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Argentina's Challenging Path to More Open Markets

In the past decade or so, Latin America has been characterized by two quite distinct groups of countries. On the one hand, countries such as Chile, Colombia, Costa Rica, Mexico, Peru, and Uruguay have expanded anchored on a market-friendly economic model, integrated to international capital markets. On the other hand, with varying degrees, countries such as Argentina, Brazil, Ecuador, and Venezuela have adopted economic models with significant degrees of government intervention and widespread controls on trade and capital flows. Within the latter group, Argentina and Venezuela represented the most extreme version of the neo-populist paradigm.

With the election of Mauricio Macri last December, Argentinians voted to initiate a potentially substantive change in economic policy. The return of Argentina to pro-market policies and to integration to international capital markets is fraught with challenges in terms of reform-strategy design and in terms of implementation risks.

Whether Argentina is successful in its endeavor will likely influence the on-going public policy debates in several other countries in the region. In particular, in view of the mounting economic difficulties in Brazil and Venezuela, Argentina's experience could be highly relevant.

1. Initial conditions

From the outset, Argentina´s new government faced a complex set of economic imbalances and distortions, including:

(a) A very difficult fiscal situation characterized by a record-high fiscal deficit of the order of 8 % of GDP, and an unprecedented level of overall public expenditures (at the federal, provincial, and municipal levels) of about 50% of GDP in 2015, that doubles the levels observed at the beginning of the 2000s. The sharp increase in public expenditure was mostly reflected in higher public employment and the wage bill, pensions, and subsidies, while public investment remained low and inefficient.

(b) The debt restructuring carried out in 2005 had resulted in a series of lawsuits lost by Argentina in US courts, and ultimately upheld by the US Supreme Court, effectively isolating the country from international capital markets. Lack of access to market-based finance forced the government to rely on monetary financing by the central bank that, in turn, fueled increasing inflation and large losses of international reserves.

(c) The depletion of international reserves had led the previous government to adopt draconian foreign exchange and capital controls that stopped capital inflows and foreign investment almost completely, as the parallel exchange rate was 50% to 70% higher than the official exchange rate. As the adoption of foreign exchange restrictions proved unsuccessful at stopping the reserve drainage, arbitrary restrictions were imposed on the outflow of dividend payments and on the provision of foreign exchange to pay for imports at the official rate. As net international reserves fell close to zero, the mounting arbitrary restrictions on imports contributed to an already stagnant economy and adversely distorted entrepreneurial and household incentives.

(d) The decision to substitute a fully funded pension system with a pay-as-you-go system facilitated the decapitalization of the State and increased cash flow requirements at the federal government by nearly 4% of GDP annually between 2010 and 2015.

(e) Despite an inflation rate between 25% and 40% per annum between 2008 and 2015, the former government maintained prices of public services almost frozen in nominal terms. Maintaining a price structure that fails adequately to reflect average costs of public-services provision—such as electricity, gas, and transportation—resulted in a dearth of investment in needed infrastructure. Moreover, by compensating operating losses with direct subsidies, the government added a 4% of GDP worth of annual deficit to public finances, while the quality of public services provision deteriorated severely.

(f) In the wake of a reversal in the terms of trade experienced by Argentina, as well as other countries in the region, the former government maintained high and unsustainable export taxes that turned many regional productive activities uncompetitive.

2. International context

Argentina's adjustment will take place facing significant headwinds from the rest of the world. Commodity prices, and in particular agricultural commodities, have fallen sharply and are expected to remain depressed. In particular, the world price of Soy has fallen by nearly 50 percent from its 2012 peak, and future prices through 2019 signal continued weakness, with prices at about the same level as today.

Conditions in world financial markets are also unfavorable. World real interest rates are likely to remain very low and the pace of tightening of U.S. monetary policy has slowed. However, capital flows into emerging markets in general are not expected to recover strongly, and there are further downside risks associated with China's deceleration. Argentina's access to capital markets is very uncertain and hinges on the success of its adjustment policies and the return to sustainable growth.

