



Part VI

Country Case Studies



Chapter 14

Latin America and the Caribbean **Argentina**

A weak central government, declining economy, and uncontrolled deficits undermine the role of the credit markets in subnational finance.

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Lessons

Long plagued by macroeconomic instability and political upheavals, Argentina appeared to have set the right course with the Convertibility Plan in 1991, undertaking a number of reforms and pegging the Argentine peso to the U.S. dollar. However, the solutions to the country's many related structural problems either never took hold or proved to be the wrong ones. A declining economy and growing government deficits undermined the national administration, and the ensuing devaluation and default not only closed the international financial markets to Argentine borrowers but also crippled the domestic markets.

Subnational borrowers have played a major part in the nation's recurring financial crises. The reasons for this include the loose federal structure of government (in which the provinces, not the federal government, form the core of the system), the appetite for deficit spending, and the extensive government ownership of

assets, including commercial banks. Argentine subnational governments have borrowed heavily from the banks, in the domestic bond market, and abroad, and by 2001 debt service was absorbing 25 percent of provincial spending. Devaluation and high domestic rates of interest (due to variable rate bank loans) pushed debt service beyond sustainable levels, precipitating widespread defaults, and in November 2002 the national government took the ultimate step of defaulting on multilateral loans.

In Argentina the weak federal government has no effective control over provincial borrowing, which it monitors but cannot regulate. Provinces historically have owned captive banks, which they have tapped for funds. While bank loans make up only part of subnational borrowing, the high interest rates and the shutting down of the domestic market were a disaster for subnational governments. The crisis has led provinces to resume the practice of issuing interest-bearing notes that serve as a substitute currency, undermining the central government's monetary policy.

Argentina provides a vivid reminder that fixes at the top or in one sector cannot cure systemic problems—and that the subnational credit market may be not only a victim of a financial crisis but also a contributor to it. An elastic revenue system; heavy reliance on negotiated transfers from the central government; and a large, expensive, and protected public workforce have reduced the ability of subnational governments to manage their finances responsibly. In addition, the bottom-up political structure has not provided the public will to make the changes needed.

Case studies look at the experience of three Argentine subnational borrowers—the province of Salta, the city of Buenos Aires, and the province of Buenos Aires—that were able to access international capital markets during the interval between crises in the mid- to late 1990s. The cases show what happened when the reforms that investors were betting on at both national and subnational levels failed to materialize. The national experience shows that extensive rebuilding is needed to solve the problems endemic to the Argentine political system if it is to cope with the challenges of a modern open economy.

Until the early 1990s Argentina experienced recurring periods of slow economic growth and high inflation, a cycle that led to the devaluation of the Argentine peso and the imposition of exchange controls. The Convertibility Plan, introduced in 1991, marked a sharp change. It appeared to finally get macroeconomic management right. Based on tighter monetary policy, tax system reforms, privatization, and liberalization of the economy, the plan reduced inflation rates from more than 1,300 percent in 1990 to 0 percent in 1996 and pushed GDP growth from 0.1 percent in 1990 to more than 7 percent a year in 1991–94. Foreign direct investment increased five-fold, reaching US\$6 billion in 1993. The Convertibility Plan fixed the exchange rate to the U.S. dollar, established the independence of the Central Bank, and made the monetary base equal to the external reserves.

In the mid-1990s it also appeared that the new government could handle shocks when they arose. The Mexican crisis in 1994–95 led to a sharp recession in Argentina marked by capital outflows, declining bank deposits, rising interest rates, reduced liquidity, and increased market volatility. GDP fell by 4 percent in 1995, and the unemployment rate reached a record 18.4 percent. The government responded quickly and effectively, restoring financial equilibrium with cuts in government spending, tax increases, and proactive measures to promote fiscal discipline at the provincial level.

After a temporary recovery, conditions deteriorated sharply in the rest of the 1990s. Exports fell, the trade deficit grew, GDP growth plunged to 0.5 percent in 2000 (in part because of the Brazilian devaluation), and the fiscal deficit reached 3 percent of GDP. The central government's total outstanding debt, not including provincial debt, reached US\$132 billion in June 2001, with interest payments absorbing 22 percent of the annual budget. A combination of political factors and economic mismanagement deepened the economic crisis, leading to general unrest among Argentines and to the fall of the de la Rúa government at the end of 2001.

Political turmoil—involving the establishment of two interim governments—and the persisting economic crisis led to the devaluation of the peso, which soared to an exchange rate of more than 3 to 1 with the U.S. dollar from the initial parity it had held for 10 years. In late 2002 the government was holding ongoing negotiations with the international financial community, led by the International Monetary Fund (IMF), on how to correct the huge fiscal imbalances and put the economy back on track. In November 2002 the country defaulted on loans from the World Bank and the Inter-American Development Bank. In the midst of this crisis the federal government had to reduce its budget deficit, a difficult task given the

constitutionally defined independence of provinces. Payments to provinces were under close scrutiny, and the government felt the need to reduce discretionary federal transfers (those that do not depend on constitutional provisions). This put further pressure on provincial budgets and make timely servicing of provincial bonds difficult.

Intergovernmental Relations

Argentina's government comprises three levels: the federal government; 24 provinces, including the city of Buenos Aires, which has the rank of province; and 1,911 local governments (municipalities) with borrowing powers. Provincial governments form the core of the country's political organization. Provinces have their own constitutions and executive and legislative branches of government. Provincial governors and legislators are elected directly to four-year terms. The municipalities are dependent on the provinces, which dictate their organization and taxing powers and, in some cases (such as the province of Chubut), have delegated taxing powers to municipalities. According to the Constitution, the federal government can intervene, with the approval of the Congress, "in the territory of a province in order to guarantee the republican form of Government." As a result, the federal government is able to assume control of a province at any time and replace an elected governor with a federal appointee.

Subnational Revenues: The Coparticipation Scheme

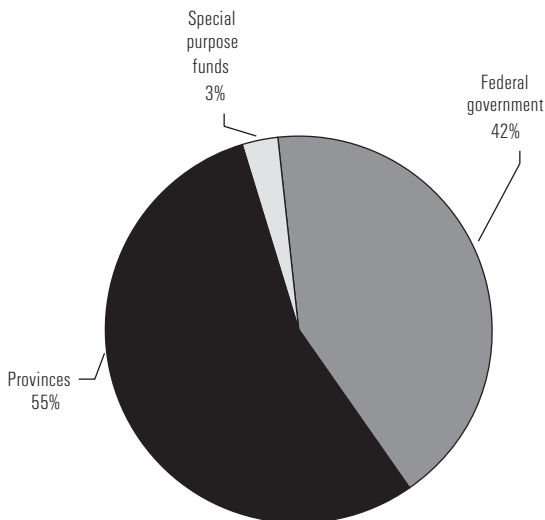
Argentine provinces have three major sources of direct own-source revenues: the sales tax, the property tax, and the vehicle registration tax. The sales tax is the most important, accounting for about 60 percent of total direct revenue. Indirect revenues come in the form of federal transfers: two unconditional and 10 conditional transfers. Unconditional transfers, representing 70 percent of the total, include general treasury support and the coparticipation revenue, which is the cornerstone of subnational finance in Argentina.

The gross coparticipation¹ transfer accounts for 90 percent of federal transfers to provinces and 52 percent of provincial revenues. The coparticipation law mandates that 89 percent of revenues from the federal value added tax, 64 percent of income tax revenues (after a fixed reduction), and 50 percent of a variety of other revenues go into the gross coparticipation fund. Of this, some 15 percent is retained at the federal level to finance the social security system, and another 546 million Argentine pesos (Arg\$) a

year is allocated to a fiscal imbalance compensation fund distributed to the provinces under a separate formula. The balance, the net coparticipation fund, is shared among the federal government (42.3 percent), the provinces (54.7 percent), and special emergency and equalization funds (3 percent) (figure 14.1).

The distribution of the coparticipation revenues among provinces was set in 1988 based on fixed percentages reflecting each province's share of total spending at the time: 43.7 percent for the more developed provinces (such as Buenos Aires, Santa Fe, Mendoza, Córdoba, and the city of Buenos Aires); 19.1 percent for the intermediate provinces; 27.3 percent for the low-density provinces; and 9.9 percent for the less developed provinces. As a result of subsequent adjustments to this formula, the current distribution of resources among provinces is based on arbitrary criteria emerging from bilateral negotiations between each province and the federal government.

Provincial governments also have coparticipation schemes, for transferring revenues to their municipalities (three provinces, Jujuy, La Rioja, and San Juan, have no coparticipation system). Unlike the national coparticipation scheme, the provincial systems allocate payments to municipalities on



Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.1. Distribution of Shareable Taxes under the Coparticipation Scheme, Argentina

the basis of objective indicators such as area, population, other municipal revenues, and similar factors.

Expenditure Responsibilities

Under the Constitution the provinces have jurisdiction over education, municipal institutions, provincial police, provincial courts, and other matters of purely provincial or local concern (table 14.1). The federal government has jurisdiction only over the areas explicitly assigned by the Constitution: customs, national defense, foreign relations, issuance of currency, federal public debt and property, regulation of shipping and ports, regulation of banks and banking activity, and regulation of international and interprovincial trade and commerce. Responsibility for the remaining public services is shared among the three levels of government.

There has been extensive devolution of public services to the provincial level in Argentina. The share of the federal government in public sector spending fell from more than 70 percent in 1986 to less than 55 percent in the 1990s. Provinces and municipalities are responsible for the other 45 percent. Since the provinces' direct revenues account for only 18 percent of their total revenue, they depend heavily on federal transfers. Recently provinces have used proceeds from privatizations to reduce deficits and cover capital spending.

Table 14.1. Allocation of Responsibilities among Levels of Government, Argentina

Federal government	Federal and provincial governments	Provincial and municipal governments	Municipal governments
Defense	Higher education	Basic education	Markets
Foreign affairs	Preventive health	Health care	Cemeteries
Currency and banking regulations	Economic development	Water and sewerage	Solid waste collection and disposal
Public debt	Justice and security	Regional and local roads	Local streets and drainage
Interprovincial transport	Housing	Land use	Parks
Trade regulation	Passenger and cargo terminals	Fire control	
Mail and telex	Gas and electricity		

Source: World Bank.

