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Hearing on The Argentine Financial Crisis
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By Michael Mussa
Senior Fellow
Institute of International Economics
Washington, D.C.

Mr. Chairman and members of the Subcommittee, it is a pleasure to respond to your request for an assessment of recent developments and key issues in the Argentine financial crisis, with particular reference to the economic and financial dimensions of U.S. policy towards Argentina and to U.S. positions with regard to Argentina's engagement with the International Monetary Fund since 2002.

At the outset, it should be emphasized that I am an informed but outside observer of the developments and issues that are the main subject of this hearing. In July 2002, the Institute of International Economics published my study, *Argentina and the Fund: From Triumph to Tragedy* (IIE Policy Analyses in International Economics Num. 67), which examined the developments leading up to those that are our central focus today. Subsequently, I have maintained a close watch on events in Argentina, especially as they relate to its relations with the IMF. But, my knowledge of developments in Argentina (since I left the staff of the IMF in September 2001) is mainly based on publicly available information and does not include detailed knowledge of great deal of internal, confidential, and private information that would probably be helpful to a complete understanding of the issues before us. Nevertheless, I believe that a great deal can usefully be said on the basis of publicly available information, including extensive documentation that has been made available by and through the IMF.

As a basis for assessing developments of the past 14 months and key current issues, it is essential to recall the desperate situation of Argentina in 2002 and (briefly) the conditions that led up to this catastrophe during the preceding decade.

From 1990 through mid 1998, the Argentine economy enjoyed spectacularly good performance, with real GDP rising nearly 40 percent and hyperinflation giving way to virtual price stability. The Convertibility Plan (which pegged the Argentine peso at one-to-one with the U.S. dollar) played a central role in these accomplishments; and other important reforms (including trade liberalization, privatisation of many public enterprises, and financial sector reform) contributed to prosperity. Unfortunately, the Argentine government (including the provinces) did not take advantage of these good times to put the public finances on a sound footing. Instead, they pursued policies that led to a significant increase in the ratio of public debt to GDP. Nevertheless, for many years, both foreign and domestic investors provided ample demand for government debt issues and for equities issued in privatizations.

The Brazilian crisis of 1998 and the sharp depreciation of the Brazilian real in early 1999 were important adverse shocks for the Argentine economy. Combined with the general appreciation of the Argentine peso because of its rigid link to the appreciating U.S. dollar, these adverse external developments helped to pitch the Argentine economy into a prolonged recession beginning about mid 1998. With recession and deflation, the fiscal position of the Argentine government deteriorated further, and the increase in the ratio of public debt to GDP accelerated. Nevertheless, private capital markets generally remained well disposed toward Argentina, with interest rate spreads on Argentine sovereign debt generally remaining below the average for emerging market borrowers until the autumn of 2000. The IMF maintained financial support programs for Argentina from 1991 through 2000, but except for the tequila crisis episode of 1995-96, actual disbursements of IMF support were quite limited.

By late 2000, it was clear that a major trouble was brewing for Argentina—with substantial risk of sovereign default, collapse of the Convertibility Plan, and a catastrophic economic and financial crisis. Interest rate spreads on Argentine sovereign debt escalated above the average for emerging market borrowers, and it appeared that both foreign and domestic investors were prepared to flee on signs of deepening difficulty. In December 2000, a major international support package was arranged under the auspices of the IMF (with about $14 billion of committed IMF funding and about $6 billion of committed funding from other official sources). Most of this funding was to be disbursed during 2001, conditional of the Argentine government's efforts to rein in its fiscal deficit and pursue other essential reforms.

This effort ran into difficulty early in 2001 as it became clear that the Argentine government would fail to meet its fiscal objectives for the first quarter. Subsequent attempts to reinforce the stabilization effort proved inadequate and, in my judgment, by mid 2001 both sovereign default (and compulsory sovereign debt restructuring) and collapse of the Convertibility Plan had become inevitable. However, the Argentine government was not prepared to give up, and the IMF and the official community continued to support the Argentines through the summer and most of autumn of 2001, including through a disbursement of more that $6 billion of IMF support in early September. The collapse finally came with massive runs on Argentine banks in late November, the freezing of most bank deposits on December 2, subsequent riots that brought the resignations of Minister Cavallo and President de la Rua, and at end December by the official declarations of sovereign default and termination of the Convertibility Plan by (interim) President Rodrigues Saa.

