

ARGENTINA'S FINANCIAL CRISIS

HEARING
BEFORE THE
SUBCOMMITTEE ON
INTERNATIONAL TRADE AND FINANCE
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

ON

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ING ON THE BILATERAL RELATIONSHIP BETWEEN THE UNITED
STATES AND ARGENTINA

MARCH 10, 2004

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WEDNESDAY, MARCH 10, 2004

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met, at 1:05 p.m., in room SD-538, Dirksen Senate Office Building, Senator Chuck Hagel, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Good afternoon. The Argentina debt crisis has become an important issue and, as we know, Argentina has struggled through a series of structural economic reforms dating back to the early 1990's. Unfortunately, this has resulted in one of the largest defaults by a debtor nation in history.

Argentina is now faced with billions of dollars in debts, both the International Monetary Fund, IMF, and private investors who took a significant stake in Argentina's future. The impact of this financial crisis is being felt not only Argentina, but also throughout the world, particularly in the United States, which is a key player in the IMF and has a major private investment in Argentina.

Historically, the United States has played a significant role within IMF in influencing the policies that have assisted Argentina with its past financial restructuring. The United States has assumed this role because of its strong bilateral ties with Argentina and its historic influence on the economies of South America. Investors from Europe, Japan, and throughout South America look to the United States for leadership in institutions like the IMF.

This hearing today will examine what the implications of the Argentine crisis are for the United States and its role in the IMF. Argentina, South America, and countries throughout the world will continue to look at this crisis in the context of what the United States did to help resolve these problems. Close examination and scrutiny will be made of the roles that the United States and IMF played in protecting the rights of investors in Argentina.

Ironically, Argentina was considered, in the recent past, one of the wealthiest countries in the world. It is a nation rich in natural resources, and has been an important international trading partner for the United States and the entire South American economy.

Unfortunately, the early economic policies of former Presidents de la Rúa and Duhalde caused Argentina to fall into a state of financial, political, and civil disarray. These economic policies included a massive devaluation of the peso, increased taxes, and fro-

zen bank deposits, all which led to civil unrest and a succession of finance ministers.

When current President Kirchner came to office in May 2003, Argentina had defaulted on its foreign debt obligations of approximately \$140 billion. Included in this default were private creditors, mostly holding sovereign debt in the form of bonds, valued in excess of \$80 billion.

Argentina's failed economic policies resulted in the IMF adopting several bailout plans. In early 2003, the IMF approved an interim \$6.8 billion agreement with Argentina. In September 2003, the IMF approved an additional 3-year standby agreement with Argentina for \$12.5 billion.

This afternoon, we will hear testimony about the massive Argentine bond default. What will be the impact on future U.S. direct investment in Argentina and the region as a result of this crisis? What is the role of the IMF in protecting private investment when a foreign government defaults on its obligations?

We look forward to hearing the testimony of today's witnesses. Our first panel will be Assistant Secretary of the Treasury for International Affairs, Mr. Randy Quarles, and Assistant Secretary of State for Western Hemisphere Affairs, Mr. Roger Noriega. The second panel will include Mr. Michael Mussa, a Senior Fellow at the Institute for International Economics, and Mr. Adam Lerrick, of Carnegie Mellon University.

We appreciate very much all of you coming forward today with your thoughts and testimony, and we look forward to engaging in a question-and-answer period that will delve even deeper into the issue that we are about today.

With that thank you, let me now ask the Ranking Minority Member of the Subcommittee, the distinguished Senator from Indiana, Senator Bayh, for his comments.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman. I thank you for holding this hearing today. It is a matter of great importance not only to our country and to Argentina, but also to the global financial system. I think your priorities are well-placed in holding this hearing, and I want to thank all of those in attendance today who are interested, and also our panelists as we look forward to having the benefit of your expertise.

Just a few quick comments, Mr. Chairman. I think there are some very important issues at stake in today's hearing.

The first that I would mention is nothing less than the credibility of the International Monetary Fund, and through it the global financial system, through which we attempt to deal with countries experience financial crises. We run the risk, if this is not handled well, and we do not continue to use every reasonable method to convince the Argentines to deal honestly with their creditors, of running substantial moral hazard in the future.

I regret to say that we may be on the cusp of a situation where default, such as Argentina, may appear to be the reasonable thing to do on the part of creditor nations. If they can default without consequence, I am afraid that this may set a precedent that may come back to haunt us in the longer-term.

I am also afraid that the credibility of the IMF is at stake if we maintain a financial fiction of pretending that a country is not in default based upon a mere technicality when, to any reasonable observer, default is in fact what has occurred. We have avoided offending the United States taxpayers by being honest with them and saying that we have wasted money by putting it through the International Monetary Fund into Argentina, but in the long-run, this will only serve to undermine the commitment of the U.S. Government and, through us, our taxpayers to long-term interventions of this type.

I think honesty is the best policy. If Argentina is, in fact, in default, merely technically propping them up, maintaining this fiction, will do nothing but undermine the credibility of the U.S. Government in dealing with our own public, and therefore, as I mentioned, undermine our own commitment in this area in the long-term, which I think would be very unfortunate, Mr. Chairman.

I agree with something former Treasury Secretary Larry Summers once said. He said it is in the United States' best interests to advocate the forward defense of America's financial interests, and by that trying to deal with the spread of contagion before it gets out of control. But I think in this case we have gone beyond that and run a very real risk of creating substantial moral hazard going forward. As I said, default may, in fact, appear to be the reasonable thing to do, given the Argentine experience.

Second, another major issue is the behavior of the private international financial community. I hope it is clear to all of the representatives of the major creditors in the audience today who have loaned money to the Government of Argentina that, going forward, you have to be out of your minds to issue loans like this. That should be abundantly clear by now. And 4 or 5 years from now, I hope you do not forget this experience, when interest rates provided by Argentina have gone up to try and attract foreign capital, I hope you do not forget this experience.

They call it a risk premium for a reason. Your capital is at risk, and no one will be coming running to your rescue in the future to try and help you with the situation. But the Argentine behavior, it has been deplorable in many respects, but it should no longer come as a surprise. So, going forward, I think you need to make these investments and realize that you are on your own, and if you invest in countries that stiff-arm the global financial structure, in this case the IMF, or stiff-arm you, well, you should not be surprised if the results are similar going forward.

The analysts and the executives in your companies that authorize these loans because the interest rates looked attractive compared to more secure instruments I think bear some measure of responsibility here as well. There is something called political risk. We have seen it in Argentina in abundance. And going forward, I hope that you will insist upon accountability in your own ranks for short-term lending strategies that appear to prop up your returns, but in the long-run place your capital at risk. Again, do not be surprised if the IMF does not ride to your rescue, if the U.S. Government does not ride to your rescue. How many times do we have to learn this lesson before it finally sinks in? So, I hope you will hold some in your own ranks to account for this.

Finally, to the Argentines themselves, it is a great country. You have a great people. It is lamentable what has happened in your country, and I would say that delay can no longer be tolerated, playing semantic games can no longer be tolerated.

If we are going to rectify the situation and get your country back on the path to growth, which the citizens of Argentina deserve, I see in the paper today, Mr. Chairman, that Argentina has now agreed to engage in negotiations, not merely discussions, and that they are going to recognize the group of creditors and so forth. I think a fair amount of skepticism is in order as to whether this will, in fact, constitute more than a semantic difference, whether there will be, in fact, a significant improvement in the dialogue taking place with the creditors and some realistic attempt to try and solve this problem.

I would encourage the Argentines, unless you simply do no longer desire to have private capital invested in your country by investors from other countries, unless you no longer to have a relationship with the IMF, with the World Bank, with other multilateral institutions, please, please make a sincere aggressive effort to try and resolve this situation. I know it is not easy, but my final piece of advice would be short-term political expediency in the long-run rarely turns out to be wise public policy, and yet I fear that at the altar of short-term domestic political expediency, long-term sound policy for the people of Argentina may be being sacrificed.

Having said that, Mr. Chairman. I want to thank you for conducting these hearings. I look forward to hearing from our witnesses today.

Senator HAGEL. Senator Bayh, thank you.

Before I ask Secretary Noriega to begin with his testimony, let me advise the witnesses that we will most likely have some votes throughout the hearing. We have been advised that the first might come as early as 1:30. That is approximately 15 minutes from now. When that occurs, we will go as far as we can, with some time remaining on the vote, and then what I will do is, with the concurrence of Senator Bayh, is gavel a recess. We will go vote and come back. That way we will get the full benefit, each of us, of the testimony and the questions.

Thank you.

Secretary Noriega.

**STATEMENT OF ROGER F. NORIEGA
ASSISTANT SECRETARY FOR WESTERN HEMISPHERE AFFAIRS
U.S. DEPARTMENT OF STATE**

Mr. NORIEGA. Thank you very much, Mr. Chairman and Senator Bayh. I appreciate the opportunity to discuss Argentina's current economic and political situation, as well as our bilateral relationship with that country. I especially appreciate the chance to share the panel with my Treasury colleague, Assistant Secretary for International Affairs Randy Quarles, whose day-to-day management of this issue has been critical in producing what we regard as positive results.

My comments, very briefly, which I will submit in writing, will address the political and regional context for our policy toward Argentina. Argentina is a close and valued ally of the United States.

It has been through very tough times in the past several years. We are pleased that it has now begun its political, economic, and social recovery. The Bush Administration hopes to see Argentina succeed over the short-term and the long-term. Argentina's agreement with the IMF yesterday is a key part of reaching that objective, and we believe it is very good news that Argentina and the IMF reached that agreement on the program's second review, with Argentina making a \$3.1-billion payment to the IMF.

Mr. Chairman, President Kirchner has stressed that he wants to make Argentina a more predictable nation. He also has sought to root out corruption, restart the Argentine economy, and refurbish Argentina's stature in the world. He is facing a very daunting set of challenges to deal with the fallout of the recent economic crisis, as well as treat the institutional weaknesses that are the root of that crisis.

He has made an important start, we believe, in addressing this complicated, tough agenda, aided by talented Argentine people. With their support, he is making progress. Because he enjoys considerable popular support, he is well-positioned to seek the reforms that we believe are critical to Argentina's continued progress and development over the long haul. On the economic front, these reforms include revising the system of revenue sharing between the federal and provincial governments.

Bilaterally, we welcome President Kirchner's policy of maintaining close contact with the United States. He has met twice with President Bush since taking office in very candid exchanges on the issues that confront our bilateral relationship and those which President Kirchner is confronting at home.

Other officials in our Administration, of course, maintain regular dialogue on economic issues at the highest levels. Neither we, nor the Government of Argentina, however, have lost sight of the fact that we have other ties that link us—political trade, cultural, scientific, educational, and social areas.

As one of my predecessors used to admonish, we have to remember that Argentina is a country, not just an economy. It is indeed in our interest that Argentina occupy its rightful place as one of the global leaders in the promotion of democracy and human rights and in other values that we share.

In our deep and broad relationship, we address one another cooperatively on a range of issues. One specific area of a continued engagement is counterterrorism. As you know, Mr. Chairman and Senator, Argentina suffered devastating terrorist attacks in 1992 and 1994, and our shared experience with terrorist attacks on our home soil creates a special bond between our countries. Argentina has been a leader in this hemisphere in promoting cooperation in addressing the threats to our common security from those tied to terrorist organizations and those involved in money laundering and trafficking in arms and drugs, particularly in the Tri-Border Area where Argentina has been a leader in addressing some security concerns that we share.

I also want to highlight Argentina's important role in seeking to advance the cause of democracy, peace, and stability in the hemisphere and elsewhere. Argentina has peacekeeping forces today serving in five U.N. missions from Cyprus to Kosovo to the Congo,

and Argentina has recently offered to play a role in helping address the crisis in Haiti.

Argentine diplomacy has also been active on challenging regional issues including Bolivia and Venezuela. For example, in Caracas, President Kirchner, in February, met with representatives of the democratic opposition. So the leadership of Argentina is important.

