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Argentina: economic challenges in an adverse international setting

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Abstract

The Argentine economy is in a complicated transition phase. To correct the major fiscal and inflationary imbalances built up in the previous decade, the new government that took office in December 2015 opted for a gradual fiscal adjustment, supported by a situation of abundant international liquidity. In parallel, the Argentine central bank assumed ambitious inflation-reducing objectives. However, in 2018 the lack of progress on the inflation front, the tightening of international financial conditions and a severe drought placed Argentina under the market's gaze and prevented it from pursuing the financing of this gradual adjustment; accordingly, the government decided to apply for IMF financial assistance. The agreement with the Fund, approved in June and amended in October 2018, plans for a rapid fiscal and monetary adjustment that will provide for a reduction in its twin deficits (fiscal and external alike) and an effective decline in inflation, moving the economy onto a stable growth path. The success of the programme, to which the Argentine authorities have made a clear commitment, is nonetheless subject to internal and external risks, and poses a significant challenge for the country.

Keywords: Argentina, IMF, Stand-By Arrangement (SBA), economic growth, macroeconomic risks, debt sustainability.

JEL codes: O11, O54.

ARGENTINA: ECONOMIC CHALLENGES IN AN ADVERSE INTERNATIONAL SETTING

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Introduction

Argentina is in a complicated economic transition phase, which began with the change of government in December 2015. The new government took charge of an economy which had built up major macroeconomic imbalances and set in train a series of reforms aimed at liberalising the exchange rate and correcting these maladjustments. The authorities opted for a gradual fiscal adjustment path, which it was possible to maintain during 2016 and 2017, against a background of abundant international liquidity and appetite for risk at the global level. However, the lack of progress in curtailing inflation, the tightening of international financial conditions as from spring 2018 and a severe drought, which diminished agricultural output and exports in the first half of the year, made it very difficult for Argentina to continue funding this gradual adjustment on the markets. The government duly decided to request IMF assistance in May this year.

This article analyses, first, the economic framework proposed by the new government (second section). It then details how, in the current setting of high vulnerabilities, the deterioration in external financial conditions and the turbulence on financial markets led to the request for financial assistance from the IMF (third section). The agreement with the Fund is described in the fourth section. Lastly, the fifth section briefly draws conclusions.

The new economic model

In December 2015, Argentina was facing a build-up of macroeconomic imbalances, microeconomic distortions and institutional weakness. The country did not have access to international financial markets owing to the blocking of its external debt payments as a result of its “holdouts” problem (Argentine bondholders who had not accepted the restructuring offered by the previous government). Consequently, the strong growth in public spending and the resulting deficit were essentially funded through monetary financing. Central bank financing of the deficit amounted to 5.3% of GDP in 2014 and led inflation to rates between 20% and 40%, on unofficial estimates.[1] At the same time, the deterioration in international competitiveness, owing to the overvaluation of the official exchange rate, and the impossibility of attracting foreign capital led to a strong reduction in currency reserves, against the background of the high external deficit. The introduction of exchange controls restricted imports, impairing economic growth, and was conducive to the emergence of a parallel exchange rate market. Moreover, agricultural exports had high taxes placed on them.

The new government, which took charge in December 2015, proposed a radical reforms plan, which it decided to implement at different speeds. The authorities prioritised the liberalisation of foreign exchange arrangements to correct the overvaluation of the official exchange rate, to eliminate the distortion that a parallel market entailed and to put an end to the restrictions on goods imports, which limited the functioning of the Argentine chain