The first half of 2002 was terrible for the Argentine economy. Real GDP dropped another 12 to 15 percent, bringing the cumulative decline since the peak in mid 1998 to about 25 percent. Domestic inflation accelerated under the impact rapid depreciation of the peso which declined in value to less than one-third of a U.S. dollar—implying a massive increase in the ratio of Argentina's dollar denominated debt to its GDP. The financial system effectively ceased to function. The freeze continued on many (but not all) deposits. The government imposed asymmetric conversion rates for bank deposits and bank loans from dollars into pesos. Courts forced payouts of some deposits at artificially high conversion rates. Government and court actions effectively freed many debtors of much or all of their responsibility to make payments to creditors including banks. The value of government debt held by banks declined substantially. All told, the effect was a massive decline in the value of bank assets relative to bank liabilities which wiped out the equity value of banks several times over.

By the summer of 2002, however, the worst was over for Argentina. Indeed, on a tour to Buenos Aires to promote my book about Argentina and the Fund, I told a number of incredulous Argentine journalists that the economy had probably already began an upturn. This daring prediction was based on partly on upticks in a few economic indicators but mainly on the general pattern that we have observed in virtually all recent emerging market financial crises (Mexico and Argentina 1995-96; Thailand, Philippines, Malaysia, Indonesia, and Korea 1997-98; Russia and Brazil 1998-99): after six to nine months of economic and financial terror, recovery begins unexpectedly and proceeds at a pace far above most expectations.

Argentina followed that pattern. The policies of the Argentine government (under the administration of President Duhalde) made both positive and negative contributions to this result. On the one hand, despite a large depreciation of the peso and an initial upsurge in many domestic prices, Argentina avoided a bout of hyperinflation—as had occurred during the crisis of 1989-90. Governmental suppression of increases in the prices for public utilities and other goods and services and restraint on wage increases helped to contain inflation. So too did efforts to limit the depreciation of the peso through exchange controls, limits on withdrawals of bank deposits, and reductions in the demand for foreign exchange arising from the default by the government and many private debtors on their foreign exchange obligations. The avoidance of hyperinflation, in turn, probably helped to limit the collapse of confidence and thereby contributed to the economic rebound.

On the other hand, the policies pursued during the Duhalde administration interfered with the efficient allocation of resources, failed to address key problems in government finances and the financial sector, perpetrated a huge and arbitrary redistribution of wealth from creditors to debtors, and exacerbated several of the key difficulties that will impede Argentina's path to full recovery in the years to come. In particular, it is noteworthy that although the Argentine government (at both the federal and provincial levels) was insolvent and in formal default on its external debt, new government borrowing nevertheless effectively proceeded at a prodigious rate. The issuance of quasi-currencies by the federal government and several provinces was one important mechanism for this new borrowing. So too was the direct issuance of new debt (declared to be senior to existing debt already in default) to re-capitalize banks and thereby avoid defaults on deposits.

The massive issuance of new government debt, however, was not reflected in the government budget—which appeared to show highly respectable fiscal performance despite grave economic difficulties. Instead (in line with the recently exposed accounting practices of private enterprises like Enron, Worldcom, and Parmalat), the Argentine government conducted its massive debt issuance during 2002 outside of the government budget. This effort was so massive and so egregious that, contrary to the language usually employed in politely worded statements of the IMF Executive Board, the Public Information Notice accompanying the release of the 2002 Article IV IMF Consultation Report for Argentina (PIN No. 03/88, released July 25 2003) explicitly notes the following:

