

## Has investor protection been rendered obsolete by the Argentine crisis?

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U nlike the train of events in previous crises, when the negotiations between the parties –creditors and debtors, investors and host countries– were played out within some kind of institutional framework, the crisis of 2001 portrayed Argentina as a country abandoned to its fate, not just once, but twice. But although investors had initially been able to alter the rules in their favour to secure better protection and enhanced legal certainty, ultimately they came out of the situation worse off. The Argentine experience suggests that, as the influence of the international financial institutions declines, asymmetric solutions cannot last and, at the end of the day, democratic governments will put their electorate before their investors. But is the Argentine case an exception to the rule or does it reflect a more general weakening of foreign investment protection?

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# I

## Introduction

Foreign investment has played a key role in the Argentine economy in the last 30 years, especially in the 1970s and the 1990s, when inflows reached highs of 8% of GDP (see figure 1). These highs were associated with three types of investor: first, in the 1970s, transnational banks that extended large syndicated loans; then, in the 1990s, with financial intermediaries who lent voluminous sums in bonds and TNCs that made heavy direct investments.

Notwithstanding this, on 23 December 2001 Argentina shook the international financial community by announcing a default of over US\$ 100 billion on its public debt. The default involved more than 150 varieties of financial paper governed by eight different jurisdictions. The magnitude of the default was obvious: at the time, Argentina's debt represented a quarter of all debt traded in the emerging bonds market. At the same time, in January 2002, the Argentine peso declined to one third of its value and the Government "pesified" public utility rates. This infringed the contracts signed with TNCs operating in the country and prompted a number of international lawsuits against Argentina under the terms of bilateral investment agreements. The Argentine case formed a landmark in modern financial history, not only because of its sheer magnitude, but also because it combined two different crises and because of the institutional circumstances in which they unfolded. In fact, the extremity of the debt crisis was such that the balance tipped in the debtor's favour. The foreign direct investment (FDI) crisis, by contrast, had long-term repercussions associated with the pattern of investment in the sectors affected.

To start with, the Argentine case brought new twists into the dispute between sovereign debtors and creditors. Unlike what had occurred in the 1980s, Argentina had more bargaining power in this financial crisis, since at the time of the collapse its creditors consisted of a dispersed and unorganized mass of thousands of bondholders, rather than a small number of strategically grouped transnational banks. Argentina

was not coerced into a renegotiation, therefore. This was in addition to the misguided strategy of the bondholders, who, anxious to limit their debtor's leverage, blocked all attempts at renegotiation. In the Argentine case at least, this strategy ultimately backfired. It was also clear that there was no institutional framework, since the International Monetary Fund (IMF) was unable to play a more significant role in the renegotiation. Lastly, divisions within the Group of Seven (G7) had a far from negligible influence on the course of events. In the light of these last two factors, Argentina could do no other than devise a solution of its own.

With regard to the real sector, i.e., FDI in utilities, the bilateral scheme for treatment of investment had existed since the late 1950s, but did not become widely used until the 1990s, which saw not only a large increase in FDI flows to developing countries, but also the establishment of international arbitration procedures. Argentina soon became one of the most fervent advocates of the bilateral scheme, signing more than 50 bilateral investment agreements and joining the World Bank's International Centre for Settlement of Investment Disputes (ICSID).

The guarantees Argentina extended in contracts with foreign direct investors, especially those with interests in utility companies, gave those investors a basis on which to sue the country after the declaration of the economic emergency law. This began a process that has cited Argentina in more than 40 lawsuits, which alone account for almost 40% of cases outstanding before ICSID, the main international institution for the settlement of investment disputes between foreign investors and host governments.

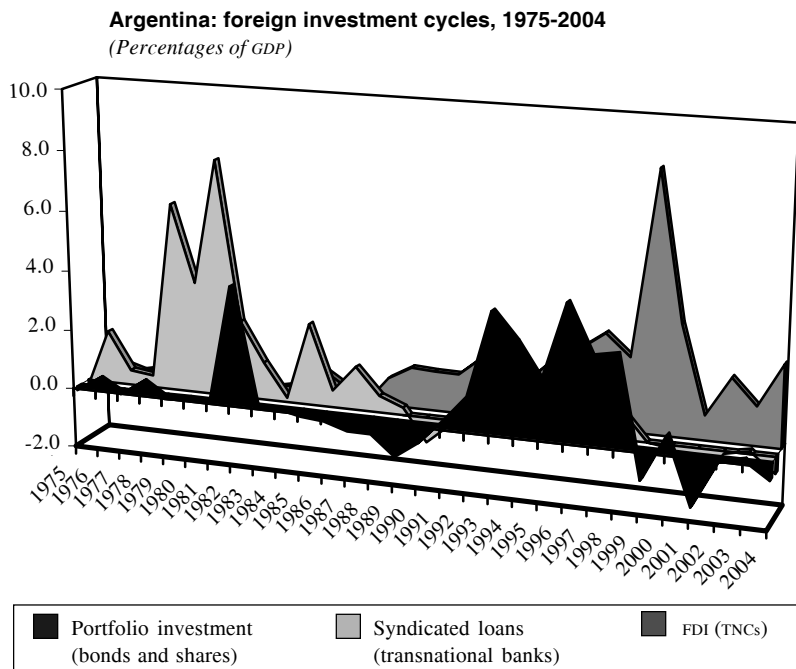
A number of authors have researched the causes of the recent crises, but there is no consensus on the trigger. Some blame the Argentine authorities for adopting policies that ultimately led the country into a crisis. Others suggest that creditors and investors were incautious in choosing a capital investment location. This paper seeks to spotlight a different aspect, however: the role of the international financial institutions (IFIs).

Despite strong growth of flows of capital and FDI in the 1990s, IFIs continued to be weak, irrelevant and inconsistent. This being so, when crises occurred, the

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□ The authors are grateful for comments by a judge who preferred to remain anonymous. The opinions expressed in this paper are the sole responsibility of the authors and do not necessarily coincide with those of the organizations to which they belong.