As I mentioned a moment ago, our discussions with Argentina on economic matters have occurred at all levels involving several executive branch agencies, but I also wanted to commend the role that has been played by Members of Congress who have visited Argentina in this period and met with Argentine officials in Washington and on trips because it is important that the Argentine authorities hear this message from our Government, from all levels, and from all branches of Government, on some essential elements that we think are important to its economic future and recovery.

Our consistent goal has been to back Argentina's efforts to restore economic stability, as well as to restart economic growth, culminating with a 3-year economic program that Argentina launched with the IMF in September 2003 to lay the basis for long-term economic growth.

This program provides a solid framework, we believe, for sustainable growth that will benefit the Argentine people and the region. And Argentina's progress on this score is a positive message, we believe, to the rest of the region.

As the United States, we can and will be helpful, but ultimately the shape of the IMF program, and Argentina's performance under that program, are in the hands of the Argentine Government and the Fund. Yesterday's payment provides solid encouragement for the program's success.

Mr. Chairman, as friends, the United States and Argentina can and do speak openly and frankly to one another, while sharing common goals in the hemisphere. The United States also shares Argentina's conviction and determination that it can and will reverse its severe collapse of the last few years and return to the prosperity that it once enjoyed.

We stand ready to help to continue supporting Argentina's efforts, and through them strengthen all of our shared goals for our countries in this region and throughout the world.

Thank you very much, Mr. Chairman.

Senator HAGEL. Secretary Noriega, thank you. Your full statement will be included in the record.

Thank you.

Secretary Quarles.

**STATEMENT OF RANDAL K. QUARLES
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY**

Mr. QUARLES. Thank you, Mr. Chairman and Senator Bayh.

I am pleased to be here to discuss the Administration's economic and financial policy toward Argentina, particularly the U.S. stance with regard to Argentina's engagement with the International Monetary Fund since 2002.

I think it is worth spending a moment putting the engagement since 2002 in the historical context. As you mentioned at the out-

set, Mr. Chairman, Argentina had made good strides in the early 1990's in dealing with hyper-inflation and some of the economic challenges that they had faced in the late 1980's. But the excessive budget deficits during the 1990's that were driven largely by fiscal arrangements that required the central government to fund spending decisions by the provinces without any effective central budget constraint this led to the buildup of a large debt burden that the government could not service any longer by the end of 2001. Faced with that situation, the government defaulted on its debt, and it abandoned the pesos pegged to the U.S. dollar. And that economic crisis was accompanied by political instability that eventually led to a new interim government that was led by President Eduardo Duhalde.

Now, in the wake of that fault in devaluation, real GDP fell by 11 percent in 2002, inflation rose to over 40 percent, the peso depreciated by 69 percent, unemployment rose to 24 percent, severe economic consequences. In addition, seeking to avoid a complete collapse of the banking system, the government imposed far-reaching deposit controls. Other government actions, in particular, forced the conversion of dollar-denominated financial contracts into pesos that further weakened the banking system. On the monetary side, the authorities were struggling with the provincial creation of multiple quasi-currencies that at one point represented an astonishing 50 percent of the total currency in circulation, and the provinces had issued these quasi-currencies during the crisis to finance their spending in the face of collapsing revenues.

It was in that context that the U.S. Government began working with the Duhalde Administration and the IMF throughout 2002 in an attempt to develop a new IMF program and a set of policies that would stabilize this chaotic economic situation. Argentina's authorities took an extended period of time to develop such a program, in part, because of the deeply unsettled political situation. I think everyone is familiar with the fact that there were five presidents in the period of a month immediately after the collapse.

Argentina then, after this extended period of development of a program, launched an 8-month transitional IMF program in January 2003, which the United States strongly supported. The purpose of the transitional program was to stabilize the Argentine economy in the most basic way because the most basic things were going deeply wrong. The program's 8-month length, very short for an IMF program, was long enough to last through the presidential elections in May, and for a sufficient period of time after that to give the incoming government enough time to develop its policy priorities. And then the focus of the transitional program was on macroeconomic stabilization. The expectation was that then a new administration that would come in with the elections in May would have a political mandate to pursue the more difficult reforms that would be needed to lay the basis for sustained economic growth.

First, you had to stabilize the situation, and then the more difficult structural reforms could be made by a new government that would come into place in May.

Argentina performed well under that transitional program. It met its IMF fiscal and monetary targets by wide margins. The central government signed bilateral agreements with the provinces

that set clear limits on the provincial deficits in 2003. Basically, they plugged this hole in the bucket that had led to the crisis in the first place. The government launched a program to retire the quasi-currencies, which was critical to ensuring that the federal government and the provinces lived within their means and that retirement of currencies is now complete. And in the context of improved macroeconomic policies, the government was able to lift the freeze on bank deposits without the inflationary surge or the collapse in deposits that many had feared.

The transitional program helped to boost confidence in the economy, and that confidence underpinned the acceleration of economic growth in early 2003. Real GDP for the year as a whole grew an impressive 8 percent. Unemployment fell to 16 percent by the end of the year. Inflation fell to under 4 percent. And during that same period, the peso appreciated 15 percent, foreign exchange reserves increased by about \$3.5 billion. In short, the transitional program fulfilled its objectives, which was to stabilize the situation so that a new government could come in and begin taking the more difficult steps that would be necessary for medium- and longer-term economic growth.

As the Kirchner Administration came into office, it faced the dual challenges of consolidating the achievements of the transitional program and then of undertaking the actions that were needed to lay the basis for sustained economic growth in the future. That latter means both adopting reforms to deal with the root causes of the Argentine crisis, which I described very briefly at the outset, as well as taking steps to address the problems that were created by the crisis and that included resolution of Argentina's defaulted debt. So the 3-year program that was launched in September 2003 was designed around those objectives.

The fiscal and monetary framework of the program, as well as the institutionalization of central bank independence, the gradual shift to inflation targeting was designed to entrench macroeconomic stability in order to keep the current recovery going.

Fiscal problems, as I had outlined, were at the core of Argentina's financial crisis. The 3-year program not only mandates strict limits on provincial deficits in borrowing, but also provides for a comprehensive reform of the federal provincial fiscal framework to prevent the problems that led to the crisis from reoccurring, and that includes new measures to strengthen tax administration to fight illegal tax evasion.

In addition, the crisis and the government actions during the crisis seriously damaged Argentina's banking system. The program establishes a framework for restoring health to the banking system by providing compensation from the government to address balance sheet damage that was done by the previous government, clarifying the regulatory environment, establishing capital standards designed to facilitate the strengthening of balance sheets over time, requiring banks to develop business plans for achieving specified capital requirements.

Another key area affected by the crisis was the utility sector. Under its program, Argentina has undertaken to work with the World Bank to resolve the problems in the utility sector, including ending the price freeze, redesigning a tariff structure, reestab-

lishing a coherent regulatory framework, renegotiating concession contracts, and finally a key objective of the program is to facilitate the successful resolution of Argentina's defaulted debt.

Argentina has about \$100 billion in private-sector claims outstanding. Its debt restructuring is the most complex in emerging markets' history. That is not only because of its size, but also because of the number of different currencies, the number of different legal jurisdictions in which it was issued, as well as the number of different types of bondholders involved, including sizeable holdings by retail investors in Italy, Japan, and Germany.

The program provides the broad policy framework to underpin a debt-restructuring agreement between Argentina and its creditors. The program requires Argentina to work in good faith with its creditors, to reach a collaborative agreement that restores debt sustainability.

IMF lending policies require transparent and constructive negotiations by Argentina with its private creditors to secure the broad creditor support in a debt restructuring that is needed to achieve a sustainable debt situation to facilitate Argentina's progressive reintegration into international capital markets. Argentina is going to need substantial investment to generate economic growth for the long-term.

Argentina has continued to perform well under this program on its fiscal and monetary policies at least under the program. It has extended the gains that it has made under the transitional program. The government's budget performance to date exceeded the program targets by a significant margin. There has been important progress in strengthening the institutional and legal framework for tax administration. In the area of intergovernmental finances, the central government has concluded agreements with the provincial governments, limiting provincial spending and borrowing consistent with the requirements of the program.

Progress in some other structural areas of the program up to now has been less satisfactory. Although the government has implemented new regulatory standards for the banking system, there have been delays in finalizing the agreed compensation to banks for the action that was taken by the government during the crisis. Bank lending remains depressed. Argentina's progress with the World Bank on reform of the utility sector has also been slow, although the Argentine Government did recently agree to raise tariffs on electricity and gas for the first time since the crisis.

It continues to be essential for Argentina to make progress on debt restructuring with its private creditors. The government's announcement that it has made arrangements for the hiring of investment banking advisers to handle its debt exchange is a step forward. In addition, we expect to see, over the upcoming weeks, Argentina take the concrete steps necessary to negotiate with representative creditor groups on the terms of its restructured debt. Only with a negotiation process that builds mutual trust can Argentina achieve the broad creditor support that is needed for a comprehensive and a sustainable debt restructuring.

Let me just conclude by saying that we want Argentina to succeed, to succeed in stabilizing its economy in the wake of crisis, to succeed in resolving its defaulted debt and to succeed in laying the

basis for long-term economic growth. That will require rigorous implementation of this program. We have been a forceful advocate for IMF engagement with Argentina in pursuit of these ends, and we are continuing to work with Argentina and the IMF to encourage this implementation.

Senator HAGEL. Secretary Quarles, thank you.

I have been informed that a vote has begun, and if my distinguished colleague agrees, we will take a short recess, vote, and then come back and get to the questions.

Thank you.

[Recess.]

Senator HAGEL. We will resume activity of this distinguished panel now that Senator Bayh and I have voted, and we may get a reprieve here for a few minutes. I am aware of the schedules of both of our witnesses on the first panel, so we will get right to the questions.

Thank you.

Let me begin a couple of my questions with Secretary Noriega. In your opinion, what impact has this crisis had on regional relationships in South America. You alluded to some of that, Secretary Quarles did as well, as the fabric is woven together by not just economics, but economics affect political and geopolitical security interests. And if you could give us some sense of the larger political sense of those relationships in South America, good, bad, or maybe nothing has been affected by this Argentine problem.

Mr. NORIEGA. It is a good question, Senator. I think it is important to note that Argentina has, particularly in the 1990's, established itself as a very good friend of the United States. Sending forces to Iraq in 1991 is one example of that very close relationship.

And so our neighbors in the region naturally judge us by how we treat our very best friends. I think there was, therefore, some concern, when there was a perception that the international financial community was cutting Argentina loose and letting its economy collapse. Sophisticated observers, I think, recognized, however, that the United States made an effort.

They also, frankly, ascribed the troubles to Argentina's own decisions, the institutional problems in Argentina, corruption, et cetera. Frankly, the level of sympathy from other countries in the region was not that high, and they recognized that Argentina had, through its own policies, sewn the seeds of the problems that they have encountered.

Nevertheless, there is this question of whether the United States is or is not with its friends. In particular, in the last 18 months to 2 years, I think they have seen the United States going the extra mile, helping Argentina to interpret for the other developed countries that have a stake in this crisis, and serving as a bridge between our other G-7 partners and Argentina. I think that certainly has come through in the last few weeks and days really.

We have not seen other countries for example, Brazil—looking at the brinkmanship that Argentina has practiced as an example or a model that they want to follow. I think the Brazilians would like to see Argentina succeed. They have taken a very different approach in their dealings with the IMF, though. I do not really see

a contagion in terms of the way Argentina has behaved vis-à-vis the IMF.

Senator HAGEL. Secretary Quarles, would you like to add anything?

Mr. QUARLES. I think, simply to underscore the point that Secretary Noriega made, that I do not think, particularly with respect to the debt default, with respect to Argentina's economic stance, generally, that is something that will be emulated by other countries in the region.

Senator HAGEL. We hope not.

Mr. QUARLES. The consequences of it were so dire for Argentina, the collapse in GDP, the rise in unemployment, 50-percent of their population, by their figures, under the poverty line, that I do not think that Argentina is viewed as a model for the region or that its policies are viewed as successful policies, and I think we have seen that in the fact that other countries are not emulating their approach.

Senator HAGEL. Thank you.