> "The public finances deteriorated sharply in 2001, at both the federal and provincial level, with the overall cash deficit of the consolidated public sector increasing by 2 ¾ percent of GDP to 6 ¼ percent of GDP. *The position improved in 2002*, owing mainly to the implementation of a revised revenue-sharing agreement with the provinces and tight control over spending. *The cash fiscal position, however, conceals the extent of the underlying deterioration in the public finances*, as there were large debt-creating expenditures, such as bond issuance in connection with the banking crisis, and capitalization of interest payments. A comprehensive measure would bring the augmented primary and overall deficits of the consolidated public sector in 2002 to 11 ¼ and 25 ¼ percent of GDP, respectively. [This compares with an estimate of a zero deficit in the cash primary balance and an estimated deficit of 10.3 percent of GDP in the overall cash deficit of the public sector.] [emphasis added]

IMF Policy Toward Argentina in 2002

Relations between the IMF and the Argentine authorities were difficult throughout 2002, and the major sources of these difficulties have carried over to 2003 and are still not resolved. Correspondingly, the key issues concerning U.S. policy toward Argentina and its relations with the IMF that are the main subject of this hearing have their origins in the controversies of 2002.

In view of the desperate situation in the Argentine economy, one might think that Argentina would naturally have been the target for a great deal of official assistance during 2002, particularly from the IMF. The need for and desirability of such assistance, however, was limited by four important factors. First, with the termination of the Convertibility Plan, the Argentine peso depreciated substantially against the dollar and this (together with a sharp contraction in the economy) turned the trade balance from deficit toward surplus, thereby lessening pressures on the balance of payments. Second, the Argentine government decided to default on a large volume of its external private debt, and the savings in interest and principal payments implied by this default were of substantial assistance to the budget and the balance of payments. Third, by end 2001, Argentina already had large obligations to the IMF and other international financial institutions (IFIs) and significant expansion of these liabilities would raise concerns for these institutions and for the value of claims of other creditors. Fourth, while additional official support might have been a superior *substitute* for large amounts of new off-budget government borrowing, it was difficult to assure that the result would not be *both* additional official support *and* large new off-budget borrowing.

Even if significant increases in IMF and other official support for Argentina were not warranted, there remained the important questions about the interest and principal payments due on already existing IFI support and of the conditions under which these payments might be rescheduled. Interest payments due to the IMF were comparatively modest because of the generally low rate of charge on IMF loans; but substantial principal payments were due to the IMF on tranches lent under the Supplementary Reserve Facility (SRF). Agreement on a new program with the IMF was also an essential condition for other IFIs to roll over their existing loans or provide net new credits.

It is no secret that the management and staff of the IMF (and probably most of the Executive Board) were dissatisfied with the policies of the Duhalde administration and did not believe that they provided an adequate basis for a renewed program with the IMF during 2002. Important concerns included the following: (i) inadequate fiscal discipline, especially the lack of and enforceable arrangement to control deficits at the provincial level; (ii) inadequate monetary discipline, specifically relating to the continuing issuance of quasi monies by the central and provincial governments; (iii) government opposition to any adjustment in public utility rates; and (iv) lack of progress in resolving the difficulties of the financial sector, including problems with the continuing freeze on some classes of bank deposits, asymmetric conversion rates for bank assets and liabilities, court actions to force payments of some deposits at unrealistically high values, and massive derogation of creditor rights through revision and lack of enforcement of bankruptcy laws. Absence of virtually any effort to deal with Argentina's external private creditors was also a concern, although it was probably recognized that progress in this area was difficult in the turbulence and uncertainties of 2002.

Indeed, although the IMF was pressed by some of its major shareholders--including the U.S. government—to reach an “interim” or “transitional” agreement with Argentina in December 2002 (approved by the Executive Board in January 2003), the staff and probably also the management much of the Executive Board of the IMF remained convinced that this program failed to meet the normal standards for an IMF program. This assessment is reflected in the following extraordinary statement in the Staff Report on Argentina’s Request for this Stand-By Arrangement (IMF Country Report No. 03/101, page 9):

> “In the staff’s view, the transitional program contains insufficient steps to give confidence to restoring medium-term sustainability and, thus, does not provide a basis of an assessment that Argentina would have the capacity to service its obligations to the Fund (or to comprehensively restructure the debt to private creditors.”