FIGURE 1



Source: Authors' calculations on the basis of World Bank data (2004).

market option (financial system) or the bilateral investment scheme tended to prevail, even though neither offered lasting solutions.

The rest of this work addresses these two aspects, looking at the way financial standards and rules on the treatment of FDI have evolved. Argentina's problems

are examined in the light of each of the conflicts the country experienced when the Government dismantled the convertibility scheme (fixed exchange-rate regime) and, lastly, a number of considerations are set forth concerning the implications for foreign investor protection.

## II

### The financial crisis

#### 1. Absence of the international financial system

In the 1970s, cracks began to appear in the financial scheme that had emerged after the Bretton Woods Conference (1944). Overflowing with liquidity thanks to large, readily available deposits (eurodollars) and strongly rising petroleum prices (petrodollars), the transnational banks set out to find new clients, mainly in newly independent and Latin American countries. In Latin America, the wide availability of funds fuelled a new model of growth. But despite the precautions of investors<sup>1</sup>

and the benefits the new model brought for borrowers, the stage was set for a serious crisis, which broke out in 1982.

After Argentina formally defaulted, there ensued a wide-ranging debate on the framework of the renegotiation. Divisions emerged between the proponents of an institutional scheme and those in favour of letting the market resolve the crisis (Eichengreen, 1988). Thus, the crisis evolved in three stages. First, the transnational banks attempted to lever all the costs onto the debtor countries in the form of

<sup>1</sup> Contracts for loans extended from the United Kingdom and the United States imposed a sovereignty waiver in the event of a dispute,

among other clauses. The creditors believed that this strategy would make a default impossible.

restructuring loans, which entailed extremely high commissions and interest and stringent economic conditionalities imposed by IMF. Second, IFIs set forth a restructuring programme aimed at helping the debtor countries to deal with the debt burden, requiring the transnational banks to lend more. Following the banks' refusal, there was a third stage in which the United States Treasury Department provided more active support through mechanisms to reduce the value of the debt (Brady bonds, debt-for-capital swaps, and so forth). Thus, separately from the debate, the debt restructuring process developed into essentially a private matter with an asymmetric outcome in which the debtors shouldered the heavier share of the adjustment burden. This lasted until it became clear that the crisis would not be worked out unless the debt was reduced and some of the adjustment costs shifted to the main creditors. Unfortunately, it took about 10 years for this conclusion to be reached (Mortimore, 1989; UNCTC, 1990; ECLAC, 1989).

By the early 1990s the situation had changed again. With the end of the crisis, capital returned to the Latin American countries and the nature of financing changed, as bonds replaced loans. With the outbreak in 1994 of the tequila crisis (triggered in Mexico) the possible mechanics of an institutional framework for such situations again became a discussion point. At that point, a wide range of options were proposed; some favoured the introduction of collective action clauses and others the institutionalization of some kind of scheme of economic and financial reorganization, principally along the lines of United States bankruptcy proceedings.

Those in favour of the institutional approach included Jeffrey Sachs,<sup>2</sup> who proposed a bankruptcy regime of international scope based on chapter 11 of the United States bankruptcy law. The idea was to set up a legal framework which would give governments temporary support to renegotiate with their creditors before the respective lawsuits were brought.

Advocates of the market stance argued in favour of the conflict being worked out between the contracting parties (the sovereign debtor and the creditors), without the intervention of third parties (an arbiter such as IMF or another international agency). But, admitting the impossibility of arriving at an agreement that would satisfy all of the bondholders, many academics and

policymakers<sup>3</sup> began to consider it advisable to devise some kind of clause that would enable the majority group of bondholders to renegotiate with the sovereign debtor.<sup>4</sup> This was resolved with the introduction of a collective action clause, which reduced the power of creditors, known as holdouts, who opted not to participate in the renegotiation.

However, the toughest creditors deemed this alternative non-viable, on the grounds that any kind of clause that broke the unanimity conditions would represent an erosion of their rights.

This was the point the debate had reached when it was interrupted by two developments in 2001. First, was the entry to office of the Government of George W. Bush,<sup>5</sup> which was to play a strong role in the later debate, in the United States. Second, the situation in Argentina continued to worsen, and default began to appear inevitable.

These developments led the new Chief Economist of IMF, Anne Krueger, to propose the Sovereign Debt Restructuring Mechanism (SDRM). This mechanism was based on United States bankruptcy law and included elements of two chapters of this legislation: chapter 11 on corporations and chapter 9 on municipalities. The most salient aspects of the proposal referred to increased Fund involvement in bankruptcy administration and the establishment of a new institution, the Sovereign Debt Dispute Resolution Forum (SDDRF), to oversee the process of sovereign bankruptcy.

Not surprisingly, this scheme met with the disapprobation of the financial community, which felt that crises should be worked out by the market and that debtors' leverage should be kept to a minimum. This was the position adopted by the Institute of International Finance (IIF, 1999; 2001), which viewed even temporary attempts to defer debt payment or any other avenue leading to arrears as illegitimate.

At the same time, the United States Secretary of the Treasury was insisting on letting the market have a stronger influence and, paradoxical though it may seem, suggested that at some point investors would have to

<sup>2</sup> See Sachs (1995).

<sup>3</sup> The proposal was backed at the academic level by Eichengreen, Portes and others (1995) and at the government level by a report of the Group of Ten (G-10) (1996).

<sup>4</sup> As occurs in the case of bonds issued under the jurisdiction of London.