Secretary Quarles, in your opinion, what additional measures could have or should have the IMF taken in Argentina, given the proportion of this default and this debt?

Mr. QUARLES. I think in considering what the IMF could have or should have done, you look at the context, and there I think that the criticism of the transitional program that I described as weak, needs to be looked at in the context of what it was trying to achieve in that very chaotic situation, stabilizing the macroeconomic foundations.

I actually think that the judgment that that is what that program should focus on, and limit itself to that, so that it could be effective in doing that with an administration that was admittedly an interim administration, without a significant political mandate, is a judgment that events have borne out, with the success of stabilizing the macroeconomic situation.

I think, then, what the IMF could and should do now going forward is to ensure that focus is placed on the structural reforms that I described and in a way that really places focus on the reforms that Argentina needs to accomplish in a prioritized way. For example, with respect to this recent disbursement and Letter of Intent that has just been announced by the IMF and Argentina, a central focus was placed on changing the attitude with respect to the debt negotiations to getting Argentina to agree that they will negotiate with all representative groups of creditors. And my understanding is that Argentina has done this. That is what has been announced by the Fund, and that is what we in the United States will expect to see going forward.

We will expect to see additional progress on compensating the banks and addressing the banking sector issues that Argentina has begun to address, but has not yet addressed as much as we would have preferred to see by this point and, similarly, with respect to steps that need to be taken in the utility sector.

So what the IMF can, and should do, is not lose focus on these structural reforms that Argentina needs to take. I do not think that some of the criticism that the IMF program has been toothless, that it has been overly weak, is justified because, in fact, it does

focus on the important structural reforms that are necessary given what the nature of the crisis was, given what the root causes of the crisis were.

But what has to happen is that the implementation of those reforms needs to be vigorous, and the Fund needs to ensure that Argentina is vigorous in implementing them.

Senator HAGEL. Two quick questions in regard to two points you just made, one on the banking system.

First question—and I know you addressed some of this in your testimony, as you just have noted now—do you believe the banking system, as it currently exists in Argentina, is capable in fact of the structural reforms and putting itself back together as a functioning financial service industry? And give me some reason why, if you believe that—and I assume you do—why you think that, aside from what you said in your statement.

And the other question is this: With this crisis in Argentina, I assume this will lead to IMF learning something, adjusting, recalibrating in how it deals with other debtor nations, and I would like you to address that as well.

Mr. QUARLES. Certainly. With respect to the banking system being able to reestablish itself, yes, I do think that that is possible. I think that the elements of the program that address the banking system create a framework in which that can happen. It is a process that is not going to happen overnight. It is going to take time. The damage that has been done to the Argentine banking system has been severe, but it is a system that can reestablish itself, over a period of several years, to health.

Some of the reasons that I think that this has begun to happen, I mean, Argentina has taken steps in strengthening the regulatory framework that is going to be required for a healthy banking system, for immediately after the crisis, there was a significant amount of regulatory forbearance, basically preventing the banks from having to face their problems by not acknowledging the problems. You are never going to fix the problem if you are ignoring the problem.

That regulatory forbearance has ended, and banks are being required to face the problems by the regulators, and that is the first step toward the health of a banking system. We discovered that in our own financial system issues at the end of the 1980's and early 1990's that ending regulatory forbearance was the way to eventually move toward the health of a system, and Argentina is beginning to do that.

They have also imposed capital standards, improved their capital standards, established a framework for bringing banks up to those standards. The road map has been laid out, and that is obviously an important part of getting a banking system back to health, is that you know you have laid out the map as to how it is going to happen.

I think they have not yet done as much as they need to do in dealing with the role of the public banks versus the private banks in Argentina. Public banks in a banking system are frequently a source of malaise and ill health. They have been in Argentina, and I think that needs to be dealt with going forward. But all of these

are issues that can be dealt with, but it is going to take a long time.

I am sorry, the second question?

Senator HAGEL. The second one is what has the IMF learned, what should they learn? And this then would lead to changes in the way IMF in the future deals with debtor nations.

Mr. QUARLES. I believe there are a few things. I think it is clear that the IMF could have been more vigorous during the 1990's in pressing Argentina on problems that it knew were there, particularly this hole in the fiscal bucket, that at the end of the day was really the root of the crisis, this fiscal Federalism problem where the provinces were allowed to spend, require the central government to borrow to fund that spending with no ability of the central government really to limit that spending.

That is something the IMF was aware of. It was something they certainly had spoken to Argentina about in the context of their regular Article IV consultations that they do every year with every country in the Fund, but it was not stressed sufficiently.

I think that increased transparency of countries that are members of the Fund, requiring them to be more transparent to the market about information that is relevant to the market, about the views of the Fund, the information that they are getting from the Fund, the advice they are getting from the Fund requiring countries to be more transparent about that is something that the Fund should be increasingly strong about. They have pushed that.

I think they need to push it more but basically, what the Fund needs to learn, and I think it is a lesson that they are beginning to implement, is that they cannot be complacent about problems like this and need to both push countries themselves, with the advice that they are giving, and push countries to be transparent about the advice that they are getting in order to prevent problems like this from occurring.

Senator HAGEL. Secretary Noriega, did you have a comment on that?

Mr. NORIEGA. No, sir, I think it was adequately addressed.

Senator HAGEL. Thank you.

Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman.

There are no television cameras in the room here today, at least none that I can see, so you do not have to be worried about being captured on film.

I would like to ask for a show of hands. Anybody in the audience today representing any of the creditors?

One, two, three. That is it? Some of the rest of you prefer to be unidentified.

Let me start, Secretary Quarles, with you then. As you know, the IMF requires as a part of their agreements to require that the country in question, Argentina, for our purposes today, is making "a good-faith effort" to reach an agreement with its creditors.

Do you think Argentina has been making a good-faith effort to reach an agreement with its creditors?

Mr. QUARLES. That question was central to the recent negotiations between the Fund and Argentina as to whether they have

been making a good-faith effort and will be making a good-faith effort going forward.

There are certain things that we think Argentina needs to do in order for its efforts with its creditors to be viewed as good-faith efforts, and we have been very clear about them with Argentina. We have been very clear about them with the Fund.

We think that they need to negotiate, not just talk, but negotiate, with all representative creditor groups. That includes the Global Committee for Argentine bondholders and other representative creditor groups. That is going to be essential to achieving a successful debt restructuring.

We think they need to hire and retain investment banks. Now, they have made progress on that. When we walked in the room, I do not think that had finally been assigned, but we expect it to be. And the hiring and retention of investment banks to advise them on this process is absolutely critical to it going forward.

They need to work with those banks to identify a minimum threshold for achieving a debt restructuring that has broad creditor support.

Senator BAYH. Say that again. They need to—

Mr. QUARLES. They need to work with their investment banks in defining a minimum threshold that is going to be necessary in the debt restructuring, a threshold of acceptance of the debt restructuring, to show that there is broad creditor support for that restructuring.

Senator BAYH. Is a 10-percent pledge of repayment sufficient to generate a broad base of creditor support in your opinion?

Mr. QUARLES. Our stance is that we do not want to take a view—

Senator BAYH. You do not want to get in the middle of it.

Mr. QUARLES. Exactly.

Senator BAYH. Let me put you down as agnostic in response to the question of good faith. Any of the representatives here from the creditors, raise your hands if you think that Argentina has been making a good-faith effort.

Let the record show that no hands were raised.

The agreement that was just signed, as I understand it, Mr. Secretary, required that transparent and constructive negotiations take place. I assume that is more or less the same thing as making a good-faith effort or is there some substantive difference between those two?

Mr. QUARLES. No, we think that the two are importantly related. I do not think that there is a substantive difference.

Senator BAYH. In your opinion, will the IMF ever be repaid or are we simply going to continue to rollover these loans ad infinitum?

Mr. QUARLES. No, we will not roll them over ad infinitum. Yes, the IMF will be repaid. That is something that we have also been very clear about with the Argentines. We expect the international financial institutions, the IMF and the MDB's, the World Bank, and the Inter-American Development Bank to be repaid, and Argentina has the capacity to do that, and I believe they will do that.

Senator BAYH. Hopefully, at some point in the not-too-distant future. I mean, you would have to say most observers looking at the

current situation would have to say that it might not be ad infinitum, but it does not appear that it is going to be any time soon.

Mr. QUARLES. We have been clear with Argentina that they must be continually, that the exposure of the IFIs to Argentina must be declining over time, and we expect that to happen.

Senator BAYH. Well, it would be very helpful for them to agree to some schedule that they could then be held accountable for adhering to because I think you are right. My initial comments to the point, I think it is vitally important that the United States continue to be engaged in addressing global financial crises. It is in our long-term best interests. At the same time, we have to be candid with the American public and say that this is not altogether a risk-free or a costless enterprise. And if there is a situation where a default has occurred or a de facto default has occurred, it is better to acknowledge that.

But let us just say I hope you are correct. I hope you are correct. I think that is an important question to get nailed down with some schedule that we can try and adhere to.

With regard to the structural reform, I was very encouraged to hear a lot of the things you had to say—the political reform, some of the other things that have been done. As you are probably aware, though, there has been I think a fair amount of skepticism is in order here. I regret to say that, but there is a history of pledges being made, commitments being made that are then not adhered to, of steps being taken, at least in theory, but then not being fully, and I think you used the word which I would say is the key word in all of this, not implemented.

And so I think, in some respects, this is the triumph of hope over experience. We have to focus on the actual implementation of the political reform, the other reforms that have been enacted or committed to, and I think, frankly, it is going to take some zealous oversight.

So you are here today to testify to us. I do not want to be unfair about this, but part of this is just a question of trust and that, frankly, there is not a lot of trust left after this long history. And I know some previous governments are to blame for that, and so forth and so on, but are you and your colleagues going to zealously participate in overseeing the actual implementation of this new process?

Mr. QUARLES. We are going to be very engaged, as a shareholder of the Fund, in doing that. There will be regular disbursements under the program. At every one of these disbursements, it will be necessary to evaluate how Argentina is performing, both under the program and in the continuing resolution of its outstanding debt. And we do not intend to be lax in ensuring that these elements of the program are implemented.

Senator BAYH. There were domestic political reasons, as I understand it, for the relationship that evolved between the central government and the provinces, and some of the other problematic situations that developed over time in Argentina, and I assume that some of that domestic political pressure has not entirely gone away. So put me down, as I am by nature an optimist, but put me down as a skeptic until we actually see some steps taken on the process, on the road toward implementation. But I appreciate your

commitment and that of your colleagues toward seeing this through.

Just a couple of other questions. Japan, Italy, and I believe Britain all declined to approve December's disbursement from the IMF. Do either one of you have any idea, do you want to give us the reasons why they declined to do that?

Mr. QUARLES. Let me just phrase it as their stance with respect to Argentina, as opposed to their votes on the board. I think we do for a variety of reasons. Governments seek to maintain the confidentiality of board votes. The board directors are not supposed to reveal—

Senator BAYH. This was reported in the popular press.

Mr. QUARLES. I understand. But let me just phrase it as the stance of those countries with respect to Argentina's progress at the end of January in implementing the IMF program. I do think that they were concerned about the degree to which Argentina was proceeding in good faith in restructuring its debt, but that is a question that people could have differing views about at that point.

Argentina certainly had met with a large number of creditor groups. People had differing views about the value of those meetings, but this is a very complicated debt restructuring. Taking off my assistant secretary hat and putting back on my lawyer hat from my time as a lawyer with a Wall Street law firm, for the nearly 20 years I spent there, this is the most complicated sovereign deal that has ever been done. It is going to take a long time.

It is a very complicated process, and there were reasonable differences of view at the end of January as to whether Argentina was proceeding in good faith or not, in good faith with a very difficult job or not in such good faith with a very difficult job.

Senator BAYH. Can I hazard a theory, Mr. Quarles? Feel free to disagree. Because the foreign policy ramifications of the situation are more important or, to us, have more significance to us than the other three countries, they are not completely without significance to them, but given our position in the world, it is a bigger priority for us. They placed more weight upon the good faith of the negotiations, the progress toward trying to resolve these financial disagreements.

