Economics – FX/FI Research

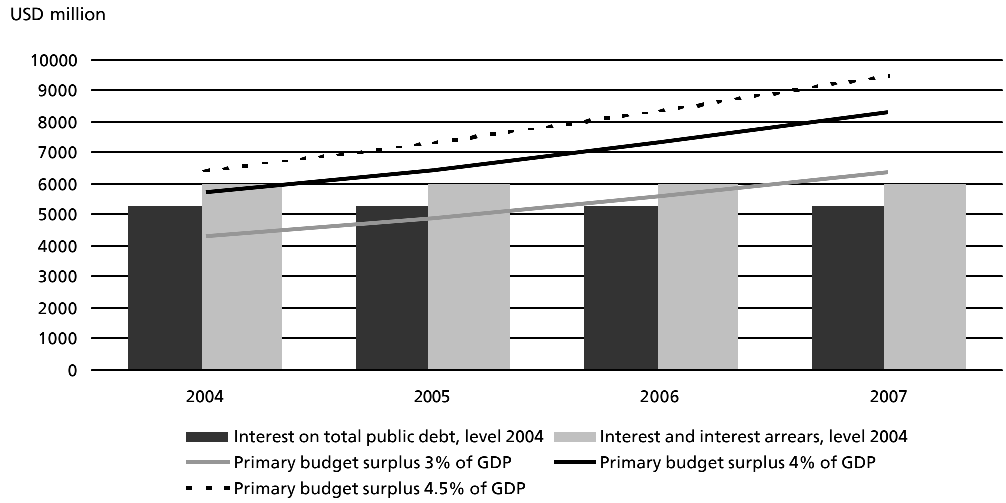
Country Analysis

October 30, 2003

ARGENTINA COULD SERVICE ITS DEBT, NO REDUCTION NECESSARY

- President Kirchner enjoys growing popularity among the Argentine people. His Peronist party and his candidates have emerged as winners of the current regional and federal elections, despite some recent setbacks on regional level.
- As the economy recovers, growth is forging ahead (real GDP 2003: +6%, forecast), inflation is falling, the exchange rate is stable, currency reserves are piling up.
- The outlook depends on a coherent stability and reform programme which is not yet discernible. Structural reforms are barely making progress. However, we anticipate that the IMF will provide support.
- An urgent problem is posed by the huge public debt (above 100% of GDP). The main obstacle to restructuring the foreign component is not so much external liquidity as the primary budget surplus.
- If this surplus were to come in at 4% of GDP, Argentina could pay the interest on its debts without any remission. Debt reduction would be required only if net principal repayments were also be made and if no maturity extension were to be granted. Even then, the remission needed would be nowhere near the 75% of face value (90% of net present value) that is being demanded.

PRIMARY BUDGET SURPLUS OF 4% ADEQUATE FOR DEBT SERVICING



Debt as of December 2003 (forecast)

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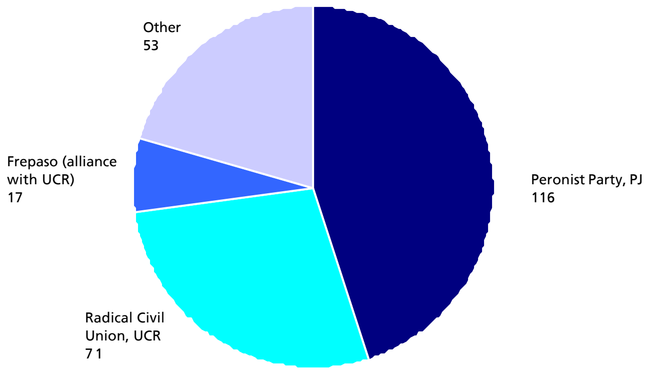
GOVERNMENT'S POSITION CONSOLIDATING

President Kirchner, both head of state and head of government, enjoys growing popular support in spite of widespread unemployment (roughly 16% according to official figures). This is reflected in the results of the current elections, which besides new provincial governors decide part of the seats in the Senate and 50% in the Chamber of Deputies. The vote looks set to strengthen Kirchner's previously shaky power base in the Peronist movement. However, trouble may loom within the party. The President's socially oriented and markedly national stance glosses over Argentina's own responsibility for the severe economic crisis, pointing the finger instead at foreign creditors and the IMF in particular.

