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Argentina

The hole gets deeper

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Argentina will suffer most from not repaying a World Bank loan. But President Duhalde (above left) and his economy minister may have started something bigger

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ON NOVEMBER 14th Argentina took a big step towards joining the club of financial deadbeats that includes Zimbabwe, Iraq, Liberia and the Seychelles—countries that are in default on their official debts to the World Bank. Argentina's government paid only $79.2m out of an $805m repayment that had become more than 30 days overdue. Since the country has over $9 billion of reserves—a figure that has been rising recently—its motive was largely tactical. Frustrated by the slow pace of negotiations with the International Monetary Fund over a new loan package, Roberto Lavagna, Argentina's economy minister, argued that no more money could be repaid to the Bank without an IMF agreement. He was clearly playing a game of chicken.

Will he win? Argentina stands to lose most in the short term. Since it defaulted to private creditors last December, the World Bank and other international financial institutions have been the only potential source of funds for Argentina's government. Now that lifeline, too, is at risk. Until it pays off its arrears, Argentina will not be eligible for new World Bank loans (such as a $600m loan to help the poorest households). If no repayment is made within the next 30 days, all disbursements of existing loans will stop. After six months, the Bank would declare all its loans to Argentina—$8.5 billion in all—to be in "non-accrual status" (in effect, in default).

This deadbeat club is relatively exclusive. For the Bank's first four decades no borrower defaulted. In 1984, Nicaragua was the first country to become more than six months overdue. Since then only 19 countries have followed suit. By comparison, 85 governments have defaulted on their debts to foreign commercial creditors since 1975. Since the World Bank and other official lenders provide loans when nobody else will, countries usually try hard to keep paying them back. This "preferred creditor status" is one reason why the World Bank's bonds are rated AAA, even though most of its loans are to a host of risky developing countries. So far, the Bank has always—eventually—been paid back in full, as deadbeat countries get out of their financial holes. Only this year, Syria and the Democratic Republic of Congo have paid off outstanding arrears. A "default" on World Bank debt, unlike a default on commercial debt, has not, so far, implied a permanent loss to the Bank of principal and interest. That explains why Standard & Poor's announced last week that it was keeping stable its rating outlook for the World Bank and other multilateral lenders to Argentina, despite the government's decision not to pay.

Other reasons include the World Bank's strong capital base and its conservative financial management. As emerging markets have experienced bigger financial crises in recent years, the Bank has been increasing its loan-loss provisions (currently at $4.1 billion) and putting aside extra reserves. Over the past five years, the Bank's total equity (the amount of cash that could, in extremis, be paid out to bondholders) has risen to $29 billion—much higher than its total exposure to Argentina. And beyond, there is still "callable capital": the $178 billion or so that the World Bank's shareholder governments have promised to supply if necessary. With that kind of cushion, it is small wonder that few are worried about the Bank's credit rating.

Double default

Even so, last week's decision could have serious consequences. First, as the World Bank's fourth-biggest debtor, with around 7% of its loans, Argentina is much bigger than any previous deadbeats. The amount of principal that Argentina left unpaid last week is more than the overdue amounts owed by all the other defaulting countries put together. Elsewhere the problem is much worse. At the Inter-American Development Bank, the World Bank's sister institution that focuses on Latin America, the concentration of loans to Argentina—and hence the potential cost of an Argentine default—is much bigger.

Second, if Argentina fails to pay up for more than a few months, prudence suggests that the World Bank will need to provide more against the risk of Argentina's loans. More provisioning reduces the Bank's profits, which are a big source of cash for the poorest developing countries. In particular, there might be less money to subsidise cheap loans and pay for forgiving the debts of the very poorest. Alternatively, the Bank could boost its income by docking various interest-rate reductions that most borrowers tend to receive as a matter of course. Eliminating these "waivers" would hit other middle-income countries that borrow from the Bank, such as Brazil or Bulgaria. In short, the rest of the developing world will pay a price for Argentina's default.

Most troubling of all is the risk that Argentina's action might herald a shift in countries' willingness to default on loans from multilateral creditors. The deadbeat club has mostly consisted of the war-torn and the ungovernable: Sudan, Yugoslavia and Sierra Leone have all been members. In the 1980s debt crisis, Peru, Nicaragua, Guatemala, Honduras and Panama temporarily defaulted to the Bank. The region's bigger countries, such as Mexico, Brazil or Argentina, never did.

Now, with the world economy looking shaky and private finance scarce, several emerging economies, including Latin America's behemoth, Brazil, have debt burdens that are causing concern. Unless things improve soon, there could be more sovereign defaults in emerging markets. So far, Argentina is the only big emerging market that has been reduced to using default on multilateral debt as a chip in its financial negotiations. The worry is that it will not be the last.