The roots of Argentina's surprise crisis

By Martin Guzman and Joe Stiglitz
June 12, 2018 – *INET*

A change in macroeconomic policies will not be sufficient to set Argentina on a path of inclusive and sustained economic development. But, as last month's currency scare showed, abandoning the approach adopted by President Mauricio Macri's administration at the end of 2015 is a necessary step.

The currency scare that Argentina suffered last month caught many by surprise. In fact, a set of risky bets that Argentina's government undertook starting in December 2015 increased the country's vulnerability. What was not clear was *when* Argentina's economy would be put to the test. When the test came, Argentina failed.

Argentina had to address a number of macroeconomic imbalances when President Mauricio Macri took office at the end of 2015. Early measures included the removal of exchange-rate and capital controls and the reduction of taxes on commodity exports. Argentina also recovered access to international credit markets following a settlement with so-called vulture funds over a debt dispute that had lasted more than a decade.

The government undertook a new macroeconomic approach based on two pillars: gradual reduction of the primary fiscal deficit, and an ambitious inflation-targeting regime that was supposed to bring annual price growth down to a single-digit rate in just three years.

Markets cheered. The prevailing view, eagerly promoted by Argentina's government, was that the country had done what was necessary to achieve sustainably faster economic growth. Presumably, foreign direct investment would flow in. But it did not.

Instead, Argentina suffered stagflation in 2016, followed by a debt-based recovery in 2017. That led to a surge in imports that was not accompanied by a proportional increase in exports, widening the current-account deficit to 4.6% of GDP and sowing doubt about the virtues of the new approach.

Then, a few weeks ago, markets stopped cheering, expectations soured, and capital fled. The peso depreciated 19% against the US dollar in just the first three weeks of May.

Contrary to Macri's hopes, his reforms attracted mainly short-term portfolio capital and financing in the form of bonds, both in foreign and domestic currency, rather than foreign direct investment. Argentina's central bank bears a significant share of the responsibility; while its approach proved largely ineffective in reducing inflation to the target level (the annual rate is still at about 25%), high interest rates encouraged inflows of speculative capital, which worsened the external imbalances and heightened Argentina's vulnerability to external shocks.

As part of their inflation-targeting approach, the central bank has been sterilizing a large share of the increases in the monetary base through the sale of central banks bonds (LEBACS). This means that the public sector has been effectively financing through short-run central bank debt issuance the largest part of the sizable primary fiscal deficit (4.2% and 3.83% of GDP in 2016 and 2017, respectively). The issuance of LEBACS has been massive, soaring by 345% since December 2015. This might have been sustainable had early expectations of Argentina's prospects been validated.

There were obviously trade-offs. Less aggressive sterilization would have contained the growth in central bank debt that has now proven to be so risky, and it would have prevented upward pressure on the exchange rate; but it would have led to higher inflation. Nonetheless, attempting to reduce inflation and the fiscal deficit at similar speeds would have been a more prudent approach. After all, macroeconomic policy decisions should not be made on the basis of the most optimistic scenario when the cost of missed expectations is large.

The currency crisis finally revealed Argentina's vulnerabilities. Looking ahead, the country will be exposed to several different sources of risk. First, there is still a large stock of LEBACS. And every time a significant portion of that debt falls due, Argentina will be a hostage of financial markets' mood. This will increase the expected exchange-rate volatility, which may create opportunities for speculative financial investments, but will discourage investments in the real economy. Second, because the public sector's foreign-currency-denominated debt is much higher than it was two years ago, the increase in exchange-rate risk will also call into question the sustainability of public-sector debt.

To assess where Argentina is heading after the crisis requires highlighting several salient elements of how the episode was managed. First, the central bank lost 10% of its total stock of foreign-exchange reserves in just a month. Second, the annual nominal interest rate on the LEBACS was raised to 40% – the highest in the world, and a move that risks creating a snowball of central-bank debt. Third, and most shocking for Argentines, Macri announced that the country would seek a stand-by agreement with the International Monetary Fund.

Thus, if Argentina's public sector falls into a state of debt distress in the coming years, it will have to submit to the tutelage of the IMF – a creditor in itself, but also an institution that is dominated by international creditors. At that point, the conditionality that the IMF typically imposes in exchange for financing could cause severe damage.

Most worrisome is that the inflation-targeting approach that has exacerbated Argentina's external imbalances has been reaffirmed. It would thus not be surprising if a new cycle of real exchange-rate appreciation starts in 2019. With a presidential election next year, that would be good news for Macri; but it would not bode well for Argentina's future.

Ultimately, because Macri's approach to putting Argentina's economy on a sustained growth path has so far failed, and has increased the country's dependence on international creditors, his administration still faces the challenge of avoiding a debt crisis. To protect economic activity and redress vulnerabilities, the strategy of gradually reducing the primary fiscal deficit should be maintained. But, to save Argentina from an increase in external imbalances affecting the sustainability of external public debt, monetary policy must change. That means finally recognizing that attempting to reduce inflation at a much faster rate than the fiscal deficit entails costly risks. The prudent path also requires a gradual reduction in the stock of LEBACS, recognizing that greater inflationary pressure in the short term is the price of minimizing the risk of higher external imbalances and larger exchange-rate depreciations down the road.

And it would certainly be a mistake to continue reducing the tax on soybean exports, as Macri's administration has announced it will do. Further tax cuts would increase the deficit, while benefiting a sector that already enjoys rents.

A change in macroeconomic policies is not sufficient to set Argentina on a path of inclusive and sustained economic development; but it is necessary. At the outset of Macri's administration, there were warnings that he had chosen a high-risk approach. Unfortunately, those warnings were ignored. The strategy we are recommending is not without its own risks. But we are convinced that it offers a viable and sounder path forward.

Martin Guzman is Senior Non-Resident Fellow, Center for a New Economy in San Juan, Puerto Rico and Research Fellow, Columbia School of Business. Joe Stiglitz, a Nobel laureate, is Co-Chair, Commission on Global Economic Transformation and Professor of Economics, Columbia University.