<sup>5</sup> The presidential changeover also implied the replacement of Larry Summers and Stanley Fischer, of the United States Treasury Department and IMF, respectively, by R. Taylor and Anne Krueger.

assume their part in the settlement of the dispute.<sup>6</sup> This new stance brought into play five new principles that were supposed to steer the resolution of the crisis (Machinea, 2002, pp. 31-32): (i) that this resolution would not imply a write-down in the liabilities of debtor countries; (ii) that creditors would not believe that official assistance would protect them from moral hazard; (iii) that private sector engagement could help to reduce the public sector's borrowing needs; (iv) that, as far as possible, private sector involvement should take the form of voluntary schemes agreed upon between debtors and creditors; and (v) that no category of private debt should be afforded special treatment. These guidelines would be applied on a case-by-case basis and IMF would work out the details.

Thus the debate ended up leaning more towards a market solution, pushing the relevant international agency, IMF, into a less influential role. Argentina was lined up to be the first country to deal with its debt crisis under this new approach. However, given the failure to define a renegotiation scheme and the lack of leading role for the Fund, Argentina ultimately crafted its own solution for the debt swap.

## 2. Convertibility in Argentina: origins and crisis

The launch of the convertibility plan in March 1991, under the Convertibility Law, enabled Menem's Government to stabilize the economy after the chaos that followed the debt crisis of the 1980s, with the introduction of a fixed one-to-one dollar-peso exchange rate. Although this was costly in economic policy terms, it soon gained broad acceptance. The fact that the convertibility regime effectively tied the hands of policymakers in fiscal and monetary matters enhanced Argentina's credibility vis-à-vis external creditors and multilateral institutions.

More or less simultaneously, Argentina moved ahead with an ambitious programme of privatizations and launched a process of financial and trade deregulation and liberalization. The privatizations soon became one of the pillars of the new economic programme. From an aggregate point of view, the sale of public assets and the use of the debt-capitalization scheme (UNCTC, 1990, p. 85) enabled Argentina to attract fresh FDI, reduce its external debt and remove the financial liabilities generated by public utilities from

the public sphere. From a microeconomic perspective, the process was soon to draw criticism for focusing on a quest for credibility (Gerchunoff and Canovas, 1995), which would ultimately tie the fate of the privatized firms to the success of the convertibility plan.

As far as macroeconomic performance goes, the effects of the plan kicked in quite quickly and hyperinflation and instability became things of the past. Inflation dropped impressively and the economy, fuelled by domestic demand, expanded steadily thanks to the increase in real wages and the reappearance of credit, although this generated a trade deficit. But investment was rising too. Thus the country entered a solid upward spiral of growth, with the economy expanding by around 9% per year in 1994, and productivity increased (Stallings and Peres, 2000, p. 78). At the same time, public external debt was trending downwards thanks to Brady bonds.

Argentina thus became catalogued as a fast-track reformer, winning the support and approbation of the international financial community and of the Washington-based international financial institutions (IMF, World Bank and IDB).

The economy continued on an upward course until the tequila crisis; but this challenge, too, was quickly overcome and confidence in the model restored. The situation began to change in the second half of the 1990s, however, when a series of financial crises broke out, starting in East Asia. In 1998, the Argentine economy slipped into a downward spiral towards depression and crisis.<sup>7</sup>

## 3. Declaration of default and renegotiation of the public debt

Thirty-eight months after the declaration of default, and with no help whatsoever from IMF, Argentina shed its defaulted status when its offer was widely accepted (by over 75%) among bondholders and it achieved what no country had achieved before: the bondholders not only accepted a large cut in principal, but agreed to a lengthening of maturity and a reduction in the interest rates finally paid. In other restructurings, creditors have had to accept one of these measures, but Argentina achieved all three (*The Economist*, 2005).

<sup>6</sup> It was thought that this stance would reduce the problem of moral hazard, by avoiding international agency resources being used to lower the risks of private investment in emerging markets.

<sup>7</sup> The many causes cited to explain the failure of the convertibility scheme fall into three main categories: structural reasons, based on the overvaluation of the exchange rate; fiscal reasons that cite lack of fiscal discipline on the part of the Government; and behavioural reasons that point to the role of unrealistic expectations in triggering the crisis.

What were the factors that enabled Argentina to impose a unilateral solution in the process of debt renegotiation?

To start with, any solution was going to depend on the Government's swap proposal, the leverage of each of the parties and the stances taken by the international financial institutions and the developed countries in the renegotiations.

The Government's proposal was both unilateral and ambitious. Argentina's "game plan" could be defined as non-cooperation ("take it or leave it"), working on the supposition that the creditors' bargaining power would weaken over time. The short-term cost to the country was minimal, since Argentina clearly had no possibility of obtaining external financing in the international financial markets anyway. The additional resources the Government could access by not paying its external debt, together with the introduction of new taxes (withholding tax on exports), the higher level of economic activity and, probably, improved tax management, enabled the new leader, President Kirchner, to adopt a tougher negotiating stance with creditors.

The offer was all the more unilateral given the Administration's patent lack of interest in finding an interlocutor.<sup>8</sup> The Government's every move was aimed at preventing the creditors from coordinating with each other. This implied a course from which there could be no turning back: from then on, the question was the level of acceptance the swap could achieve. A high acceptance level would ensure the operation's success, although the move was risky in that a failure would reunify the bloc of creditors and align them behind the demand for a new swap proposal. In weighing up the strategy's probabilities of success, however, the Government already had a significant "floor acceptance", since around 30% of the debt stock was held by local financial agents (retirement and pension funds administrators, insurance companies, institutional funds, financial entities and so on) whose acceptance could be taken for granted. Ultimately, the lack of cohesion among the different organizations

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<sup>8</sup> This strategy was later reinforced by the Minister of Economic Affairs, with the establishment of the floor level of acceptances to consider the swap a success (50%); the adoption of legislation preventing the Government from reopening the swap without the approval of the National Congress, and the stance of not permitting the involvement of IMF in negotiations with creditors.

representing the creditors worked to the advantage of the Government.