Normally, a positive assessment of a country’s ability to service its obligations to the IMF is an absolute requirement for approval of an IMF program. Aside from this staff report on Argentina, I have never seen an instance where a negative assessment was given on capacity to service obligations to the IMF.

On the Argentine side, there was also considerable frustration with the negotiations over an IMF program during 2002. To the Argentine authorities, the IMF’s policy prescriptions appeared rigid, doctrinaire, and unsuited to the economic and political realities of the crisis in Argentina. The political power of the provinces and the independence of the courts were seen as key constraints on the policies of the federal government. Especially in view of Argentina’s history, avoidance of another episode of hyperinflation was a key priority of the authorities—even if it was achieved partly through policies that repressed inflation and distorted relative prices. The apparent success of this policy by the second half of 2002, and the ability of the government to relax and subsequently remove the freeze on bank deposits were seen as under-appreciated by the IMF. So too was the fact that Argentina continued to make substantial payments (about $3 billion) to the IFIs during 2002—despite the terrible state of the Argentine economy. Indeed, the Argentine authorities were concerned that the continuation of large payments to the IFIs, without assurance of a substantial roll over of scheduled principal payments would, over time, massively deplete Argentina's limited foreign exchange reserves and undermine confidence in, and the effectiveness of, the government's stabilization efforts.

In my view, the IMF staff was correct in insisting that Argentina's economic policies during 2002 did not meet the standard normally required for and IMF program. However, I also agree with the Argentine authorities that (despite their deficiencies) the policies of the Argentine government were a reasonable response to the very difficult economic and political problems confronting Argentina during 2002. Thus, while Argentina's policies and performance did not merit a renewed IMF program that provided a substantial increase in IMF financial support; they did merit a roll-over of already existing IMF support and an official endorsement of Argentina's decision to defer payments to its external private creditors (as provided for in the IMF's "leanding into arrears" policy). Accordingly, I applaud reported the efforts of the U.S. government and other leading IMF shareholders in late 2002 to press the IMF to reach an interim agreement with Argentina.

However, I believe that it would have been better if interim IMF agreement with Argentina had explicitly recognized the special circumstances under which this form type of agreement was appropriate. This could have been accomplished formally creating a special category of IMF programs and conditionality to deal with cases like Argentina in 2002. In my study on *Argentina and the Fund*, I called this, " bifurcated conditionality." The idea is that for a country in truly desperate circumstances, with already large outstanding obligations to the IMF, it may be appropriate to roll over existing IMF loans on the basis of policies that are weaker than would normally be consistent with IMF conditionality for significant new lending. The virtue of this approach is that it would make it clear that countries with substantial obligations to the IMF could not generally presume that roll overs would be easily available. And, even Argentina would need to recognize that as economic conditions improved, the conditions for continuing roll overs of IMF credits would become meaningfully more demanding.

IMF Policy Toward Argentina in 2003

The interim IMF program with Argentina was designed to carry through the Argentine elections scheduled for the spring of 2003 and give the new government an opportunity to formulate the policies on which a successor IMF program would be negotiated. Under the interim program, relations between Argentina and the IMF proceeded relatively smoothly through the early summer. Economic performance was generally better than assumed when the interim program was agreed, and this contributed to Argentina's compliance with the main macroeconomic conditions of the program. Tension and controversy continued over the continuing freeze on utility rates, problems with the application and enforcement of bankruptcy laws, and sluggishness in addressing key problems in the financial sector. But, these difficulties did not seriously impede favorable conclusions from IMF reviews of progress under the interim program.