Weak growth of world trade and the crisis in Brazil indicate that external demand will be a drag for Argentina's growth in the near future. Brazil, Argentina's biggest trade partner, is suffering its worst recession in decades. Brazil's GDP fell by 3.8% in 2015 and it is expected to fall between 3.0% and 3.5% in 2016. Out of total exports of USD 68.3 billion in 2014, Argentina exported USD 13.9 billion to Brazil, followed by China with USD 4.5 billion and the United States with USD 4.0 billion. Compared to 2013, this implied a reduction of exports to Brazil by USD 2.3 billion. Most of Argentina's exports to Brazil are manufactured goods (vehicles, close to USD 6 billion in 2014 down from USD 8 billion in 2013) while exports to other markets are mainly commodities. In addition, the negative effects of the recession in Brazil will affect tourism and capital flows. Thus, **the Committee believes that Brazil will continue to be a risk factor for Argentina over the short-term.**

3. Early decisions

The new administration implemented policies in several crucial areas in the first 100 days, and implicitly revealed a sequencing of reforms that recognizes the constraints posed by the political environment—in particular, its minority stake in Congress.

At the outset, the new administration moved swiftly to remove the toughest foreign exchange restrictions and proceeded effectively to unify the foreign exchange market. Exchange rate unification—which implied a depreciation of around 40% of the official exchange rate—appears to have had a limited pass-through to the price level. Indeed, exchange-rate unification had been expected for some time, and there is evidence that the pass-through to prices had already taken place during 2014 and 2015, as the parallel exchange rate had become the relevant rate for price-setting decisions.

The second important area where the new administration acted quickly is that of taxation. In particular, making good on campaign promises, the new administration doubled the non-taxable minimum of the personal income tax, and eliminated all export taxes except for soybean. In the latter case, the elimination of the 35% export tax will take place with reductions of 5 percentage points per year starting in 2016. These tax reductions are estimated to add 1.3 % of GDP to the 2016 fiscal deficit. Additional revenue losses will derive from a Supreme Court decision issued in December by which a significant portion of the tax revenue will be reallocated to provincial governments. Such decision, which was extended by the outgoing government to all provinces by decree, has now been renegotiated to be transferred over a 5-year period.

Partly in connection with the above fiscal measures, the new administration also moved in the direction of adjusting several regulated prices, to remove distortions and restart investments in infrastructure. Regulated prices of energy, public transportation, water, gas, and petroleum have been sharply increased, reducing government subsidies by about 1.5% of GDP. The social impact of these adjustments is expected to be largely offset by the previously mentioned tax reductions.

Finally, the government rapidly sought to resolve to outstanding default situation generated by the lawsuits lost by Argentina in US courts and by proceedings outstanding at International Centre for Settlement of Investment Disputes (ICSID). Agreement was reached with most holdouts, and the government obtained a significant political success in Congress with the abrogation of two laws that impeded the implementation of those agreements. The resolution of the holdout situation is regarded by the government as instrumental in allowing the Argentine economy to regain access to international capital markets. The agreements to settle obligations with holdouts initially imply a new debt issue of USD 12 billion.

Normalization of relations with the international capital market as well as the IMF is widely expected to contribute to an improvement in the monetary policy front. While Argentina works towards restoring the credibility of its statistics—in particular, the price level and GDP—the government has announced the intention to focus the role of the Central Bank on gradually reducing inflation and monetary financing of the budget deficit, while reducing its focus on the nominal exchange rate as price anchor. The announced gradual reduction in the monetary financing of the deficit relies on the assumption that the budget deficit will be increasingly financed through debt.

To manage the difficult monetary transition, the Central Bank has relied on a strong program of sterilization through issuance of short-term domestic debt held by the banking system, at interest rates currently running at 38% per annum. Sterilization has been necessary not only to respond to the money creation stemming from the budget deficit, but also to absorb the endogenous money creation generated by massive forward exchange contracts entered by the previous Central Bank administration at the official exchange rate.