PERONIST MAJORITY

Distribution of seats



DEBT PROBLEM NOT SOLVED BY ECONOMIC UPTURN

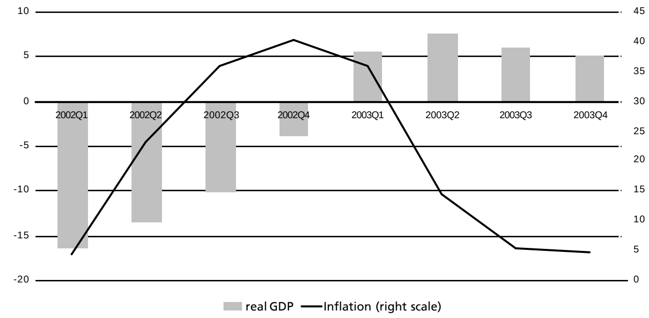
POSITIVE TRENDS FOR GROWTH AND INFLATION

The Argentine economy surged ahead in the first six months of 2003, posting strong real growth of 6.6% yoy. A rate of 6% does not seem unrealistic for the year as a whole, although the pace is likely to ease off to 4% next year due to financing difficulties.

Consumer price inflation has carried on decreasing throughout 2003 (+4.9% yoy in August) thanks to a restrictive monetary policy and the strength of the peso. Single-figure inflation appears feasible for next year (forecast: 8%, annual average)

GROWTH UP, INFLATION DOWN

% y-o-y



2003Q3/Q4: forecast

...BUT ONLY CAUTIOUS OPTIMISM FOR THE MEDIUM TERM

The country's medium-term growth prospects depend both on the implementation of a coherent economic programme and on ready access to the international capital markets. Neither of these exists at present. Given Argentina's poor track record on reform, we anticipate only limited progress and expect to see real GDP growth averaging 3%-3.5% per annum – in other words, below the country's potential.

MEDIUM AND LONG-TERM PROJECTIONS

The government's "Restructuring guidelines" of September 2003

	2003-07	Long term
Real GDP	3.8% p.a.	3.0% p.a.
Inflation (annual average)	7.0%	2.6%
Primary budget surplus as % of GDP	3.0%	3.0%
Peso/USD exchange rate	2.87	n.a.

n.a. = not available

HORRENDOUS NATIONAL DEBT ONLY HALF-SERVICED

While the recovery has prompted a sharp rise in tax revenues, thereby improving the state of the nation's finances, the situation is still critical in view of the country's massive debts. The government's financial liabilities at the end of 2002 amounted to the equivalent of USD 155.4 billion, including bonds issued as compensation for losses caused by the abolition of the currency board. Argentina's public debt is likely to be running at 150% of GDP by December 2003, and this is double the average for the emerging markets.

This debt, 45% of which is made up of bond issues, is currently being serviced in a number of very different ways depending on the creditors concerned (e.g. IMF loans are being fully serviced, while foreign bondholders are getting nothing). Payments are now in arrears by roughly 10% of the above total.

