Weekly
Geopolitical Report

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The Eighth Default of Argentina

Very few countries have seen as spectacular of a decline in its economic standing over the past 100 years as Argentina has. The country started the 20th century as one of the richest in the world, but has fallen behind as a result of its turbulent political history and inconsistent economic policies.

Argentina has been in the international headlines recently due to its sovereign debt default. This default is the eighth default in the history of the country. Additionally, Argentina is facing capital flight, rising inflation and dwindling dollar reserves. The government's response has been to tighten its grip on the economy, instituting trade barriers to protect its domestic industries and restricting capital outflows to support its official currency peg. While this is a serious issue for Argentina and a possible concern in the general trade policy for Latin America, we do not believe that this situation will persist in the rest of emerging markets. More than anything, Argentina's extensive government interventions and resulting economic calamities might serve as a cautionary tale for other countries that may be considering deglobalization.

This week we will look at Argentina, its long history of economic booms and busts, its political background, and its extensive chronicle of sovereign debt defaults. As always, we will conclude with market ramifications.

Brief History

Before Europeans reached the Argentine area of South America, the region was scarcely populated. Spain colonized the country in the 16th century and instituted a strong central government. A sizeable railroad system was built under Spanish rule, which helped transport the country's agricultural products to the coast for shipping. The economy grew via strong export expansion. As the Spanish kingdom weakened due to constant wars in Europe and abroad, a military junta took control of Argentina. The country declared its independence in 1816 and a bitter internal struggle between different military factions ensued.

(Source: World Atlas)

Argentine economic growth in the 19th century was primarily driven by the development of large farms. The fertile land and availability of cheap labor allowed the country to produce and export large amounts of grain and meat products. Additionally, Argentina is extremely commodity reliant. The country is rich in resources, but has failed to invest sufficiently in educating its population, which is necessary in order to make its manufacturing internationally competitive. Argentina became the "land of opportunity" as it was a destination for many European immigrants. Prior to WWI, Argentina was the 10th wealthiest country in the world in terms of GDP per capita.

WWI took a large toll on the economy and the Great Depression in the U.S. further weakened the country as global economic growth slowed, leading to increased unemployment and social unrest in Argentina. This also marked the beginning of a long period of political instability in the country. The military took power in 1930, instituting import substitution to achieve self-sufficiency, turning the country insular. For the rest of the 20th century, 14 generals and 11 elected civilian presidents would run the country. In fact, between 1930 and 1983, presidents averaged only two years in office.

In 1952, Juan Domingo Peron was elected president on the back of increasing social fragmentation. Peron promised to redistribute wealth and power to the large urban working class, and away from the bourgeois land owners. Peron nationalized several private and foreign-owned companies, leading to large capital outflows as foreign investors became increasingly nervous. Capital flight, combined with falling commodity prices, caused severe economic turmoil, while labor and trade restrictions pushed inflation to 40% annually. Peron kept social unrest at bay through increased social spending. In many ways, Peron shaped the economic development path that Argentina has followed. The economic calamity and the death of Peron's wildly popular first lady, Eva "Evita" Peron, caused extensive discontent and, once again, the military took over. A series of military and civilian presidents followed, but the economy suffered as inflation reached record highs and unemployment surged.

The 1990s were a period of free trade and economic growth for Argentina under a more economically liberal president, Carlos Menem. The country cultivated foreign investment, slashed trade barriers and tariffs, and privatized state enterprises. It also stabilized its currency, the peso, by pegging it to the U.S. dollar via a currency board.[1] This currency peg stabilized the economy and eased inflation, leading to large capital inflows into the country. However, corruption was rampant. For example, in 1989, only 30,000 out of 30 million Argentinians paid any income taxes.

The 1997-99 Asian financial crisis affected Argentina as international capital flows reversed, with investors pulling funds out of emerging markets at a rapid pace. The currency board proved unsustainable as growth faltered. This led to the government's inability to make payments on its loans in 2001, leading to the world's largest sovereign debt default of $100 bn.

In terms of trade, throughout its history Argentina has been out of sync with the rest of the world. Argentina supported free trade at the beginning of the 20th century, when the rest of the world was insular. By the time world trade started to open up, the military had taken control of Argentina and established trade restrictions. Argentina has also relied on foreign investment for growth, which has often exaggerated economic volatility.

[1] A currency board is a monetary authority which is required to maintain a fixed exchange rate with a foreign currency. This policy objective requires the conventional objectives of a central bank to be subordinated to the exchange rate target.

Default History

Argentina has defaulted on its international debt seven times and on its domestic debt five times since its independence in 1816. The first sovereign default came only 11 years after independence. Argentina, along with other Latin American countries, issued bonds in London to fund its transition to independence. When the Bank of England hiked its interest rates in 1825, Argentina struggled to make payments on the loans and defaulted in 1827. The country did not make payments on its defaulted bonds until 1857.

