

**Rabobank**

Argentina - Ten years on

24 December 2011 marks the 10th anniversary of Argentina's dramatic USD 95bn sovereign default. Ten years later, it seems that Argentina is in a much healthier state. The economy has been booming, with the country officially posting Chinese style growth rates of almost 8% since 2003. Unemployment is low and the number of poor has gone down dramatically. In this article we explain what is behind this 'miracle'. Furthermore, we will look forward and conclude that the boom years are coming to an end. The external environment is deteriorating, while the government's growth stimulating policies have led to the disappearance of the crucial current account and fiscal surpluses.

From bust to boom

On 24 December 2001, Argentina's government defaulted on USD 95bn of foreign debt. After already having been in recession for 3 years, the economy plunged into depression in 2002, resulting in a contraction of GDP of 11% that year. Bank accounts were frozen and parts of the economy got a barter character. Simultaneously, the country underwent a deep political and social crisis, with the urban poverty rate increasing to 54% of the population. Not only the poor, but also the middle class took the streets. Argentina experienced mass demonstrations and large scale lootings of shops. Thirty people were killed by the police after the declaration of martial law had fuelled Argentinians with even more anger. Argentina became almost ungovernable: president De la Rúa fled his official residency by helicopter in late 2001. Afterwards, the presidency changed hands quickly, as no one seemed able or willing to lead Argentina.

Argentina's woes were to a large extent linked to the currency board it had installed in 1991 to fight inflation. This currency

board made the peso at a one-to-one rate convertible into the dollar. Argentina thus managed to defeat hyperinflation, but got into trouble when the devaluation of the Brazilian *real* in 1998 suddenly left many Argentinean producers uncompetitive. The economy fell into recession. As the government maintained the dollar peg, the country could not grow out of this recession. In the direct aftermath of the sovereign default, Argentina's economic policies were chaotic. The governments first tried to re-peg the peso at 1.40 to the dollar, before allowing the peso to float, which resulted in a quick further depreciation. However, after some time, a macroeconomic policy set emerged that was, although unorthodox, at least to some extent coherent.

As the government tried to force creditors to accept deep haircuts on their outstanding loans, access to finance remained extremely difficult for Argentina after the crisis. The deep haircuts led to long lawsuits with creditors who held bonds issued in foreign jurisdictions. To avoid being reliant on financial markets, the government therefore had two major goals: create and maintain a fiscal surplus and a current account surplus. This way, the government did not need foreign money to finance imports or government deficits. Meanwhile, the economy benefitted from the devaluation of the Argentine peso. Both the manufacturing and tourist sectors began to boom.

Ten years later, Argentina's economic track record looks impressive. Except for a short global financial crisis-induced break in 2009, Argentina's economy has experienced almost ten years of economic boom. Argentinians have seen their income rise rapidly from USD 8,589 in 2002 to USD 14,363 in 2010¹,

¹ In 2005 USD at PPP

according to statistics from the World Bank. This income makes Argentines (still) the richest inhabitants in Latin America. Meanwhile, poverty has fallen strongly. According to government statistics, the percentage of Argentines living on less than USD 2 per day declined from 20% in 2002 to 2% in 2009, while the urban poverty rate fell from 54% in 2002 to 10% in 2010. At the same time, income inequality, which had strongly increased in the 1990s and made Argentina more of a standard Latin American high-inequality society, has also gone down in the past ten years, according to the statistics. Politically, Argentina has become much more stable. After the quick succession of presidents in 2001 and 2002, Néstor Kirchner became Argentina's president in 2003. His wife Cristina Fernández de Kirchner succeeded him in 2007. On 23 October 2011, she convincingly won re-election by gaining 54% of the vote in the first round of the presidential elections, the biggest victory since democracy was restored in Argentina in the early 1980s.

In strong winds even turkeys can fly

The first reason why Argentina has grown rapidly is that it benefitted tremendously from global developments. Two developments stand out: high demand for agricultural commodities and the economic boom in Brazil. Rapid economic growth in China and other emerging markets fuelled global demand for agricultural commodities. In particular demand for soybean products, of which Argentina is an important and low cost producer, has grown strongly. Thanks to the increase in demand, the soybean price has risen dramatically over the past decade. Whereas a ton of soy cost roughly USD 160 in December 2001, the price of a ton of soy was worth USD 500 this summer (afterwards the price has fallen somewhat to USD 407 on 12 December 2011). With its unique agricultural resources, Argentina was able to increase its soybean production strongly from roughly 30mIn ton in the

2001/2002 season to 50mIn ton in the 2010/2011. As a result, almost 25% of the USD 68bn Argentina exported in 2010 consisted of soybeans or soy products, while total Argentine exports of primary and processed agricultural products increased from USD 13.4bn in 2002 to USD 37.8bn in 2010.