So our position of continuing to favor the disbursements was influenced by our own foreign policy, which are not illegitimate, but they are separate.

Mr. QUARLES. You are absolutely right that foreign policy concerns are not illegitimate, but I would say that, again, at the time that those decisions were made and those disagreements were, those differences of view, were present, it was not principally foreign policy decisions that were driving it.

There were genuine differences of point of view of the financial professionals involved in the finance ministries of all of the relevant countries involved as to whether we really could say that there was not good faith on the part of Argentina at that time.

Senator BAYH. Fair enough. I just wanted to point out that apparently some other countries were taking a little bit firmer attitude toward this on the financial side of things.

My last point, Mr. Chairman, and you have been very patient. I believe, Secretary Quarles, and my dictating skills are not so

great, but as best as I was able to take down your comments, you said something to the effect that Argentina will need substantial foreign investment going forward to try and stabilize and grow the economy the way we would all like to see it take place.

Given this history, I just find it to be breathtaking, how the foreign banks were treated, the utilities, the creditors are getting diddled, the IMF has been given the runaround, et cetera. Where will that capital come from? Why would they make those investments?

Mr. QUARLES. No, I think that is a very important question. It is another reason why I do not think that the Argentine model is ultimately going to be a siren call for other countries in the region because, in the near-term, there is going to be difficulty for Argentina, even if they ultimately successfully resolve this debt.

Senator BAYH. Here is my concern, and I will let you go. For the moment, the country seems to have been stabilized. It seems to be heading back in a better direction, and I am afraid that the long-term lessons may be lost, and they may basically take the attitude, okay, we could do all that, and it worked out okay, and that it will only be a period of years from now, when they are cut off from international investment and from multinational assistance, et cetera, that the full cost of this course of action will be made apparent.

In the meantime, other people look at the situation and say, you know, they are still there. Things seem to have stabilized. They are heading in a better direction. Why should we, speaking of other countries, take on the domestic pressure of doing the tough, but right, thing?

Mr. QUARLES. That is an acute observation and a subtle and serious concern. But I do think that the short-term costs to Argentina have been so great, as we already described, and the medium- and long-term costs of not making some of these steps that we have been talking about today will also be significant and obvious enough that this period, there may be a period of a year or two where it might seem that, oh, things are going better and medium- and long-term costs would not be obvious if Argentina were not to address some of these questions.

But that is a brief enough period, and the original costs and the medium- and long-term costs will be obvious enough that I think that will be clear to other countries in the region, certainly, to their governments, even to the extent there might be some threads in these countries that might find it attractive or not understand the situation.

Senator BAYH. You have both been very patient today. My final point is that unfortunately it seems that memories are short. They are short in the public sector. They are short in the private sector. People reach for high rates of return in the near-term, perhaps forgetting the lessons of the past about putting capital at risk, and I am afraid that sometimes people take the path of least resistance in domestic political terms, even with the long-term financial costs.

I am afraid that one of the reasons for this hearing, I understand, is that we want to get on the record this history so that perhaps we can learn from it and not repeat it.

Mr. NORIEGA. Mr. Chairman, may I add a few comments on a couple of these issues?

Senator HAGEL. Yes.

Mr. NORIEGA. I think, if you read what President Kirchner has said, one of his concerns is he recognizes that Argentina has made commitments over the years and has not taken them very seriously. One of his commitments to his own people and to us is that he wants to break that cycle, and he wants to meet these commitments.

He has driven a very hard bargain with the IMF, and he has managed to exceed, in significant ways, the macroeconomic targets he set for himself. He has to move along the rest of this agenda, and we have been very, very clear to him that he has to do these important things to get domestic credit moving, attracting investment, being more predictable to those companies that, frankly, do want to continue to do business in Argentina.

In the last few weeks, I think it should be noted that our partners in the G-7 and the United States have been united, really, worked very, very closely together. There is not really a division, and that united front has been influential, I think, and important.

President Bush met with President Kirchner in January and said, you have to do some of these essential things to help me help you. And so his credibility with Kirchner is high, and President Kirchner recognizes that his credibility with President Bush is at stake. I think he has recognized that he has political space at home, he has economic space to do some of these other things that are being required of him now.

One of the important things now is dealing with restructuring his credit and negotiating in good faith with his creditors. The last Letter of Intent really sets out, in very detailed terms, measurable steps that they can take and we will be considering whether they take them, developing a time table and a process that will ensure meaningful negotiations and empowering investment banks to carry out these negotiations. So you have the profit motive, frankly.

We know what is at stake here, Senator and Mr. Chairman, and that is the essential property rights of these people, the attractiveness of the Argentine economy to investment, getting that economy going, and I think President Kirchner is recognizing that too. We are working very closely with our partners. I do not think there is any space between us in holding them accountable, in moving forward down the rest of that agenda that will be necessary to jump-start that economy.

Senator HAGEL. Thank you. Secretary Quarles, picking up a little bit on where Senator Bayh left off his line of questioning, in your opinion is there private investment capital available today in Argentina?

Mr. QUARLES. The amount of certainly foreign direct investment in Argentina is very small, and I think that the amount of capital from outside the country and, frankly, from inside the country, the amount of investment that is available, is greatly constrained by the situation.

I do think that it is certainly within the capacity of Argentina, and it is one of the reasons why we are so focused, why we have been so focused on changing the course with which they were approaching the debt restructuring and pushing them to address

some of these questions about compensating the banks and addressing the utility sector.

I do think it is possible for Argentina to change that situation and attract foreign investment again.

Senator HAGEL. Let me ask you how do you measure that? Is that measured by the IMF? The question that I ask, direct investment capital, I have heard different reports—it is not empirical data—that, in fact, there is a significant amount of private capital washing around in Argentina. I do not know that. But how do you measure that, if there is capital or not or some? How were you led to the conclusion that you had just shared with us in answering my question?

Mr. QUARLES. The Argentine Government has statistics with which it measures certainly the amount of foreign capital available. Bank lending, for example, is about 7 percent of GDP, and in a country like Argentina, an emerging market like Argentina, it should be closer to 20 to 40 percent of GDP. And it is statistics like that, that add up to the picture that the availability of capital for investment in Argentina is severely constrained. But as I said, I think there are steps that Argentina can take, that it is beginning to take, that can change that situation.

Senator HAGEL. But if that does not occur, then the scenarios, the sources of recapitalizing the banking structure and reorganizing the banking structure are somewhat dim.

Mr. QUARLES. Yes, I agree with that.

Senator HAGEL. Then, why would American investors be tempted back into Argentina, given the current situation. I understand what you were saying. While they were in a position they could do it, somewhere down the road they have to start addressing these issues, but these are down-the-road dynamics which are important, yes, and a political dynamic is important, but if there is little capital flowing in, and everyone stays out because of the huge, I would suspect, unprecedented default here, then what would incentivize or tempt anyone back in.

Mr. QUARLES. That is a very important question, and it is one of the reasons why we are being so clear about the structural forms we think Argentina needs to make because it is only through doing that that they will be able to attract future capital.

Argentina is a country that has significant resources. It has natural resources. It has resources in its people. As you noted at the outset of this hearing, it has been one of the richest countries in the world and could be so again. And those opportunities will, if there is a sufficiently facilitating investment climate, be attractive to both domestic and foreign investors.

Capital will return to a country like Argentina that has the ability for economic returns that Argentina offers if there is the right investment climate. And it is trying to address those issues that the IMF agreement includes some of these structural reform elements that we have been talking about today.

Senator HAGEL. Let me ask you—and I know you both have to leave and comply with another commitment—outside the financial services industry, the utilities, what could Argentina be doing that it is not doing to address the utilities industry issue? Obviously, re-

structuring debt, could there be a change of ownership? What are the options are that I am not aware of?

It does not mean that they are not occurring, but I have been somewhat aware of some of the specific utilities issues that we are dealing with down there, and it seems to me there has been some very limited imagination used by the Argentines in dealing with that specific sector.

Mr. QUARLES. The most direct and straightforward thing that Argentina can do is move more rapidly. They have begun in some sectors, but not broadly, to raise the tariffs, the utility rates, basically, to allow the utility rates to be raised to a market rate to allow the utility companies to make the necessary profit, to then continue to invest. Now, obviously, that is politically very difficult. I think it is something that could be done more quickly.

The second thing, however, is that Argentina has agreed to engage with the World Bank in thinking through exactly these sorts of questions. The World Bank is ready to provide assistance to Argentina as a program is worked out to address the utility sector issues, and that also is something that Argentina can do, is to be more forward-learning, faster, if you will, in its engagement with the World Bank on working through these questions.

Senator HAGEL. We could spend the afternoon, obviously, pursuing the questions that we have asked and your answers and other questions, but I very much appreciate both of you coming up here this afternoon.

We may well have additional questions for the record from other colleagues who were not able to attend today. Senator Bayh may have additional questions, as may I. So we will leave the record open until the end of the week and may well forward you some questions for the record.

Any additional comments that either of you would like to make?

Mr. NORIEGA. Thank you, sir.

Mr. QUARLES. No.

Senator HAGEL. Thank you.

Mr. QUARLES. Thank you very much.

Senator HAGEL. If the second panel would move up, we would appreciate it.

Thank you.

Professor Lerrick and Mr. Mussa, thank you for joining us today. We appreciate very much your time and your effort and look forward to your testimony.

Professor Lerrick, let us begin with you.

**STATEMENT OF ADAM LERRICK
LEADER OF THE NEGOTIATIONS TEAM OF THE
ARGENTINA BOND RESTRUCTURING AGENCY PLC,
DIRECTOR, GAILLIOT CENTER FOR PUBLIC POLICY, AND
FRIENDS OF ALLAN H. MELTZER PROFESSOR OF ECONOMICS
CARNEGIE MELLON UNIVERSITY**

Mr. LERRICK. Thank you, Mr. Chairman.

First, let me say I appear before the Subcommittee wearing two hats; first, as the Director for the Center of Public Policy at Carnegie Mellon and, second, as leader of the negotiation team for the

Argentine Bond Restructuring Agency, which is known in the market as ABRA.

ABRA is the largest creditor in the Argentine debt restructuring. It holds approximately \$1.2 billion, a nominal amount of Argentine bonds, and the interests of an estimated 30,000 to 40,000 retail investors in Germany, Austria, Switzerland, and the Netherlands.

ABRA was one of the three founders and is a member of the Steering Committee of the Global Committee of Argentina Bondholders, which represents directly holders of more than \$37 billion of bonds or more than two-thirds of the \$53 billion of Argentine debt held by foreign investors. All of the major constituencies of Argentina's foreign bondholders are represented, both geographically and by type of investor. Italy, Germany, Austria, Japan, and the United States dominate. Retail and institutional investors share power to match their equal shares of Argentina's debt.

How did we get here? Well, we have a developing nation of 38 million people, insignificant in the world economy and largely dependent on agricultural exports, that was able to borrow an extraordinary \$100 billion in the capital markets. It became the largest debtor in the emerging world with 25 percent of the global total. The most sophisticated global hedge funds and portfolio managers, along with the most naive Japanese farmers and Italian pensioners readily purchased these promises to pay without any regard to the debtor's capacity to pay. The credit worthiness of the borrower was irrelevant. It was the bailout policies of the Clinton Administration in the 1990's that socialized the risks and privatized the returns from emerging market lending.

In 1995, in Mexico, Lawrence Summers, then-U.S. Treasury Under Secretary, gave life to a financial anomaly: An asset with a high rate of return and with an unwritten AAA guarantee from G-7 governments via IMF bailouts. The natural laws of the risk return tradeoff were contravened. The demand was explosive. Annual bond issuance by Latin American governments instantly quadrupled from \$9 billion to \$37 billion.

Bailouts grew with borrowing. The \$50-billion package from Mexico was promised to be a one-time event. Instead, there followed in swift succession: In 1997, Thailand for \$17 billion, Indonesia for \$34 billion, and Korea for \$57 billion; in 1998, Russia for \$16 billion and Brazil for \$42 billion; and, in 2002, Turkey for \$10 billion and Argentina for \$20 billion. Loss largely bypassed the private sector that, with the exception of Russia, did not write off a single dollar on sovereign lending to large emerging nations. A quarter-trillion dollars in risk was shifted from the balance sheets of private creditors to official ledgers.