DISCRIMINATION AGAINST FOREIGN CREDITORS

Percentages of debt being serviced as at 31 December 2002

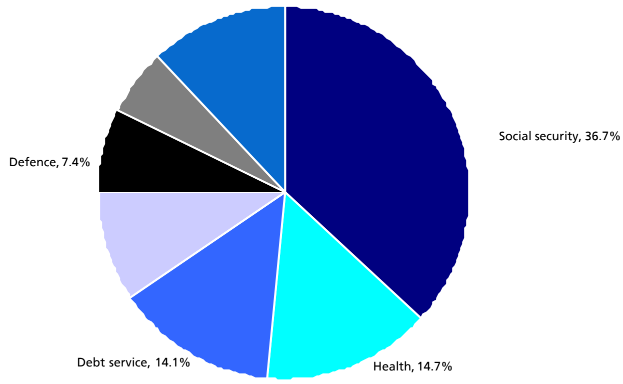
	Proportion
Total debts	51%
Bonds	23%
BODEN*	100%
in foreign currency	0%
in pesos	15%
Loans	92%
International financial institutions	100%
Banks, guaranteed loans	95%
Other creditors	0%

Source: Ministry of Finance
* Compensation bonds for losses suffered by Argentine banks and depositors due to the change in currency regime.

Planned reforms of taxation and the system of financial compensation with the provinces are unlikely to have an impact until 2005. In any shake-out of public finances, social security is a key factor. Here, however, significant reform is not on the cards until the medium term at best.

BUDGET DOMINATED BY SOCIAL SPENDING

Expenditure as a % of total spending



EXTERNAL TRADE POSITIVE, CAPITAL FLOWS NEGATIVE

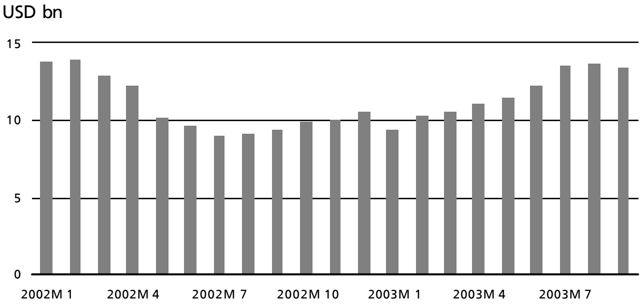
TRADE AND CURRENT ACCOUNT BALANCES COMFORTABLY IN THE BLACK

The slump in imports prompted by the recession, combined with good harvests and rising commodity prices, pushed Argentina's balance of trade well into the black in 2002. For this year as a whole, we expect a trade surplus of USD 16.5 billion and a current account surplus of USD 7.5 billion (6% of GDP) – including existing debt servicing commitments. If we count only the debt servicing obligations actually met, the surplus will be in the region of USD 12.5 billon on a cash basis. These surpluses will probably shrink considerably in the medium term as imports increase again. In the past, countries that defaulted on debt repayments have shown current account deficits of 2% of GDP on average five years after the default.

INTERNATIONAL LIQUIDITY IMPROVED

Despite the lack of net capital inflows, the central bank's currency reserves have been rising steadily since mid-2002, reaching USD 13.4 billion at the end of September (extensive import cover of about one year). We expect this steady increase to continue in the months ahead.

CURRENCY RESERVES MOUNTING UP



PESO EXCHANGE RATE SHARPLY HIGHER

Since its drastic depreciation in 2002, the Argentine peso has recovered strongly (average rate in first half of 2003: ARS 2.96 to the USD). We expect to see a sideways trend over the next few months. The effective exchange rate may well continue to gain ground (2003 forecast: +7%), albeit from a low baseline.

100%, 75%, 50% – WHAT LEVEL OF DEBT SERVICING CAN ARGENTINA AFFORD?

EXTREMELY HIGH EXTERNAL DEBT WITH VERY VARIED STRUCTURE

The country’s public and private external debt at the end of 2002 totalled USD 142 billion, or more than five times the value of its exports. The public sector accounted for 63% of this total, which is expected to climb to about USD 146 billion by the end of 2003.

