04/02/2020

Creditor Technical Note on IMF "Staff Technical Note On Public Debt Sustainability" of Argentina

Introduction

On March 19th, the IMF published a "Staff Technical Note On Public Debt Sustainability" of the Republic of Argentina. The Note was prepared in "close collaboration" with Argentinean state officials and introduced by a statement from its Managing Director. Its avowed purpose is to define a "feasible macroeconomic framework that could underpin a debt restructuring operation that would restore debt sustainability with a high probability." Its principal conclusions are that:

1. Argentina's public debt is "unsustainable", not due to its stock, but because the required cash flows exceed levels "consistent with ability to durably service" it. Indeed, "the analysis shows that there is virtually no scope for FX debt service payments to private creditors during 2020–24".

   The chosen metrics are the Gross Financing Needs (GFNs), set to average no more than 5% of GDP, and FX Debt Service, always less than 3%.

2. The restructuring should be underpinned by long-term, terminal macroeconomic assumptions radically downgraded from those used in the 4th Review in July of 2019. Argentina's real GDP growth is set at 1.5%, primary fiscal balance at 1.3% of GDP.

Point #1 notwithstanding, the Note finds room for the timely repayment of the IMF's own programme's recent disbursements, totaling, with interest, $49.5 bil through 2024, and using 80% of the supposed GFN capacity in 2022 and 2023.

Argentina's bondholders find the foundational assumptions of IMF's work irreconcilable with the Fund's own views of Argentina only a short 9 months ago, and at odds with Argentina's economic history – full as it is of both crashes and subsequent sharp recoveries—and completely out of alignment with the international context and experience. This memo will highlight some of the most salient objections, and conclude with reflections on the IMF's conflicted position in the Republic's restructuring. The Fund lent last, and has surely never had a weaker claim to be the senior lender.

The GFN Target

The Note stipulates that

> it would be appropriate to target GFNs averaging <u>no more than 5 percent of GDP after 2024</u>, and not exceeding 6 percent of GDP in any year. (p. 8)

motivated by the wish to

> ensure that Argentina's <u>domestic banking system would, as the residual financier</u>, be in a position to absorb the borrowing requirements created by adverse, but plausible, shocks. (ibid)

To begin seeing how extraordinary a change of perspective this is, one need only turn the page back to the previous, 4th IMF Review of July 2019.

> (GFN) are expected to breach 15 percent of GDP in 2019 but remain below the threshold during the rest of the projection period" (p. 46)

A temporary breach of 15% - three times higher! – was not an impediment to disburse $5.4 bil of new funds then. And no wonder, since IMF's 2013 "Staff Guidance Note for Public Debt Sustainability Analysis" set 15% as the threshold for "High risk". (Table 5a)

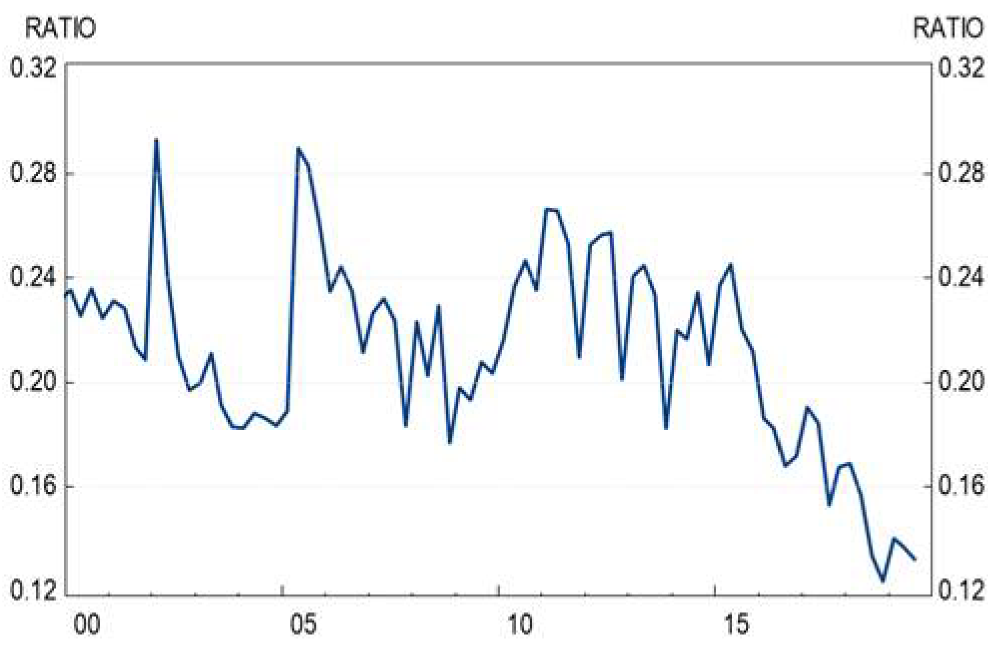
Nor was there any expression of concern that all of Argentina's financing needs should be at all times supportable by its domestic banking system alone. The IMF itself catalogued some of the other sources of liquidity Argentina would, realistically, have access to: "international reserves", "China swap", "Treasury cash buffers", "financing from other multilateral sources." (p. 18) One should also add seigniorage.