Regulatory Framework for Subnational Debt

There are no national regulations on the ability of subsovereign entities in Argentina to raise debt. Under the 1991 Convertibility Plan, however, the provinces were prevented from rolling over existing borrowings from local banks and had limited access to provincial banks, their traditional source of financing.

The Constitution allows each province jurisdiction over its borrowing. Approval procedures vary among provinces, but most provinces need a favorable opinion from their controller institution (general accountant office or general prosecutor office, for example). These procedures establish that debt should not finance current expenditures and that the debt stock cannot exceed a certain share of annual revenue, a limit that usually ranges from 20 percent to 25 percent.² For municipal borrowing, authorization is required from the municipal council and, in some cases, from provincial financial authorities. Foreign currency debt requires the approval of the Ministry of Economy under Resolution 1075/93 of the ministry. Banks are prohibited by the Central Bank from lending to subnational governments in either foreign or local currency and from underwriting provincial bonds (Central Bank Rule A 3054) unless the Ministry of Economy authorizes the transaction or the bond issue on an exceptional basis.

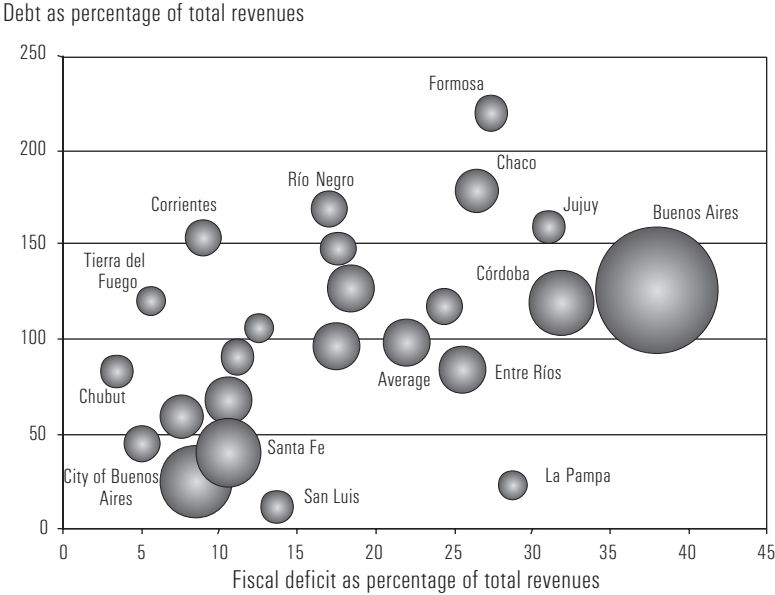
Another important rule is Resolution 571/95 of the Ministry of Economy, which sets the criteria for lenders to subnational borrowers. Among these, the most notable are experience in local or international subnational debt markets, a sound financial position, and “good” loan terms (interest rate, maturity, amount, interest payments, amortization payments, and up-front fees). In cooperation with the largest Argentine bond custody company and the major stock exchanges, the Ministry of Economy has developed ways to better monitor provincial bonds. The bottom line is that the Ministry of Economy can monitor, but not control, subnational borrowers.

Subnational Indebtedness

Argentina’s provincial debt reached US\$29.4 billion (100 percent of consolidated provincial revenue) at the end of 2001, while the consolidated provincial fiscal deficit rose to US\$6.5 billion (2.4 percent of GDP).³ Few provinces have made an effort to cut spending, with 60 percent of expenditures in 2001 going to salaries and interest payments. All provinces ran a fiscal deficit in 2001. Figure 14.2 shows the relative position of provinces based on their operating deficit and accumulated debt as a share of their total revenue.

The provinces have pursued different debt strategies. The province of Buenos Aires accessed the bond market in 2001, issuing four bonds for a total of US\$737 million. In the second half of the year the bond market was closed, and the province had to issue compulsory money bonds (Patacones) to pay salaries, contractors, and suppliers (see section below on compulsory money bonds). Córdoba tried to privatize its provincial bank and its electricity company to pay short-term commercial bank loans with bullet amortizations. Because of the high country risk, the privatizations never took place. Some provinces—such as La Pampa, San Luis, and the city of Buenos Aires, which had run fiscal surpluses in previous years—faced a sharp fall in revenues and had to fund their fiscal deficits in an adverse financial environment.

The situation is complicated, especially since the peso devaluation in January 2002. Still, the situation of provinces has improved as a result of a federal rescue through a debt swap. Formosa faces the worst situation, and



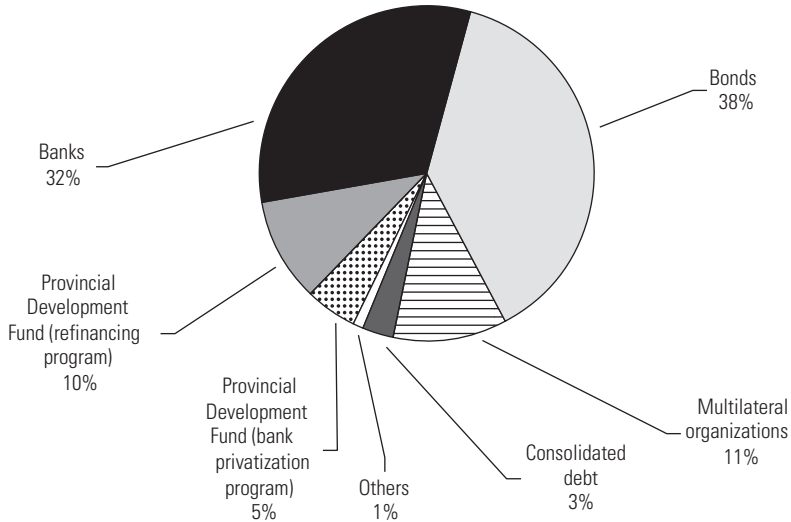
Note: The size of the bubbles represents the relative size of provincial revenue.
 Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.2. Relative Fiscal and Debt Situations of Provinces, Argentina, 2001

the provinces of Chaco, Córdoba, Buenos Aires, and Jujuy also confront large problems. During the first half of 2001 many provinces tapped the bond and banking markets, but during the second half financial conditions tightened and most provinces returned to issuing money bonds.

Bonds account for the largest share of provincial indebtedness, which totaled US\$29.4 billion at the end of 2001 (figure 14.3). However, the debt with banks is the most expensive because it is linked to the average rate for certificates of deposit (as published by the Argentine Central Bank) plus a rate spread or adjusted by a rate multiplier. These floating rates are recalculated every month. During the second half of 2001, when Argentine sovereign risk increased dramatically, some provinces faced real annual interest rates of 45 percent. More than 30 banks have made loans to provinces, but four banks—Banco de la Nación Argentina, Banco de Galicia, Banco Frances, and Banco Río—clearly dominate the market, with almost 60 percent of total bank lending to provincial governments.

In 2000 the federal government implemented a voluntary refinancing program for provinces through the Provincial Development Fund. The



Note: The figure excludes short-term debt with suppliers and employees.

Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.3. Provincial Indebtedness by Type of Debt or Lender, Argentina, December 2001

nine participating provinces (Catamarca, Chaco, Chubut, Formosa, Jujuy, Neuquén, Río Negro, Tierra del Fuego, and Tucumán) made commitments to reduce their 1999 deficits by 20 percent, to borrow no money other than that provided by the Provincial Development Fund, to implement certain structural reforms, and to keep increases in their debt stock to no more than their 2000 fiscal deficit. In return, the fund committed to finance the provinces' 2000 fiscal deficits and the rollover of debt principal payments. The program was repeated in 2001, and two more provinces (Misiones and San Juan) joined the scheme. Both programs were unsuccessful, for two main reasons: the federal government lacked the enforcement capacity to ensure that the provinces met their targets, and politically negotiated waivers were given. Although a few provinces met their fiscal targets, most did not because there was no system to reward those that did and punish those that did not.

Multilateral lenders are also important sources of credit, accounting for 11 percent of provincial indebtedness. Until the recent devaluation of the Argentine peso, this type of debt had the lowest cost and longest maturity. However, devaluation greatly increased the cost of servicing this debt in domestic currency. Under an agreement between the federal government and the provinces signed on 27 February 2002, the federal government will provide some kind of hedging to help provinces meet the cost of this debt. Although some municipalities have borrowed indirectly from multilateral organizations, no province has indicated whether it will help its municipalities with such debt.

The debt under the Provincial Development Fund's bank privatization program⁴ has a long term and low cost (7.6 percent annual fixed interest rate) because the funds were provided by multilateral organizations (the World Bank and the Inter-American Development Bank). Some 17 of the 24 provinces have been involved in programs to privatize provincial banks. The largest provincial banks (Banco de la Provincia de Buenos Aires, Banco Ciudad de Buenos Aires, and Banco de Córdoba) were not privatized, and other banks returned to provincial ownership because of the poor performance of some private managers and the nontransparent process of privatization.

Debt Service

In 2001, before the most recent debt swap, debt service payments absorbed more than 25 percent of the operating revenue of provinces. More than 45 percent of the debt service payments went to commercial banks, often for short-term loans subject to refinancing risk. There was no possibility of refi-

nanancing such loans because of the run on deposits during the second half of 2001. In addition, banks that were active players in the provincial lending market were also active players in the sovereign bond market, a situation that complicated the refinancing of provincial debt. The average life of provincial debts at the end of 2001 was six years, but some provinces had to face important due dates with no possibility of refinancing those payments. Thus at the end of 2001, as the federal government worked out a swap for sovereign debt, most of the provinces followed suit in a provincial debt swap.

Provincial Debt Swap

In establishing the criteria for the debt swap, the federal government extended eligibility only to bank loans, provincial bonds denominated in Argentine pesos and U.S. dollars, and provincial debt with the Provincial Development Fund. Bonds and bank loans would be exchanged for loans issued by the Provincial Development Fund with a federal government guarantee. In exchange for this better guarantee, creditors agreed to extend the maturities of their loans and bonds by three years, established a three-year grace period for principal payments, and lowered interest rates (70% of the original interest rate with a maximum of 7% for fixed interest rates and a maximum of London interbank offered rate, or LIBOR, plus 3 percent for floating rates).

The transaction involved 18 provinces and US\$18 billion. By 14 December 2001, the last day on which creditors could enter the provincial swap, more than 450 bank loans and 70 provincial bond had entered the swap.

