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Argentina: From Gradualism to Shock Therapy

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Argentine President Mauricio Macri. / Wikimedia / Creative Common

The austerity measures that President Mauricio Macri announced yesterday to deal with the sharp depreciation of the Argentine peso and acceleration of inflation in the past couple of months are a belated but entirely appropriate effort to stem the country's massive capital flight. His administration intends to lower government spending and reimpose taxes on exports to reduce the fiscal deficit faster than envisioned in May, when a three-year economic program was agreed with the International Monetary Fund (IMF). This is in addition to a previously announced government hiring freeze and cuts to subsidies for electricity and other services.

- Specifically, the goal now is to minimize the public sector's financing requirement for 2019, limiting it to rolling over debt maturities coming due plus borrowing $15 billion mostly from the IMF, World Bank, and Latin America's development banks (CAF and IADB), to cover the interest payments coming due next year. All told, the fiscal deficit contraction that would be achieved between 2017 and 2019 is equivalent to about four percentage points of GDP, compared to the previously pledged 2¾ percent of GDP in savings embodied in the IMF program.
- In return, Macri's government has requested the IMF to speed up disbursements under the $50 billion loan facility, which had envisioned a $15 billion up-front payment in June, made on schedule, plus installments of about $3 billion per quarter through June 2021, depending on performance and need. The Fund's Managing Director, Christine Lagarde, has instructed IMF staff to work with the Argentines to reach a rapid conclusion of discussions to present to the Executive Board for approval.

Macri's announcement was an admission that what had been advertised in May as a strictly "precautionary" loan must now be amended to provide emergency financing full-throttle. While a number of emerging-market currencies have come under downward pressure in recent months, the selloff in Argentina is only comparable to that in Turkey: both the Argentine peso and the Turkish lira currently buy about half as many U.S. dollars as they did at the start of the year (now 100 pesos = \$2.60 vs. \$5.40 then). The currency downdraft has dragged Argentine stocks and bonds down when measured in dollar terms; the probability of a debt default in Argentina, as deduced from bond yields, currently ranks highest of all in the emerging markets but for Venezuela, in default since late 2017.

- Last December, the central bank of Argentina (BCRA) committed itself to achieving an inflation rate of 15 percent during 2018, but prices rose more than that just in the first six months of the year. Given the cost-push pressures unleashed by the peso's sharp depreciation since May, Argentina would be lucky to end the year with inflation cumulating less than 40 percent. The patent failure of monetary policy to stabilize the currency and curb inflation thus far will probably be hotly discussed during the government's negotiations with the IMF. Last week the BCRA hiked its target interest rate to 60 percent from 40 percent in early August, which is more than double the level that prevailed through May. Chances are that the IMF will pressure the central bank to keep interest rates significantly above expected inflation until the fever breaks.

We wrote in mid-May that we were witnessing in Argentina the demise of President Macri's cherished – and popular – gradualism in tackling the poisoned inheritance left after 12 years of populism under presidents Néstor and Cristina Kirchner. Now we are beholding the embrace of "shock therapy" in fiscal and monetary policies by the Macri administration.

- *Macri and his economic team keep blaming adverse circumstances, such as the worst drought in 30 years, which has delivered the poorest harvest since 2009; risk aversion among investors because of the tightening of U.S. monetary policy; and uncertainty generated by the "corruption copybooks" scandal involving Kirchner government officials and construction industry businesspersons. Their diagnosis is patently wrong. Despite the poor harvest, Argentine export earnings through July have increased in the best performance in several years. The tightening of U.S. monetary policy has been very gradual and well telegraphed in advance; it has not caused problems in prudently managed countries. And the recent scandal is tarnishing Macri's opposition in the legislature and has not reached the scope of the "carwash" scandal in Brazil.*
- *Macri and his team are reaping what they sowed. In 2016-17 they claimed that they could do little to address the inherited fiscal and monetary problems because otherwise they would lose precious seats in midterm congressional elections and end up as lame ducks. And then, after Macri's party* Cambiemos *did well in the October 2017 contest, they claimed that in 2018-19 they could do little to address the inherited fiscal and monetary problems because otherwise they would lose the presidential elections in October of next year. Up until February, local and foreign investors were willing to give the Macri administration the benefit of the doubt, but then they got impatient, started to pare their positions especially in short-term government bonds, and subsequently decided to exit on a large scale when the central bank failed to tighten monetary conditions sufficiently to keep the peso from depreciating rapidly.*

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