During the summer of 2003, attention shifted toward negotiation of the new 3-year IMF program that would take effect in the autumn of 2003 under the administration of the newly elected Argentine President, Nestor Kirchner. In addition to several of the incompletely resolved issues from the interim program, a key issue that received much increased attention in the negotiations for a new IMF program was Argentina's policies toward external private creditors holding large amounts of Argentine sovereign debt in default since late 2001. The long-standing IMF policy concerning "lending into arrears" of private creditors required that the countries engage in good faith efforts to resolve differences with private creditors. During 2002, current conditions and future prospects for the Argentine economy were so turbulent and uncertain that efforts to reach understandings with external private creditors appeared senseless. However, as economic conditions stabilized and improved during 2003, a credible effort by the Argentine authorities to begin discussions with external private creditors became a much more relevant issue.

Based on developments at the time and on what we know now, I believe that it is fair to say that the difficulties in the negotiations over the new IMF program during the summer of 2003 derived primarily from the reluctance of the Argentine authorities to commit to policies that would promise a substantial return to private holders of Argentina's external debt then in default. Continued resistance of the Argentine government to any upward adjustment in rates for the (mainly foreign-owed) public utilities was also an issue. The publicly stated policy of President Kirchner was that Argentines who had already suffered greatly in the current crisis should not be asked to sacrifice further to compensate for the losses of external creditors or pay increased utility rates to foreign companies that had negotiated allegedly unfair contracts with previous Argentine governments. Understanding that higher payments to foreigners necessarily meant, other things equal, less for Argentines, it is not surprising that President Kirchner's policy enjoyed widespread public support in Argentina. Similarly, there was popular support for veiled or explicit threats that the Argentine government would default on payments to the IMF and other IFIs unless the IMF agreed to a new program that rolled over existing IMF loans and met other conditions deemed acceptable by the Argentine government. In pressing these positions, the Argentine government probably also counted on the IMF's leading shareholders—especially the U.S. government—to press the IMF to reach a new agreement rather than incur both the political costs of a breach in friendly relations with Argentina and the operational difficulties for the IFIs of default on the large volume of loans outstanding to Argentina. Moreover, with its trade and current accounts in surplus (thanks partly to the effects of default), Argentina faced little need for external financing and, accordingly little immediate threat (other than the risk of being labeled an outcast from the international community) from a possible cut-off of IMF and other IFI loans.

In the end, with the support of the IMF's major shareholders, a new three-year IMF program was agreed with Argentina in August 2003. As requested by the Argentine government, this program provided for a complete roll over of the principal payments due on outstanding IMF loans (and an implicit promise of similar or better treatment by the other IFIs). The key issue of Argentina's treatment of its external private creditors (and public utility investors) was not really resolved; rather it was "kicked down the road." The Argentine authorities agreed to begin a process of engagement with their external private creditors and committed to provide an outline of their proposal of comprehensive debt restructuring to creditors on the occasion of the annual meetings of the IMF and World Bank in Doha, Qatar in late September/early October. The content of this outline of an offer, however, was not discussed with, or approved by, the IMF. For its part, the IMF's approval of the new program implied that, at that time, Argentina was making reasonable good faith efforts to deal with its external private creditors, as required by the IMF's "lending into arrears" policy. But, a positive assessment that Argentina was continuing to make reasonable good faith efforts vis-à-vis its external private creditors was made a performance criteria to be judged by the IMF Executive Board on the occasion of each quarterly review of the IMF program with Argentina. If

Argentina failed to behave responsibly toward its external private creditors, the IMF could—and, under its rules, should—pull the plug on the Argentine program.

This approach to dealing with the thorny issue of Argentina's treatment of its external private creditors (and other foreign investors) was, in my view, a reasonable compromise; and U.S. policy played a constructive role in supporting it. Resolution of large-scale defaults is often a complex and time-consuming process; and Argentina's sovereign default is exceptionally complicated. Although conditions had improved significantly in Argentina by the summer of 2003; they were nowhere near back to normal. An effort to force a resolution of Argentina's default—or to narrow substantially the range of options for such a resolution—would have been premature and counterproductive.