International credit rating agencies (Fitch Ratings, Standard & Poor's, and Moody's) considered the debt swap a "selective default" because it involved a reduction in net present value for creditors. As a result, some borrowers (such as the city of Buenos Aires) did not enter the swap. On 19 November 2001 Fitch Ratings published a press release explaining its concerns about the debt swap stemming from the change in terms and conditions of bonds and loans and the reduction in net present value of the debt exchanged.

Impact of the Devaluation

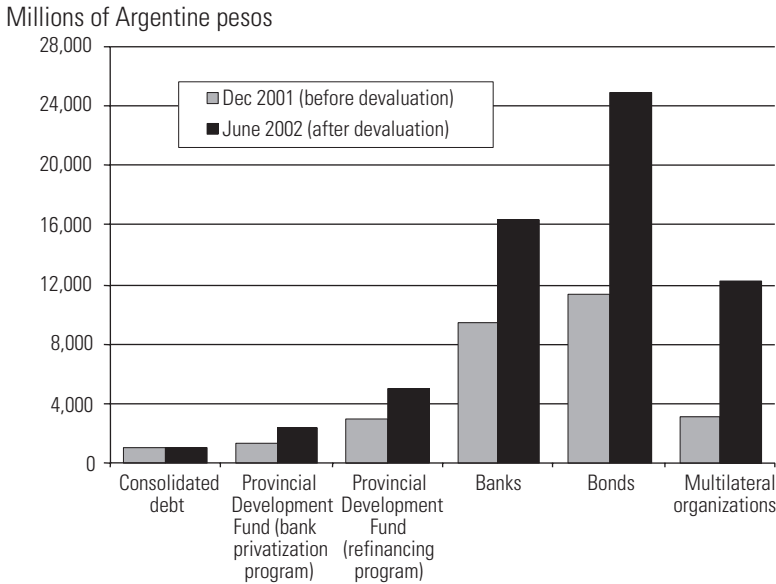
Among the first economic actions by the new government was to devalue the Argentine peso and establish a new parity for exchanging dollar-denominated debt for peso-denominated debt. Parity was set at Arg\$1.4 to US\$1. Some provincial debts were excluded from the exchange parity because they were incurred under foreign laws (including all multilateral loans and some provincial bonds).

After the devaluation, provincial debt instantly increased (figure 14.4). The debt stock, which had been Arg\$29.4 billion at the end of December 2001, rose to Arg\$62 billion by June 2002. Most provinces could no longer afford to service their debt. For international debt, ultimate responsibility rests with the federal government, which acts as guarantor. Indeed, before the present financial crisis the central government had implicitly bailed out some provinces by making their payments to multilateral lenders and then intercepting coparticipation revenues to cover the debt service costs.

Collateral for Subnational Borrowing

Two main types of collateral back provincial loans and bonds: coparticipation revenues and hydrocarbon royalties. Most subnational borrowing is backed by pledged coparticipation revenues.

Coparticipation Revenues. There are two basic mechanisms for collateralizing a borrowing with coparticipation payments (figure 14.5). The first, and the more common and safer of the two, is the intercept at the source of the



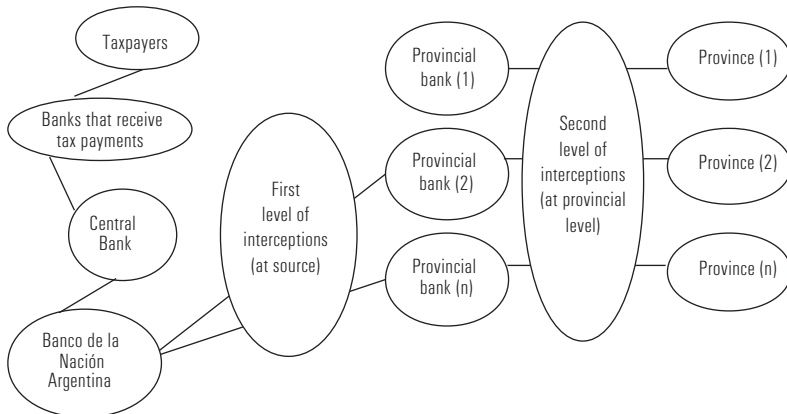
Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.4. Impact of the Devaluation on Provincial Debt, Argentina

disbursements: Banco de la Nación Argentina, the commercial bank of the federal government. The second is the intercept at the provincial bank (or the financial agent of the province) that receives the coparticipation revenues from Banco de la Nación Argentina.

These mechanisms have been tested as a result of the recent Argentine default, and some interesting differences have appeared. At the first level of interception every bond with a trustee has been honored. At the second level, however, behavior has differed depending on whether the provincial bank had been privatized, and moral hazard problems have arisen. Privatized provincial banks did not follow provincial instructions to default on bonds for which those banks served as trustee. In contrast, provincial banks that had not been privatized followed provincial instructions to default on bonds for which they were the trustee.

The province of Chaco issued three bonds for which the provincially owned bank (Banco del Chaco) acted as trustee. When hard times came in 2001, the provincial government issued two decrees (1845/01 and 1869/01) unilaterally deferring payments on the bonds and ordering its bank to return to the province the amount collected in the trust escrow accounts.⁵ Contrast the experience of the province of Río Negro, which had established a trust with its financial agent, Banco Patagonia (its former provincial bank). In January 2002 the province postponed principal and in-



Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.5. Disbursement of Coparticipation Revenues, Argentina

terest payments on all its bonds except those for which Banco Patagonia acted as trustee, because the bank would not follow provincial instructions to default on the bonds covered by the trust.

In 2001 some commercial banks proposed that the federal government intercept coparticipation revenues at the level of the Central Bank. Clearly, they perceived the Central Bank as having greater independence than Banco de la Nación Argentina. The federal government rejected the proposal.

Municipal governments receive their share of coparticipation revenues through the financial agent of their province. Two interesting cases are the provinces of Buenos Aires and Mendoza. Because these provinces allow their municipalities to pledge their share of coparticipation revenues at the first level of disbursement (Banco de la Nación Argentina), lenders see these municipalities as more secure, enabling them to reduce their borrowing costs.

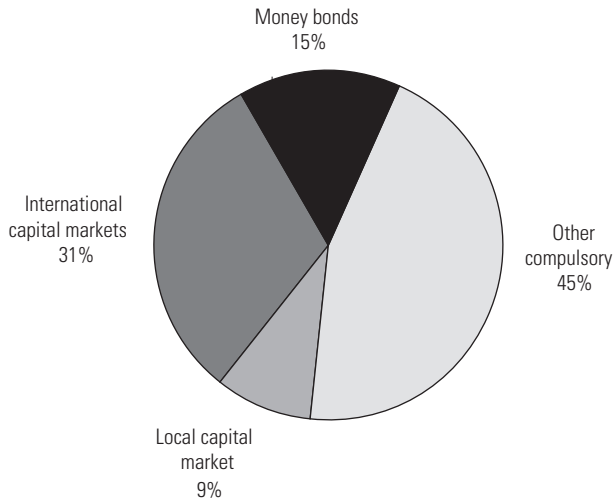
Hydrocarbon Royalties. Four provinces have issued bonds backed by hydrocarbon royalties (oil and gas) as collateral (Mendoza, Neuquén, Salta, and Tierra del Fuego). Although transactions backed by hydrocarbon royalties are much more complicated to structure than those backed by coparticipation revenues, all the bond issues were successful because investors perceive this type of collateral as the safest.⁶ Hydrocarbon royalties back the most successful Argentine provincial bond issue, the Salta Hydrocarbon Royalty Trust.

One of the main advantages of hydrocarbon royalties is that concessionaires pay the royalties to the provinces through private local banks (including offshore banks), avoiding federal and provincial government interference. During the financial crisis affecting provinces in the second half of 2001 and the first half of 2002, there were no defaults on loans and bonds backed by hydrocarbon royalties.

Still, the use of hydrocarbon royalties as collateral is rare, mainly because only 10 provinces receive such royalties. Neuquén receives the largest amount, more than US\$400 million in 2001.

Experience with Subnational Bonds

Argentine provincial bonds are of two types: those known as compulsory bonds, for which the investor must accept the terms and conditions offered, and those issued by conventionally accessing capital markets. At the end of 2001 more than 135 provincial bond issues were outstanding, with a total value of US\$11.4 billion, and bond issues in international and domestic capital markets accounted for 40 percent of the bond debt (figure 14.6).



Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.6. Provincial Bond Debt Outstanding by Type, Argentina, End of 2001

Few local governments have floated bond issues in the capital market; most of the municipal bonds that have been issued have been compulsory bonds. At the end of 2001 the municipal bond debt outstanding reached US\$110.5 million, and no municipality had accessed the international market.

Compulsory Money Bonds. In 2001, facing revenue shortages, many provinces began to issue bearer bonds, reviving an old scheme of using bonds to pay salaries and other expenses.⁷ Money bonds are printed at the same size as Argentine pesos—indeed, they look like currency. Money bonds can be used to pay provincial taxes and are commonly accepted as money at their face value. The most well-known provincial money bond is the Patacon, issued by the Buenos Aires provincial treasury. Patacones are the only money bonds that can be used to pay federal taxes, and federal transfers to the province of Buenos Aires are made in Patacones. Most money bonds are short-term notes that pay a fixed interest rate and are backed by the full faith of provincial treasuries. This backing means little, however, because most provincial treasuries have defaulted on their bonds.

Provinces such as Tucumán never gave up using money bonds, while provinces that have done better in managing debt and accessing capital markets in the past decade, such as Buenos Aires, only recently became active issuers of money bonds. Buenos Aires has been the largest issuer: at the end of 2001 its debt outstanding in money bonds reached almost Arg\$1 billion. By comparison, the debt outstanding of all provinces in this type of bonds on the same date was Arg\$1.8 billion. The Provincial Development Fund has also issued money bonds (Letra de Cancelación de Obligaciones Provinciales) to pay coparticipation revenues. In all, some Arg\$4.3 billion in money bonds were outstanding at the end of 2001.

Local revenues continued to decline in the first half of 2002, and at the end of June the stock of money bonds (excluding those issued by the Provincial Development Fund) reached Arg\$4.1 billion and Arg\$ 7.4 billion including those issued by the Provincial Development Fund. Some of these bonds, such as those issued by Buenos Aires, Córdoba, and the Provincial Development Fund, have wide acceptance and a liquid secondary market with low volatility. Nonetheless, these bonds adversely affect monetary policy, not only because they prevent open market policies but also because they can be used to buy U.S. dollars. For this reason, under an IMF financial rescue package for Argentina, provinces would stop issuing money bonds. The IMF and the Ministry of Economy have discussed options such as buy-back programs for retiring these money bonds from the market.