Later in the 19th century, Argentina had borrowed heavily to build infrastructure, and to transform its capital, Buenos Aires, to the "Paris of South America." Rising commodity prices and borrowing led the country into a speculative financial bubble, which ended in a yet another default.

In 1956, the country was at the brink of default after the populist president Peron was ousted by the military. Argentina was able to avoid a new default by reaching a restructuring deal. A portion of these bonds were paid back as late as this year. Another default followed in 1989 in the midst of emerging market bond calamities.

In 2001, Argentina defaulted again. The roots of this default lay in the heavy borrowing during the 1990s to finance the unsustainable fiscal deficits that the government had been running for several years. Argentina desperately wanted to avoid another default, so it initiated a debt exchange. To avoid a default, the exchange had to be voluntary. During two rounds of exchanges, the government offered untenable coupon payment rates to attract more bond holders to exchange their holdings. The debt exchange failed as the government was pushed further into insolvency.

Current Default

On July 30th, 2014, Argentina entered into default again when it failed to make payments on its bonds. The 2001 default sowed the seeds for the current default. Argentina renegotiated the terms of its portfolio when it defaulted in 2001. Most of its creditors exchanged their defaulted debt in the two restructurings that took place in 2005 and 2010. However, there were a few investors who saw an arbitrage opportunity in buying up the defaulted debt. Since the debt was issued under New York legal framework, these investors decided to pursue the full principal amount, plus interest, via American courts. These bond holders, called "the holdouts," were led by Paul Singer's Elliott Management.

Argentina was held in contempt of court by a New York judge, ruling that Argentina could not make bond payments on the restructured bonds without paying all the holdouts first. Furthermore, any U.S. financial institution that would help Argentina make bond payments on these bonds would also be in violation of this court order. A bond payment was due on July 30th, for which Argentina transferred money to its U.S. financial intermediary, Bank of New York Mellon. However, the court order blocked the funds from being transferred to the bond holders, and since the country did not make a payment, it entered default.

Argentina's president Cristina Fernandez de Kirchner claims that the default is immaterial. Argentina, in general, is ignoring the ruling, with politicians saying that the ruling is "baseless" and that it would not have any "practical effect" on the economy. It is true that the country had already been effectively cut off from international borrowing after its 2001 default, so the current default does not have any immediate effect on the country. As the frequent default history shows, Argentina is used to operating in the state of default. However, the longer the default goes, the harder it will be for the country to grow. The country's foreign reserves are dwindling, and maintaining its exchange rate peg is likely to become impossible, leading to devaluation. The boost the country got from the decade of rising commodity prices is unlikely to be repeated. Thus, the country needs access to international debt markets to grow.

The terms that keep Argentina from making any payments on its defaulted bonds will expire in the beginning of 2015, at which time Argentina can enter into negotiations with its bondholders. The fear is that before reaching an agreement, the country would have to print money to finance its deficit, spurring inflation and deepening the economic contraction already seen this year.

Ramifications

Simon Kuznets, a Nobel-laureate economist, remarked, "There are four kinds of countries in the world: developed countries, undeveloped countries, Japan and Argentina." Argentina does indeed have its own kind of a mess to deal with, and serves as a cautionary tale for countries that are considering government intervention in their economies.

The global economic slow-down is affecting all emerging markets. The Argentine economy has suffered as end-market demand for its commodities has slowed, but also due to the large capital outflows following its interventionist policies and defaults. The recent Argentine default was expected, and has not had a significant impact on Latin America or emerging markets in general.

One of the more immediate market ramifications is a possibility of more volatility in the soybean market. Argentina is the third largest soybean producer in the world. Due to the most recent devaluation of the peso and the concern that another devaluation may be forthcoming, Argentine farmers have withheld soybean sales. This is significant for Argentina, since falling exports and capital outflows have left the government with too few dollars. Too few dollars are a problem, since the government needs dollars to pay interest on dollar-denominated bonds and to support the official exchange rate. Given that agricultural products are the largest export product for the country and the government needs dollars, it is possible that the government could force the farmers to sell their soy in the international markets. If this happens, the already depressed soybean prices could be pressured further by the increased supply.

Another more immediate outcome could be a further anti-globalization of all of Latin America. Argentina is the second largest economy of the Latin American trade union Mercosur. Mercosur generally governs the trade agreements of its members, including free trade between its member countries, while regulating trade agreements with other countries. Since a new trade agreement or an amendment requires approval by all member states, it is likely that Argentina's desire to protect its industries with increasing trade barriers could also reduce trade for the rest of the Mercosur members. We have already seen a new Brazil-backed trade agreement with the EU blocked by Argentina.

Argentina's inflation is likely to stay high; it is estimated to come in at 40%. If the country establishes further trade restrictions or capital controls, inflation will likely increase. Unemployment has picked up. The current government has avoided civil unrest via government spending and social welfare programs, but with the government's reserves dwindling, the continuation of these programs is uncertain. If social spending is cut, increasing inflation and high unemployment are likely to lead to more social disorder.

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Confluence Investment Management LLC

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