Furthermore, the IMF rightly took comfort from the following factors:

> A significant share of liabilities is held by classes of investors, including domestic financial institutions, retail investors and other public entities, who are expected to continue investing in Argentine debt even amid stressed conditions. Also, the long maturity of Argentina's privately-held foreign currency-denominated debt improves the prospects of adequate private creditor exposure being maintained throughout the program. (p. 19)

Indeed, the bottom line is that over a long and volatile stretch of Argentina's history, it never did have to rely solely on its banks, which have never been the primary financers of the public sector.

Banks's credit to the public sector as a % of total government debt

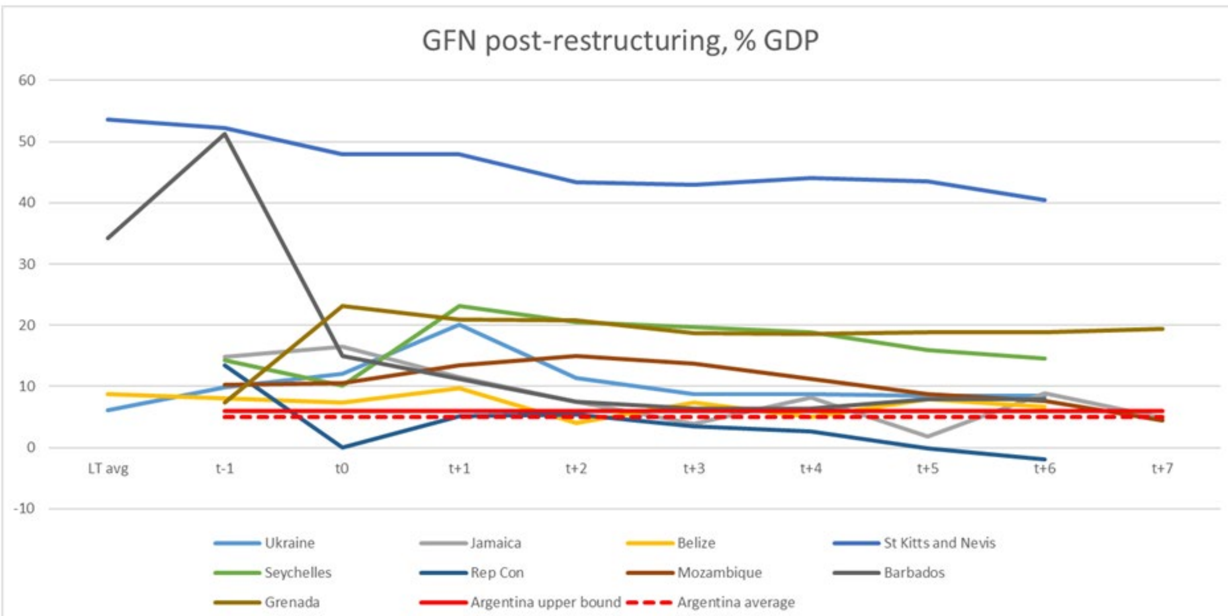


Source: Haver Analytics

The recent history of the Fund's engagement with Argentina is not the only place where one finds the opposite of what the Note contains. Its authors write:

> … in seven major restructurings since 2005, projected medium-term GFNs averaged 5.8 percent of GDP and peaked at an average of 7.6 percent of GDP (Figure 2). (p. 7)

The sample used for Figure 2, however, does not correspond to any of the standard lists of events "since 2005": neither the Cruces and Trebesch ("Sovereign Defaults: The Price of Haircuts", updated in 2014) database, nor the lists of events compiled by the ratings agencies. We use the Moody's "Sovereign Default and Recovery Rates" list, and consider all of the 9[1] EM restructurings over the past 15 years for which the IMF had published analyses either concurrently or immediately thereafter. Here are the post-restructuring *ex ante* projected GFN/GDP ratios.



Only 1 country out of 9 fell at or below the Argentina limit – Congo Brazzaville, a nation with ~$450 per capita income. The other 8 were above, especially in the first few years after the restructuring. Can Argentina truly be argued to be a weaker, more liquidity-constrained borrower than these economies?

