Argentina's Economy: Endgame Scenarios

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The economic and financial headlines coming out of Argentina have been increasingly at odds with the norm throughout the world's main emerging markets.

- Whereas most countries have been coping with a flood of incoming capital by soaking up excessive inflows and adding to their hoard of international reserves, and a few have even resorted to taxes or other measures to discourage capital inflows, capital has been hemorrhaging out of Argentina despite increasingly stringent controls on imports, remittances abroad, and other cross-border transactions.
- While most central banks have countenanced significant appreciation of their currencies since 2009, capital flight in Argentina has led to a major depreciation of the peso, such that in terms of dollars the currency is now worth about half its value relative to 2005 – and a mere one third its value in the black market.
- Whereas most central banks have been keeping interest rates very low or have been cutting them because of the absence of inflationary pressures, in Argentina inflation has been galloping at double-digit rates since 2006 despite the imposition of ever-widening price controls.
- While in most emerging markets the pace of economic activity has decelerated somewhat, in Argentina a previously red-hot economy has been stagnant for over a year. Many companies cannot afford to grant salary increases that would compensate workers for inflation, and concerns about layoffs are growing.
- Whereas most governments – even exotic issuers like Bolivia, Honduras, Mongolia and Ukraine – have been tapping the world's bond markets and raising long-term funds at rock-bottom interest rates, Argentina has been shut out of capital markets. Its obligations trade at huge discounts to par because they are deemed to be extremely risky and prone to renewed default.

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What has gone terribly wrong in the land of beef and soybeans? In the past dozen years, successive governments have pursued a 21st century version of the populist, nationalist policies made infamous by the late General Juan Perón more than six decades ago. State intervention in the economy is now widespread, including via arbitrary controls on prices, wages, public utilities, exports, imports, and foreign exchange – all intended to benefit Perón's core constituency of the urban working class. It has been accompanied by a quantum leap in government subsidies to consumers – mainly cheap oil, gas and electricity – and by largesse on an extensive patronage system.

Populism and nationalism have prompted the expropriation without compensation of private pension funds and of assets like the oil company YPF, previously controlled by Spain's Repsol. The provisions of international investment treaties and foreign-law contracts have been violated, and the government has refused to pay and settle numerous judicial rulings and arbitral awards against Argentina. Even official bilateral creditors like the U.S. Ex-Im Bank and its counterparts in Europe and Japan have gone unpaid for many years, and lately the IMF has censured Argentina for failing to comply with its obligation to deliver accurate economic statistics.

Argentina's foreign policy has witnessed a marked shift away from cooperation with the United States and Europe and toward alliances with other populist, nationalist regimes spanning from Venezuela under the late Hugo Chávez to the otherwise isolated Iranian regime. Diplomacy has turned defiant vis-à-vis the United Kingdom on the issue of the Malvinas islands, and even neighboring countries from Brazil to Chile have been stung by Argentina's refusal to play by the established trade and other rules under Mercosur and the WTO. The giant Brazilian mining company Vale recently gave up on an $11 billion potash project in Argentina, citing escalating costs and a greatly deteriorated business climate.

Matters are coming to a head, however. To paraphrase Baroness Margaret Thatcher, "the problem with populism is that eventually you run out of other people's money" – and this is precisely what has happened. Despite the tax burden having been nearly doubled since the early 2000s to a historic high of 38 percent of GDP, government spending in Argentina has skyrocketed even faster, such that fiscal red ink has been flowing since 2005.

Lack of domestic investor confidence, and the government's insistence on paying low coupons, has meant that the local financial markets have not supplied the requisite funding to refinance maturing obligations or to cover the operating deficits. The authorities have chosen to borrow the needed pesos and dollars from the central bank, and also from the nationalized pension system and from the large, state-owned commercial bank (Banco de la Nación Argentina). Monetary growth on the order of 40 percent per annum and drawdowns of international reserves, in turn, have aggravated the country's inflation and weakened confidence in the Argentine peso.