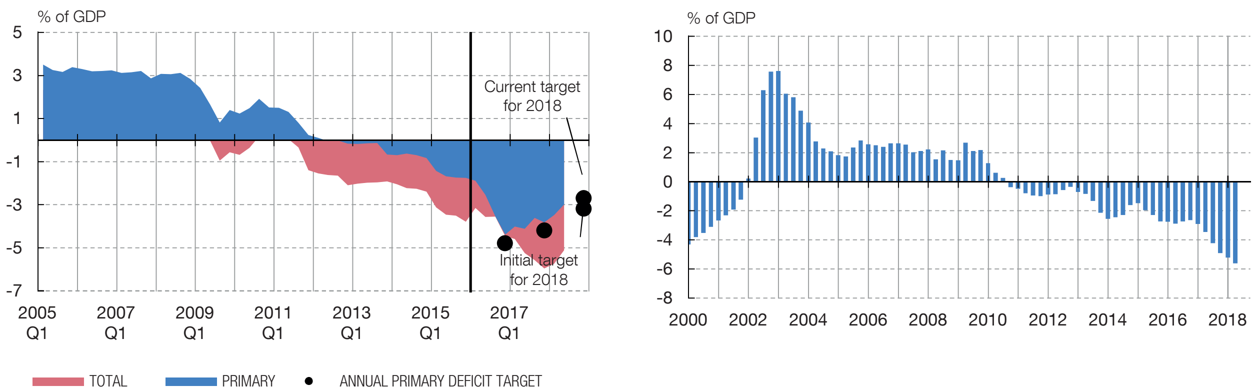
1 The official inflation statistics and the national accounts lost credibility as from 2007, which led to a proliferation of private estimates and to the non-existence of an official price index to steer monetary policy. The government used price controls and a freeze on public prices as inflation management measures, adding significant distortions to relative prices. Campos et al. (2018) estimate Argentine inflation using provincial data. From 2007 to 2015 the year-on-year rate of inflation in Argentina was 25.8%, peaking at 38.9% in September 2014.

IN 2015, ARGENTINA FACED A MACROECONOMIC SITUATION MARKED BY MAJOR IMBALANCES, POSTING HIGH TWIN DEFICITS (FISCAL AND CURRENT ACCOUNT) — CHART 1

The new government, which came to power in December 2015, opted for a series of reforms aimed at liberalising the exchange rate and correcting the economy's imbalances. The authorities opted for a gradual fiscal adjustment path, which they were able to maintain in 2016 and 2017 against a background of abundant international liquidity and global appetite for risk.

1 TOTAL AND PRIMARY BUDGET BALANCE

2 CURRENT ACCOUNT BALANCE



SOURCE: Datastream.

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of production. Exchange controls were eliminated and a “managed float” exchange rate regime was introduced. On the monetary policy front, the government specified a framework of highly demanding inflation targets, to converge on inflation of 5% in 2019, at the end of its four-year mandate, and it set a declining path for transfers from the central bank to the Treasury.

In fiscal policy, a medium-term consolidation plan setting out gradual reductions in the primary fiscal deficit to 2019 was announced.[2] Further, the government finalised a “holdouts” agreement, which enabled it to tap the international debt markets once more, against a backdrop of high appetite for risk[3]; nonetheless, foreign direct investment inflows did not increase significantly. Generally, the policy mix proposed by the government was favourably received, although it was argued in some quarters that it was not enough to resolve Argentina’s twin-deficit (fiscal and current account) problem (see Charts 1.1 and 1.2).

The reforms and policies implemented brought the Argentine economy out of isolation, growth turned positive again in 2017 and the central bank built up reserves thanks to portfolio investment inflows. However, the current account deficit widened and dollar-denominated public debt increased, while the central bank used short-term debt issues

2 The primary fiscal deficit targets were 4.8% of GDP in 2016, 4.2% in 2017, 3.2% in 2018 and 2.2% in 2019. Expenditure-cutting measures focused on eliminating energy and transport subsidies. On the revenue side, a tax amnesty was approved for assets located abroad, which partly offset the loss of revenue relating to the reduction of distortionary taxes, such as those on the export of agricultural goods, and to the decline in economic activity. In 2017, the government came to fiscal agreements with the provinces whereunder the latter undertook to cap increases in nominal expenditure at levels below that of inflation.

3 After regaining access to international financial markets, the Argentine government was able to reduce central bank financing to 4.4% of GDP in 2015, 2.0% in 2016, 1.5% in 2017, and a further reduction to 0.5% in 2018 was projected.

(central bank bills known as LEBACs by their Argentine acronym) as a sterilisation instrument to align the quantity of money in circulation (and the exchange rate) with monetary policy objectives. In sum, the Argentine economy continued to evidence vulnerabilities, which were masked by foreign investors' search for returns.