The unilateral offer, however was indirectly supported by the other actors. On the one hand, the international financial institutions had no hand whatsoever in the launch of the swap, which was attributable to the dissension on how to deal with such situations.<sup>9</sup> On the other, the developed countries did not adopt a unified stance, and the Government of President Bush has taken a *laissez-faire* approach to sovereign crisis resolution (Roubini, 2005). The non-intervention of IMF together with the lack of cohesion within the G7 ultimately benefited the debtor country.

There are also a series of exogenous factors that ought not to be disregarded. The international economic situation, associated with low interest rates in the United States, and the narrowing of emerging bond spreads, improved the conditions of the offer<sup>10</sup> at no cost to Argentina. It should also be considered that the Government's proposal was not far off the bonds' market value at the time the swap was launched (Roubini, 2005).

The outcome of the swap far exceeded Argentina's expectations. The fact that Argentina worked out its default unilaterally without the intervention of the international financial institutions has sent strong signals to the financial markets. Given the inoperativeness of these institutions and the existence of (numerous) creditors and investors keen to teach Argentina a lesson,<sup>11</sup> is the situation salvageable or will more sovereign debtors follow Argentina's "example"?

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<sup>9</sup> In addition to this dissension was the fact that IMF would have had little credibility (mainly vis-à-vis the Argentine Government) to mediate among the parties (IMF, 2004).

<sup>10</sup> By reducing the discount rate used to calculate the offer's present value.

<sup>11</sup> The success of the unilateral debt swap does not detract from the fact that Argentina will face serious problems if it attempts to return to the international financial markets. In addition, the discounted external private debt still represents a heavy financial burden that the country will have to begin to pay in the future. As Argentina is forced to seek external financing, its current bargaining power will be weakened.

### III

## The other crisis: FDI in public utilities

### 1. Rules or discretionary powers in the international system

Since the mid-twentieth century, bilateralism has been growing in strength as it became increasingly difficult to arrive at a multilateral consensus on the degree of protection that ought to be afforded to FDI. After the end of the Second World War, the United Nations Conference on Trade and Employment (1948) was held with a view to setting up an “international trade organization” (ITO), which would deal with all matters of trade and investment. The Conference arrived at an agreement only on trade matters, however, and this was set out in the General Agreement on Tariffs and Trade (GATT). The issue of investment attracted scant interest until the start of the Uruguay Round (1982), when the countries began to debate the process of strengthening foreign investment. This led to a series of partial multilateral agreements on trade-related investment measures (TRIMs), trade in services (GATS), a special energy agreement known as the Energy Chapter<sup>12</sup> and trade-related aspects of intellectual property rights (TRIPs). Any attempt to introduce some sort of agreement on investment was doomed to failure, however, as evidenced by the multilateral agreement on investment (MAI) initiative launched by OECD and later attempts in the framework of WTO (the Singapore Declaration and the Doha Ministerial Declaration).

The process of economic and political transformation that began in the 1980s and deepened in the 1990s thus led to the signature of numerous bilateral investment agreements, and use of the bilateral scheme became widespread.

The success of the bilateral scheme does not refute the proposal of Kydland and Prescott (1977) on the advisability of establishing rules of economic policy, instead of leaving it to be handled on a discretionary basis. This is particularly relevant in the case of investment because, unlike trade flows, investments have important consequences for the future, which makes them more vulnerable to opportunistic moves

on the part of governments.<sup>13</sup> This point is even more important when inbound FDI is going to public utilities, in which the intertemporal nature of the problem is made more acute by the State’s role in regulating rates, investments and service quality. In this case, discretionary administrative jurisdiction or governmental opportunism can be serious matters and the lack of contractual commitments can prompt firms to reduce or even, in the most extreme cases, suspend their investments. To avoid this kind of situation, the Argentine Government established rules and guarantees as a way of limiting its own manoeuvring room to alter contracts.<sup>14</sup>

Rules on investors’ rights were adopted implicitly by signing bilateral investment agreements and through membership of international institutions whose purpose it is to settle disputes between investor and State (ICSID or similar bodies). The bilateral scheme gathered tremendous momentum, and the number of bilateral agreements jumped from less than 400 in 1989 to 2,392 in 2004, of which 70% were operational (UNCTAD, 2005a). As for ICSID, from having five outstanding cases representing US\$ 15 million a decade ago, the Centre now has 113 cases worth US\$ 30 billion (Dañino, 2005).

Certain rules did become harmonized in the framework of the bilateral scheme as it gathered strength, but it had a number of disadvantages with respect to the multilateral system. Without a doubt, the benefits of such schemes leaned heavily towards the investors, who used them to secure important guarantees. For capital-exporting countries, the bilateral scheme facilitated and protected outward investments by native firms and became a channel for introducing greater demands (Moltke and Mann, 2004).

The bilateral scheme had its advantages for FDI host countries, since the start-up of such regimes sent a positive signal to foreign investors. Its effectiveness, however, was subsequently to be called into question.

<sup>12</sup> A multilateral agreement devised to encourage private-sector engagement in the energy sector in the former Soviet republics.

<sup>13</sup> Opportunism arises because of the intertemporal nature of the relationship, since the government may be tempted to change the rules set at the start.

<sup>14</sup> The more comprehensive the contract extended, the greater the Government’s commitment to non-renegotiation.

An econometric study (UNCTAD, 1998) found that no causal relationship existed between FDI flows and the signature of bilateral investment agreements.<sup>15</sup> Hallward-Driemeier (2003) found that the examination of FDI flows from developed countries did not sustain the conclusion that higher protection acted as a pull factor for additional investment. This author found that the choice of investment location continued to be driven by factors such as market size, strategic reasons or natural resource endowments. With respect to United States investments, Sullivan (2003) concludes that the bilateral protection agreement framework has little bearing on investment location decisions.<sup>16</sup> Tobin and Rose-Ackerman (2003) examined the contribution of bilateral investment agreements to well-being and concluded that the effect was at best ambiguous, since such agreements could not only be harmful in terms of flexibility but could also end up benefiting the foreign investors over the population at large. Ultimately, the studies cited call into question the hypothesis that increased protection always brings greater inflows of FDI and signal that, conversely, they impose very significant international commitments on the recipient countries.