EXTERNAL DEBT: LARGE PROPORTION OF PRIVATE, NON-BANK CREDITORS

USD billion, year-end

	2002e	2003f
Overall	142.0	145.6
Multilateral creditors	32.5	33.2
Bilateral creditors	10.8	11.1
Banks	11.3	10.1
Non-banks	87.4	91.2
Bonds, notes	60.4	n.a.
Payment arrears	12.9	25.5
Principal	7.6	15.2
Interest	5,3	10,5

e = estimate; f = forecast; n.a. = not available
Source: Ministry of Finance, IIF

Foreign bond issues totalling USD 60.4 billion make up 44% of the country’s entire external debt. They have a very varied structure, with 152 issues in 7 different currencies originating from 8 different governing laws.

To service the entire external debt (interest and capital repayments) as contractually agreed would this year require just under 70% of export revenues, not counting payments in arrears.

ONGOING TENSION DESPITE AGREEMENT WITH IMF

After some hard bargaining by Buenos Aires, the IMF agreed in September to restructure USD 12.4 billion worth of Argentine debt falling due over the next three years. As part of the deal, a default to the value of USD 2.9 billion ended.

The parties have yet to sign a medium-term standby agreement setting mutually agreed macroeconomic targets. However, we expect to see agreement in the next six months on, among other things, primary budget surpluses after 2004 and further compensa-tion for the banks (which, although still liquid, are on the verge of insolvency).

Even after such an agreement, though, the Argentine government will remain in conflict with the IMF on the objectives and its compliance with them. Last-minute deals should make it possible to avoid having to make net capital repayments to the IMF.

ARGENTINE OFFER TO RESCHEDULE PRIVATE DEBT IS PROVOCATIVE

The debt rescheduling proposed by Argentina in September covers bonds to a total value of USD 87.1 billion (estimated as at December 2003). Argentine creditors account for 38.4% of this debt, German investors 5.1%. The government is calling for an unprecedented level of debt to be waived: 75% of face value and an estimated 90% of net present value, after allowing for coupon and maturity concessions (face value reductions for Russia and Ecuador: 35% and 42% respectively).

The key terms of this highly provocative 'offer' are:

- conversion of existing bonds into new ones with different categories:
  - par bond: 100% of face value, coupon 0.5%-1.5%, maturity 20-42 years
  - discount bond: 25% of face value, coupon 1% in first year and then +0.5 percentage point p.a. up to a maximum 5%, maturity 8-32 years
  - quasi par bond: 70% of face value, coupon 1%-2%, maturity 20-42 years
- no repayment of interest accrued since end of 2001 (about USD 5 billion)
- reduction in number of different bonds to paper denominated in four currencies (USD, EUR, JPY, indexed ARS) issued under four governing laws.

There is no longer any talk of variants of the above bond types indexed to GDP growth. Only a fifth of all new bonds are to be issued as par bonds – according to the government plans.

ABILITY TO PAY SUBJECT TO TWO RESTRICTIONS: PRIMARY BUDGET AND CURRENT ACCOUNT BALANCE

It is not currently possible to make reliable calculations for the various possible solutions to Argentina's debt problem. The following comments are therefore to be understood as reflecting only rough estimates.

At the heart of the dispute over fulfilment of obligations to foreign creditors is not just the state's willingness to pay, but also its ability to pay.

This is essentially dependent on

- the size of the primary budget surplus (budget before interest payments)
- Argentina's international liquidity (foreign currency revenues and reserves).

In addition, a kind of distribution effect is at work here: the greater the amount of public debt included in the debt rescheduling (i.e. debts that have up to now been serviced), the lower the level of debt reduction needed from international bondholders. The government's proposal applies only to debt that is not being serviced. Nevertheless, any attempt to extend the scope of the rescheduling would be unrealistic and, from the point of view of non-bond creditors, would have to be rejected.

Given the volume of cross-border investments concerned, the exchange rate is another important factor. If the national currency depreciates, this will raise the peso amount to be budgeted, whereas any appreciation will have the opposite effect. We have assumed that the value of the peso will remain roughly flat.

PRIMARY BUDGET SURPLUS: ARGENTINE SAMPLE CALCULATION INACCEPTABLE

The tightest restriction on Argentina's ability to pay is the size of the primary budget surplus.