The deterioration in external financial conditions in 2018

In December 2017, against a still-favourable external background, the government decided to relax its inflation targets[4], so as to ease the pressure on the real exchange rate, which was deemed to be over-appreciated, and, in January 2018, the central bank cut its policy interest rate on two occasions (by 75 bp each time), arguing that the change in the inflation target allowed a more lax monetary policy. However, the change in targets was interpreted as a loss of independence by the central bank, which led to an increase in inflation expectations and to the depreciation of the peso against the dollar, meaning that the central bank had to halt the cycle of interest-rate cuts (see Chart 2.1).

The downward pressures on the peso continued in March and April, strengthened by domestic and external causes alike. On the domestic front, inflation and expectations remained high, and a severe drought affected harvests, reducing the expected currency inflows for agricultural exports.[5] Externally, the consequences of the US monetary policy normalisation began to be clearly felt in a reduction in global appetite for risk, with a greater impact on emerging markets. The heavy central bank interventions to sustain the peso on the currency market (see Chart 2.2) were unable to contain the currency's depreciation, and the central bank opted to raise its policy interest rate to 40% and to take measures to increase the supply of dollars on the market.[6] In parallel, the government announced stricter primary fiscal deficit targets. However, these measures only managed to check the pressures on the exchange rate temporarily, and on 8 May, faced with fresh capital outflows, the Argentine government requested IMF assistance.

Agreement with the IMF and a restrictive twist to economic policies

On 20 June, the IMF Executive Board approved a three-year Stand-By Arrangement (SBA) with Argentina (see Box 1). The agreement envisaged access to $50 billion on loan (the biggest programme in the IMF's history, although not when measured in terms of quotas or of GDP, 9%), with a first disbursement of $15 billion at the start of the programme, while the authorities signalled that the remaining amount was precautionary in nature. The aim was to restore the international financial markets' confidence in the country, to shore up the credibility of the central bank's monetary policy framework, to lessen balance of payments pressures and to protect the most vulnerable sectors of society. In the area of macroeconomic policies, inflation targets were basically eased[7] and a swifter fiscal adjustment was introduced.

The agreement with the Fund initially improved market sentiment: in July, the volatility on financial markets eased considerably, and the exchange rate stabilised. However, from early August significant pressures on the exchange rate and on country risk began to be felt again (see Chart 2.3), to which – once more – a combination of domestic and external factors contributed. On the external front, the tightening of financial conditions for the emerging countries, capital flight to safe-haven assets and the escalating trade disputes between the United States and China played a relevant role. Domestically, judicial enquiries

4 It raised them by 5 pp in 2018 and 2019.

5 Furthermore, the income tax on foreign holders of LEBACs (central bank bills) also came into force.

6 The policy interest rate increased on 27 April (+300 bp), 3 May (+300 bp) and 4 May (+675 bp). The central bank also approved a regulatory change, limiting the amount of dollars that commercial banks could use to meet their liquidity requirements.

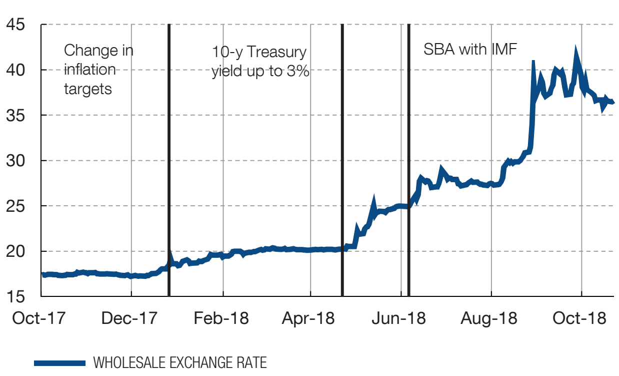
7 The initial targets were 15% in 2018, 10% in 2019 and 5% in 2019. Under the June agreement the targets became 27% in 2018, 17% in 2019, 13% in 2020 and 9% in 2021.

