Argentina’s Challenges and Opportunities: Reasons for (Sober and Realistic) Optimism

Eugenio Diaz Bonilla
Executive Director for Argentina and Haiti
Inter American Development Bank
Recent History

Argentina: from poster child to pariah...

Reasons?

- Failure of the Washington Consensus, the G-7, and the International Financial Organizations (IMF et al)?
- Fiscal profligacy, corruption, and ineptitude in Argentina?
- Other explanations?
Other Explanations

  - Change in Social Security System, fiscal vulnerability, and debt accumulation
  - Deteriorated social (and regional) conditions

- External economic shocks (late 1990s, early 2000s)
  - Commodity prices, interest rates, K flows, US$

- Internal Political weakness
  - Fracture of the governing coalition

- Argentina: pawn in, hostage of, other debates
  - Devaluation/ pesification or dollarization
  - Bail out or bail in of private investors; public money versus market based (IMF policies)
Crisis and Recovery

2001-2002

- 5 presidents in few weeks; +30 deaths and +100 injured; riots; institutional collapse
- Growth - 10% in 2002 on top of 3 previous years of decline (another - 10%); unemployment +22%; poverty +50%

Since then...

- Recovery of democratic institutions: normal elections for President, Legislators, Provinces. Regaining social calm
- Sustained improvements in economic and social variables
Strong Economic Performance

- Very high growth (comparable to China)
- Pro-poor and pro-employment (World Bank, June 2005). Poverty ~30%; unemployment ~10%. Regionally balanced.
- Cannot be explained only by external conditions, or rebound after crisis
- Based on strong macroeconomic anchor: primary and total fiscal, and trade and current account surpluses; increase reserves in CB.

Confronted uncertainty and volatility linked to:

- Fixed exchange rates that exploded, with exchange-rate, fiscal, and financial crises
- Weak fiscal performance (mostly privatization of Social Security System) and debt accumulation
Main Debates (with IMF)

- **Macro issues:**

- **Structural issues:**
  - Debt negotiations: different paradigms (public money versus moral hazard/ market based).
  - Utilities/ privatized companies: quick and narrow (tariffs) renegotiation of contracts versus wider view of contractual obligations, shared responsibilities and growth/ time.
  - Provinces: legal restraints or a better balanced growth pattern of development that strongly reactivated regional economies (particularly a competitive exchange rate).
  - Banks: compensations versus growth and time.
The Debt Problem: Background

- Default not declared by this government
- Largest and more complex default
- Two competing paradigms: Public Bailout versus Market-based Resolution
  - Failure to understand all the consequences of the dichotomy
  - Different views in US/Europe, and within the US.
  - Argentina was placed under the market-based paradigm; all the other cases were not.
The Debt Problem: Issues Debated

- "Good Faith"
  - More than 70 meetings
  - Self-designated bondholders’ “representatives”, not so…

- "Punishing haircut"
  - Market based approach not only without public money but with Argentina paying net to IFIs (about 12000 million US dollars at the time of the exchange)
  - Argentina’s debt burden and GDP collapse far worse than other cases
  - Realistic projections of capacity to pay
  - GDP-linked option as a way of sharing the upside

- "Precedent"
  - Not comparable
  - Too costly for any country to imitate

- "Undermines financial architecture"
  - By definition of market-based the IMF must stay aside
Decline of GDP (Nominal Dollars)
Debt

- Argentina is reducing debt in general; but is considering neutral to positive flows with MDBs
- Payment to IMF: reduces interest payments; improves liquidity profile; reduces economic and political uncertainty. Strong trade and financial ratios after exchange
- Full payment of debt is in the Budget (as if 100% accepted; no “savings” for holdouts; used to buy-back debt)
Utilities/Privatized Companies

- Renegotiation of contracts with public utilities: 64 contracts being renegotiated in different sectors.
- Because of judicial challenges a specific law was required (end of 2003). Since then an elaborate process of negotiations is advancing: http://www.uniren.gov.ar/

Issues:
- Maintenance/operations
- Investments
- Previous Debt (no bailout of private external debt as in the past)
- Growth and time
Public Services (Index 1996=100)
Inflation

- Inflation 2004-2005 within government projections
- Slow pass-through of devaluation (adjustment in relative prices to new equilibrium)
- Context of high growth
- External shocks (e.g. increase in world prices of beef and dairy products with about 10% CPI)
Inflation

- $I = a_1 + a_2(L)\times I(-1) + a_3 \times I_{exp}$
  + $a_4(L)\times (AD-AS) + a_5(L)\times Z + e$

  - Backward ($a_2$); Forward ($a_3$); Aggregate Demand and Supply ($a_4$); External shocks ($a_5$)

- Price agreements to avoid persistence ($a_2$) and precautionary increases ($a_3$) that may end up being self-fulfilling, in a context of external shocks, high growth, and incomplete pass-through. Coordination of expectations. Guidelines for salary negotiations.