Secondly, Argentina's industry greatly benefitted from Brazil's economic success in the past decade. Strong consumption growth in Brazil fuelled the demand for Argentine manufacturing exports, of which more than 40% are exported to Brazil. At the same time, Brazil's currency, the *real*, became one of the world's most rapidly appreciating currencies, thanks to capital inflows and rising commodity prices. This appreciation made Argentine products relatively cheap on the Brazilian market, and thus further increased demand for Argentina's products. As a result, total Argentine exports to Brazil almost tripled from USD 4.8bn in 2002 to USD 14.4bn in 2010.

Graph 1: Going up...



Source: Ecwin

Sowing the wind, reaping the storm?

However, not only the external environment was the cause of Argentina's high growth; the policies of the government have also contributed significantly, at least in the short run. The first way the government stimulated growth was by dramatically increasing public spending: government expenditure grew from USD 19bn in 2002 to an expected USD 119bn in 2011 (as a share of GDP the increase was

less spectacular, but still large, with public expenditure growing from 19% of GDP in 2002 to 26% of GDP in 2011). Most of this additional spending stimulated consumption, while the efficiency of spending was low.

Furthermore, in order to allow for the boost in public spending, the government also sought out new income sources. First and foremost was the agricultural sector, which was hit with taxation after taxation and other intrusive measures. As the external environment remained good, this has not led to big problems in the sector, although the sector was definitely hurt, in particular the beef subsector, and is now also facing lower prices. Secondly, a few years ago, the government nationalized private pension funds, which allowed it bring down the deficit when the economy was hit by the global financial crisis. Thirdly, the government also financed itself by using the foreign reserves of the central bank.

Another way in which the government stimulated consumption and short term economic growth was through its monetary policies. The government kept interest rates low, even when inflation became high. In fact, in the past years, interest rates were below the private sector estimates of the inflation rate, which gave the Argentineans a strong incentive to consume, rather than save. Therefore, while the economy already benefitted from an extremely favorable external environment, both fiscal and monetary policy even further boosted short-term growth. Thus, Argentina was making a mistake it had made many times in the past. Instead of saving for a rainy day, the government stoked up an already booming economy even more, leaving the country once again unprepared for a sudden worsening of the external economic environment.

Fighting reality

Part of Argentina's good economic performance is just a statistical illusion. Argentine economic data are unreliable, with its inflation statistics being most notorious in this respect. Since

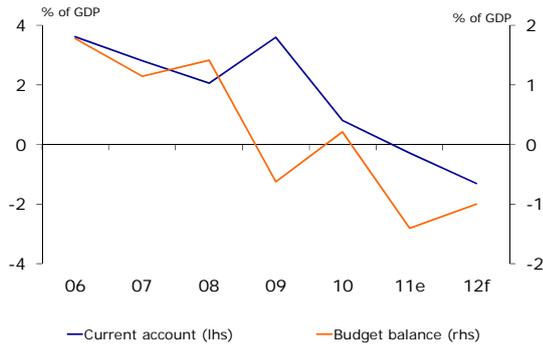
2007, the government has grossly under-reported inflation. According to the government, inflation is now roughly 10%, but private sector economists estimate that inflation has been running above 20% for some time. Meanwhile, it seems that the government has been overreporting growth in the past years, even as these data are probably less manipulated than the inflation statistics. As a result, Argentineans are less rich than the statistics suggest. Furthermore, poverty also seems more of a problem than the government acknowledges. For example, the number of shantytowns around Buenos Aires has been growing sharply in the past years.

Meanwhile, the government's policies not only leave Argentina vulnerable to a future worsening of the economic tide, but they are already resulting in more and more problems. For example, extremely expansionary fiscal and monetary policies have resulted in the already mentioned inflation rate exceeding 20%. At the same time, the government has let the peso appreciate only very gradually, probably because it fears a sudden or more rapid fall of the peso would lead to panic within the still partially dollarized economy. Thus, in the past two years, Argentina's consumer prices have risen with 50%, while the exchange rate has fallen only roughly 13%. As a result, compared with their foreign competitors, the costs for Argentinean producers have risen strongly. This erosion of competitiveness has led to a deterioration of the current account, which is now about to fall into deficit (see chart 2). As we noted before, this is a huge problem for Argentina, as maintaining a surplus on the current account is of crucial importance, given its bad access to foreign investment.

Similarly, the fiscal position of the government is also becoming a vulnerability, even as net public debt has gone down from 75% of GDP in 2005 to 38% of GDP in 2011. This vulnerability is thanks to the large increase of public spending, which has eliminated the sizeable

fiscal surpluses the government ran until 2008. Instead, the government is likely to run a deficit in both 2011 and 2012 (see chart 2). As we noted before, this is risky due to the government's bad access to foreign finance and the government may get into trouble should its income fall suddenly, for example in case of a sharp and sustained drop of commodity prices.