AS FROM 2018 Q2, FINANCIAL CONDITIONS IN ARGENTINA DETERIORATED RAPIDLY

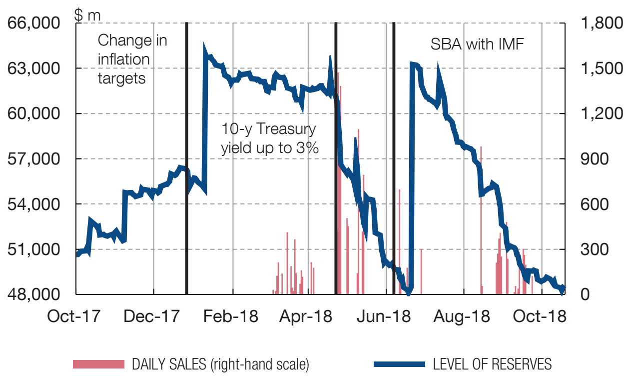
CHART 2

Following the tightening of financial conditions for the emerging economies, the financial market penalised the combination of a gradual fiscal adjustment and the relatively insignificant headway in combating inflation. The outcome was heavy capital outflows and a depreciation of the peso, which led to intervention on foreign exchange markets, to the rise in policy interest rates and, finally, to the request for assistance from the IMF.

1 EXCHANGE RATE AGAINST THE DOLLAR

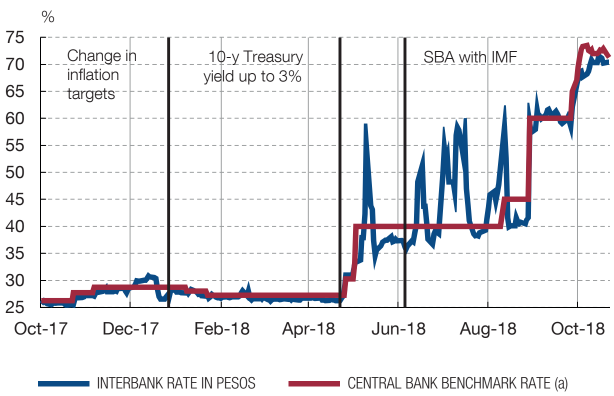


2 INTERNATIONAL RESERVES (a)



3 SOVEREIGN SPREAD (EMBI) AND 10-YEAR CDS

4 SHORT-TERM INTEREST RATES (INTERBANK RATE IN PESOS)



SOURCES: Datastream and BCRA (Argentine central bank).

a Since October 2018, the inflation targeting-based monetary policy framework has been replaced by one based on ceilings for the growth of the monetary base. The central bank's benchmark rate is thus determined endogenously.

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into certain corruption cases,[8] large-scale redemptions of central bank bills and the perception of potential failure in achieving the objectives agreed upon with the IMF were likewise relevant.

To reduce the impact of these events on inflation and check the ongoing depreciation of the peso, the authorities added an even more restrictive bias to their economic policies. In August, the central bank increased its policy interest rate to 60%[9] (see Chart 2.4) and, in the fiscal arena, stricter objectives than those included in the initial agreement with the

8 The award of public works contracts between 2005 and 2015.

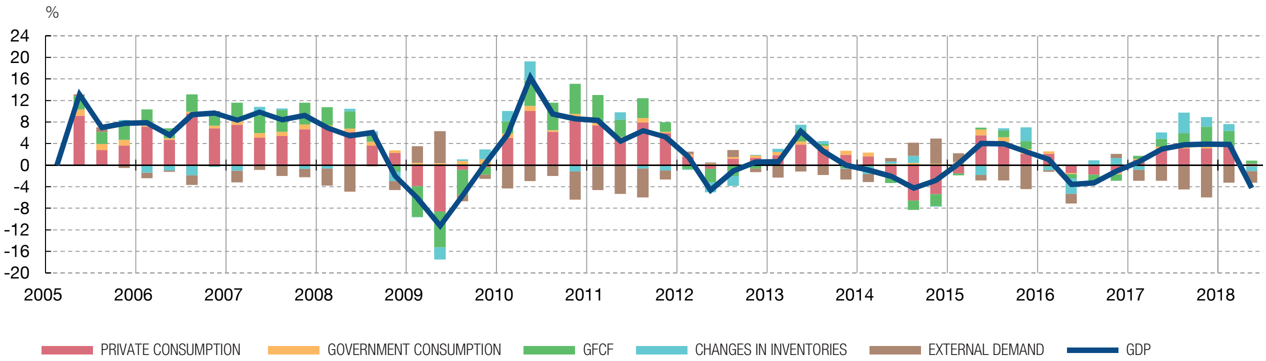
9 These changes were announced at two extraordinary meetings convened by the central bank: one in mid-August, at which the interest rate was raised by 500 bp to 45%; and another at which the policy interest rate was raised by 1500 bp to 60%. The Argentine central bank engaged, moreover, in forward guidance, undertaking to maintain the level of its benchmark interest rate above 60% until December 2018, initially, and subsequently until inflation expectations did not fall for two consecutive months, and it raised its reserve requirement by 5 pp.