Although the abovementioned actions cannot at all be characterized as gradual, the government has placed emphasis on announcing that the reduction in the budget deficit and inflation will be gradual. On the fiscal front the government has announced targets for the primary deficit until 2019, without specifying how these targets will be achieved. On the inflation front targets have not been made explicit, other than saying that inflation will decline sharply in the second half of 2016. The adjustments in administered prices and the exchange rate unification have resulted in a monthly inflation rate of about 4% in the first quarter of 2016.

4. Challenges and recommendations in light of Latin America's experience

The success of Argentina's reform strategy requires building a strong credibility in the policy framework moving forward. In this respect, **the Committee supports the actions taken so far by the Argentine government to rebuild institutional capacity—such as the reconstruction of a transparent national statistics office and the resolution of the holdouts issue—and to remove severe distortions—such as the adjustments in administered prices.** However, and recognizing that these reforms cannot be made overnight, **the Committee believes that to achieve the credibility needed to boost investment, the government has to move beyond price adjustments and develop new modern and stable regulatory frameworks for public services and transport infrastructure.** Modernizing the regulatory frameworks is crucial in order to improve the terms of financing and investment in these sectors.

Also, **the Committee sees merit in adopting a gradual approach in reducing the budget deficit and monetary financing, but this approach, to be credible, requires a well-crafted and clearly announced plan that is consistent with a reduction in inflation and with the external financing limits that Argentina will most likely face.** The importance of credibility should not be played down, as the quality of Argentina's institutions deteriorated significantly over the last decade.

Adopting a gradual approach regarding the reduction of the budget deficit makes sense as the economy is currently experiencing a moderate contraction, but also a smoothing approach is efficient because the structural measures being adopted are likely to generate a resumption of growth in the future that may itself contribute to the deficit reduction. Hence, it would be unreasonable exclusively to rely on frontloading the fiscal adjustment, especially at a time when the needed removal of distortions is already generating a noticeable net social cost.

The gradual pace of fiscal adjustment announced by the government requires a significant access to debt financing. The 2016 fiscal deficit is estimated at USD 30 billion, and the borrowing requirement includes an additional USD 8 billion in debt rollover while payments to holdouts add a lump-sum payment of USD 12 billion. Given that the domestic capital market is small—partially as a result of the nationalization of the pension system undertaken by the previous government—most of the needed debt financing will have to come from international capital markets. Net of the intra-public sector financing of USD 11 billion, and an estimated debt issue in the domestic market of USD 7 billion, borrowing needs for 2016 are estimated at USD 32 billion. Given the precarious credit rating of Argentina and considering that the total external bond issuance by emerging markets in 2015 was around USD 75 billion, **the Committee believes that the government will need to rely on monetary financing by about USD 12 billion to reduce the amount of external debt issuance to a still large level of around USD 20 billion. The Committee believes that this amount of external financing, though feasible during 2016, will test the limits of Argentina's access to international capital markets.** Thus, the needed monetary financing is consistent with a moderate reduction of inflation, down from a 30% level in past three years.

The central bank has announced that its primary objective is to control inflation, phasing out the exchange rate as the nominal anchor. **The Committee believes that this is a sensible approach because (a) international reserves are low; (b) pass-through coefficients in the region have declined; thus, there seems to be less risk that currency devaluation, for example, would translate into higher inflation, as it was the case in the 1990s; and (c) de-dollarization has significantly reduced balance-sheet risks of exchange-rate volatility.** Given this, **the Committee also believes that the current reliance on sterilization policy with short-term central bank debt at high interest rates runs the risk of creating a snowball effect on debt that may compromise the credibility of the government's inflation objectives, and destabilize inflation expectations.**

In the context of building a sound and credible macro framework, **the Committee is concerned about the possibility of a sudden increase in the debt issuance in international capital markets by a number of provinces.** For example, the province of Buenos Aires has already issued external debt at a very high interest rate and more provinces may follow suit as the holdout problem is resolved.