In conclusion, one wonders what changed so much, by IMF's reckoning, that, after disbursing its own resources in July, today it cannot abide – at a purely intellectual level, since they will have been repaid – GFN/GDP > 5% after 2024? It can hardly be said that the answer is "the current political climate", since by 2024, the next elections will have been held; in fact, the Note's analysis extends to 2030 and even beyond.

[1] Ukraine, Jamaica, Belize (most recent), St. Kitts and Nevis, Seychelles, Congo Brazzaville, Mozambique (most recent), Barbados and Grenada.

The Framing Macroeconomic Assumptions

Debt sustainability analyses are highly sensitive to their key assumptions, which must be made with care. Some of the crucial choices made in the Note cannot be described as reasonable.

GDP growth

> Staff estimates potential real GDP growth at 1½ percent, in line with Argentina's average real GDP growth over the past 20 years.

Using INDEC's base-2004 real GDP series, the 20-year average is 1.70% if one cuts the sample off in 2018, 1.76% if 2019 is included with -2.2% penciled in (1999, now omitted, had been an even worse year). Given that this span includes the 2000-1 Argentina default, the 2008-9 Global Financial Crisis and the 2014 Argentina default, there is no conceivable reason to further "round them down".

The fundamentally punitive nature of 1.5% becomes clear, when one recalls that Argentina's population and work force are currently growing at ~1%, which means that the assumed economic productivity growth would be only ~0.5%. In this light, it is not at all surprising to see that the IMF's long-term growth assumption in the 4th Review was 3.6%! To get an intuitive sense of how plunging a downgrade from 3.6% to 1.5% really is, observe that it sends Argentina from the 3rd to the bottom quartile among the 193 countries for which the latest IMF WEO had 5-year forecasts. Put another way, 9 months ago, Argentina's medium-term peers were Chile, Ukraine, and Turkey – now, they are the stagnant France, Portugal and Haiti.

Finally, it's worth noting that in the sample of the EM 9 restructurings, the initial IMF projections had underestimated the end-of-forecast-horizon USD GDP level by an average of 7%.

Primary Surplus

> Staff's framework assumes a continued (but slower) improvement in the primary balance after 2023 to reach a medium-term level of 1.3 percent of GDP starting in 2025

A terminal 1.3% primary surplus would be lower than that planned for 8 out of the 9 EM restructurings: the projections ranged between 1.6% (Ukraine) and 9.4% (Congo Brazzaville); the one exception was Mozambique, a country excused from making a fiscal effort because, at least on paper, it is expected to multiply its GDP with a natural gas bonanza.

The IMF makes much of the fiscal consolidation effort undertaken by President Macri's administration in 2016-2019, and the "feasibility" of now pushing further. Yet this misses the big picture. In 2011, Argentina's non-interest government expenditures were 32% of GDP. The 2nd administration of President Cristina Kirchner pushed them up to an astonishing 39.4% in the next 4 years! The last review of Macri's plans saw this number back down to 34.8% by end-2019, and bottoming at 34% over the forecast horizon. In truth, the whole arc of the fiscal consolidation so far is nothing more than a partial reversal of the imprudent fiscal commitments of the latter part of the "Kirchner era".

Conclusion

The IMF Staff Note has been shown to be a startling U-turn from both the Fund's own very recent opinions and its past methodologies. The Note simultaneously makes pessimistic assumptions across all the DSA dimensions, layers a global shock on top, and advises investors to reconcile themselves to underwriting that as their base case. In fact, the 5% GFN/GDP requirement is so implausibly tight, that, in fulfilling it, the IMF's projection has to drive down debt / GDP to 30%-35%. This deleveraging would be so gratuitous that it would put Argentina below the BBB-bucket-economy average. Yet this "BBB outcome" is to be attained mostly on the back of creditor confiscations, without challenging Argentina itself to make the efforts all the other distressed EM economies were expected to make.

Ultimately, according to the IMF's DSA, there is no room for cash flows to anyone over the next 4-8 years - **except to the Fund itself**. Yet has the IMF ever had a weaker claim to its implicit "senior lender" status than in Argentina in 2020? Taking its projections at face value, the Fund will end up being a higher-cost lender to Argentina than the external markets. President Macri's Finance Ministry issued the *last* Eurobond on 22nd of June 2018; IMF approved its ill-fated Stand-by-Arrangement with Argentina on 20th of June 2018, and disbursed 75% of its funds from 26th of October 2018 and on. It lent last, presided over the subsequent use of its resources mostly for domestic capital flight out of the country, and now expects to be paid first. Creditors cannot take the Note as an impartial and fair analysis, or a foundation for a just restructuring deal between themselves and Argentina.