THE RAPID DETERIORATION IN MACROECONOMIC AND FINANCIAL VARIABLES GAVE RISE TO A REVISION OF THE SBA WITH THE IMF

CHART 3

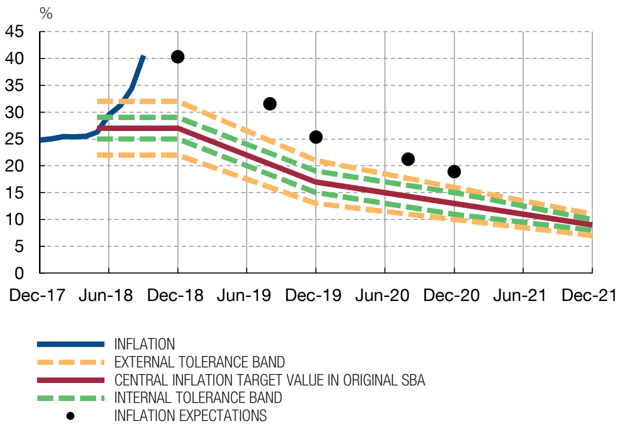
The Argentine economy posted a decline in 2018 Q2 (-4.2% y-o-y). The exchange rate underwent fresh downward pressures in August, subsequently stabilising following the announcement of the revision of the SBA with the IMF. Inflation remains on an upward path, owing mainly to the effects of the depreciation of the peso, pending the effects of the new monetary policy measures.

1 CONTRIBUTIONS TO GDP GROWTH



2 NOMINAL PESO/DOLLAR EXCHANGE RATE

3 INFLATION, EXPECTATIONS AND FORMER IMF SBA LIMITS (a)



SOURCES: Datastream, BCRA (Argentine central bank) and IMF.

a The inflation target was abandoned in the revision of the agreement approved by the IMF Executive Board on 26 October 2018.

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IMF for 2019 (primary balance in equilibrium[10]) and 2020 (primary surplus of 1% of GDP) were announced in September, as were new fiscal measures.

In parallel, the authorities renegotiated certain aspects of the agreement with the IMF, including a change in the monetary policy framework, and an increase in and bringing forward of the funds envisaged under the arrangement[11], abandoning the preventive nature of the funds, in order to meet fiscal and current account balance requirements up to the end of 2019. The revised agreement was approved by the IMF Board on 26 October. As regards monetary policy, and given the failure of the inflation targeting-based framework as a nominal anchor of the economy, it was opted to switch to control of the monetary

10 The draft 2019 Budget includes the following assumptions for 2019: a decline of 0.5% in GDP (after a projected fall of 2.4% for 2018), an average exchange rate of 40.10 pesos/dollar and inflation of 23%.

11 As Box 1 indicates, the changes in the terms of the SBA agreement entail the end of its preventive nature, an increase in the size of the programme (+$6.3 billion to $56.3 billion) and a bringing forward of funds (+$19 billion, for a total of $50.5 billion until end-2019), with the possibility of using them as budgetary support.

base, the growth in which is restricted to 0% until June 2019.[12] As to foreign exchange policy, given the difficulties in supporting the exchange rate, especially with the low level of reserves, central bank interventions will be restricted to a limited amount on occasions on which the exchange rate lies outside broad bands set at ±15% around a central exchange rate. Since 1 October the exchange rate band has stood between 34 and 44 pesos per dollar, and the central exchange rate will adjust daily at a rate of 3% month-on-month until end-2018 (see Chart 3.2).[13]

The decline in GDP in 2018 Q2 (-4.2% year-on-year, see Chart 3.1), while compatible with the GDP path for 2018 and 2019 incorporated into the agreement (with rates of change of -2.6% and -1.6%, respectively), is indicative of the restrictive impact that the adjustment will have in the short term. Also, inflation is holding at high levels, having posted a significant rise during the year to a rate of 40.5% in September (see Chart 3.3), partly as a result of the depreciation of the peso. That illustrates the difficulty of bringing about the reduction in inflation expectations needed for the programme to be successful. Beyond domestic factors, developments in the international environment will also be an important component for assessing the effects of the agreement.