- Alignment aggregate demand
- Expansion potential output. Investment.
Aggregate Demand

- Restrictive fiscal impulse
  - 2004 = -4.6; 2005 = -1.9; 2006 = -2.0

- New monetary program based on M2 instead of Monetary Base. Reduces monetary growth for 2006 to a band of between 11.7% and 21.2%; middle point is a cut of about 30% in 2005 growth rate (and a reduction of almost half for the 2003-2005 average).

- External shocks and RER ("retenciones"). Other short-term trade measures
Investment

* Recovery been investment-led. Investment/ GDP (higher than 1990s)
  - 1990s= 18.9% ; 2005=21% (current prices); last Quarter 2005: 24%

* Investments more balanced across sectors, regions, and types of enterprises than in the past. Macro prices (RER, salary/ capital) reflect endowments better.


* Surveys show strong Investment expectations for 2006, and a long list of investments in export sectors (agribusiness, forestry, mining), tourism, biotechnology, IT (including the recent cases of INTEL and Motorola), automobiles, and energy.

* Public sector investments in technical education, infrastructure, and science and technology
What drives Investment?

- Political stability
- Macroeconomic stability and growth. Argentina has been a very volatile country in the most volatile developing region. Recurrent crises around stagnant growth trend.
- Greater public solvency, and macro stability helped private sector renegotiate its own debts. Allows greater access to domestic and international savings, to finance investment.
- Renegotiation of contracts the result of macro disasters; institutional issues have been less relevant so far...
Growth and Inflation

- What is the “right balance”?
  - Bias towards growth because of social debt and public/external debt

- Possible trade-offs?
  - Impact of Employment and Inflation on Poverty
  - Impact of Growth and Price Agreements on Investment
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Growth (% year)</strong></td>
<td>0.7</td>
<td>6.4</td>
<td>7.3</td>
<td>5.4</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>Inflation (% year)</strong></td>
<td>22.4</td>
<td>20.4</td>
<td>17.5</td>
<td>6.0</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Source: IMF WEO
Inflation and Growth
Average 2003-2005

INFLATION GROWTH

Argentina
After a crisis the main problem is how to distribute losses in a way that is perceived as fair by the society, protects the poor and vulnerable, and provides a firm foundation for the recovery. Value judgments that must be made by the country’s democratic system.

Argentina considered that social inclusion, solid democracy, robust growth, macroeconomic strength, and legal stability are all interrelated.

A key pre-requisite to ensure that contracts are respected, that poverty is reduced, and that democratic governance is strengthened, is to avoid crises caused by unsustainable macro policies.

The best legal system will not lead to investments if a country suffers from weak growth, macroeconomic instability, social unrest and democratic disarray.
Different Perspectives

Comprehensive approach based on:

- a) restarting growth and allowing time for the necessary adjustments;
- b) addressing the substantial social debt;
- c) emphasizing the notion of “equitable and shared burden” (particularly considering the impact on the vulnerable and the poor);
- d) processing conflicts within democratic institutions;
- e) preservation of fiscal accounts (rejecting the use of public money for private bailouts) and setting in motion a process of reduction of public debt;
- f) being mindful of the impact on nominal variables of renegotiations and other policy interventions.

A narrow institutional approach would have been counterproductive because of the political unrest, low growth, fiscal overburden, and inflationary expectations that would have generated.
Looking Forward

- Address stock of problems
  - Social (unemployment, poverty, inequality)
  - Economic (competitiveness, technology, human capital, infrastructure, fiscal issues, banking and financial system, utilities)
  - Political/institutional (modernization of political system, public sector reform, judicial system reform)
Looking Forward

Build on strengths

- Human Development Indicators: best in Latin America.
- Important natural resources: not only agriculture, but also forestry, fishing, mining, energy, water. Tourism
- Education, science and technology
  - Biotechnology, Medicine, Nuclear, Aerospace
- Vigorous and lively democracy and civil society
Reconstruction of a society with broad middle class: an integrated economic, social and political program, sustained over time...