Although a compromise that deferred official efforts to press for a resolution of Argentina's sovereign default was the right approach in the summer of 2003, I believe that the IMF and its leading shareholders missed an important opportunity to remind Argentina of its responsibilities as a member in good standing of the international community. The international community strongly supported Argentina in its efforts to forestall a catastrophic crisis in 1995 and again in 2001. When those efforts failed, the international community understood the need, in the dire circumstances of 2002, to roll over most official lending to Argentina and to endorse the Argentine government's decision to defer payments to private external creditors. Symmetrically, it is reasonable for the international community to expect that Argentina would recognize that as economic conditions return toward normal there is a responsibility to treat foreign creditors and investors in a fair and reasonable manner. This important point was not made with appropriate clarity and force at the time of the approval of the new IMF program for Argentina in August/September 2003.

Difficulties in Resolving Argentina's Sovereign Default

President Kirchner has consistently indicated a tough attitude in dealing with Argentina's external private creditors. The face value of the debt is to be written down by 75 percent and no allowance is to be made for interest accrued since the debt went into default at the end of 2001. In addition, the outline of the offer for debt restructuring presented by the Argentine authorities at Doha (and at other regional meetings) implies substantial back-loading of interest and principal payments and the imposition of coupon interest rates at well below market levels. Looking at these proposals, bond holders have concluded that in market value terms, the Argentine offer amounts to no more than about ten cents on each dollar of face value plus accumulated arrears. This is a much lower return for bond holders in other sovereign restructurings by emerging market countries (e.g. about 65 percent recovery in the Brady restructurings) and even lower than the returns in restructurings for very poor or devastated countries (e.g. a 33 percent recovery rate agreed for official credits to Iraq). As bond holders see it, the Argentine government is asking them to accept not just a hair cut, or even a scalping, but a beheading. Understandably, they have rejected the Argentine offer as grossly inadequate—even "insulting."

The revolt by creditors, along with recognition of the substance of the Argentine offer, has apparently led to a stiffening of positions by some of the IMF's leading shareholders. At the Executive Board meeting in January 2004 for the regular quarterly review of the Argentine program, Executive Directors representing more than a third of total voting power declined to support the review. Such opposition (on a country matter) is virtually unprecedented in the history of the IMF. In addition, it is reported that at the G-7 finance ministers meeting in Boca Raton in February 2004, it was agreed that Argentina should be given a message about the need to improve its offer to creditors; and the IMF's managing director was dispatched to give this message to the Argentine authorities. Thus, the message that regrettably was not sent in August/September 2003 appears now to be being sent. Again, I believe that this is the right policy for the U.S. government to support.

The Argentine government's position is that it cannot afford to make a better offer to its external private creditors and still meet its other essential commitments. This position is based on key assumptions about the real growth rate of the Argentine economy, about the path of the real exchange rate, about the size of the primary fiscal surplus, and about interest and principal payments on debt of the Argentine government to the IFIs and to domestic residents (both the debt restructured in November 2001 and the newly issued "senior" debt). Applying the assumed primary surplus (3 percent of GDP) to the projected path of the dollar value of Argentine GDP determines the amount (of dollars) that is available for the Argentine government to pay interest on all of its debts. Subtracting out interest due to the IFIs and on domestic debt yields the residual that is available to pay interest on the external private debt now in default. Assumptions about the roll over rates for IFI and domestic debt affect the resources that are available for principal (or additional interest) payments on the external private debt.

Given reasonable assumptions about the longer-term growth rate of the Argentine economy and the path of the exchange rate, these calculations confirm the conclusion that the Argentine government has very little room to make payments to external private creditors. Indeed, in its analysis of this issue, the IMF staff concluded that (see IMF Country Report 03/392 Annex II) "…a primary surplus of 3 percent of GDP would not be sufficient to cover payments due on official debt [mainly to the IFIs] and private [domestic] debt after 2004; it would also *leave no room* for payments to [external private creditors holding debt now in default]." [emphasis added]

Does this mean that the Argentine government is correct in insisting on a 90 percent write-down of the external sovereign debt now in default? Not necessarily. Key assumptions used in reaching this conclusion are open to question. In particular, there is no compelling reason why the primary budget surplus is limited to 3 percent of GDP. Other countries that have faced critical fiscal challenges, such as Brazil and Turkey, have maintained primary budget surpluses above 4 percent of GDP. As the Argentine economy recovers toward more normal levels, there is no convincing reason why the primary budget surplus should not be able to rise somewhat from its present level of a little more than 3 percent of GDP.