Conclusions

The Argentine authorities face the enormous challenge of correcting the imbalances built up in their economy over years of deficient economic management. The government's plans to address this challenge are very ambitious, but also necessary to lead the economy onto a path of stable and sustained growth. The fiscal and monetary adjustment measures programmed will have a highly restrictive impact on growth in the short term, albeit bearing in mind the budgetary provisions to maintain a floor for social spending. Accordingly, the authorities should apply them credibly, resolutely and transparently to provide for their social and political acceptance, and to bring about a rapid downward adjustment in inflation expectations.

In this connection, Argentina has the technical and financial support of the IMF and of other international financial institutions. However, the risks are also very significant. These range from a potential negative interaction between the course of the exchange rate and the growth and inflation path or debt sustainability (with a substantial portion denominated in foreign currency), to higher economic and social costs stemming from the adjustment. In this respect, one favourable factor is the IMF's bringing forward of the financial funds, which will enable the possible consequences derived from less favourable global credit conditions than in the past to be postponed until 2020.

5.11.2018.

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12 Adjustments will be permitted to take into account the seasonal oscillations in the demand for money (December 2018 and June 2019). From June 2019, the growth of the monetary base will be restricted to 1% per month, until end-2019.

13 If the peso stands above this upper limit, the central bank will carry out sales of up to $150 million per day. Where the peso to stand below it, dollar purchases that could be sterilised would be made. The monetary base would only increase if there were signs of confidence in the peso and the counterpart would be an increase in reserves.

In June the Executive Board of the IMF approved, via the emergency financing mechanism, a three-year Stand-By Arrangement (SBA) for Argentina amounting to $50 billion (35.4 billion special drawing rights (SDRs)) equivalent to 1,110% of its quota in the IMF. The arrangement envisaged an immediate initial disbursement of $15 billion (333% of Argentina's quota) to cover estimated financing needs until year-end and the remainder is drawable in twelve quarterly tranches of equal amount ($2.9 billion each) to meet additional financial needs under scenarios with more adverse rollover rates on debt. The Argentine authorities drew down the first disbursement when the programme was approved and stated that they did not intend to request further disbursements and considered the remainder of the arrangement as precautionary.

In the IMF's opinion, Argentina met the four criteria of the exceptional access framework[1] since: a) it had exceptionally large balance of payment needs, which could not be met with normal lending limits; b) although there was not a high probability that its public debt was sustainable, it had additional sources of financing[2] which could improve sustainability; c) it had access to private capital markets and a favourable long-term outlook with the successful implementation of the programme and support from the international community; and d) it had sufficient political and institutional capacity, and was committed to implementing an IMF-supported programme.

Concerned by how the arrangement was communicated and the associated risks of stigmatisation, the IMF emphasised that it should not be perceived as an austerity programme and underlined the high degree of its ownership by the authorities. The programme's conditionality set targets for primary deficit ceilings (-1.9% in 2019 and equilibrium in 2020), a reserves floor (rising to $7.5 billion in June 2019 and $28 billion by the end of the programme), the non-accumulation of domestic and external debt payment arrears, the absence of monetary financing (in order to reduce inflation to a single-digit figure by end-2021), and the social assistance spending floor (1.3% of GDP in 2018). Similarly, it envisaged the strengthening of the central bank's institutional autonomy, its recapitalisation and greater staff involvement of the monetary institution in the management of the funds provided by the IMF. As a result of the authorities' favourable attitude in the negotiation of outstanding arrears to private creditors, it was possible to approve the programme under the IMF's lending into arrears policy.

