Better late than never

Ms Fernandez tries to charm the markets by revisiting the 2005 debt swap

WHEN Argentina conducted the biggest sovereign-debt restructuring in financial history in 2005, it made clear that creditors who rejected the government's proposal would receive no mercy. The terms were harsh: holders of the $81 billion in Argentine bonds that defaulted in 2001 would lose a whopping 65% if they accepted the government's offer. But even a 65% "haircut" represented a better outcome for investors than a 100% loss, the fate Argentina insisted would await creditors who held out for a better offer. Told simply to take it or leave it, owners of 76% of the defaulted bonds accepted the swap.

For three and a half years, the government stuck to its guns, and the holders of the remaining debt received not a cent. But on September 22nd Argentina's president, Cristina Fernandez de Kirchner, made a surprise announcement that her government would "analyse" a proposal it had received from three banks to reach a settlement with these holdouts, clearly implying she was now ready to negotiate.

Although many technical aspects of the deal have not been made public, it will probably entail the creditors giving Argentina both their defaulted paper, with a face value of $31 billion (including all past due interest), and a fresh $2.5 billion in cash, in exchange for a series of new bonds. The

banks say they have nearly half of the holdouts already on board, and it is likely that a big majority will eventually accept such a settlement.

Ms Fernandez's about-face represents a belated recognition of Argentina's deteriorating financial situation. In 2007, when the presidency was held by her husband, Nestor Kirchner, the country began doctoring its official inflation statistics to keep them in single digits, while the true rate rose to around 25%. This enabled the government to save some $500m in payments on its bonds linked to the consumer price index, but destroyed its credibility.

Meanwhile, the state's previously robust budget surplus began to dwindle. Mr Kirchner, who chose to have his wife replace him rather than run for re-election himself, drastically increased spending on pensions and public works to support her candidacy, and the global spike in fuel prices caused Argentina's expenditure on energy and transport subsidies to soar.

Once Ms Fernandez was elected in October, the government twice increased its taxes on the country's farm exports in a bid to strengthen its balance sheet. But the higher levies prompted a virtual rebellion in Argentina's rural provinces and, after a bruising political battle, she was forced to cancel the measure in June.

Thus, less than a year into her presidency, Ms Fernandez found herself in an unenviable position: economic growth was slowing, prices for Argentina's agricultural commodities had fallen, and the country had to refinance some $23 billion of debt that would mature in 2009 and 2010. Clearly, she would need to borrow money. But only Hugo Chavez, the leftist Venezuelan president, was willing to provide it-charging (in August) a swingeing interest rate of 15% for the privilege.

Rather than continuing to rely on Mr Chavez, Ms Fernandez quietly began to implement a number of measures that orthodox economists had long suggested would be necessary for Argentina to stabilise its economy and regain market confidence. In recent months, the growth in public-works spending has slowed, while utility tariffs have risen modestly, enabling the government to cut its subsidy bills this year by around 10%. The central bank has raised interest rates and strengthened the peso. And earlier this month Ms Fernandez announced that Argentina would pay off its defaulted debt with the Paris Club group of creditor nations.

Although each of these moves should benefit Argentina's growth in the long run, none of them succeeded in bringing down the country's stubbornly high interest payments. So Ms Fernandez began to reconsider the government's intractable position on the holdouts.

Local economists estimate that a successful exchange—one that would elevate the overall acceptance rate of the restructuring from its current 76% to 95% or better—could reduce Argentina's interest rate fromi5% to betweeni 10% and 13.5%, producing savings that would easily compensate for the expansion of the debt burden. Moreover, the deal as currently structured would provide the extra cash Argentina needs now to meet its financial obligations for 2009. Reaching a settlement with the holdouts would be an important landmark for Argentina, enabling the country to remove the last vestige of its 2001-02 economic collapse. But if Ms Fernandez is hoping that the decision will serve as a panacea for her woes, the markets are bound to disillusion her.

Argentina still suffers from a yawning credibility gap with investors, due to its shortsighted economic policies in general, and its meddling with the inflation figures in particular. Bridging that gap will require an explicit and believable plan to reduce inflation, eliminate price controls and subsidies, and attract investment, rather than a continuation of the somewhat chaotic series of ad hoc measures Ms Fernandez has implemented so far. Although in recent months she has taken some very welcome moves to right a foundering ship, she still has a long way to go before convincing the markets that Argentina will at last get serious on her watch.

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