In 1996, the Group of 10 took note of the moral hazard inherent in bailouts, with a promise that they would act "to discourage expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector." But as time went on, an overriding, but unspoken, U.S. Treasury policy, without legislative endorsement, held that development in emerging economies was a global public good and that a high flow of affordable funding to these markets, beyond official capability, must be encouraged at all costs.

Even as the IMF was warning the Argentine Government behind closed doors that its fiscal policy was unsustainable, the Fund continued to support the nation publicly. In 5 years, starting in 1995, bondholders doubled their investment from \$50 billion to \$100 billion.

By 2000, G-7 taxpayers were staring at a long list of payouts down the road. Excesses were finally halted by the Bush Administration in December 2001, when the IMF stood by and a clearly insolvent Argentina was allowed to default on its massive debt to the private sector.

The second problem is that now the IMF has a tiger by the tail. The economist, John Maynard Keynes once wrote that "if you owe the bank 100 pounds, you have a problem. If you owe the bank 1 million pounds, the bank has a problem."

Just as past bailout policy had allowed Argentina to dominate emerging bond markets with \$100 billion of debt to the private sector, it permitted Argentina to accumulate \$30 billion of debt to the official sector and to hold the disproportionate share of official lending.

Argentina is now the IMF's third-largest debtor, with 15 percent of the Fund's portfolio. It is the second-largest borrower with the Inter-American Development Bank, with 17 percent of loans outstanding; it is the World Bank's fifth-largest exposure, with 7 percent of total risk.

Nothing is more feared by the multilateral agencies than default. It not only threatens their capital structure, but also even more dangerous, calls into question the long-held posture that official loans are riskless and consequently have no cost to donor country taxpayers. As then-Secretary of Treasury Robert Rubin stated to Congress, when he requested the \$18-billion appropriation for the IMF in 1998, "It does not cost one dime."

Default to any of the international financial institutions by a major borrower opens a Pandora's Box of policy issues. Why are the multilateral agencies providing funds at subsidized interest rates to developing borrowers that enjoy full access to the capital markets? What are the costs and risks for G-7 taxpayers? What has been the effectiveness of past efforts? Why are the costs of participation in these institutions not accounted for in the U.S. budget? When new funding is requested, Congress will be called upon to scrutinize the merits and costs of international financial institution programs relative to completing uses of scarce public monies.

Twice in the past 2 years, Argentina has successfully played the default card. To combat IMF conditions of reform, the Argentine Government halted payments to the World Bank and Inter-American Development Bank in late 2002. Similarly, in September 2003, Argentina defaulted to the IMF for a day until an agreement on the government's terms was signed.

The emerging market is watching. Lending to governments is a tricky business. We no longer live in an era where the governments of private-sector lenders send the Navy to collect on their bad loans. There is no collateral, no security, no ability to enforce the contract, and no ability to seize assets. The only rational reason to pay is there is more to gain from paying than from not paying.

Argentina has made a preemptive decision. Payments to the country's lenders are now deemed discretionary expenditure, not fixed obligations. Government-sponsored posters of ragged children crystallized a new concept, the social debt. To provide a better quality of life for citizens, takes priority over the financial debt to the Nation's creditors.

If Argentina even comes close to imposing the 90-percent debt reduction it currently is demanding, a level of relief that has not been obtained by even the poorest African nations, how can Latin American leaders or any developing-country politician justify to their electorates stringent fiscal efforts to honor obligations to foreign lenders? Why not schools and hospitals, instead of repaying rich foreigners? The resulting defaults will cascade through the international capital markets.

At the beginning of this statement, it was noted that ABRA was the largest creditor in the Argentine debt restructuring. I misspoke. The debt held by the IMF is a 13-time multiple. In order to qualify for IMF loans, the rules of the Fund require governments in default to the private sector to demonstrate good-faith efforts to restructure their debt. Is it not a conflict of interest to ask this agency to rule on a debtor's good faith toward what are competing creditors at a time when its own balance sheet is threatened?

Every month that Argentina delays its restructuring, it saves \$700 million in accumulating interest. Since the default in December 2001, this adds up to more than \$20 billion. Instead of relying on exhortation and a vague and subjective standard of good faith, the IMF should create automatic financial incentives that encourage governments to restructure defaulted foreign debt without delay. As a condition of desirable Fund loans that carry highly subsidized interest rates and no repayment for 3 years, the IMF should require an accelerated 5-percent monthly prepayment until the country comes to terms with its private creditors.

The Argentine crisis is the creature of a misguided international financial policy. When the expectation of bailouts no longer intervenes, then market forces will limit the debt a government can accumulate, and the IMF will no longer be at the mercy of its large borrowers.

Senator HAGEL. Professor Lerrick, thank you.
Mr. Mussa.

**STATEMENT OF MICHAEL MUSSA, SENIOR FELLOW
INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. MUSSA. Thank you, Mr. Chairman.

In your invitation to this hearing, you asked for an assessment of the economic and financial dimensions of United States policy toward Argentina, particularly United States positions with regard to Argentina's engagement with the International Monetary Fund since 2002.

Now, I have a long prepared statement. Let me try and summarize five key points.

Senator HAGEL. Your full statement will be included for the record.

Mr. MUSSA. Thank you.

First, in 2002 itself, the first half-year, the Argentine economy continued to collapse in a massive depression that ultimately took GDP about 25-percent below its mid-1998 peak, saw the currency depreciate by two-thirds, saw inflation pick up, the banking system collapse, and many other calamities.

In the context of this catastrophe, one can look to the policies of President Duhalde, and there is I think much to criticize in those policies. There is no doubt, and the deliberations at the IMF ultimately made this clear, that the policies of the Duhalde Administration failed to meet the normal standards for an IMF program.

Nevertheless, the Duhalde Administration did successfully avoid a recurrence of hyper-inflation. They halted the collapse of confidence and, at mid-year, the economy began to recover. Argentina, also, in 2002, paid a net of \$3 billion to the international financial institutions.

In my view, while far from perfect, this was good enough to justify a rollover of large payments coming due to the Fund and other IFT's, without which Argentina would have been forced either to exhaust its reserves or default on its official debts. And the U.S. Administration, I believe, was right in pressing a somewhat reluctant IMF to come to the interim agreement which was reached in December 2002.

Second, while I think this was the right approach at that time and under those circumstances, I believe it would have been better to do this in a new special IMF facility that would have emphasized that situations like Argentina could be treated as special cases, but only if they met quite specific criteria.

Countries, in general, could not expect to simply rollover their IMF debts nor could they expect the IMF to certify that they were making good-faith efforts to deal with private creditors, credits in default, even when no such efforts were being made at all.

However, in the desperate circumstances of 2002, no efforts, other than saying "we will get back to you later," to deal with private creditors really made much sense. But it should have been made explicit that: This was a special response to a special circumstance. Other countries should not count on it, except in exceptional circumstances, and Argentina should not count on continuing treatment of this kind as its own situation improves.

Third, the interim IMF program of 2003. I agree with Assistant Secretary Quarles that, on the whole, this program worked pretty well, despite continuing controversies over the freeze on utility rates, court actions to free deposits, and a number of other irritations.

There was, however, a stumbling block in the negotiations for the new IMF program to take effect after the administration of the new President, Nestor Kirchner, had taken office and had an opportunity to formulate its policies and priorities. That new issue was the issue of Argentina's efforts to deal with the external private debt then in default.

It is fair to say that in negotiations over the start of that program, this issue was kicked down the road, rather than resolved. But that too was a reasonable solution as of August/September 2003, based on Argentina's commitment to begin a serious process of discussions with its external creditors and to present an offer in

Doha, at the time of the World Bank/IMF annual meetings, that would indicate to creditors what Argentina was prepared to do.

Fourth, when that offer was made public, it became clear, to the extent that it was not clear already, that the Argentines did not intend to make very generous payments to the holders of their external sovereign debt. The face value was to be written down 75 percent, and the effective reduction in value, including deferred interest payments, was more like 90 percent. This compares with a 65-percent recovery rate, on average, from many other emerging-market debt restructuring and a recovery rate from even restructuring of official debts to poor countries that is generally above the 10-percent range. For instance, for Iraq, former Secretary Baker has achieved agreement on the principle of one-third recovery by official lenders.

Needless to say, creditors were not pleased by the prospect of what I describe as not a haircut or even a scalping, but a beheading. As the dissatisfaction of creditors became known, and as the major shareholders of the IMF came to recognize from their own assessment of the Argentine offer, dissatisfaction with Argentina's proposals, vis-à-vis its external default, grew. Those dissatisfactions manifested themselves in the abstentions by more than a third of the voting power of the IMF Executive Board on the occasion of the first review of the new IMF program.

Normally, countries vote, yes, on virtually every country matter. A one-third abstention on a country matter is virtually unprecedented in the history of the IMF. So there was a message in that vote, and that message was later reinforced by the discussions at the Boca Raton G-7 ministerial meeting, where press reports indicated that the assembled ministers agreed that the managing Director of the IMF should be asked to give a tough message to President Kirchner about the need to get more serious concerning the debt restructuring.

Now, here I think again the proper actions were taken, but maybe there was a bit too much of a delay and lack of clarity—at the time of discussion of the agreement of August/September 2003—and, subsequently, a bit too much of a delay in making public official concerns about some of the deficiencies of the Argentine offer.

Finally, I think there is a key issue about establishing the proper role and function of the IMF and the international community in dealing with situations like Argentina and its default on its external credit. The issue is not the narrow question of pressing Argentina to serve its creditors or pressing its creditors to agree to a large write-down to benefit Argentina. The issue that is central to the international community is the integrity and deficiency of the functioning of international credit markets.

If we are going to have international credit markets in sovereign obligations, then those markets need to be able to deal with situations of sovereign default. They will arise from time to time. They can be dealt with only if two broad principles are observed:

One, creditors need to be prepared to accept significant write-downs in the value of their claims when a debtor really cannot afford to pay the contractual terms of the debt that is outstanding.

Two, debtors cannot be allowed to simply walk away from their obligations because they do not want to pay or find it politically convenient at home to announce that they will not pay when they really do have the capacity to pay significant returns on their outstanding claims.

The issue for the international community is how to enforce those two broad principles. I think, in the case of Argentina, we have seen some considerable slippage relative to what has been done in past instances, and the leadership of the United States, particularly within the context of the International Monetary Fund, will be important in repairing that situation.

Senator HAGEL. Mr. Mussa, thank you.

Let me ask each of you, especially in light of Professor Lerrick's testimony, do you think we should just abolish the IMF?

Professor Lerrick.

Mr. LERRICK. No, Mr. Chairman. The IMF has a very useful role to play. In fact, it has a number of very useful roles to play. The principal one is to act as a lender of last resort for developing countries in the international financial system. However, that is not the function that the IMF played in the case of Argentina. There are very strict rules, guidelines that have been established over more than a century of central bank intervention in domestic credit markets, and those were clearly violated in the case of IMF intervention in Argentina. It was for another purpose; there was another goal involved.

But let us be clear, the responsibility of the IMF is the stability of the international financial system. It has no responsibility for the prosperity of any individual country. That is not what it was created for. Therefore, central banks have, for over 100 years, established methods of intervention that follow that key rule. And this rule was not followed in the case of Argentina.

The problem in the case of Argentina is that there was a different policy that was being pursued. The goal was to ensure a large supply of low-cost capital to emerging markets, far beyond what the official sector could provide. So the only way of achieving this objective was—since the private sector only responds to two things, risk and return, and the official sector was not prepared to subsidize investments by paying returns to private investors to send money to developing countries—was to eliminate the risk. And that is what was achieved through IMF bailouts. And that is how we got into this situation.

If we eliminate bailouts, then what will happen is the markets themselves will control the amount of funds that go to emerging economies. Countries like Argentina will not be able to borrow so much. They will then not be able to force bailouts and they will not gain their leverage over the official sector by holding them hostage through large loans by the IMF, the World Bank, and the IADB.