Other Compulsory Bonds. Other compulsory bonds typically are the result of debt consolidation related to judicial decisions, debt restructurings, and old provincial debts. Because of their compulsory nature, most of these bonds replicate the terms and conditions of consolidation bonds issued by the federal government (table 14.2).

Although the compulsory bonds were not issued in the capital market, many were listed on the Buenos Aires Stock Exchange and in the Buenos Aires over-the-counter market (Mercado Abierto Electrónico). These listings helped provinces gain knowledge about bond issuance.

Bonds Issued in the Capital Market. Capital markets have proved to be a good avenue for lowering the cost of funds and extending debt maturities for Argentine provinces: in the past several years 12 provinces have accessed the bond market, and seven of them have reached international capital markets (table 14.3). The earliest and most active issuer is the province of Buenos Aires, which launched its first issue in 1994; the province is the second largest issuer, after the city of Buenos Aires. Because of the size of its fiscal deficits, Buenos Aires cannot finance them through

Table 14.2. Terms and Conditions of the Typical Consolidation Bond, Argentina

Most common name	BOCON (bonos de consolidación)
Currency	U.S. dollar or Argentine peso
Interest rate	30-day U.S. dollar London interbank offered rate (LIBOR) or average interest rate for savings accounts in Argentine pesos
Maturity	16 years
Grace period for principal	6 years
Grace period for interest	6 years
Interest payments	Monthly, beginning in month 73; 119 payments of 0.84 percent of the principal and a final payment of 0.04 percent of principal
Period of capitalization	During the first 72 months
Collateral	None
Status	General obligation

Source: Argentine Ministry of Economy.

Table 14.3. Provincial Bond Issues in Domestic and International Capital Markets, Argentina, 1994–2001

Year	Issues	Issuers	Total amount (millions of U.S. dollars)	Average issue (millions of U.S. dollars)	Average interest rate (percent)	Average life (years)
1994	1	Buenos Aires	100	100	9.83	3.00
1995	4	Buenos Aires, Neuquén	283	71	10.15	3.17
1996	3	Buenos Aires, Mendoza	479	160	9.25	5.08
1997	8	City of Buenos Aires, Mendoza, Tierra del Fuego, Tucumán	1,156	144	10.64	7.43
1998	2	Buenos Aires	164	82	7.83	4.34
1999	10	Buenos Aires, Formosa, Misiones, San Juan, Santiago del Estero	946	95	12.88	5.09
2000	9	Buenos Aires, City of Buenos Aires, Chaco	1,306	145	12.05	5.96
2001	4	Buenos Aires, Salta	859	215	11.84	6.12

Note: The table excludes treasury bills.

Source: World Bank based on Argentine Ministry of Economy data.

the banking system. Thus it is a regular issuer in the bond market, while other provinces are opportunistic issuers.

The bond issued by the province of Buenos Aires in 1994, a U.S.-dollar fixed-rate bullet bond, was the only provincial one issued that year. Four bond issues were launched in 1995: three by Buenos Aires and one by

Neuquén. The Neuquén bond was the first (and still the only one) backed by coparticipation revenues and hydrocarbon royalties. It was also the first with a trust structure under the Argentine Trust Law (Law 24441). Neuquén was the first subnational issuer to use the largest Argentine custody house, Caja de Valores, as trustee. In 1996 Mendoza province issued its first bond, collateralized by hydrocarbon royalties. The bonds, due July 2002, were reportedly fully repaid despite the Argentine default and devaluation, demonstrating the strength of security arrangements through offshore trusts.

The province of Buenos Aires has issued bonds in the market every year except 1997, when the province achieved a fiscal surplus as a result of its privatization program. In that year, the most successful in the 1990s for bond issues, four provinces accessed the market. The market confidence prompted Mendoza to issue a bond with no collateral. (Unfortunately, the confidence proved to be misplaced.) The city of Buenos Aires launched four bonds, one denominated in Argentine pesos, two in Italian lire, and the last in U.S. dollars. All general obligation bonds, they were sold to fund an accumulated deficit. Tierra del Fuego completed a successful transaction in October 1997, offering a fixed rate bond backed by hydrocarbon royalties. Tucumán became the first province to tap international capital markets, backing its bonds with coparticipation revenues. Its program included two bonds (US\$200 million each), one issued with a fixed interest rate and the other with a floating rate.

In 1998 financial conditions tightened because of the Asian, Russian, and hedge fund crises. Most of the provinces refinanced their loans in the banking market, with the province of Buenos Aires the only subnational government accessing the market. The next year, 1999, was a complicated one for Argentine provinces not only because of the Brazilian devaluation but also because of presidential and gubernatorial elections.

Also a very difficult year was 2001. The Argentine financial problem was the eye of the hurricane. Despite the turmoil, Salta launched the first Argentine subsovereign bond rated better than the sovereign. Indeed, the bond received investment-grade ratings from the three major rating agencies. The bond was denominated in U.S. dollars and backed by hydrocarbon royalties.

Among these provincial bonds, 85 percent were issued with fixed interest rates and the most common currency used was the U.S. dollar. The debt in dollar-denominated bonds increased significantly after the currency devaluation. In addition to bonds in Argentine pesos and U.S. dollars, the province of Buenos Aires and the city of Buenos Aires issued bonds in deutsche marks,

yen, Swiss francs, Italian lire, and euros. Coparticipation revenues, hydrocarbon royalties, or both were usually used as collateral. The offering process often was protracted and challenging. Except for the province of Buenos Aires, subnational governments that accessed capital markets lacked experienced and permanent debt offices and reliable information. The lack of well-trained and properly prepared subnational debt offices has hampered the expansion of the subnational bond market in Argentina.

Every local bond issue used a trust scheme, which has proved to be a safe measure, especially during a financial crisis. While many provinces defaulted on their bonds after the sovereign default, there was no default on bonds with a trust scheme. There has been no common approach to dealing with the defaults. A few provinces have taken actions to reschedule their payments, others have done nothing, and still others have deferred payments.

Most bond issuing activity has been at the provincial level, with just three municipalities—Guaymallén, Bariloche, and Bahía Blanca—accessing local bond markets. Bahía Blanca is the only one with debt still outstanding as of June 2002.

Recent Developments in Subnational Finance (Up to End-2002)

Although all provinces face a deep liquidity crisis, their fiscal situation varies. The province of Buenos Aires, with the largest economy (35 percent of GDP), has accounted for two-thirds of the total provincial deficit in the past three years (1999 through 2001) on average. Even so, the relative performance of other provinces is much worse. While the central government has made efforts to rationalize spending, mainly by cutting salaries for civil servants, only a few provinces have followed this example. Many others have financed their imbalances by issuing money bonds.

The federal government's dwindling resources and its declining ability to assist subnational governments are major concerns in the protracted crisis. After the second half of 2001, because of the dramatic decline in federal revenues, the federal government failed to transfer the minimum amounts required under the federal compromise, an agreement fixing the monthly transfers owed to the provinces.⁸ At the end of 2001 most of the provinces (including the city of Buenos Aires) signed a new agreement with the federal government allowing it to use notes to pay all past-due amounts to provinces and up to 40 percent of the amounts due after November 2001. The agreement also allowed the federal government to reduce transfers due

after January 2002 by up to 13 percent of the total (as long as it makes corresponding reductions in the federal budget) and allowed provinces to use these reductions as a credit on debt service payments to the Provincial Development Fund.

The persisting economic crisis was causing problems in the coparticipation scheme. To address these problems, the federal government signed an agreement with provinces on 27 February 2002 aimed at sharing the costs of the crisis. The agreement includes restructuring provincial debt through the issuance of a central government bond that will be used to assume provincial debt in a new debt swap. A precondition for the debt restructuring is a reduction in the provincial fiscal deficit of about 60 percent. A deadline of the end of 2002 was set for passing a new coparticipation law. The law was not passed, and the system remains unchanged.

To guarantee their debts, the provinces pledged 15 percent of their gross coparticipation revenues. However, the amounts to be collected from provinces will be inadequate to pay the bond launched by the federal government, and the national Treasury will face imbalances beginning in the fourth year after the issue.

The agreement also calls for the central government to provide currency hedging for provincial multilateral debt. Provincial debt issued in foreign markets will receive the same treatment as central government debt.

At the end of August 2002 the federal government issued a decree (1579/02) establishing the terms and conditions for the debt-restructuring program:

- The bond issuer is the Provincial Development Fund.
- The interest rate is 2 percent annually.
- The grace period for interest payments is 7 months, and for principal payments, 36 months.
- The maturity is 16 years.
- The amortization is monthly in 13 years.
- The principal is to be adjusted by an index based on the consumer price index.
- The issue date is 4 February 2002.

An important difference between the 2001 and 2002 debt swaps is that the latter extended eligibility to debts denominated in any currency.

To reach an agreement with the IMF, the federal government was required to sign an agreement with each province establishing an ordered financial

package. The aim was to avoid the issuance of provincial money bonds and to reduce fiscal deficits by up to 60 percent of the 2001 fiscal deficit. The provinces appear to be better situated than in previous years to achieve these goals: Some of them receive oil royalties that are settled in U.S. dollars. Because of inflation, tax revenues are again growing. The interest payments for the 2002 debt swap are much lower (almost 40 percent less) than those for the 2001 debt swap; salaries, which account for 50 percent of spending, have not been increased or indexed to inflation. Nonetheless, a sound monetary policy and a real commitment from the federal government to cut spending are required to avoid hyperinflation pressures and to change the situation dramatically for both the federal government and the provinces.

Key Issues for the Viability of Subnational Bonds

During the 1990s Argentina addressed several reforms that had positive effects on capital markets. Nevertheless, other major reforms are still pending.

Among the structural problems facing Argentina, building a workable fiscal relationship between the federal government and the provinces is one of the most pressing. Structural change is needed to make the revenue-sharing mechanism simpler and more equitable. Despite a constitutional requirement for change in the structure of the coparticipation scheme, there has been a political stalemate: such changes require approval by the federal government and all the provinces, something very difficult to achieve politically. Unless additional revenues are allocated to the coparticipation funds, which can happen only after economic growth resumes, the issue will remain unresolved because no province is likely to agree to reduce its share of revenues to benefit another.

