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ECONOMICS

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Argentina's Uncertain Prospects

SHANGHAI – Mauricio Macri's election as Argentina's president brought to an end 12 years of government led by Néstor and Cristina Fernández Kirchner. Macri's administration inherits a delicate economy. If he is not careful, Argentina could face a balance-of-payments crisis, owing to deteriorating external conditions and macroeconomic mismanagement, especially since 2011.

Some aspects of Argentina's economic situation, however, are highly desirable – not least its low debt-to-GDP ratio. As a result, Macri's government faces a much less daunting task than the one confronting Kirchner in 2003, after a decade-long experiment with Washington Consensus policies (financial deregulation, trade liberalization, and privatization), together with the peso's peg to the US dollar, ended in disaster. When Kirchner took office, Argentina had just experienced its most severe economic crisis ever. Unemployment, inequality, poverty, and the national debt had all risen. Massive deindustrialization and deep weaknesses in its education system did not bode well for the future.

Following devaluation and default, Argentina experienced a spectacular recovery. In a severely demand-constrained economy, the Kirchner government pursued policies that led to a massive reduction in unemployment, poverty, and inequality. A deep debt restructuring greatly contributed to the restoration of macroeconomic sustainability.

In a favorable global environment, the more competitive exchange rate set the stage for reindustrialization, creating jobs for many who had been excluded from labor markets during the previous decade. As a result, from 2003 to 2008, GDP growth averaged more than 8% per year.

During Fernández's presidency, the country navigated the global financial crisis with relative success. But, after 2011, instead of carefully designing macro and micro policies to favor a consistent increase in supply and demand, most policies fostered sustaining aggregate demand in a context that was no longer purely Keynesian.

Demand grew, but supply didn't keep up. Some sectors (particularly energy) experienced bottlenecks, causing inflation to accelerate. (Given political intervention in the National Institute of Statistics, official reports are not credible; but all estimates suggest that before the recent devaluation, inflation exceeded 20%.) As a result, the exchange rate continued appreciating, undermining Argentina's post-2003 development strategy. Exports and real activity stagnated. Exchange controls and import restrictions were imposed to fight capital flight and shore up the trade balance. Nonetheless, foreign reserves continued to fall.

Argentina had followed a successful policy of debt reduction (including full repayment to the International Monetary Fund, thereby increasing the government's policymaking autonomy). But the fiscal surplus during Nestor Kirchner's presidency turned into a sizable deficit under Fernández. Her leadership brought about significant improvements in the lives of many, a more egalitarian income distribution, an economy close to full employment, and a much lower debt-to-GDP ratio; but the erosion in the external balance (and the even greater imbalance that would have occurred, had distortionary measures to control the imbalances not been undertaken) now threatens to reverse part of that progress.

Macri's task is to address the external and fiscal imbalances and reduce inflation, without undoing what has been achieved. In its first weeks, his government eliminated or reduced taxes on commodity exports and abolished exchange controls, resulting in a *de facto* devaluation of around 35% against the dollar.

Any course of action (including doing nothing) in the current context is risky. Several threats stand out: an acceleration of inflation; a worsening of the trade position (and, even more worrisome, further erosion of already dwindling foreign-currency reserves); and a marked increase in inequality. Responses to inflation or to declining reserves could, in turn, lead to the worst of all possible worlds: stagflation – a cooling economy in which inflation is not fully contained.

There are four key uncertainties: the pass-through to consumer prices of the removal of export taxes and exchange controls; the effect of this *de facto* devaluation on exports and imports; foreign investors' response to the new environment; and access to "bridge" finance, which depends on a settlement with holdout creditors (the so-called vulture funds).

The immediate winners are agricultural and other commodity exporters, who will receive much more for what they sell. *If* the devaluation does not cause significant inflationary pressures, it will boost competitiveness without decreasing real wages.

But that seems to be wishful thinking. If higher prices for domestic goods previously subject to export taxes and higher import prices (as a result of devaluation) are passed on to consumers, real wages will fall, in which case workers are likely to demand larger pay increases, pushing up inflation. And the effect of the devaluation on consumer prices could go beyond traded goods: Argentina has a long history of highly unstable relative prices, with the US dollar often the reference currency for setting prices of non-traded goods.

In the face of growing inflationary pressures, the central bank would presumably raise interest rates. If done carefully, this could dampen demand *just enough* to restore a semblance of macroeconomic balance. Even then, rising redundancies in non-bottleneck sectors would most likely push up the overall unemployment rate, with inflation only partly tamed, producing stagflation.

If the central bank acts too aggressively and drives the economy into recession, the poor would be disproportionately affected. An inflation-targeting regime (which the central bank has announced that it intends to establish) would make this outcome more likely.

Optimists believe the new policy regime will lead to an influx of foreign direct investment, and that a "fair" resolution to the vultures' claims will clear the way for a bridge loan to cover any financing gap. Moreover, the weaker exchange rate, combined with pent-up sales of commodities waiting for the one-time devaluation, will suffice to meet any foreign-currency needs.

Pessimists, seeing a global slowdown and a recession in neighboring Brazil, worry that there will need to be further devaluations, especially given significant pass-through to consumer prices, and that this – or even the expectation of it – may lead some exporters to delay shipments. They also worry about a surge of pent-up demand for imports, once import restrictions are fully lifted.

The pessimists also doubt that any mutually acceptable settlement of the debt-holdout problem can be found, putting a bridge loan out of reach. After all, any settlement would have to be ratified by Argentina's parliament, which, as Finance Minister Alfonso Prat-Gay recently reinforced, is unlikely to agree to an offer that includes the high punitive interest rate that US federal judge Thomas Griesa ruled the country should pay – and rightly so.

The government's initial actions are worrisome: In particular, the permanent cut in export taxes is a large transfer to the wealthy, at great cost to ordinary workers. Whatever the efficiency benefits, the distributive consequences and development implications cannot be ignored.

Yet Macri's early economic policies seem to rely on several controversial assumptions about how the devaluation will affect consumer prices and how investment will respond to more market-driven policies. If those assumptions founder, the government will need to react fast, intervening to avoid the possible recessionary effects or increases in inequality and poverty – or else the process of inclusive development will be severely harmed.

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