The advantages for host countries wane even more in view of the pro-investor bias that this type of scheme tends to build up in terms of investors' rights and guarantees against expropriation, especially of the "indirect" variety. This trend is evident in new bilateral investment agreements which are ever broader in scope and impose increasingly large constraints on government action. Foreign investors also have an advantage when it comes to assessing whether a particular government measure may be considered expropriatory, leading firms to "defy" attempts to alter existing laws and regulations (Stanley, 2004). This phenomenon is beginning to be examined after widespread complaints in the framework of NAFTA<sup>17</sup> and

is now spreading into other jurisdictions (Moltke and Mann, 2004; Peterson, 2004).<sup>18</sup>

These considerations lead to the conclusion that the bilateral investment agreement scheme can be detrimental in certain circumstances. Investor's rights have gained so much ground that they risk causing disproportionate costs in the recipient countries.

## 2. The Argentine crisis and FDI

The abrupt end of exchange rate parity opened a new front in the dispute with foreign investors, now with those who had invested in the real sector, especially public utilities. Under the agreements signed in the 1990s, investors felt that they were entitled to full compensation from the Government. Although most investors in Argentina were affected by the change in the exchange rate model, the bulk of the complaints came from those with some kind of interest in public utilities, mainly those associated with the energy industry (gas and electric power).<sup>19</sup>

The predominance of this type of investment was due not only to the guarantees offered under the new bilateral scheme (such as the mechanism for settling disputes between the State and the investor), but also the provision of national regulations (for example, rates set in dollars and indexed to the United States wholesale price index). The contractual framework consisted of legislative provisions, regulatory terms and agreements reached with third countries through bilateral investment schemes guaranteed in an independent international legal framework (ICSID or other arbitration tribunal). Thus, seeking to ensure the arrival of investors and the success of the scheme, the Government ended up by accepting a system of "complete" contracts, thereby accepting risks that did not correspond to it.

This mechanism helped the Argentine Government to demonstrate its commitment to international standards, but it also became the main shield behind which foreign investors started legal proceedings. The

<sup>15</sup> According to UNCTAD, agreements play a minor role in defining the destination of FDI flows, although this role may be more important in certain circumstances.

<sup>16</sup> Eighty percent of United States FDI goes to three countries (Mexico, China and Brazil) with which the United States has not signed any special investment protection agreement, except in the context of NAFTA, which Mexico also signed.

<sup>17</sup> The health and environment sectors are among the worst affected, because of firms pressuring the State not to alter the original rules. The threat of legal action imposes a constraint known as regulatory chill on the capacity to regulate. This was among the phenomena that gave rise to a debate on Chapter XI of NAFTA.

<sup>18</sup> Basically because of the new bilateral investment agreements launched by the United States. The papers cited discuss the cases of South Africa and Malaysia, whose respective Governments have encountered strong resistance –on the part of foreign investors– to the introduction of programmes aimed at racial or ethnic equality.

<sup>19</sup> According to the International Institute for Sustainable Development (IISD), bondholders not included in the Argentine Government's debt swap and organized by the Global Committee of Argentine Bondholders planned to bring the Government of Argentina to arbitration proceedings based on investment agreements (IISD, 2005).



spirit of the restrictions the Government had imposed upon itself (the legislation combined with the agreements) was to minimize the possibility of contract renegotiation with privatized firms, since the magnitude of the commitments made any alteration, however necessary, too costly. Ultimately, the crisis was to demonstrate the intrinsic “incompleteness” of the contract scheme implicit in the regulation of the privatized firms (Guash, Laffont and Straub, 2002; Navajas, 2004). As successive Administrations proved reluctant to abide by the terms of the contracts signed, a number of investors began to withdraw –this may have been the case of the French firms EdF and France Telecom and National Grid of the United Kingdom– and investments were confined to those needed to maintain quality of service.

This divergence prompted a torrent of suits before ICSID. Argentina is currently facing 42 lawsuits,<sup>20</sup> including four brought before the United Nations Centre for International Trade Law (UNCITRAL),<sup>21</sup> which raise the country’s contingent liabilities by around US\$ 20 billion. This amount could rise considerably if a series of potential suits before ICSID prosper.<sup>22</sup>

The measures adopted by the Government affected the economic and financial equation for investors. In the case of the regulated sectors (with pesified rates), the higher the level of indebtedness in dollars, the larger the impact of the measures. Hence, regardless of the sector, most of the disputes brought after 2002 cited the effects of the devaluation on contracts in general and on the rate-setting system in particular. Investors maintained that the Government of Argentina had agreed to assume the exchange-rate risk then broke this promise in January 2002.

Some of the most vigorous presentations came from regulated firms belonging to the energy sector (gas and electric power), which initiated 22 lawsuits (19 before ICSID and three before UNCITRAL). Given the strong vertical and horizontal that exists in those industries, the firms’ complaints referred not only to the effects of the economic emergency law on rates, through pesification and rate freezes, but also to the effects on prices in the unregulated sector (in the case of gas, the price of inputs; in the case of electricity, the price of generation). Another group of plaintiffs in the

regulated sector consisted of mainly French (five of a total of eight suits) investors with interests in the provision of drinking water and sanitation. A third group of cases were initiated by investors with telecoms operations (Telefónica S.A. of Spain and France Telecom S.A.). Yet another group of complaints were lodged by foreign investors who had some kind of contract with the public administration, who sued the State for breach of contract.<sup>23</sup> And one last of group of six suits involved firms that had no link whatsoever with the Government, who sued the country over the impact of the devaluation on their liabilities.