The federal government's need to balance its fiscal accounts in the face of falling tax revenues and lack of external financing requires cost-cutting efforts that also involve the provinces. These efforts are complicated by the institutional inconsistency in Argentina, where provinces depend on the central government for most of their revenues but have constitutionally granted economic and financial independence and thus are not subject to central government interference.

An agreement with the provinces on the structure of the intergovernmental fiscal relationship will have to wait until institutional changes are supported by a consensus on the urgency of reform. That consensus has not yet emerged. Meanwhile, provinces need to increase local tax revenue but lack a sound structure for collecting taxes and appear unable to curb

tax evasion. There is continual renegotiation of the compensation that the federal government assigns to the provinces for service responsibilities that have been decentralized. In some cases this issue is holding up further decentralization, such as for police and judicial services in the city of Buenos Aires. No agreement has been reached on how much additional funding the city should be awarded to provide these services.

The default and devaluation raised important questions relating to subnational bonds. Some provinces (such as Salta and Tierra del Fuego) are doing their best to avoid defaulting on their bonds, but will this effort be recognized by rating agencies and investors in the future? With just a few provinces having debt management offices, what would have happened if provinces had had well-trained debt managers? With independent trusts playing a key role in avoiding provincial defaults, will these structures lead to the reconstruction of the Argentine subnational debt market? Can the provinces manage the currency risks of multilateral loans, or will the federal government bail out provinces again? Regardless of the answers, it is clear that Argentina needs to rebuild its bond market. The challenge is to learn from the past and improve on it.

Province of Salta: A Bond Issue Backed by Hydrocarbon Royalties

The province of Salta had its first public debt issue in February 2001. The bond was issued by the Salta Hydrocarbon Royalty Trust with a targeted maturity of 12 years but an actual maturity of 15 (table 14.4). It is the first asset-backed structure for an Argentine subnational issuer rated higher than the federal government. The structure includes a strong security package enabling the bond to just reach international investment grade (figure 14.7). The transaction was considered very successful not only for its long maturity but also for its relatively low cost for an Argentine province at the time. However, the marketing period was long because of the financial problems Argentina experienced at the end of 2000.

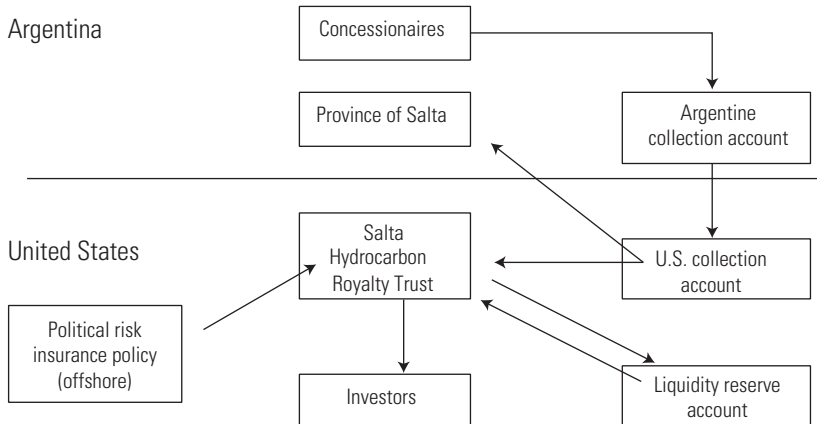
The Province

Salta is one of Argentina's major provinces, with an area of 155,488 square kilometers and 3 percent of the country's population. At the time of the issue the province was managed by a strong administration, elected in 1999 for a second four-year term and with a positive record in financial management and administrative reform.

Table 14.4. Features of the Bond Issue by the Salta Hydrocarbon Royalty Trust

Feature	Details
Issuer	Salta Hydrocarbon Royalty Trust, a trust established in the U.S. state of Delaware
Amount	US\$234 million
Market	Qualified investors in Europe and the United States
Issue date	28 December 2000; offered and closed in February 2001
Issue price	100 percent
Interest rate	Fixed at 11.55 percent a year
Interest payment period	Quarterly on 28 December, March, June, and September
Maturity date	28 December 2015
Expected maturity date	28 December 2012
Amortization	Bullet
Targeted amortization	Starting 2.25 years after the issue date, with the first targeted amortization on 28 March 2003
Ranking	Direct and unsubordinated
Credit ratings	<ul style="list-style-type: none"> • Moody's: Baa3 (global) • Standard and Poor's: BBB– (global) • Fitch Ratings: BBB– (global)

Sources: Salta Hydrocarbon Royalty Trust offering circular, Moody's, Standard & Poor's, and Fitch IBCA.



Source: Salta Hydrocarbon Royalty Trust offering circular.

Figure 14.7. Flow of Funds for the Salta Hydrocarbon Royalty Trust Bonds

Economic Performance. Following several years of robust economic growth, Salta suffered an economic downturn in 1995, paralleling the national recession triggered by the Mexican crisis. Like all Argentine provinces, Salta was deeply affected by the capital flight from the banking system and the reduced availability of international liquidity. Salta has a diversified economy by Argentine standards, but its per capita income and education levels are below the national average. Manufacturing is its main activity, accounting for almost a fourth of its production. Its chief exports are agricultural products, industrial products, and fuel and energy. Brazil has historically been Salta's most important export market, accounting for 30 percent of total exports, followed by the United States at 10.6 percent and Bolivia at 9.2 percent. Hydrocarbon production and exploration activities in the province increased sharply with the deregulation of the 1990s. As a result, hydrocarbon royalties rose from US\$16 million in 1991 to US\$20.7 million in 1995 and US\$37.5 million in 1999.

Financial Performance. At the time of the bond issue the province derived current revenues from three main sources: gross coparticipation transfers (71 percent, with net coparticipation transfers accounting for 44 percent), provincial taxes (15 percent), and provincial nontax revenues (5 percent). Current spending goes primarily to personnel costs (54 percent in 2000) and transfers to municipalities (11 percent).

Salta had strong revenue growth in the early 1990s, reflecting national economic trends following the implementation of the Convertibility Plan in 1991. The province has maintained a relatively small fiscal deficit compared with other provinces, and it achieved a fiscal surplus in 1996 as a result of its privatization program and the transfer of its pension fund to the federal government. The privatization program, considered very successful, included two banks, a water supply company, and an electricity utility.

Debt Profile. Salta's debt stock increased by 85 percent in 1995–2000 as a result of fiscal deficits in those years (table 14.5). The province has been reducing its debt with the national government, its bond debt, and its consolidated debt while increasing its bank and multilateral debt. The growth in its commercial bank debt implies a higher cost of funding and shorter maturities.

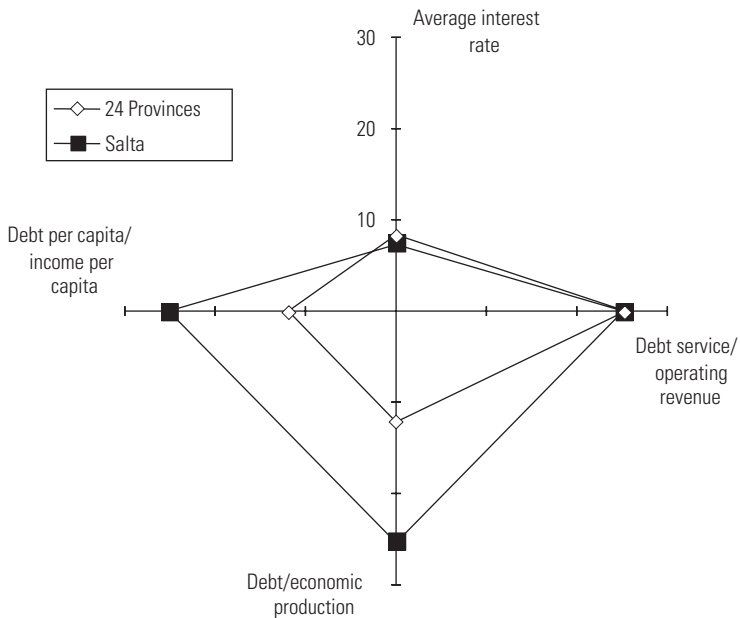
Salta's ratio of debt to economic production is worse than the average for Argentine provinces (figure 14.8). However, thanks to the tight administration by its government, its ratio of debt service to operating revenue matches the national average. Moreover, the province has a slightly lower cost of funding than the average.

Table 14.5. Debt by Source, Salta, 1995–2001
(millions of Argentine pesos⁹)

Source	1995	1996	1997	1998	1999	2000	2001
Banks	34.5	146.1	247.5	268.9	361.6	435.7	350.6
Multilateral lenders	8.8	31.6	21.4	74.1	105.3	105.4	147.4
Provincial Development Fund (bank privatization program)	16.7	50.0	50.9	50.9	50.9	50.9	49.3
Bonds	99.3	100.3	123.5	93.7	76.2	82.0	324.0
Other debt	375.6	234.2	104.6	83.7	92.8	90.0	74.9
Total	534.8	562.0	547.9	571.3	686.8	764.0	946.2

Note: Data are as of the end of December of each year.

Source: World Bank staff estimates based on Argentine Ministry of Economy data.



Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.8. Selected Debt Indicators, Salta and All Provinces, End-2001
(percent)

Issue Development

The Salta bond issue represented the first time that a subnational Argentine government was involved in a true sale of its future royalties. This made legal due diligence particularly important. The transaction was analyzed by Argentine and U.S. counsel, with both focusing on key aspects of the hydrocarbon concessions (terms and conditions, validity of permits, hydrocarbon royalties), the relevant hydrocarbon laws, the province's rights to the hydrocarbon royalties and other revenues, and the validity of the collateral documents and arrangements. Also important was the regulatory and constitutional framework governing the province's revenue-raising powers and expenditure responsibilities.

The structure of the notes was the key to their receiving the first global investment grade for an Argentine subnational bond. The notes were structured as a U.S. dollar issue to tap a deep and mature market, important for a first international issue. The structure included four innovative features that had never been used before in Argentina:

- The province sold its hydrocarbon royalties to a trust in a true sale under Argentine law.
- The trust, established in the U.S. state of Delaware, issued the notes.
- Target amortizations were scheduled to be due in 2015, but failure to make a targeted principal payment does not constitute an event of default.
- Salta used a political risk insurance policy for its bond, the first Argentine subnational issuer to do so.