Normally, national debt is serviced on an interest-only basis, with the principal usually being refinanced in full. However, Argentina's creditors, especially the foreign ones, are interested in having the bonds they have bought repaid at the agreed times. As a result, in addition to the debt interest and the interest on impaired liabilities, the cost of repaying external bonds will also have to be met from the primary budget – assuming the state cannot raise funds through fresh borrowing or asset sales.

According to a sample calculation included in the 'Restructuring guidelines' presented by Buenos Aires in September 2003, maintaining the current level of debt servicing next year would take up 2.3% of GDP (USD 3.2 billion according to our calculations). This is equivalent to around three-quarters of the hoped-for primary budget surplus of 3% of GDP. In order to meet all its public debt servicing obligations (interest and capital repayments), the government would – according to the sample calculation – need a primary budget surplus equivalent to 8.8% of GDP (USD 12.4 billion), not including payments in arrears.

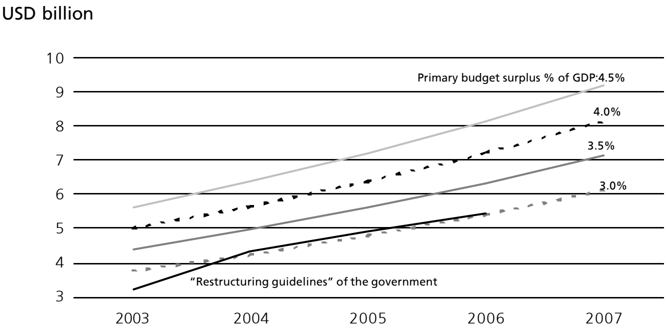
That is unrealistically high. By way of comparison, the historical average budget surplus for defaulting countries in the five years following their insolvency is just 1% of GDP. In fact, this was also the average for all the emerging markets in 2002.

According to the above calculation, the amount left over to service Argentine bonds held by foreigners is only around USD 1 billion (interest and repayment of principal). For 2004, this figure corresponds to barely 10% of the funds needed to service the entire bond debt, which equates to 30% of the interest due or 12% of the principal repayments due. Official sample calculations over the longer term paint an equally depressing picture.

SURPLUS MORE DEPENDENT ON FISCAL EFFORTS THAN ON GROWTH

If its GDP grows at 3%-4% per annum in real terms between 2003 and 2007 and its primary budget surpluses come in at 3%-4.5% of GDP per annum, Argentina will have between USD 3.5 and 9.5 billion at its disposal each year to meet the above debt obligations and settle accrued payment arrears.

PRIMARY BUDGET SURPLUS FLUCTUATES WITHIN A BROAD BANDWITH



A half-point increase in the primary budget surplus as a percentage of GDP corresponds to roughly USD 600 million, or about a fifth of the interest due on foreign bonds in 2004. If, thanks to cost-cutting or extra revenues in 2004, Argentina achieves a primary budget surplus of 4.5% of GDP rather than 3%, a coupon reduced after rescheduling might be, say, 7.5% instead of 5%. The surplus is much less sensitive to changes in growth rates in the overall economy.

INTEREST PAYMENTS ARE TOP PRIORITY: NO PROBLEM WITH A 4% PRIMARY BUDGET SURPLUS

In order to meet all of its public sector debt obligations from 2004 onwards, Argentina must generate primary budget surpluses equal to at least 4% of GDP. This assumes that the government's debts remain constant, i.e. no principal is repaid. It does, however, take into account interest on capitalised payment arrears as at December 2003.

If the Buenos Aires administration achieves a primary budget surplus of 3% of GDP in 2004, then, given the above assumptions, it will not be able to meet its interest payments unless it obtains almost 50% debt remission.