Although most of the cases cited more than one cause, pesification was the primary motivation for the lawsuits brought against Argentina (Stanley, 2004). Whatever the reasons signalled, however, the filing of cases was generally a strategic move in the positioning for renegotiation. Hence, after the economic emergency legislation was passed and the lawsuits filed, there ensued a wrangle between the Argentine Government, the foreign investors (mainly those with interests in the private sectors) and the international financial institutions (World Bank and IMF).

The Argentine response may be succinctly described as a sort of impeachment of the entire global system. Through the procurator of the treasury, the Government began by challenging the tribunal, questioning its transparency, the process by which the arbitration panel was selected and the fact that the investors were allowed to engage in forum shopping, i.e. select the tribunal most likely to provide a favourable judgment. By the same token, Argentina rejected the intervention of ICSID (by not recognizing its jurisdiction), claiming that cases should be heard, at least, in the local courts first. Lastly, in mounting a defence –the defence actually formulated in the case of CMS Gas Transmission Company and the denial of jurisdiction in others– the Government’s strategy was to deny that the steps it had taken after declaring the economic emergency, i.e., pesification and rate freezes, amounted to expropriation.<sup>24</sup> Since all the suits cited a

<sup>20</sup> It should be mentioned that five of these were filed while the convertibility regime was still in place.

<sup>21</sup> See UNCTAD (2005b).

<sup>22</sup> See *El cronista comercial* (2005).

<sup>23</sup> These may be described as eminently defensive, since they arose as a consequence of a contractual breach, but with contracts that were strongly questioned (three cases). At the threat of becoming tied up in a legal battle with the Government, the investor brings a case before ICSID or some other arbitration tribunal with the aim of negotiating with the host country to drop the original suit.

<sup>24</sup> See the list of cases against Argentina brought before ICSID in annex.

single cause, the effect of the economic emergency legislation was central to the Government's strategy. The Government argued that the measures it had taken represented the only avenue open to it and the investors had to bear part of the adjustment burden. In Argentina's favour, it must be said that voices have recently been raised in a number of academic and political circles, expressing exactly the same reservations about the arbitration scheme.<sup>25</sup> On the other hand, the delay in renegotiating contracts with privatized companies worked against Argentina, by annoying those investors willing to cede part or all of their claims.<sup>26</sup> This is likely to keep inflows of FDI below their potential level for a long time.

With its proposals rejected and its arguments disallowed, the Government shifted its stance. One of its lines of approach was to seek to have the privatized firms withdraw their suits as a goodwill gesture in view of the contract renegotiation. With this in mind, the Argentine Administration lobbied the Governments of Spain and France, requesting them to intercede with their investors, thereby politicizing the lawsuits. Another, in view of the arbitration tribunal's award in the CMS case, was the Government's suggestion that it might disacknowledge any possible awards.

The responses from investors varied, depending on the strategic interest that each had at the point of filing the original claim. One group, consisting mainly of investors who still had strategic interests in the country, began to weigh up the benefits of withdrawing

their suits.<sup>27</sup> Those firms that had withdrawn from the country (investors in public utilities) and those who had sued as a defensive response, i.e., investors who claimed breach of contract, appeared likely to continue with their legal proceedings.

The international financial institutions were fairly unresponsive to Argentina's arguments. Immediately after the crisis, the World Bank attempted to make a loan conditional upon renegotiation of the rates set in public utility contracts. The slow reaction of ICSID and its lack of definition of whether the Governments' measures were expropriatory or not created uncertainty, at least during the period when FMI was attempting to pressure Argentina. In response to this pressure, the Argentine Government prepaid all its outstanding Fund loans early (US\$ 9 billion).

Regardless of the stances and strategies of the players, the Argentine case revealed the inadequacy of the scheme that exists under the auspices of the World Bank for settling disputes between investors and host countries. With Argentina accounting for over 40% of cases pending resolution before ICSID, the problem has shifted to the door of the arbitration scheme, not the sued country. Legally speaking, the case showed up the inappropriateness of a system that prevents collective action even though most of the suits against Argentina cite the same cause (contract breaches following the collapse of the convertibility scheme). This means that Argentina could find itself the subject of 40 different and possibly contradictory rulings (Goldhaber, 2004).

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<sup>25</sup> See IISD/WWF (2001), Mann and von Moltke (2002), Peterson (2003) and OECD (2005a).

<sup>26</sup> This point was also mentioned in the award handed down in the CMS case (ICSID, 2005).

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<sup>27</sup> The suits dropped include, reportedly, those filed by: Empresa Distribuidora y Comercializadora Sur S.A. (EDESUR), AES Corporation, Pioneer National Resources Co., Camuzzi, Gas Natural BAN, Empresa Distribuidora y Comercializadora Norte S.A. (EDENOR) and Unysis, which would lower the total amount claimed by over US\$ 4 billion (*El cronista comercial*, 2006).

## IV

### Conclusions

The vagaries of the relationship between foreign investors and host countries have sometimes favoured the former, with examples being international rules that increase guarantees and legal certainty and the MAI initiative launched in the framework of OECD, and sometimes the latter, exemplified by inaction in response to the wave of nationalizations in the 1970s and the subsequent attempt to establish a code of conduct for TNCs in the framework of the United Nations. In the 1990s, the balance tipped excessively towards foreign investors.

Before the Argentine crisis, foreign investors had managed to enhance the guarantees and legal certainty that developing countries and transition economies provided, by introducing into their contracts with debtors a series of clauses waiving sovereign immunity in the case of default (as the transnational banks had done in the 1970s under the syndicated loan system). Foreign investors' guarantees and advantages were then further expanded as the bilateral scheme became more widespread and a dispute settlement mechanism was introduced enabling them to sue the host country directly.