Reasons for the Issue. Like other subnational governments, the province was facing an increasingly short-term and high-cost debt structure because of the large share of its debt contracted from commercial banks. This made an international bond issue with a longer maturity and a fixed cost of funding an attractive alternative. The province also viewed the issue as a good opportunity to gain credibility in international markets. The issue was structured as a single transaction, and all the funds raised were used to prepay commercial bank loans.

Credit Rating. The Salta bond issue was the first Argentine transaction simultaneously rated by the three major rating agencies—Fitch Ratings, Moody's, and Standard & Poor's. All ratings just reached international investment grade. The main factors supporting the ratings were these:

- The true sale of the royalties, which mitigated the risk of provincial interference with the transaction.
- The convertibility and transferability insurance policy covering 31 months of interest payments.
- The reserve liquidity fund covering six months of interest payments.
- The irrevocable and unconditional payment instructions delivered by the province to all the concessionaires with concessions dedicated to bond repayment.
- A flexible amortization schedule, which means that failure to pay targeted amortizations is not an event of default.
- Levels of collateralization that can sustain significant drops in oil and gas prices and lack of growth in oil and gas demand.
- Proven reserves representing 29 years of gas production and 33 years of oil production at 1999 levels.

Underwriting and Marketing. The syndicate acting as lead manager charged a gross fee of 2.75 percent, considered high by industry standards. The issuance took almost a year. The issue was marketed to qualified institutional investors in the United States under Rule 144A and outside the United States under Regulation S. In line with common practice, road shows were the main presales marketing technique used. Interestingly, investors formally requested a meeting about the issue with the Ministry of Economy, and it was the first time such a request had been made for an Argentine provincial bond issue. Seven large institutional investors subscribed to the offer, and all attended the meeting held in Buenos Aires at the Ministry of Economy. The lead manager made presentations to the investors and took them to the province to build knowledge and confidence.

Key Factors Affecting the Issue

Salta had little tax authority or revenue flexibility, and its expenditures were rigid. These fiscal constraints, together with the province's lack of visibility in the international markets, prompted the decision to use hydrocarbon royalties as collateral and issue the bond through a trust.

The regulatory framework also played a key role in the bond issue for several reasons. Two sets of regulations—those for oil and gas—had to be taken into account. The transaction was the first involving a true sale of royalties by a subnational government, and possible changes in hydrocarbon royalties and currency exchange transfers were being contemplated.

The perception in international capital markets of Argentina's financial condition had a large influence on the offer price and coupon rate of the issue. In addition, after the 1997 Asian crisis and the ensuing crises in other emerging markets (Russia in 1998, Brazil in 1999), investors had become cautious about emerging market bonds and demanded larger spreads over U.S. treasury bonds. However, while the issue was adversely affected by the weak sovereign position at the time of the launch, the province was considered highly competent and gained broad credibility during the road shows. There were several reasons for this. The province, which was well managed by a strong team, had implemented a series of reforms aimed at improving tax collection and controlling spending. The province had privatized its bank and other provincial companies and transferred its pension fund to the national government.

Despite competent management, the province still had a lot of work to do in financial reporting and disclosure. Financial statements were not prepared or audited in accordance with international standards, and the budgeting process was still elementary. The insufficient and inconsistent statistical and financial information on the province complicated financial and economic due diligence. Given these inadequacies, the security structure of the issue was the key to its success.

Recent Developments

In 1999 and 2000 the effects of the Brazilian devaluation and the slowdown of the Argentine economy led to a worsening of Salta's fiscal position and increased its fiscal imbalances. Debt (excluding short-term arrears to suppliers and employees) was equal to 76 percent of provincial revenue, and debt service absorbed 20 percent of revenue. In December 2001 the province's total debt stock reached Arg\$946 million.

To improve its debt profile, the province decided to participate in the debt swap program promoted by the Argentine government in December 2001. However, it could include only commercial bank debt and consolidation bonds in this swap. On 27 February 2002 Moody's downgraded the Salta Hydrocarbon Royalty Trust from Baa3 to Caa1 because of the redenomination of dollar-denominated contracts between private parties at the exchange rate of 1 to 1.

While most private companies found it impossible to obtain authorization from the Central Bank to transfer money overseas to pay their debts, most provinces received authorization from the Ministry of Economy to pay their international bonds. This shows that at times of deep crisis such

as that experienced in Argentina, the strength of the credit arrangements backing a bond and its overall security structure is as important as the political will to make good on payments.

City of Buenos Aires: A Debut in the International Bond Markets

The city of Buenos Aires made its debut in the international bond market with a euro medium-term note program in March 1997 equivalent to US\$500 million (table 14.6). The city launched four issues from April to June 1997 and a fifth and final one in July 2000. The notes could be issued in a variety of currencies, including the Argentine peso, U.S. dollar, Italian lira, and euro. The first series was issued in U.S. dollars and targeted primarily to the U.S. market (table 14.7). The purpose of the program was to refinance the city's debt stock and restructure its bank, Banco Ciudad de Buenos Aires. It was also aimed at gaining credibility and a sound reputation for the city among global investors.

Table 14.6. Key Features of the Bond Program of the City of Buenos Aires

Feature	Details
Issuer	City of Buenos Aires
Arranger	Chase Manhattan International/Chase Bank AG
Dealer	Chase Manhattan International
Currency	Various hard currencies, including the U.S. dollar, Argentine peso, Italian lira, pound sterling, Swiss franc, yen, and euro
Amount	Up to US\$500 million equivalent in series
Maturity	Variable by series (up to 30 years)
Issue price	At par, discount, or premium over par by series
Method of issue	Continuous basis with syndication if needed and minimum offerings of US\$10 million equivalent
Interest rate	Fixed, variable, or zero coupon, depending on the series
Fixed rate notes	Payable in arrears on agreed dates
Variable rate notes	Interest borne separately in each series by reference to such benchmarks as the LIBOR and London interbank bid rate (LIBID)
Interest periods	As agreed between issuer and dealers
Zero coupon notes	Bear no interest and normally issued at a discount
Status	Direct, unconditional, unsecured, unsubordinated ranking pari passu with all obligations of issuer

Source: City of Buenos Aires offering circular.

Table 14.7. Main Characteristics of the Bond Issues by the City of Buenos Aires

	First issue	Second issue	Third issue	Fourth issue	Fifth issue
Currency	U.S. dollar	Italian lira	Argentine peso	Italian lira	Euro
Hedging		Swap		Swap	Swap
Amount in					
original currency	250 million	100 billion	150 million	69 billion	100 million
Issue date	11 April 1997	23 May 1997	28 May 1997	10 June 1997	7 July 2000
Maturity date	11 April 2007	23 May 2004	28 May 2004	10 June 2005	7 July 2003
Interest	Semiannual	Annual	Annual	Annual	Annual
	11.25 percent	10 percent	10.5 percent	9.5 percent	9.5 percent
Amortization			Bullet		
Listing			Luxembourg Stock Exchange/PORTAL		
Arranger			Chase Manhattan International		
Rating			Moody's: B1; Standard & Poor's: BB-		

Source: City of Buenos Aires offering circulars.

Each of the issues sold well, thanks to the city's good international reputation and low indebtedness. Despite the city's growing fiscal deficit, its debt at the time of the issue was equal to only 1.4 percent of its annual economic production. This, coupled with a targeted reform program, helped achieve reasonable ratings, which strengthened market perceptions. The notes were placed at a fairly large spread over the benchmark U.S. treasury bonds, but the city was more interested in achieving a placement well diversified by region and investor than in minimizing costs.

The Issuer

The city of Buenos Aires, located at the mouth of Rio de la Plata, was founded in 1580 and has been the capital district of Argentina since 1880. Its population of 3 million represents 8.6 percent of the country's total. The city is administratively independent from the province of Buenos Aires and has no fiscal or political relationship with it.

The city was granted its autonomous status (similar to that of a province) following constitutional reforms in 1994. Before these administrative changes the president of Argentina appointed its mayor, and the federal government made most key decisions. The city's constitution, approved in October 1996, provides for executive, legislative, and judicial branches. The city has a decentralized administration consisting of "communities" managed by an elected seven-member administrative board. These communities are responsible for secondary services, such as maintaining streets and parks, but have no independent revenue-raising powers.

Economic Performance. Besides being the federal capital and key financial center of the country, the city is a major driver of the economy, contributing more than a quarter of GDP. Thanks to a strong concentration of services and industry, the city's per capita income grew by 90 percent over the past decade to reach Arg\$22,400 in 2001, about three times the national average. The city was affected by the Mexican crisis of 1995 but less so than other parts of the country; its production fell by 1 percent, while national GDP declined by 4.4 percent. Production growth in the city averaged a strong 5.7 percent in 1992–98. Argentina's most recent economic crisis, which led to a contraction in GDP of 3.4 percent in 1999 and 0.5 percent in 2000, started to affect the city's finances only in 2001.

Financial Performance. At the time the bond program was launched in 1997, the city of Buenos Aires derived more than 90 percent of its revenue from local taxes, mainly turnover taxes (57 percent), property taxes (16 percent), and motor vehicle licensing fees (9 percent). Federal transfers contributed only 6 percent of revenue, far less than the 50 percent typical for most other provinces. The city is a net contributor to Argentina's subnational system: while the federal government collects about a third of its total tax revenue in the city, it gives back to the city only 1 percent of its total transfers to provinces.

The city maintained a solid financial position from 1996 when it received autonomy to 2001 when it was affected by the Argentine crisis, with operational surpluses each year. The situation was sharply different before 1996. The city had large structural deficits amounting to US\$1 billion over the period 1991–96. It generally funded the deficits through late payments to suppliers and short-term loans. Growing spending coupled with shrinking revenues led to a surge in the fiscal deficit—from US\$9 million in 1995 to US\$349 million (13 percent of revenue) in 1996.

Debt Profile. When the bond program was launched, the city had a moderate level of direct debt by national and international standards, with a debt stock of US\$1.16 billion, about 1.4 percent of annual economic production (table 14.8). The moderate level of debt was possible because of the substantial transfer of outstanding debts to the federal government that occurred when the city's new constitution was adopted. This debt was later refinanced as part of the Brady bond program, in exchange for offsetting claims against the federal authorities.