Graph 2: ... and falling down



Source: EIU

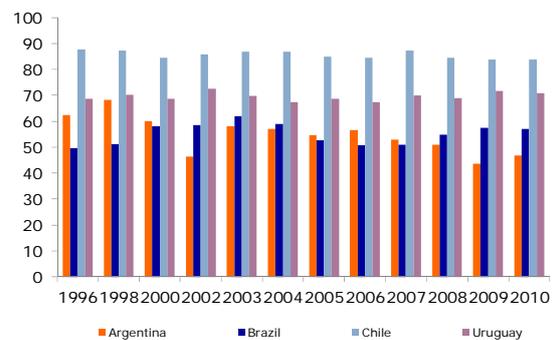
Making (some) things worse

So far, the government's response to these problems has made (some) things only worse. Many Argentines expected the government to devalue the peso in response to the deterioration of the current account balance and therefore exchanged their pesos into dollars. This resulted in a massive USD 18bn capital flight in the first 9 months of 2011 and a drop in the foreign reserves level. However, instead of letting the currency fall, the government has chosen to implement more formal and informal controls to contain capital flight. It forced Argentinean insurers to sell foreign assets and energy exporters to repatriate all their export income and has made it more difficult for ordinary Argentines to change their pesos in to foreign currencies.

Furthermore, earlier in 2011, the government has made it much more difficult to import products into Argentina. Imports have to be matched dollar- for-dollar by exports, which has forced Porsche to export Argentine wine.

Even Argentina's core agricultural sector has been hit, as it has become very hard for farmers to buy tractors produced abroad. The new controls will lead to a further worsening of Argentina's regulatory environment, which according to the World Bank's Governance Indicators has already been dismally poor since the 2001 crisis (see chart 3). Although tighter controls seem to have halted the fall of the foreign reserve levels, they do nothing to solve the underlying causes of the capital flight. The government seems still unwilling to let the peso fall, while high inflation is well-entrenched. Balance of payment risk is thus very high, which may lead to further capital flight and a depletion of the FX-reserves. Meanwhile, access to foreign capital remains extremely difficult, as some lawsuits with creditors still continue and investment risk in Argentina remains high. Then there is the deterioration of the fiscal balance. In this area the government response has been somewhat more appropriate than its response to the current account deterioration, as it has taken some measures to contain its rising spending bill. The new government will try to reduce public spending by letting rich customers and companies pay more for their utilities. However, this will only result in a limited reduction of the total utility and transport subsidy bill, which has grown to 4.2% of GDP. Meanwhile, the government continues to finance itself monetarily, which is further stoking up inflation.

Graph 3: Percentile score on regulatory quality



Source: World Bank Governance Indicators

Looking forward

Meanwhile, the external environment, which has been so favorable towards Argentina in the past ten years, is becoming less friendly. Soybean prices have fallen recently, and may fall further if the eurozone crisis intensifies. Growth in Brazil, Argentina's primary export market for manufacturing products, is declining strongly, probably falling from 7.5% in 2010 to a meager 3% in 2011 and 2012. What is more, the Brazilian *real* has also depreciated since this summer, which has further reduced the competitiveness of Argentinean producers, which had already been under pressure due to Argentina's high inflation rate.

However, Argentina may still not be running out of luck, as there have been large finds of shale gas and oil reserves recently. Argentina thus may become a major energy producer, which would result in a high export and government incomes. However, it will require a lot of capital to bring the new oil and gas fields into production. Due to the government's habit of suddenly changing the rules and implementing controls, and its energy policies, which consist of keeping energy prices extremely low, it will be very hard for Argentina to attract the necessary investment. Indeed, the destructive impact of the government's energy policies has become increasingly clear in the past years. They have boosted overconsumption, especially among the rich and the middle class, while at the other hand discouraging energy production. As a consequence, at least in the short run, energy-rich Argentina is likely to become a net importer of energy.

Conclusion

Argentina's China style economic growth in the past decade is the result of statistical illusions, luck (as the external environment has been extremely favorable) and growth stimulating, government policies. Strangely enough, just like ten years ago, Argentina's government is

getting into trouble as it once again fails to accept that its economic policies, particular its exchange rate policy, are unsustainable. Ten years ago, the government desire to hold on to the currency board made its economy fatally uncompetitive after the devaluation of the real in 1998. This time, the government defends an untenable growth strategy with more and more intrusive policies.

In the short run, the consequences are likely to be less dramatic than ten years ago. Foreign indebtedness is low, and barring a long period of low commodity prices, the sovereign is not likely to get into direct trouble. Nevertheless, it looks as if the boom years are already over, as the external environment has become less favorable. The recent large shale oil and gas finds might come to the rescue, but the existing government policies will make it hard to exploit these resources in the near future.

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