Senator HAGEL. But you note in your testimony not only the Argentine issue, but you also mention 1995 in Mexico, Lawrence Summers, then-U.S. Treasury Under Secretary, gave life to a financial anomaly, an asset with a high rate of return and with an unwritten AAA guarantee from G-7 governments. And then you went on, actually, prior to the Mexican 1995 issue, it was the bailout

policies of the Clinton Administration in the 1990's. So it is not just Argentina.

Mr. LERRICK. No, it is not just Argentina. It was the policy regarding developing countries.

Senator HAGEL. It is a course of actions taken in events that—

Mr. LERRICK. Absolutely. But Argentina is the most egregious example.

Senator HAGEL. Then what are the options?

Mr. LERRICK. The options are to let the markets function.

Senator HAGEL. So you would just let Mexico go down, Argentina go down—

Mr. LERRICK. No. No, each case is—

Senator HAGEL. Structural changes in the IMF?

Mr. LERRICK. No, each case is different—each situation must be evaluated separately. It is very clear that Argentina was clearly insolvent. There is no role for a lender of last resort in stabilizing an insolvent borrower. There is a role for a lender of last resort in providing liquidity to a borrower that is solvent but at the moment does not have the resources to pay its obligations. In the case of an insolvent borrower, where—and again, intervention should only take place when there is concern for the stability of the entire international system—it does not matter what will happen to any individual country. And so therefore, if you have a case like Argentina, where the center of the crisis, Argentina, is clearly insolvent, the intervention from the IMF should not be to lend to Argentina. The intervention from the IMF should be to announce that, for any other economy affected by the crisis, that is potentially a victim of contagion, the IMF will lend freely. But they will not lend to the insolvent center of the crisis.

This has been followed in the United States. There is the example Drexel Burnham. When Drexel Burnham was insolvent, the Federal Reserve did not lend to Drexel Burnham to forestall the insolvency. The Federal Reserve announced to the entire financial system that anyone else who suffered from the insolvency of Drexel Burnham could come to the Federal Reserve and obtain liquid resources immediately. And that is what should have happened in the case of Argentina.

Senator HAGEL. Mr. Mussa.

Mr. MUSSA. Well, I also agree the IMF—I might say, particularly the IMF Pension Fund—should not be abolished. I disagree with a fair bit of what Adam said, both in his prepared remarks and just now. But I wanted to focus on the announced topic of the hearing.

Senator HAGEL. I appreciate that, but I would also be interested in your response to Professor Lerrick's comments to my question.

Mr. MUSSA. Indeed.

Senator HAGEL. Thank you.

Mr. MUSSA. The IMF has the established function of an official lender of final resort. I am not going to go through the definition of this topic. There is a long Princeton essay by Stan Fischer on this subject. But let me read from the Articles of Agreement the purposes of the IMF as originally stated and still prevailing. This is with regard to Purpose 5, which relates to the financing function.

To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the

opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

It was clearly envisioned that the IMF had general resources and it was going to lend them temporarily, under adequate safeguards, in order to enable countries to adjust to balance-of-payments problems without resorting to unproductive measures. That has always been understood to be a central function of the Fund.

One of the important elements “under adequate safeguards” is that the Fund is supposed to have confidence that it will be repaid when it lends money to a country. And as Adam suggests, if you are lending money to a government that is insolvent already, that raises certain, quite legitimate concerns.

So, I agree there is a difference between lending to a country that has a liquidity problem, which I think was Mexico in 1995, and lending to a country that clearly has a solvency problem, I would also agree by the summer of 2001, when the last \$6.5 billion was disbursed by the IMF to Argentina, there was no reasonable doubt that Argentina had a solvency problem. Very careful thought is required about under what circumstances the IMF should be prepared to do that.

My own view is that once a country reaches the point where it is pretty clearly insolvent, the IMF should not lend additional money except on the condition that the country declare that it needs to do a sovereign debt restructuring. That is the way the debt crisis of the 1980’s was handled. The banks were forced to agree to a rollover of their credits before the IMF disbursed. That was done in Ecuador more recently and in a number of other cases. And I think that is the right approach when you are dealing with a country that is insolvent.

Now, with regard to the AAA guarantee, well, Fannie Mae and Freddie Mac are perceived to have AAA guarantees from the United States, and their obligations trade at 50 to 75 basis points over U.S. Treasuries, partly because they are not exempt from State income taxes—we could go into all the reasons, but the spread is only 50 to 75 basis points. Emerging market sovereign debt in the decade of the 1990’s, on average, traded at 600 basis points over U.S. Treasuries. If there was an implicit AAA guarantee, the market did not seem to recognize it.

I do not dispute that there is some modest amount of moral hazard associated with potential IMF lending. But the notion that it is of this enormous magnitude of a AAA guarantee just does not correspond to the facts in the market or, indeed, what holders of sovereign debt have learned not only from the Argentine collapse and the Russian collapse, but from the Uruguay restructuring, from the Ecuador restructuring, from the Ukraine restructuring, and on down the road.

So, I think there is an issue of moral hazard. It does need to be carefully contained. Adequate safeguards through IMF funding are important. And careful attention to how IMF lending, or not lending, affects the private sector and its credit decisions is merited. But we should not exaggerate the nature of this problem if we are going to find a rational way forward.

Senator HAGEL. Thank you. Let me ask you each—you, I believe, heard the question that Senator Bayh put to Secretary Quarles re-

garding the IMF loans to Argentina. And Senator Bayh said, Do you believe, Mr. Secretary, those loans will be repaid or just rolled over—I think is basically what he said. And if I recall, Secretary Quarles said they will be repaid, they will not be rolled over.

I would be interested in a reaction from each of you on Secretary Quarles's response.

Mr. LERRICK. First, Mr. Chairman, I think Argentina has given very good evidence of its intention regarding repayment of its IMF loans. In September 2003, Argentina signed an agreement with the IMF that stated it would repay all its loans from 2007 through 2009. And that is the agreement it literally signed. Ten days later, Argentina unilaterally announced that it would not repay any of those loans until after 2014. That is in their written documentation, right on the website of the Ministry of Economy.

Do I believe Argentina will eventually repay those loans? Probably. Will they be repaid according to their scheduled dates, which are contractual obligations? Absolutely not.

Mr. MUSSA. I basically agree with Adam on that issue. I would note, however, that Argentina is paying the interest on its IMF loans and on its other IFI loans. So it is the principal that is being rolled. But that is not something that is supposed to be done under the rules of the IMF. That is one of the reasons why I would have favored a special facility to set Argentina aside and say that this is not a normal practice; they are only very special circumstances. And for Argentina, I do not know that I would have gone to 2014. I think that issue should be addressed year-by-year or every 2 or 3 years rather than implicitly agreeing to a decade of rollovers. I think that that is not sound policy.

Senator HAGEL. Thank you. I would be interested in each of your thoughts on this. What are the longer-term consequences, implications for cost of capital for other emerging nations? Obviously, there will be consequences, and there are consequences developing, evolving not just with the IMF, but certainly within the private capital structure, and not just limited to American banks. But for emerging Nations, what are the consequences?

Mr. LERRICK. I think it depend to a very large extent on how the Argentine debt restructuring is resolved. If Argentina even remotely succeeds in obtaining the 90 percent-plus debt reduction it is demanding, how can any other leader of a developing country say that his people we must make huge efforts to pay the foreigners? It will just be politically impossible domestically. If, on the other hand, Argentina, after many contortions and delays, is convinced to enter into a fair and sustainable restructuring of its debt, which will require payments significantly above the terms that it has proposed, then the market will learn something. The market will learn that these problems do get resolved.

I disagree with Secretary Quarles's statement that the Argentine restructuring is a very complicated process. Certainly, yes, there are more than 100 bond issues as opposed to five bond issues. But we all have Excel spreadsheets. The number of bond issues and currencies, does not make much of a difference. The main part of the negotiation of the debt restructuring has nothing to do with the terms of the new bonds. The real negotiation is over what quantity of resources the Argentine Government is willing to devote to repay

the bondholders. Once you determine the amount of resources the government will pay the bondholders, establishing the values and conditions of the individual bonds in the restructuring may take 2 to 3 hours. In an afternoon it can be done. That is not the issue. The real negotiation is what quantity of resources will be set aside to repay the bondholders.

Senator HAGEL. Thank you.

Mr. Mussa.

Mr. MUSSA. I am not as sanguine on solving the problem of the distribution among the bondholders. My guess is that the Argentine debt restructuring is going to take 15 years, like the Penn Central bankruptcy did, to ultimately resolve.

Also, I would like to believe Adam that the market is going to learn something important from Argentina and is going to put that lesson to work. And that may well be the case. No doubt, some lessons have been learned. But the fact of the matter is that interest rate spreads for emerging market borrowers—leaving Argentina aside—have been headed very sharply downward over the last year and a half. They have not yet quite gotten to the lows of the spring and summer of 1997, when you could sell virtually anything, but the market really has been picking up, spreads have been coming down, values have been going up, and the volume of new lending, while, again, not at the peak of the spring and early summer of 1997, is also picking up.

Notwithstanding developments in Argentina, and Argentine bonds in the secondary market are selling at 25 cents on the dollar, which anticipates that there will be an improvement in the Argentine offer—but still it will be a pretty aggressive haircut. Nevertheless, emerging market spreads much more generally are down considerably. This is consistent with the fact that we have very low interest rates in virtually all of the industrial countries monetary policy making liquidity easily available. The global economy is picking up; and we are beginning to have a real party.

The hangover will come, however I think probably not until 2005 or, more likely, 2006. But the lessons that Argentina might teach seem to be a bit blurred by the alcoholic environment.

Senator HAGEL. Thank you.

Mr. LERRICK. Mr. Chairman.

Senator HAGEL. Professor.

Mr. LERRICK. A very quick comment. Markets are messy. Markets do not go to clean and clear solutions in a straight line. I agree with Michael that maybe at this level the emerging debt market is what we call overdone, that the spreads are too tight, do not adequately reflect the risks involved. But, there has been one large default. Investors will have large losses in the case of Argentina. Well, there will be another one in the future. These are high-risk borrowers. The market will slowly learn, by experience, what the correct risk premiums are, but, it is not going to be a very clean and simple solution.

Senator HAGEL. Thank you.

Mr. Mussa, I noted as I was going through your written statement, you suggest that the Argentine Government engaged in Enron-like accounting, which included substantial debt issuance in 2002 that was outside the government budget. This had the effect

of masking the true extent of the public sector's cash deficit. In your opinion, is this situation anywhere near being adjusted for, handled, or rectified by the government?

Mr. MUSSA. Let me say first Argentina is by no means unique among national governments in this practice.

Senator HAGEL. Well, we are dealing with that right now on the floor of the Senate.

Mr. MUSSA. Yes, indeed. So it is a more general problem. The amount of that activity that occurred in Argentina in 2002 was particularly large, amounting to 12 or 13 percent of GDP. So there was a lot of off-balance-sheet borrowing, dealing with recapitalizing some of the banks, and other issues of that kind which was simply done off-budget.

I think a key worry going forward for Argentina, and Adam referred to this as well, is the resources that Argentina is prepared to devote to debt repayment, both for the debt now in default but also for the domestic debt. We tend to focus on the primary surplus—that is the budget position of the government excluding interest payments. Then, if you can run a primary surplus of 4 percent of GDP, that surplus is available to pay interest. But if, off the books, you are borrowing 5 or 6 percent of GDP, then you are really fooling yourself that those resources are available to make payments to creditors. And Argentina—and it is not just Argentina, but Argentina is, should we say, particularly successful in this dubious activity—has a long history of doing a lot of off-budget borrowing, where the debt grows much more rapidly than the budget deficit would normally suggest.

Secretary Quarles referred to one of the key reasons for this, which is the relations between the central government and the provinces, where the provinces borrow and the central government ultimately has to step in and pay for it. That is when the stuff hits the books, when it has to be dealt with at the central government level. And there have been a number of episodes of Argentine history where that has come to the fore, as it did again in 2002.