The assumption that the domestic debt of the Argentine government should be exempt from further restructuring is also open to serious question. In dealing with a sovereign default, two general principles should apply: (i) all creditors should be expected to accept significant losses; and (ii) losses should not fall disproportionately on either domestic or foreign creditors. In this regard, it is noteworthy that domestic holders of debt restructured in November 2001 have already incurred substantial losses (measured by the dollar value of their claims); but these losses appear to be substantially less than the Argentine government is requesting from holders of external debt now in default. For newly issued domestic debt (which now amounts to more than $30 billion), the Argentine government insists that no restructuring is appropriate. But, much of this debt was issued with the purpose or effect of compensating Argentines from losses that they would otherwise have absorbed as holders of bank deposits or other indirect creditors of the Argentine government. In general, the losses sustained by these Argentines are proportionately far less than what is being asked of private holders of external sovereign debts now in default. If the Argentine government insists that the primary budget surplus cannot be raised above 3 percent of GDP and that external private creditors must absorb exceptionally large losses, then further consideration should be given to the restructuring of domestic debts of the Argentine sovereign.

The special status of Argentina's debts to the IFIs is also open to some question. In the context of the HIPC initiative the IFIs have accepted that a write down in the present value of their credits is appropriate for highly indebted poor countries pursuing responsible policies. If the official community concludes that Argentina meets the criteria of HIPC in terms of treatment appropriate for external private creditors, then consideration should perhaps be given to HIPC status for official credits as well. More generally, however, I see very good reasons why credits of the IFIs, especially credits of the IMF, should generally be accorded preferred status in sovereign debt restructurings. The IMF is the official lender of final resort that steps in to aid countries when private creditors are fleeing or threatening to flee; and the IMF charges much lower interest rates than generally face emerging market borrowers. The IMF can do these things because of the protections provided by its preferred creditor status and its conditionality. In contrast, private lenders take much greater risks in the event of default, but they get paid for this in the high interest rate spreads that they typically charge.

As things now stand, we appear to be a considerable distance away from the resolution of differences between the Argentine government and most of its private external creditors. Although quite low, secondary market prices for Argentine debt now in default appear to be significantly higher than can be justified by what the Argentine government has so far put forward as a restructuring offer. If the gap remains this large, negotiations between the Argentine government and its disgruntled private creditors are unlikely to get very far very fast. In this event, the international community, operating through the IMF, needs to be prepared for a breach in its relations with Argentina. This breach need not come soon if the Argentine government shows some flexibility in dealing with its private creditor. But it should come if and when it is clear that the recalcitrant attitude of the Argentine government is the main reason why negotiations are not making reasonable progress.

This does not mean that the IMF and the international community should attempt to set the exact terms of Argentina's sovereign debt restructuring. This needs to be left to the negotiating parties. But the international community cannot avoid responsibility for establishing broad parameters for what is fair and reasonable—both for Argentina and its creditors. The key objective is not to press for a resolution that particularly serves Argentina's interests or that particularly serves its creditors' interests. The objective is to protect the integrity and efficiency of international credit markets. These markets must be able to deal with situations of sovereign default on debts issued under international law (i.e., under the laws of other countries). Dealing with such defaults in a equitable and efficient manner requires both that creditors accept write downs in the value of their claims to levels that debtors can reasonably be expected to pay and that debtors not be allowed to walk away from their obligations on grounds that they do not want to pay as much as they reasonably could be expected to pay. Argentina is clearly a case where the ability of the international community to enforce these broad principles is being and will be severely tested. Principled leadership by the United States will be critical in meeting this challenge.