When the Argentine crisis broke out, however, the international system failed to provide a solution to either the sovereign default or the losses of foreign investors caused by the country's refusal to apply the rates stipulated in the original contract. The bondholders were horrified to find that IMF was unable to force the Argentine Government to renegotiate its debt under any kind of preexisting scheme or provide assistance to bondholders who opted not to accept the swap offer –holdouts– in the hope of a better proposal from the Government of Argentina. Foreign investors were equally shocked to find that the World Bank was unable to oblige the Argentine authorities to abide by the original terms of utility contracts. For its part, the Argentine Government, in its dual capacity as debtor and host country, was also appalled by the functioning of the international system, because of the way it explicitly favoured foreign investors, the lack of objectivity of the international financial institutions (basically IMF) and attempts to condition the country's economic policy to fulfilment of international commitments. As a result, and in view of the social

dimension of the crisis,<sup>28</sup> the Government found itself forced to choose between using resources to alleviate the social suffering caused by the crisis and allocating them to its international obligations to foreign investors. Ultimately, the international financial system failed to provide the Government of Argentina with specific solutions to resolve the multiple crises the country was facing.

The foregoing leads to consideration of the main lessons of Argentine case with respect to the existing institutional system. First, the solutions proposed are highly asymmetric, since they are heavily biased towards one of the parties –investor or host country– and lack long-term viability. Foreign investor's interest in securing guarantees through some type of market solutions or through bilateral investment agreements (or, more recently, through investment chapters in free trade agreements) does not seem, given its strong bias, an adequate solution to the problems associated with severe crisis. The new approach adopted by the United States Administration and IMF to dealing with financial crisis failed to offer a solution or protection to investors and paves the way for unilateral initiatives like that piloted by Argentina.

With respect to the treatment of investment, thus far all attempts to establish a multilateral scheme have failed to prosper because of differences of opinion within the bloc of investing countries. The notions underpinning those attempts are, in any case, no longer really relevant today if the idea is to solve the world's real problems. It is time to rethink the relationship between foreign investors and host countries, in order to arrive at an equitable and lasting multilateral scheme. With a view to this, an interesting starting point could be the recent initiative of OECD (OECD, 2005b) which rejects the previous approach (MAI) as intrusive and authoritarian towards developing countries.

Second, the recent Argentine experience suggests that, in the event of a multiple crisis, democratic governments will put the needs of their electorate before the demands of foreign investors. To suppose that

<sup>28</sup> Between 1999 and 2003 the proportion of Argentines living below the poverty line doubled, from 27.1 to 54.7% of the population.

strengthening the bilateral scheme will afford foreign investors more continuous guarantees and legal protection is to forget that multilateral negotiations are the only framework available to developing countries and transition economies in which to bargain. Although thus far no multilateral agreement has been reached for the settlement of financial crises or investment disputes, the multilateral principle remains the best option for developing countries, because of the benefits in terms of equity, and for external investors, because it is more predictable. In the long term, it may also mean greater credibility.

Lastly, it may be asked whether in the Argentine case the protection extended to foreign investors ultimately worked against them, by forcing them to

accept the conditions offered by the Government of Argentina. Even if this was not the case, it may become so in the medium term.<sup>29</sup> Questions are increasingly being raised over the bias that international financial institutions show towards foreign investors without providing concrete solutions to developing countries in the event of financial crisis or investment disputes, the latter of which are becoming more and more common. Disenchantment with these institutions is one of the many manifestations of mounting doubt with regard to the market-based adjustment models implemented in Latin America in the 1990s, which were excessively market-biased and limited in their benefits.

(Original: Spanish)

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<sup>29</sup> Strictly speaking, a repeat of the Argentine situation is unlikely, not because of the country's debt-swap strategy or its stance in the renegotiation with investors, but because of the origin of all these events – the excessive guarantees extended by the Government in the 1990s.

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ANNEX

### Legal proceedings brought before ICSD against Argentina

Order	Case N°	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
1	ARB/97/3	Compañía de Aguas del Aconquija S.A. and Vivendi Universal	Water and sewer services concession	Aguas del Aconquija	France	Breach of contract
2	ARB/01/3	Enron Corporation and Ponderosa Assets, L.P	Natural gas transport	TGS	United States	Application of stamp tax by provinces
3	ARB/01/8	CMS Gas Transmission Company	Natural gas transport	TGN	United States	Suspension of adjustment clause agreed upon. The suit was later broadened.
4	ARB/01/12	Azurix Corp	Water and sewer services concession	Azurix - Buenos Aires	United States	Breach of contract
5	ARB/02/1	LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc.	Gas distribution	Distribuidora de Gas del Centro; Gas Natural BAN and Distribuidora de Gas Cuyana	United States	Suspension of adjustment clause agreed upon. The suit was later broadened.
6	ARB/02/8	Siemens A.G.	Informatic services contract with the public sector	Siemens Argentina	Germany	Non-fulfilment of contractual obligations
7	ARB/02/16	Sempra Energy International	Gas distribution	Share in Camuzzi Gas del Sur SA (through SODIGAS Sur) and Camuzzi Gas Pampeana SA (through Sodigas Pampeana SA)	United States	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
8	ARB/03/2	Camuzzi International S.A.	Gas distribution	Majority shareholder in Camuzzi Gas del Sur SA and Camuzzi Pampeana SA	Belgium-Luxembourg	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
9	ARB/02/17	AES Corporation	Electricity generation and distribution	Generation (AES Paraná SA; CT San Nicolas SA; CH Alicurá SA; CH Río Juramento; CH Dique; CHT San Juan SA; Termoandes SA; AES Caracoles SA) Distributors (EDES; EDEN; and EDELAP)	United States	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
10	ARB/03/5	Metalpar S.A. and Buen Aire S.A.	Automobiles and autoparts	Manufacture, sale and finance of autoparts for public transport (bodywork)	Chile	Effects on private contracts of termination of convertibility
11	ARB/03/7	Camuzzi International S.A.	Electricity distribution and transport	Control (indirect) over EDESA (Río Negro); EDEA (Buenos Aires); and Transpa (Transportadora de Electricidad en la Patagonia Sur)	Belgium-Luxembourg	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and prevention from sending remittances abroad

