imposed on December 1st to stop the run against the banks. These restrictions had forced bankarization of payments but they had not prevented bank money to be used for whatever purpose depositors wanted, nor had they changed in any sense the original currency of the deposit. So once banks recovered liquidity for their assets, which would have happened after the completion of the debt restructuring, the restrictions could have been removed. And the so called “corralito” would have lasted only 90 days, as originally promised.

The institutional coup which transpired from December 19th to December 30th 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, that had long been praised by the coup conspirators and their allies, were brought about and chaos fell upon the Argentine economy. My interpretation of the events related to the institutional coup is included in a document presented to Judge Oyarbide on April 19th 2002.<sup>6</sup>

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<sup>6</sup> See document “Se Presenta. Manifiesta” presented to Federal Judge Dr. Norberto Oyarbide.

### **Accusations on the Global Bond Exchange of being a crime:**

The accusations presented by National Deputies who have been admitted as plaintiffs, on the Global Bond Exchange case, as well as all the trial that is being carried out, are some of the many instruments promoters of default and devaluation have used in an unscrupulous way. By reading the accusations and by learning about the positions they have taken in Congress while the Competitiveness Plan was discussed, one can conclude that these Congressmen brought about the loss of access to credit for Argentina, destroyed the currency pushing the country into chaos. The investigation led by attorneys shows a pronounced ideological bias, a complete lack of capacity to recognize experts on financial matters, and an irresponsible acceptance of false evidence and journalistic falsehoods.

After reading the complete case, I could not find a single fact that could be considered as evidence of a criminal intent on the side of those of us who have taken part in the Global Bond Exchange, or of the banks that served as underwriters of the issues exchanged for the old debt. History will demonstrate that the opening of this case and the unsworn statements required from those of us who have been unfairly accused as a textbook example of the judicialization of politics in Argentina.

Attorneys and judges seek to judge decisions taken by the Executive Power. Members of the House of Representatives pressure judges and become plaintiffs in these cases as a demonstration of their inability to participate in policymaking from their seats in the National Congress, that is, from the place from which they are supposed to work. Those of us who have dedicated our efforts to fulfill our duty, as I did fighting to avoid default and devaluation, are now exposed to derision. This is another proof of the institutional disarticulation of Argentina.