But what is the assurance that it will not happen again in, say, 2008 or 2012? One of the problems with the Argentine offer, among its many deficiencies, is that there is virtually nothing that is promised to be paid to creditors in the next 6, 7, or 8 years. It is almost all what is going to be paid after 2015. And looking at the economic and financial history of Argentina and their budget practices, private creditors, rightly, do not have a great deal of confidence in those promises.

Senator HAGEL. Thank you. Professor Lerrick, would you like to respond to that?

Mr. LERRICK. No, I think Michael raised many of the key issues. One of the points that has been raised—which Secretary Quarles raised two or three times—was the goal of achieving a large participation of bondholders in the debt restructuring. That would be a measure of the effort made by Argentina. How many investors thought it was a fair offer, in essence.

First, let me say it is in no one's interest, not Argentina's, not the bondholders, and not the IMF, that we should be back doing this again in 3 or 4 years. No one wants Argentina to promise to

pay more than it is be able to pay. This is a difficult process; it is a painful process for everyone.

But the issue, then, is, when we talk about the participation rate, one must remember that, of Argentina's debt, approximately 25 percent of the bonds is under the control of the government because they are controlled by Argentine domestic institutions that are subject to government influence and government regulation.

Second, in the last debt exchange the government executed in November 2001, domestic institutions exchanged their bonds for guaranteed loans. But normally in that practice, the bonds are cancelled and therefore their voting rights are cancelled along with the bonds. The Argentine Government has not cancelled these bonds. It has retained these bonds and seems to have every intention of exercising the voting rights in order to force the other, legitimate bondholders to accept the restructuring terms.

This will be most likely decided in a New York court, because the bonds are issued under New York law. There were many issues where the original amount was, let us say, \$4 billion; \$3 billion was exchanged. There is \$1 billion still in the hands of legitimate bondholders, and the government has control of the voting rights, or it thinks it has control of the voting rights on the \$3 billion that should have been cancelled. The threshold to pass amendments to many of the bonds is two-thirds.

The government feels that it can then vote its 75 percent holding and force amendments on the remaining legitimate bondholders that reduce the value of their bonds, which will then induce them to accept a low offer. That will be something that will be tested in the New York courts, though.

So to achieve a 40 percent participation rate, which the Argentine Government has said should be deemed a success, is not very hard if you control 25 percent of the bonds and you control the voting rights on another 15 percent. Therefore that should not be a benchmark of success.

Senator HAGEL. Thank you. Last question. You heard some of the questions I asked Secretary Quarles regarding recapitalizing the Argentine banking system. And you heard his responses. I would very much value each of your thoughts on the Argentine banking system's ability, given the facts as they are, to recapitalize, restructure, and be a vital financial services dynamic in the country once again.

Mr. LERRICK. First, Mr. Chairman, as background, Argentina had one of the strongest financial systems in the developing world up until approximately 1998, 1999. The Government of Argentina, in order to forestall its own insolvency, pursued a deliberate policy which bankrupted its financial system. It forced all its banks to purchase government bonds, in order to keep the government afloat. So the situation in the Argentine financial system is the result of the deliberate policy of the previous government.

There is no question that the Argentine financial system can restore its own stability. Most of the large banks are owned by major international banks—Hong Kong Shanghai Bank, Santander, BBVA, have a very large presence in Argentina.

The parents of these banks certainly have the capital to restore the solvency of their subsidiaries. The question arises, why would

the parent invest additional funds to restore the solvency? The only reason it will is if it views Argentina as an attractive place to invest its capital. Until that takes place, there is no reason, there is no justification for Citibank or Hong Kong Shanghai Bank or one of the leading Spanish banks to send capital into Argentina to restore the stability of their subsidiaries.

Until the government resolves its problems and creates an environment that is attractive for investment, there is no reason that the owners of these banks will recapitalize them. And this holds true for all foreign investment in Argentina. Argentina has very attractive investment opportunities that are being negated by the regulatory and economic policies that prevail in the country.

Senator HAGEL. Do you see that changing, those regulatory policies that negate?

Mr. LERRICK. My view is that it is not the IMF that is going to induce reform or progress in Argentina. What is going to induce reform and progress is when the economy of Argentina starts to slow. At this moment, the economy is growing at more than 6 percent per annum and the government is not paying its debts. From the government's standpoint, life does not get any better than that. Let us be very clear. However, that is not a sustainable situation. Within a year, the economy will probably start to slow. And when it slows, that is when there will need to be a restructuring of the debt, not because the government will need financing, but because the private sector will. Until the government restructures its debt, the private sector of Argentina, which will be the engine of growth, will not obtain access to foreign capital on attractive terms.

Senator HAGEL. Thank you.

Mr. Mussa.

Mr. MUSSA. I have a slightly different view, also with Secretary Quarles. The Argentine economy has been recovering quite rapidly. There is a lot of investment going on. That investment is being financed by mattress capital, by the capital of export firms derive from selling agricultural products on world market at, to them, very attractive prices because soybeans are up in dollars and the peso is down in dollars. So there is a lot of activity.

The economy is still depressed relative to where it was 5 years ago. What is not happening is we do not have a credit intermediation system, particularly not a credit intermediation system run by the banks. Because what happened in Argentina was basically the government and courts said if you have debts, you do not have to pay. Well, when you declare that, then creditors cannot collect, and if banks cannot collect on their loans, then they do not make them. That problem is going to be with Argentina for a very long time given the history of abrogating contracts and changing laws. You do not change attitudes on that subject very rapidly. I think there will be long-term impairment of the banking system and financial sector as a credit intermediary, particularly for longer-term loans. But other means of finance, where the financiers have more direct interest and control over the enterprise, that goes on.

Now, recapitalization of banks, I agree with Adam. What happened is the banks were made insolvent because of decisions by the government—stuffing them with debt, which the government then wrote down. Also, the convertability plan, which linked the dollar

at one-to-one to the peso was abolished by the government. Banks had a lot of dollar-denominated and peso-denominated loans, they treated them interchangeably, then the peso depreciates and all the people who had dollar-denominated loans from banks say we are not paying, so the value of those loans largely evaporated. But the Argentine Government did not allow banks to comparably write down the value of their deposit liabilities. So the asset side of the banks' balance sheet was substantially reduced, the liability side was not reduced, and there was an enormous hole in the balance sheet.

Now, that was papered over by phony accounting for some of the bank assets. But you cannot paper it over forever, as we learned in the savings and loan crisis in the United States. So what has to happen to recapitalize the banks is either the owners, whose equity capital has already been robbed two or three times over, need to put new equity capital in, or the government needs to stuff capital in the banks in the form of new government bonds.

That is an important part of what has been happening in terms of this off-budget borrowing. To keep the banks afloat so that they could pay depositors, the government printed new debt which it stuffed in the banks in order to recapitalize them. And it needs to do more of that if it is going to bring the banks up to full economic capitalization, to a level where their owners might be prepared to put in the marginal amount of capital.

But there is a difficulty for Adam and his fellow creditors when the government prints the debt to recapitalize the banks. Why does that debt have value? Because it drives down the value of other debt. So the challenge of bank recapitalization is a fiscal challenge and is one of the factors that complicates the problem of the debt restructuring. The more the government has to spend on bank restructuring, the less is available to spend on other things, including paying off the previously existing debt.

And the problem is not just with the private banks. In Argentina, we have two very large State-owned banks—one owned by the federal government and one owned by the Province of Argentina. Those two state-owned banks have been the source of enormous fiscal mischief over the history of Argentina. And the potential for additional expense in recapitalizing them, not only for what has happened in the past, but also for what might happen in the future, remains a continuing threat to fiscal probity in Argentina and its capacity to service its obligations.

Senator HAGEL. Gentlemen, you have each been very helpful and the Committee appreciates your time and the thought that you put into the presentations. And I particularly appreciated your willingness to engage the questions, which were of immense help. Thank you.

The hearing is adjourned.

[Whereupon, at 3:30 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT BY ROGER F. NORIEGA
ASSISTANT SECRETARY FOR WESTERN HEMISPHERE AFFAIRS
U.S. DEPARTMENT OF STATE

MARCH 10, 2004

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear today to discuss Argentina's current economic and political situation and the status of our bilateral relationship. I especially appreciate the chance to offer my views in the company of my Treasury colleague, Assistant Secretary for International Affairs Randy Quarles, and the other distinguished persons who will testify before you. Their presence here, and your interest in holding this hearing, attest to the importance of Argentina in this hemisphere and the world.

Argentina, a close and valued ally of the United States, has been through much over the last several years. We are pleased that it has now begun its economic and social recovery. Mr. Quarles and others will certainly highlight the economic and financial background and the latest status of the IMF negotiations. I simply want to add that the Bush Administration is united in wanting to see Argentina succeed over both the short and long-term, and believes it can do so by fully complying with the program it negotiated with the IMF.

Since assuming the presidency in May 2003, President Kirchner has sought—in his own words—to make Argentina a more predictable nation, one whose word can be relied upon. He also has sought to root out corruption, restart the Argentine economy and refurbish Argentina's stature in the world.

We believe he has made an impressive start on these daunting challenges, aided by the talented Argentine people, who strongly support him. Congressional and provincial elections last year also showed strong support for the new government. As a result of this voting, President Kirchner's party has a majority in both houses of congress, holds 16 of the country's 24 governorships, and is now well-positioned to seek the reforms critical to Argentina's future progress. These reforms include revising the system of revenue sharing between the federal and provincial governments, and finalization of compensation to the banking sector for losses associated with government actions during the 2002 crisis.

Bilaterally, President Kirchner and his government have maintained a policy of close contact with the United States. President Kirchner has met twice with President Bush since taking office in the Oval Office in July 2003 and in Monterrey at the Special Summit of the Americas in January 2004. At both meetings, President Bush underscored that we want Argentina to succeed, but that it also needed to help itself.

This Administration regularly discusses economic issues with the Argentine Government at the highest levels. In these discussions, we also raise commercial and business process issues that U.S. firms have experienced and relayed to us. Neither we nor the Government of Argentina, however, have lost sight of the other ties that link us—including those in the political, trade, cultural, scientific, educational, and social areas.

Our deep and broad relationship permits us to address cooperatively a range of issues. One specific area of continued engagement is counterterrorism. Argentina suffered devastating terrorist attacks in 1992 and 1994, and our shared experience with terrorist attacks on our home soil creates a special bond between our countries. The U.S. works closely with Argentina, Brazil, and Paraguay through the 3 + 1 regional cooperation mechanism to fight terrorism, money laundering, and drug and arms trafficking in the Tri-Border Area. We also cooperate closely in the non-proliferation and scientific spheres, to cite other areas.

I also want to highlight Argentina's important role in seeking to advance the cause of democracy, peace, and stability in this hemisphere and elsewhere. Argentina has peacekeeping forces serving in five UN Missions from Cyprus to Kosovo to the Congo. Argentina has been supportive of efforts to address the crisis in Haiti, and it is considering participation in the multinational effort there. Argentina has continued its deployments, and is considering a role in Haiti, despite its very real economic and financial constraints. Argentine diplomacy has also been active on challenging regional issues including Bolivia and Venezuela. In Caracas recently, President Kirchner met with democratic opposition leaders. On Bolivia, Argentina has supported the Mesa Government and just signed a \$1 billion natural pipeline agreement that eventually could lead to Bolivia earning up to \$500 million per year through exports.

Prior to closing, permit me to discuss in more detail our political-level contacts with the Argentine Government on its financial problems. Our open, frank, and continuous discussions with Argentina on financial and business matters have occurred

at all levels and involved several executive branch agencies. The Administration also appreciates the role of a number of Members of Congress who have spoken to Argentine officials, in Washington and on trips to Buenos Aires, on the need for Argentina to both grow and set its financial house in order—two mutually reinforcing goals.

These current activities continue our positive engagement with Argentina over the last several years on economic issues. In August 2001, recognizing the key issue of debt sustainability, we made clear our preference that part of a funding package be dedicated to support voluntary debt restructuring. In the crisis of December 2001, President Bush made a prompt offer of technical assistance. We continued our policy of engagement once President Kirchner took office. When Argentina and the IMF reached an impasse last September over the shape of a new IMF program, we worked constructively—and ultimately successfully—with all parties to advance an accord.