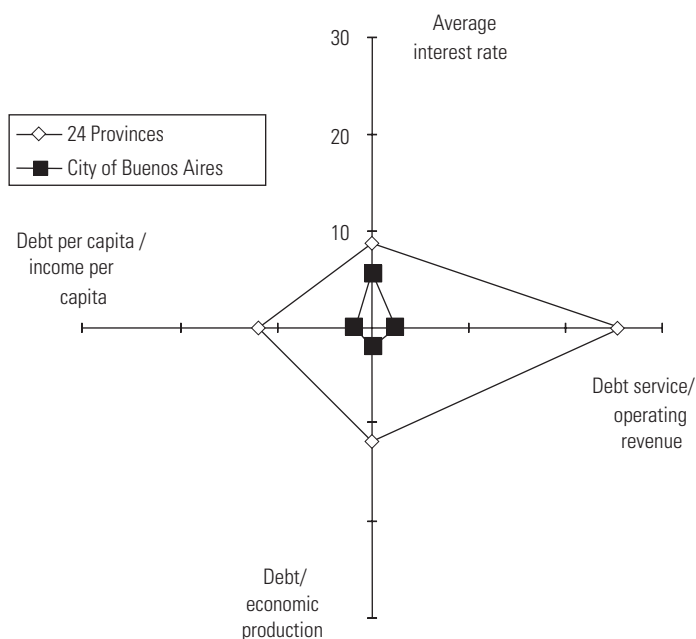
At the end of 2001, before the debt swap and devaluation, the city of Buenos Aires had a strong debt position relative to the average for Argentine provinces (figure 14.9). The only debt indicator on which the

Table 14.8. Debt by Source, City of Buenos Aires, 1995–2001
(millions of Argentine pesos)

Source	1995	1996	1997	1998	1999	2000	2001
Banks	448.9	591.1	226.1	119.0	35.5	13.8	12.8
Multilateral lenders	31.8	23.2	19.2	17.6	22.9	45.2	55.0
Bonds	0.0	0.0	450.7	450.7	450.7	545.8	545.8
Other debts	264.5	481.3	420.6	340.3	498.9	451.6	780.7
Total	745.2	1,095.6	1,116.6	927.6	1,008.0	1,056.4	1,394.3

Note: Data are as of the end of December of each year.

Source: World Bank staff estimates based on Argentine Ministry of Economy data.



Source: World Bank staff estimates based on Argentine Ministry of Economy data.

Figure 14.9. Selected Debt Indicators, City of Buenos Aires and All Provinces, End-2001
(percent)

city's performance was close to the provincial average was the cost of funding.

At the time of the bond sale the city's financial management and reporting systems were reasonably effective by Argentine standards. Howev-

er, there were problems stemming from the different accounting treatment of revenues and expenditures, the incompleteness and inconsistency of some of the information, and the lack of audited financial statements.

Issue Development

The bond issues, used to capitalize Banco Ciudad de Buenos Aires (US\$100 million) and restructure short-term obligations, reduced the city's exposure to short-term volatility in interest rates and market appetite, but they increased the city's exposure to currency risk.¹⁰ Moreover, the longer-term obligations require that the city accelerate reform in order to meet its liabilities. The city's de facto assumption of the obligations of its bank was a concern, because it could create a precedent for future bailouts. The bank had a large share of nonperforming loans, a small capital base, and narrow profitability.

Moody's and Standard & Poor's, generally optimistic about the prospects of Argentina and the city, rated the bonds B1 and BB-. These ratings were a major factor in the eventual placement of the issues. Nonetheless, both rating agencies expressed concerns about the city's ability to tackle fundamental structural problems in revenues and expenditures and about the inefficiencies of Banco Ciudad de Buenos Aires.

The first issue under the program (US\$250 million) sold extremely well in the market despite a rapid weakening of the benchmark U.S. treasuries that increased the spread from 330 basis points to 370. Even at the larger spread and in a tightening market, however, the issue was a resounding success. The issue was twice oversubscribed, and more than two-thirds was sold to U.S. investors. An important feature was that it attracted new money rather than investors selling out of existing portfolios.

The second issue, a peso issue equivalent to US\$150 million, was struck in record time, with marketing starting on a Friday and price-fixing taking place on the following Monday. The second issue had a narrower spread over the benchmark 2006 Argentine treasury bonds (95 basis points, compared with 140 basis points for the first issue). In line with the strategy of market diversification, the peso transaction was followed by lira issues, which also performed well.

The transaction as a whole was considered highly successful. Book demand was high in all cases, with issues oversubscribed about twice, and all series of notes were sold out. Interest in the bonds came mainly from institutional investors, which purchased about 90 percent of the issues on average.

Key Factors Affecting the Issues

Macroeconomic conditions in the country and the city played a major part in the success of the bond issues. Especially significant were the economy's resilience to the Mexican crisis and the importance of the city to national GDP, employment, and income. Another key factor was the city's strong revenue raising powers, a sign that repayment did not depend on central government transfers.

Conditions in the bond market affected placement dates and price-fixing arrangements and determined the underwriting and marketing process. Because the bond sale was relatively small and a debut for the issuer, a full underwriting commitment could not be obtained from the arrangers. Instead, the bonds were sold on a best-efforts basis.

The city's reputation and its plans for reform also contributed to the success of the issues, despite the city's less-than-optimal financial performance. Among the greatest concerns for the rating agencies was the fiscal deficit, considered a sign of structural problems and a constraint on reform. The city's financial reporting system, while needing improvement, did not adversely affect the issues, though it slowed the due diligence and rating process.

Recent Developments

In 1999 and 2000 the city of Buenos Aires was able to maintain a strong fiscal position despite the economic crisis in Argentina. By cutting capital spending and reducing the budget for noncore activities, it achieved surpluses of 2.3 percent of total revenue. In 2001, however, a decline in own-source revenue led to a deficit of almost Arg\$250 million, equivalent to 8.4 percent of total revenue. While revenues remained relatively stable in the first half of 2001, they started to decline in August 2001, when they averaged 9 percent less than in August 2000, and fell sharply for the rest of the year. In December 2001 revenues were 46 percent less than in the same month in 2000. With the city of Buenos Aires deriving 90 percent of its revenues from own sources, this dramatic decline in own-source revenues had a big impact on the city's solvency.

City authorities decided not to participate in the provincial debt swap promoted by the federal government in November 2001, which the rating agencies considered a partial default. The city's debt stock was sustainable. Annual debt service reached US\$196 million at the end of 2000, equivalent to 6.1 percent of current revenue. Almost all debt had been issued at a fixed rate, and about 46 percent was denominated in Argentine pesos.

At the end of December 2001 the city council approved the Economic and Social Emergency Law, which allows the executive body to issue bonds to pay employees and suppliers and to contract additional debt of up to US\$218 million. In February 2002, in response to the deterioration in economic activity in Argentina, Standard & Poor's reduced its rating of the Buenos Aires foreign currency bonds to CCC+ on the global scale, and in June 2002 Moody's rated the city Ca. In late 2002 the city was conducting negotiations with investors to restructure its bonds.

Province of Buenos Aires: An Extensive International Bond Program

The province of Buenos Aires launched a euro medium-term note program in 1994 totaling US\$3.2 billion. The intention was to finance provincial needs but also to gain credibility and a sound reputation in global markets. The notes could be structured with maturities ranging from 30 days to 30 years and issued in currencies including the Argentine peso, U.S. dollar, euro, yen, deutsche mark, Swiss franc, and Italian lira. All issues under the note program (except for the 30th) were sold at fixed rates, and all bonds had bullet maturities. In addition, the province engaged in a wide variety of debt swaps, all against the U.S. dollar.

Under this note program Buenos Aires had frequent recourse to the international bond market in recent years (table 14.9). Its record as an issuer in those years shows that it was a relatively regular issuer, it had strong debt management capacity, and its exposure to currency risk was very high, which led it to declare a default after the Argentine devaluation.

The Issuer

Buenos Aires is the largest province in Argentina, with a population of 13.8 million. The province is a net contributor to Argentina's subnational system, receiving only 23 percent of federal transfers, well below its share of the national population (38 percent) and GDP (35 percent).

Economic Performance. Buenos Aires is the main driver of the Argentine economy, contributing more than a third of GDP. Per capita income in the province reached Arg\$6,980 in 2001, a little less than the national average. The service sector accounted for almost 50 percent of production in the province in 2001, with finance, real estate, and insurance alone contributing almost 20 percent. Manufacturing is the main economic activity, representing more than 31 percent of economic production.

Table 14.9. Access to the Bond Market by the Province of Buenos Aires, 1994–2001

Issue number ^a	Currency	Amount in original currency (millions)	Amount in U.S. dollars (millions)	Issue date	Due date	Interest rate (percent)
1	U.S. dollar	100	100.0	14/07/94	14/07/97	9.50
2	U.S. dollar	15	15.0	16/08/95	16/08/98	11.50
3	U.S. dollar	100	100.0	19/10/95	20/10/98	11.50
4 (swap)	Deutsche mark	150	104.5	07/12/95	07/12/98	10.00
5 (swap)	Deutsche mark	250	170.2	05/03/96	05/03/01	10.00
6	Swiss franc	200	159.0	23/10/96	23/10/03	7.75
7	Euro	100	108.8	13/07/98	12/07/02	7.88
8 – Reopening 6	Swiss franc	75	55.7	23/12/98	23/10/03	7.75
9	U.S. dollar	150	150.0	19/03/99	15/03/02	12.50
10 (swap)	Euro	175	185.0	06/05/99	06/05/04	9.75
11 (swap)	Euro	150	151.9	12/07/99	12/07/06	10.63
13 (swap)	Euro	300	289.7	03/03/00	03/03/05	10.75
14	U.S. dollar	350	350.0	29/03/00	29/03/10	13.25
15 – Reopening 13 (swap)	Euro	50	48.3	14/04/00	03/03/05	10.75
16	Yen	3,000	27.9	24/05/00	27/05/03	4.25
18 (swap)	Euro	100	96.5	05/07/00	05/07/04	10.00
21	U.S. dollar	100	100.0	27/09/00	01/08/03	12.75
22	U.S. dollar	160	160.0	31/08/00	05/09/07	13.75
23	Euro	100	89.4	06/09/00	06/09/02	9.00
27 (swap)	Euro	300	276.3	30/01/01	30/01/03	10.25
28 (swap)	Euro	300	274.4	23/02/01	23/02/04	10.38
30	U.S. dollar	74	74.0	28/09/01	28/09/06	24.17

a. Numbers missing from the sequence in the column correspond to the number of a treasury bill issued by the province.