There are two main economic scenarios for the rest of 2013. The first and most likely is that the authorities will keep trying to postpone the day of reckoning until after the mid-term congressional elections in October. The government wants to do well in that contest in order to increase its representation and push through a constitutional reform allowing President Cristina Fernández de Kirchner to run for a third term in 2015. Therefore, the government is reluctant – and not just out of hubris – to admit any mistakes and adopt corrective measures and austerity policies that might further erode its sagging popularity.

In this scenario, the authorities seek to buy time by reducing fiscal transfers to provincial and local governments and by tightening even further controls on domestic prices and access to U.S. dollars. The economy will remain stagnant and the financial and social situation will deteriorate further. It is a high-risk scenario, however: the government could lose control of the streets to more frequent protests and even general strikes which might turn violent. As it is, a national pot-banging protest is scheduled for April 18th, farmers are slowing down their shipments for export and are threatening demonstrations, and the labor unions – mainly teachers and other civil servants – are increasingly restless. In recent weeks, even employees in the Finance Secretariat, within the Ministry of Economy, have staged intermittent strikes.

The authorities could also find themselves defaulting anew on the external public debt, and thus triggering a confidence crisis among bank depositors which could lead to withdrawals of pesos – and not just dollars – and to even more pressure on the exchange rate and on official international reserves. This outcome depends on the government's attitude after an upcoming ruling by a U.S. Court of Appeals on a case brought on by minority bondholders whose rights to payment under New York law have been ignored since 2001. The ruling is most likely to affirm that Argentina cannot continue to discriminate among its bondholders, paying some but not others.

Since there is a chance that the courts will stay the immediate application of their ruling pending an appeal to the U.S. Supreme Court, the best judicial outcome for Argentina is that the authorities in Buenos Aires will get the extensions they need to make it to the October elections. Nevertheless, the mere prospect of a looming disruption in payments to the majority of bondholders, which is already mostly priced-in, will keep taking a toll on domestic confidence in Argentina, as reflected in a postponement of big-ticket consumption and investment decisions, and in a steadily wide gap between the official and parallel exchange rates for the U.S. dollar.

An example of the corrosive damage done by trade and currency controls in Argentina was recently provided by a Bloomberg News article. It told the story of how, in desperation, the nation's largest electric company had decided to ship for repairs a 100-ton, 67-foot-long steam turbine 7,600 miles away to a Siemens plant in Switzerland using one of those huge Russian cargo planes. It could not wait any longer for permission to import the needed parts and to purchase the Swiss francs to pay the technicians who could have flown in and fixed the turbine in Argentina.[†]

The second, less likely scenario is that of a sensible course correction. It would begin with President Kirchner admitting that past fiscal and monetary policies are no longer viable, inflation has become a major problem, and dollar rationing is inducing more rather than less capital flight. It would include announcing the start of negotiations with the government's unpaid official and private creditors to eliminate all arrears. The immediate benefit of these refreshing announcements is that they would lead to a rally in Argentine stocks, bonds and the peso, and to a break of the country's inflationary fever. That, in turn, could help decompress various economic, financial, political and social tensions now erupting.

To be sure, announcements would have to be followed by corrective price increases, cuts in government spending, and a slowdown of the monetary printing presses – but the belt-tightening would not have to be draconian. The ratio of public debt to GDP stands below 50 percent in Argentina, the fiscal deficit is running under 4 percent of GDP, tax revenues are likely to keep holding up well, and voluntary demand for government bonds can only increase with some pricing flexibility on the government's part and a better attitude toward its obligations and its creditors. Moreover, the banking system is in good shape. Relative to the enormous fiscal and banking challenges which countries in Europe's periphery have needed to overcome, Argentina's adoption of more sensible and viable policies should not require any shock therapy. And yet, this is the less likely scenario because recent governments – and particularly the current administration – have been so ideological rather than pragmatic, and thus so uncompromising even when faced with more rational and beneficial alternatives.

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† See Pablo Gonzales, "Lightning Strikes Creditors in 7,580-Mile Fix: Argentina Credit," Bloomberg News, March 5, 2013.