In the past, fiscal insolvency at the provincial level has adversely affected Argentina's financial stability. In the 1980s and in the late 1990s, several large provinces issued huge amount of debt (locally and externally) using future proceeds of federal tax sharing as collateral. For example, after the Russian and Brazil's crises, a number of provinces found themselves unable to fulfill their debt payments, partly because a large proportion of the indebtedness had funded the payment of salaries and other current expenses rather than productive investments. The resulting bailout of the federal government severely complicated Argentina's fiscal sustainability. These events are still fresh in international investors' minds, affecting the credibility of Argentina. **The Committee believes that the federal government and the provinces should approach their access to international capital markets with caution and in a coordinated manner; paying special attention to avoid excessive indebtedness that could jeopardize credibility of the macro program.**

A strategy to resume and sustain growth

The strategy to establish credibility not only requires a coherent macro framework but a strategy to boost economic activity and employment. **The Committee believes that in addition to growth promoting structural measures that produce results in the medium term and are politically difficult to implement (e.g. promoting a more dynamic international integration; strengthening property rights, institutions and governance; reducing the tax burden on the return on capital and investment), the government should prioritize attracting investment to deal with the severe undercapitalization of public services and the lack of an adequate transport infrastructure.** This strategy would have three advantages: (a) it would generate an immediate boost to demand, (b) it would create future output capacity and improve productivity, (c) it would create demand for low-skilled labor with consequently positive effects on income distribution. For this to materialize the government needs to ensure that adequate regulatory frameworks for public services and infrastructure—including government procurement procedures—are in place. In the transition, sector-specific legal and financial arrangements to strengthen property rights may help in attracting focused investment projects.

The gradual macroeconomic strategy entails an already significant reliance on domestic and international capital market financing. Therefore, **the Committee believes the recapitalization of public services and investment in infrastructure projects should rely on multilateral and regional development bank support.**

Such support should include creative ways of helping mobilize long-term external and domestic private resources, following examples already underway in other countries. Thus, for example, multilateral development banks may invest in infrastructure funds and private equity funds together with private and institutional investors, as IFC is doing through its Global Infrastructure Fund, IDB through its regional Infrastructure Funds and CAF through sub-regional or national infrastructure funds in several countries in the region (Colombia, México, Peru, Uruguay, Brazil). Further, Multilateral Development Banks may also invest in or partner with national development banks for these and other purposes. Examples include the investment of CAF and IFC in Financiera de Desarrollo Nacional in Colombia and in COFIDE in Peru, the investments of CAF with Banobras and Nafin in their Funds of Funds in México and multiple cases of co-financing programs and projects with such domestic institutions.

The Committee supports the government's announcement that it will normalize relations with the IMF. This will not only contribute to improving Argentina's access to capital markets but also to facilitate access to official financing from development banks.

This statement was jointly written by:

Laura Alfaro, Warren Alpert Professor of Business Administration, Harvard Business School; former Minister of Planning and Economic Policy, Costa Rica

Guillermo Calvo, Professor, Columbia University, former Chief Economist, Inter-American Development Bank

Alberto Carrasquilla, Senior Partner, Konfigura Capital; former Minister of Finance, Colombia

Pedro Carvalho de Mello, Professor, Esags Business School (Sao Paulo); former Commissioner, Brazilian Securities Commission, Brazil

Roque Fernandez, Professor of Economics, Universidad UCEMA; former Minister of the Economy, Argentina.

Pablo Guidotti, Professor, Torcuato di Tella University; former Vice-Minister of Finance, Argentina

Guillermo Perry, Non-resident Fellow, Center for Global Development; professor, University of the Andes; former Minister of Finance, Colombia

Enrique Mendoza, Presidential Professor of Economics and Director the Penn Institute for Economic Research, University of Pennsylvania.

Liliana Rojas-Suarez, President, CLAAF; Senior Fellow, and Director Latin American Initiative, Center for Global Development; former Chief Economist for Latin America, Deutsche Bank

Ernesto Talvi, Director, Brookings Global-CERES Economic & Social Policy in Latin America Initiative, Brookings Institution; Academic Director, CERES; former Chief Economist, Central Bank of Uruguay

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