Source: Province of Buenos Aires Public Credit Office.

Financial Performance. The province derives more than 55 percent of its revenue from provincial taxes, mainly turnover taxes (23 percent), property taxes (7 percent), and motor vehicle licensing fees (5 percent). Federal transfers provide the other 45 percent, a share similar to that for most other provinces. Buenos Aires was strongly affected by the fall in its own revenues since 1999. From 1998 to 2001 operating revenues fell by more than 15 percent, while operating expenditures rose by 11.7 percent. Even so, total expenditures increased by only 2.3 percent, reflecting cuts in capital spending and investments. During this period the accumulated fiscal deficit totaled almost Arg\$8 billion.

The province privatized its electricity utility (for more than US\$1.2 billion) and its water company (US\$440 million). However, the province still owns several companies (railroads, a bank, a hotel, and a shipyard). More-

over, it retains ownership of Banco de la Provincia de Buenos Aires, the second largest Argentine bank. From time to time the bank generates significant costs to the province because of nonperforming loans resulting from unsound credit management practices. In the second half of 2002 the province bought the bank's nonperforming loan portfolio by issuing a provincial bond for US\$1.3 billion.

Because Buenos Aires predates the Argentine republic and joined the Argentine confederation only after the national Constitution was adopted, it has certain prerogatives. One of them is that its provincial bank is not governed by the Argentine Central Bank. Because of the provincial bank's importance, however, the two banks maintain close coordination.

Debt Profile. Buenos Aires has a stable and well-trained debt management team that has gained much experience in debt markets since 1994 as the province has pursued a debt strategy focusing on bonds. The province's financial management and reporting system are reasonably effective by Argentine standards, though it has problems resulting from the different accounting treatment of revenues and expenditures, the incompleteness and lack of consistency of some information, and the absence of audited financial statements.

Huge provincial deficits have led to substantial growth in the debt stock of Buenos Aires. In 2001 the province's indebtedness increased sharply because of its enormous deficit and the capitalization of the provincial bank (table 14.10). Almost US\$3.7 billion of the province's debt at the end of 2001 was issued under foreign laws; accordingly, this part of the debt increases as the Argentine peso is devalued. Even so, at the end of 2001, before the debt swap and the Argentine devaluation, Buenos Aires had debt indicators similar to the average for provinces. The exception was debt service as a share of operating revenue, where Buenos Aires exceeded the average (figure 14.10).

Buenos Aires was the first province to sign the agreement with the federal government required as a condition of the negotiations with the IMF on a financial assistance program. Like most of the provinces that later signed such agreements, Buenos Aires committed to reduce its fiscal deficit by up to 60 percent of the 2001 deficit. It achieved a substantial part of the deficit reduction by defaulting on bond and loan payments. Without structural reform the reduction is unsustainable, because the main problems that led to those deficits remain unsolved.

Key Factors Affecting the Issues

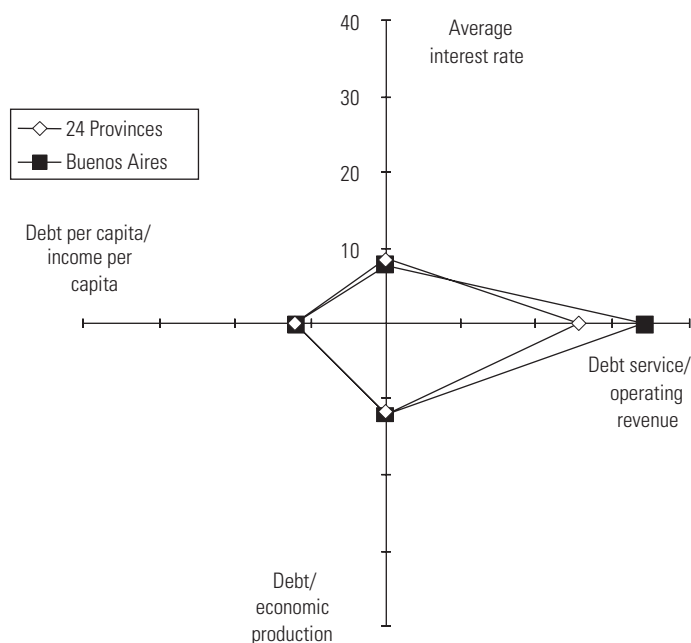
Moody's and Standard & Poor's are the credit rating agencies that rate Buenos Aires. Since the province's first launch under the program, provin-

Table 14.10. Debt by Source, Province of Buenos Aires, 1995–2001
(millions of Argentine pesos)

Source	1995	1996	1997	1998	1999	2000	2001
Banks	2,108.8	2,053.5	2,024.4	2,046.7	2,030.1	2,341.9	2,631.2
Multilateral lenders	169.2	173.8	330.3	450.2	727.2	907.2	968.7
Provincial Development Fund (refinancing program)	0.0	0.0	0.0	0.0	0.0	0.0	421.3
Bonds	319.4	694.4	735.3	725.7	1,385.1	3,340.6	6,412.8
Other debts	587.3	688.7	692.5	770.9	844.1	886.9	1,087.2
Total	3,184.7	3,610.4	3,782.4	3,993.5	4,986.5	7,476.5	11,521.3

Note: Data are as of the end of December of each year.

Source: World Bank staff estimates based on Argentine Ministry of Economy and Province of Buenos Aires Public Credit Office data.



Source: World Bank staff estimates based on Argentine Ministry of Economy and Province of Buenos Aires data.

Figure 14.10. Selected Debt Indicators, Buenos Aires and All Provinces, End-2001
(percent)

cial ratings have generally changed with the sovereign Argentine rating. The rating agencies have expressed concerns about the province's ability to tackle fundamental structural problems in revenues and expenditures and about the inefficiencies of Banco de la Provincia de Buenos Aires. During the first issues the ratings were an important factor in accessing the market.

The key factors have been the significant revenue raising powers of the province, its large tax base, and its strong negotiating position with the federal government. Buenos Aires usually leads every negotiation between the provinces and the federal government. Moreover, Buenos Aires is by far the best-known Argentine subnational debt issuer.

The provincial administration's commitment to reform has proved to be weak. While the province privatized some of the companies it owned, it continues to own Banco de la Provincia de Buenos Aires, its largest source of quasi-fiscal deficits, as well as other corporations that are not a core part of provincial activity. Provincial authorities have been unable to cut fiscal deficits or implement serious reform since 1999. They have tried to reduce fiscal deficits by cutting capital spending, but year after year the decline in revenues has exceeded the spending cuts.

Like the other provinces, Buenos Aires has much work to do in improving financial reporting and disclosure. Its financial statements still are not prepared or audited in accordance with international standards.

Recent Developments

In recent years the province has maintained stable expenditures by cutting capital spending, but the fall in revenues forced it to finance substantial fiscal deficits. Provincial authorities decided to participate in the provincial debt swap promoted by the federal government in November 2001. As usual Buenos Aires was the largest player, entering the debt swap with a targeted amount of more than US\$6.4 billion.

On 29 January 2002 the province declared a default on some bond payments, initiating the largest Argentine provincial default in history. During the first half of 2002 the province continued issuing money bonds (Patacones) to finance its fiscal deficit. At the end of June 2002 the outstanding debt in Patacones reached Arg\$2.4 billion (2.5 percent of annual economic production in the province). On 25 July 2002 the first tranche of Patacones was due, for an estimated amount of Arg\$500 million, but because of its financial situation the province had to exchange these bonds for a second tranche (Patacones B).

The province has been greatly affected by the Argentine devaluation. According to the province, its outstanding debt reached Arg\$21.3 billion at the end of March 2002. Unlike other bond issuers that were already involved in debt restructuring, such as Santiago del Estero and the city of Buenos Aires, the province of Buenos Aires declared that it would wait for the sovereign debt restructuring before renegotiating its debt. In February 2002 Standard & Poor's reduced its rating of the Buenos Aires long-term foreign currency bonds to CCC+ on the global scale, reflecting the deterioration of economic activity in Argentina. In June 2002 Moody's downgraded the province's foreign currency debt rating to Ca.

Notes

1. Gross coparticipation includes different programs such as the National Fund for Housing (FONAVI) that were historically earmarked revenues, but since 2000 these revenues have been converted to non earmarked revenues.

2. Most provinces have their own interpretations of the terms *revenues* and *debt service*.

3. The exchange rate at the end of 2001 was US\$1 to Arg\$1.

4. The privatization program was created in the mid-1990s to encourage provinces to privatize their financial institutions. Originally funded by the World Bank, the Provincial Development Fund later was capitalized by the national treasury. Thus in the late 1990s, the fund supported provincial bank privatization using its own assets.

5. Some bondholders brought suit against the province and its bank—against the province for unilaterally deferring payments and against the bank for breaking the Argentine Trust Law (Law 24,441) by carrying out the province's order.

6. Bond issuance in Argentine provinces typically takes an average of four to six months if the bonds are backed by coparticipation revenues, and six to nine months if backed by oil revenues.

7. The money bond is not unique to Argentina. They have been used in unusual circumstances in the United States. The states of Michigan (in the 1980s) and California (in the early 1990s) issued "warrants" to pay employees and suppliers during cash crises. The warrants were very short term and were issued at a discount. Banks accepted the warrants from the payees and then cashed them in at maturity.

8. In December 1999 the provinces and the federal government signed a federal compromise fixing the total monthly transfers owed to the provinces until the end of 2000. By the end of the period fiscal difficulties in Argentina and the pending negotiations with the IMF on a financial rescue package brought provincial transfers under tough scrutiny. In November 2000 a second federal compromise was signed that fixed total transfers to provinces for 2001, obligated provinces to pursue fiscal discipline, and required the federal government to increase funds for unemployment and social programs and to allow provinces to administer part of these funds.

9. From April 1991 to January 2002 the Argentine peso and the U.S. dollar were at parity.

10. The city was able to hedge euro and Italian lira debt against the U.S. dollar, but it could not hedge its U.S. dollar debts. Thus after the devaluation its indebtedness increased dramatically.