*Annex (continued)*

Order	Case N°	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
12	ARB/03/9	Continental Casualty Company	Insurance company	Control (indirect) over CNA Aseguradora de Riesgos de Trabajo	United States	Loss of investment value due to effects of economic emergency law. Prevention from sending remittances abroad.
13	ARB/03/10	Gas Natural SDG, S.A.	Gas distribution	Majority shareholder in Gas Natural BAN	Spain	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
14	ARB/03/12	Pioneer Natural Resources Company, Pioneer Natural Resources (Argentina) S.A. and Pioneer Natural Resources (Tierra del Fuego) S.A.	Petroleum concessions	Pioneer Natural Resources Argentina SA and Pioneer Natural Resources Tierra del Fuego SA	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
15	ARB/03/13	Pan American Energy LLC and BP Argentina Exploration Company	Petroleum concessions	PA Continental SRL; PA Sur SRL; PA Fuego; Argentine. Share in Central Dock Sud SA	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
16	ARB/03/15	El Paso Energy International Company	Petroleum concessions	Share in Compañías Asociadas Petroleras SA; CAPEX SA; Central Costanera SA and Gasoducto del Pacifico SA. Control (indirect) over El Paso SRL	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
17	ARB/03/17	Aguas Provinciales de Santa Fe, S.A., Suez, Sociedad General de Aguas de Barcelona, S.A. and Interagua Servicios Integrales de Agua, S.A.	Water services concession	Aguas de Santa Fe	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
18	ARB/03/18	Aguas Cordobesas, S.A., Suez, and Sociedad General de Aguas de Barcelona, S.A.	Water services concession	Aguas Cordobesas	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
19	ARB/03/19	Aguas Argentinas, S.A., Suez, Sociedad General de Aguas de Barcelona, S.A. and Vivendi Universal, S.A.	Water services concession	Aguas Argentinas	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)

*Annex (continued)*

Order	Case N°	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
20	ARB/03/20	Telefónica S.A.	Telecommunications	Telefónica de Argentina	Spain	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
21	ARB/03/21	Energis, S.A. and others	Electricity distribution	Share in Distrilec Inversora (44.74%) and EDESUR (majority). Energis is controlled in turn by ENDESA (Spain)	Spain	Suspension of adjustment clause agreed upon; prevention from calculating rates in dollars and from transferring remittances abroad
22	ARB/03/22	Electricidad Argentina S.A. and EDF International S.A.	Electricity distribution	Majority share in Electricidad Argentina (EASA), owner of EDENOR	France	Suspension of adjustment clause agreed upon; prevention from calculating rates in dollars and from transferring remittances abroad
23	ARB/03/23	EDF International S.A., SAUR International S.A. and León Participaciones Argentinas S.A.	Electricity distribution	Empresa Distribuidora de Electricidad de Mendoza	France	Suspension of adjustment clause agreed upon; prevention from calculating rates in dollars and from transferring remittances abroad
24	ARB/03/27	Unisys Corporation	Information storage and management project	Unyysis Latinoamérica SA	United States	Non-fulfilment of contractual obligations
25	ARB/03/30	Azurix Corp.	Water services concession	Share in OSM (32.08%)	United States	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
26	ARB/04/1	Total S.A.	Gas production and distribution/ power generation project	Share in Central Puerto (63.93%); Hidroeléctrica Piedra del Aguila (41.30%); TGN (19.20%). Owner of TOTAL Austral and TotalGaz Argentina SA (which participate in different consortiums in the southern and Neuquén basins)	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
27	ARB/04/4	SAUR International	Water services concession	Share in OSM (32.08 shares)	France	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes.



*Annex (continued)*

Order	Case N°	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
28	ARB/04/8	BP America Production Company and others	Hydrocarbon concession and electricity generation project	PA Continental SRL; PA Sur SRL; PA Fuegoina; Sociedades Argentinas de Petróleo y Gas. Share in Central Dock Sud SA	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
29	ARB/04/9	CIT Group Inc.	Leasing enterprise	Controller of Argentine firm The Capita Corporation of Argentina (CCA)	United States	Discrimination in the application of economic emergency measures
30	ARB/04/14	Wintershall Aktiengesellschaft	Gas production	Share in hydrocarbons concessions	Germany	
31	ARB/04/16	Mobil Exploration & Development Inc. Suc. Argentina and Mobil Argentina SA	Gas production	Share in hydrocarbons concessions	United States	
32	ARB/04/18	France Telecom SA	Telecommunications	Telecommunications	France	
33	ARB/04/20	RGA Reinsurance Company	Financial reinsurance services	The firm extends life and disability insurance to the insurers of the Pension and Retirement Fund Administrator (AFJP) of Argentina	United States	
34	ARB/05/1	DaimlerChrysler Services AG	Leasing and financial services	DaimlerChrysler Services Argentina SA and DaimlerChrysler Leasing SA	Germany	
35	ARB/05/2	Compañía General de Electricidad SA and CGE Argentina SA	Electricity distribution	Empresa de Distribución Eléctrica de Tucumán SA; Empresa Jujena de Energía; Empresa Jujena de Sistemas Energéticos Dispersos SA and Energía San Juan SA	Chile	
36	ARB/05/5	TSA Spectrum de Argentina SA	Telecommunications	Thales – airspace control	Netherlands	
37	ARB/05/11	Asset Revcovery Trust SA	Financial sector	Accused Banco de Mendoza, S.A. of cancelling contract	Germany – United States	

*Source:* Prepared by the author on the basis of World Bank/International Centre for Settlement of Investment Disputes, [www.worldbank.org/icsid/about/about.htm](http://www.worldbank.org/icsid/about/about.htm)