Now, as throughout this difficult period, we see our role as working cooperatively with Argentina, the IMF, and our G-7 partners toward achieving a sustainable economic recovery to benefit the Argentine people and contribute to stability and growth in the region. We can and will be helpful, but ultimately the shape of the IMF program, and Argentina's performance under it, are in the hands of the Argentine Government and the Fund.

In cooperation with the IMF and our G-7 partners, we also have worked to limit the regional fallout of the Argentine economic situation, most notably in Argentina's close neighbor, Uruguay. To help shield the Uruguayan economy, and to also put it on a sustainable growth path, the IMF reached a pact with that nation in 2002. We assisted in this effort and the United States granted Uruguay a \$1.5 billion bridge loan until the Fund package was approved. This loan, that allowed banks in Uruguay to reopen, was paid back, with interest, in 7 days.

As friends, the United States and Argentina can and do speak openly and frankly to one another, while sharing common goals for the hemisphere. The United States also shares Argentina's conviction that it can reverse its severe collapse of the last few years and return to the prosperity it once enjoyed. We will support Argentina's efforts and through them strengthen all our shared goals for our countries and our hemisphere.

PREPARED STATEMENT OF RANDAL K. QUARLES

ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

U.S. DEPARTMENT OF THE TREASURY

MARCH 10, 2004

Chairman Hagel, Ranking Member Bayh, and other Members of the Committee, thank you for inviting me to discuss the Administration's economic and financial policy toward Argentina, particularly the United States' stance with regard to Argentina's engagement with the International Monetary Fund since 2002.

Economic Context

Let me begin by reviewing the historical context for our engagement. Argentina had made impressive strides in the early 1990's in ending hyper-inflation and introducing important structural reforms in its economy. However, excessive budget deficits during the 1990's, driven in large measure by fiscal arrangements that required the central government to fund spending decisions by the various provinces unhindered by effective central budget constraints, led to the build-up of a large debt burden that the government could no longer service by the end of 2001. Faced with an increasingly desperate situation, the government defaulted on its debt and abandoned the peso's peg to the U.S. dollar. The economic crisis was accompanied by political instability that eventually led to a new interim government led by President Eduardo Duhalde.

In the wake of the default and devaluation, real GDP fell 11 percent in 2002. Inflation rose to over 40 percent, the peso depreciated 69 percent, and unemployment rose to 24 percent. Seeking to avoid a complete collapse of the banking system, the government imposed far-reaching deposit controls. Other government actions, in particular the forced conversion of dollar-denominated financial contracts into pesos, further weakened the banking system. On the monetary side, the authorities struggled to contend with multiple "quasi-currencies"—representing an astonishing 50 percent of currency in circulation—that had been issued during the crisis to finance spending by the provinces in the face of collapsing revenues.

Transitional IMF Program

The U.S. Government worked with the Duhalde Administration and the IMF throughout 2002 in an attempt to develop a new IMF program and a set of policies that would stabilize the economic situation. Argentina's authorities took an extended period of time to develop such a program, in part because of the unsettled political situation.

Argentina launched an 8-month "transitional" IMF program in January 2003, which the United States strongly supported. The purpose of the transitional program was to stabilize the Argentine economy. The program's 8-month length was long enough to last through the Presidential elections in May and give the incoming government time to develop its policy priorities. The focus of the transitional program was on macroeconomic stabilization, with the expectation that the new administration would have the political mandate for pursuing the more difficult reforms needed to lay the basis for sustained economic growth and for beginning to address its debt default.

To be sure, there were risks associated with launching the transitional program. Many questioned Argentina's commitment to implementing the macroeconomic policies needed to restore stability. The presence of large-scale deposit controls created a great deal of uncertainty as to the potential inflationary consequences of the monetary program. But the United States strongly backed the transitional program as the most effective way of putting Argentina solidly on the path of economic recovery.

This judgment proved correct. Argentina performed well under the transitional program, meeting its IMF fiscal and monetary targets by wide margins. The central government signed bilateral agreements with the provinces that set clear limits on the provincial deficits in 2003. The government launched a program to retire the quasi-currencies, critical to ensuring that the federal government and the provinces live within their means. The retirement of the quasi-currencies is now complete. And, in the context of improved macroeconomic policies, the government was able to lift the freeze on bank deposits without the inflationary surge or collapse in deposits that many had feared.

The transitional program helped boost confidence in the economy. This confidence underpinned the acceleration of economic growth in early 2003. Real GDP for the year as a whole grew an impressive 8 percent. Unemployment fell to 16 percent by the end of the year, and inflation fell to under 4 percent. During the same period, the peso appreciated 15 percent and foreign exchange reserves increased by \$3.5 billion. In short, the transitional program fulfilled its objectives.

Argentina's 3-Year Program

As the Kirchner Administration came into office, it faced the dual challenges of consolidating the achievements of the transitional program and of undertaking the actions needed to lay the basis for sustained economic growth in the years ahead. The latter meant both adopting reforms to deal with the root causes of the Argentine financial crisis and taking steps to address the new problems created by the crisis, including resolution of Argentina's defaulted debt.

Argentina's 3-year program launched in September 2003 was designed around these objectives.

The fiscal and monetary framework of the program, as well as the institutionalization of central bank independence and gradual shift to inflation targeting, is designed to entrench macroeconomic stability in order to keep the current recovery going.

Fiscal problems were at the core of Argentina's financial crisis. A poor system of inter-governmental fiscal relations encouraged excessive spending by Argentina's provinces. As spending increased faster than government tax revenues, deficits were financed by heavy borrowing and printing the so-called quasi-currencies. The 3-year program not only mandates strict limits on provincial deficits and borrowing, but also provides for a comprehensive reform of the federal-provincial fiscal framework to prevent the problems that led to the crisis from recurring. Since widespread tax evasion and low tax collections have been chronic problems in Argentina, the program includes new measures to strengthen tax administration and fight illegal tax evasion. The program also aims to phase out distortive taxes that were introduced during the crisis—such as the financial transactions tax—and replace them with a tax regime more conducive to economic growth.

The crisis, and government actions during the crisis, seriously damaged Argentina's banking system. As a result, lending by banks to the private sector plunged. Restarting bank lending to the private sector is essential for increasing business investment and spurring economic growth. Argentina's program establishes a framework for restoring health to the banking system by providing compensation from the government to address balance sheet damage done by the previous government,

clarifying the regulatory environment, establishing capital standards designed to facilitate the strengthening of bank balance sheets over time, and requiring banks to develop business plans for achieving specified capital requirements. It also includes measures to assess and address the special issues related to the role of public banks in the Argentine banking system.

Another key area affected by the crisis was the utilities sector. Under its program, Argentina has undertaken to work with the World Bank to resolve the problems in the utilities sector, including ending the price freeze and redesigning a tariff structure, reestablishing a coherent regulatory framework, and renegotiating concession contracts. Utility tariffs had been frozen since February 2002 despite the falling peso and rising inflation, creating large losses for the utility companies. Ending the price freeze and taking the other actions needed to create a stable regulatory framework are essential for encouraging investment in this key sector to support Argentina's needs for the future.

Finally, a key objective of the program is to facilitate the successful resolution of Argentina's defaulted debt. Argentina has \$100 billion in private sector claims outstanding. Its debt restructuring is the most complex in emerging markets history. This is not only because of its size, but also because of the number of different currencies and legal jurisdictions in which the debt was issued, as well as the number of different types of bondholders involved, including sizeable holdings by retail investors in Italy, Japan, and Germany.

The program provides the broad policy framework to underpin a debt restructuring agreement between Argentina and its creditors. The program requires Argentina to work in good faith with its creditors to reach a collaborative agreement that restores debt sustainability. The fiscal targets of the IMF program beyond 2004 were specifically left undefined above a certain 3 percent floor, precisely to give Argentina and its creditors room to negotiate over the terms of the debt restructuring. It is the responsibility of Argentina to work with its creditors to achieve a debt restructuring deal that will define the increase in the primary surplus above 3 percent that is needed to cover debt service on performing and restructured debt.

IMF lending policies require transparent and constructive negotiations by Argentina with its private creditors to secure the broad creditor support in a debt restructuring needed to achieve a sustainable debt situation and facilitate Argentina's progressive reintegration into international capital markets. Argentina will need substantial investment to generate economic growth over the long-term.

Argentina's Performance under the 3-Year Program

Argentina has continued to perform well on its fiscal and monetary policies under the 3-year program, extending the gains it made under the transitional program. The government's budget performance to date has exceeded the program targets by a significant margin demonstrating that with a determined effort Argentina can indeed collect taxes. There has also been important progress in strengthening the institutional and legal framework for tax administration. In the area of inter-governmental finances, the central government has concluded agreements with the provincial governments limiting provincial spending and borrowing, consistent with the requirements of the program. Work on the more far-reaching reforms of the system of inter-governmental fiscal relations is also moving forward.

Progress in other structural areas of the program up to now has been less satisfactory. Although the government has implemented new regulatory standards for the banking system, there have been delays in finalizing the agreed compensation to banks for the actions taken by the government during the crisis. Bank lending remains extremely depressed. Argentina's progress with the World Bank on reform of the utilities sector has also been slow, though the Argentine Government did recently agree to raise tariffs on electricity and gas for the first time since the crisis.

It continues to be essential for Argentina to make progress on debt restructuring with private creditors. The government's announcement that it has made arrangements for the hiring of investment banking advisors to handle its debt exchange is a step forward. In addition, we expect to see over the upcoming weeks Argentina take the concrete steps necessary to negotiate with representative creditor groups on the terms of its restructured debt. The negotiation process needs to build mutual trust and allow creditors real input into the design of the offer. This is the surest way for Argentina to achieve the broad creditor support needed for a comprehensive and sustainable debt restructuring.

Conclusion

We want Argentina to succeed: To succeed in stabilizing its economy in the wake of crisis, succeed in resolving its defaulted debt, and to succeed in laying the basis for long-term economic growth.

The United States has been a forceful advocate for IMF engagement with Argentina in pursuit of these ends. Argentina has made important progress during the last year. The current IMF program provides a framework for Argentina to raise the living standards of its people and move beyond the past to a prosperous future. Consistent implementation of this program is the key to success in these areas, and we are continuing to work with Argentina and with the IMF to encourage this implementation.

PREPARED STATEMENT OF MICHAEL MUSSA
SENIOR FELLOW, INSTITUTE OF INTERNATIONAL ECONOMICS

MARCH 10, 2004

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 United States policy toward Argentina and to United States 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 1995–1996, 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 than \$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 Rúa, and at end December by the official declarations of sovereign default and termination of the Convertibility Plan by (interim) President Rodríguez Saá.

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 begun 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 1995–1996; Thailand, Philippines, Malaysia, Indonesia, and Korea 1997–1998; Russia and Brazil 1998–1999): after 6 to 9 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 1989–1990. 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 recapitalize 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 $2\frac{3}{4}$ percent of GDP to $6\frac{1}{4}$ 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 $11\frac{1}{4}$ and $25\frac{1}{4}$ 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 United States 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 (IFI's) 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 IFI's 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 an 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 United States 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 an 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 United States 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 *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-owned) 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 IFI's 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 United States 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 IFI's 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 3-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 IFI's). 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 be-

have 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 United States 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 backloading of interest and principal payments and the imposition of coupon interest rates at well below market levels. Looking at these proposals, bondholders have concluded that in market value terms, the Argentine offer amounts to no more than about 10 cents on each dollar of face value plus accumulated arrears. This is a much lower return for bondholders in other sovereign restructurings by emerging market countries (for example, about 65 percent recovery in the Brady restructurings) and even lower than the returns in restructurings for very poor or devastated countries (for example, a 33 percent recovery rate agreed for official credits to Iraq). As bondholders 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 IFI's] 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 IFI's is also open to some question. In the context of the HIPC initiative the IFI's 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 IFI's, 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 (that is, under the laws of other countries). Dealing with such defaults in an 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.