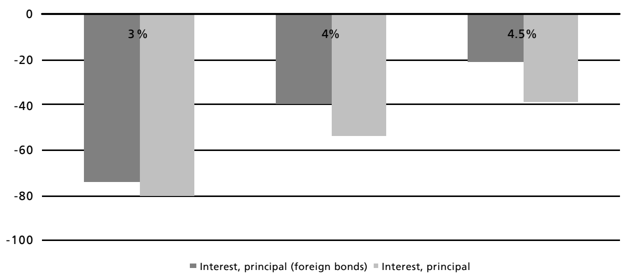
75% DEBT WAIVER NOT INEVITABLE

If we include repayments of foreign bonds, Argentina will not be in a position to service its debt as agreed until after 2007.

To achieve this as early as 2004 would require 75% of its debts to be waived, but only if we assume that the government makes no efforts to boost the primary budget surplus beyond 3% of GDP using fiscal policy, sells off no state assets and receives no fresh funding. This 75% level would be reduced to 40% or even 20% if Argentina could achieve primary surpluses of 4-4.5% of GDP. If we include current payment arrears, we arrive at waiver rates of between 80% and 40%.

DEBT WAIVER RATES BETWEEN 20% AND 80%

variable primary budget surpluses, as a % of GDP



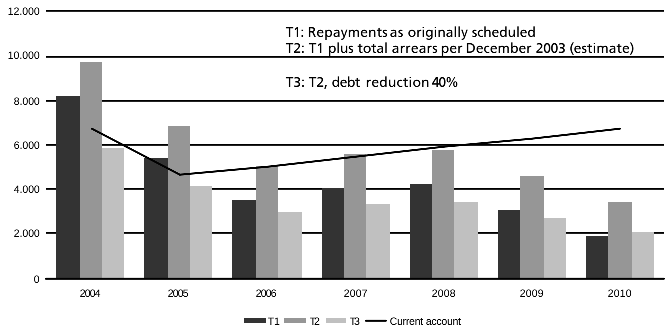
LEEWAY CREATED BY EXTERNAL LIQUIDITY

Depending on foreign exchange factors, Buenos Aires can pay the interest due on its external debt without dragging its current account balance into the red.

If the current account balance (including debt interest due) shows a 4% surplus in 2004 and a 2.5% surplus thereafter, and if no principal is repaid to multilateral and other public sector creditors (net), Argentina will be in a position to meet repayment obligations pertaining to its external public debt as agreed from 2005 onwards (including payment arrears from 2006). If Argentina were prepared to dip into its currency reserves to the tune of USD 1.5-3 billion (10%-20% of total reserves), no debt remission would be required at all.

CURRENT ACCOUNT NO BOTTLENECK

USD million, bonds only



PRIVATE SECTOR EXTERNAL DEBT MUST BE INCLUDED

One of the foreign exchange factors at work here is the fact that any consideration of the country's ability to service its debt must also take account of the sums owed by Argentina's private sector to foreign lenders (33% of the entire external debt). Only if existing loans are not rolled over will the country not be able to meet its external debt repayment obligations with the help of current account surpluses until 2010. It is normal, however, for credit facilities, especially trade finance, to be rolled over.

ABILITY TO SERVICE DEBTS IN VARIABLE

Argentina's ability to service debts to private creditors will be significantly depleted if it has to make net repayments to the IMF, for example because the IMF refused to pay out new loans. On the other hand, capital inflows, the repatriation of Argentine capital or a dip into the nation's currency reserves would increase the debt servicing capacity. Even if imports were to increase by 50%, the central bank could afford to reduce its reserves by half (USD 6.7 billion) without import cover falling short of four months.

HARD-NOSED DEBT TALKS TO DRAG ON BEYOND 2004

Buenos Aires cites the hardships suffered by the people and the failings of the IMF as the reasons for its hard-line stance on debt. We expect a compromise to be struck eventually, since the country depends on capital imports and another wave of lawsuits over the fulfilment of payment obligations is in the offing. It is unrealistic, though, to expect an agreement to be reached with creditors before the end of next year.

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Analysis

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