The rapid deterioration of the macroeconomic and financial projections at the end of summer led to a review of the agreement – completed by the Executive Board on 26 October – which envisages the end of its precautionary status, increases total lending by $6.3 billion to $56.3 billion (1,277% of the quota), provides a further $19 billion which is drawable by Argentina until end-2019 (Chart 1)[3] and reformulates the original conditionality.[4] Substantial frontloading

1 This framework is applied to funding volumes above 145% of a country's quota annually and above 435% of its quota cumulatively.

2 In June, Argentina obtained additional one-year financing of $5.65 billion: $2.5 billion from the IDB, $1.75 billion from the World Bank and $1.4 billion from the CAF-Development Bank of Latin America. Similarly, the Argentine authorities intend to increase the $11 billion swap facility with the People's Bank of China which ends in July 2020.

3 The amounts of the agreement are denominated in SDRs. The equivalent dollar value relates to the exchange rate used by the IMF when the agreement was approved in June and amended in October.

4 The Executive Board approved the request for waivers of non-observance for some end-September performance criteria: the reserves floor, the reduction of net financing to government and the ceiling on non-deliverable forwards. By contrast, Argentina met all the fiscal targets by the end-September deadline.

Table 1.
ARGENTINA'S ARRANGEMENTS WITH THE IMF (1983-2018)

				Approved			Drawn down	
Year	Type of arrangement	Starting	Ending	Millions of SDRs	% of quota	% of GDP	Millions of SDRs	% approved
1983	SBA	24-Jan-83	23-Jan-84	1,500	187	1.4	601	40
1984	SBA	28-Dec-84	30-Jun-86	1,183	106	0.9	1,183	100
1987	SBA	23-Jul-87	30-Sep-88	948	85	1.1	617	65
1989	SBA	10-Nov-89	31-Mar-91	736	66	1.1	506	69
1991	SBA	29-Jul-91	31-Mar-92	780	70	0.5	439	56
1992	EFF	31-Mar-92	30-Mar-96	4,020	361	2.2	4,020	100
1996	SBA	12-Apr-96	11-Jan-98	720	47	0.4	613	85
1998	EFF	4-Feb-98	10-Mar-00	2,080	135	0.9	0	0
2000	SBA-SRF	10-Mar-00	23-Jan-03	19,937	942	8.4	9,756	49
2003	SBA	24-Jan-03	31-Aug-03	2,175	103	2.3	2,175	100
2003	SBA	20-Sep-03	5-Jan-06	8,981	424	9.7	4,171	46
2018	SBA	20-Jun-18	19-Jun-21	40,714	1,277	8.7	14,714	36

SOURCE: IMF.

of the financing drawable is envisaged in exchange for faster fiscal consolidation (the primary deficit target of zero is brought forward one year with respect to the initial programme), the replacement of the inflation targets by a more straightforward monetary anchor, focused on control of the monetary base, and the adoption of a floating exchange rate regime, with limited room for intervention by the central bank. Furthermore, given the short-term risks, the IMF will increase the frequency of its monitoring of the programme until the end of the year.

Argentina has had a long history of agreements with the IMF since 1983, especially between 1989 and 2006, with successive programmes close in time and, generally, of a high amount (see Table 1). The current agreement is for the highest amount in the history of the IMF,[5] although in terms of quota and GDP it ranks behind the agreements with Greece, Ireland and Portugal (see Chart 2).

Argentina and the IMF are entering a new, open crisis-resolution phase following the draft agreement reached in September. More important than the increase in the volume of lending is the fact that 90% of that amount may be disbursed during the first half of the life of the arrangement, which means a loss of leverage for the Fund against a backdrop of high uncertainty. From a broader perspective, considerations of global financial stability, and the delicate circumstances for emerging economies as a whole, come into play. The IMF's short-term liquidity stands below 200 billion SDRs for the first time since the beginning of 2011, but it remains sufficient and does not require alternative sources of funding to the quotas, as long as the demand for financing from the Fund does not increase substantially.

5 Except for the successive Flexible Credit Lines (FCL) arranged with Mexico as from 2011, which currently amount to $88.2 billion (700% of Mexico's quota).

Chart 1
FURTHER TO THE REVIEW OF THE SBA, LENDING INCREASED AND THE FINANCING AVAILABLE WAS BROUGHT FORWARD

DISBURSEMENT SCHEDULE (2018-2021)

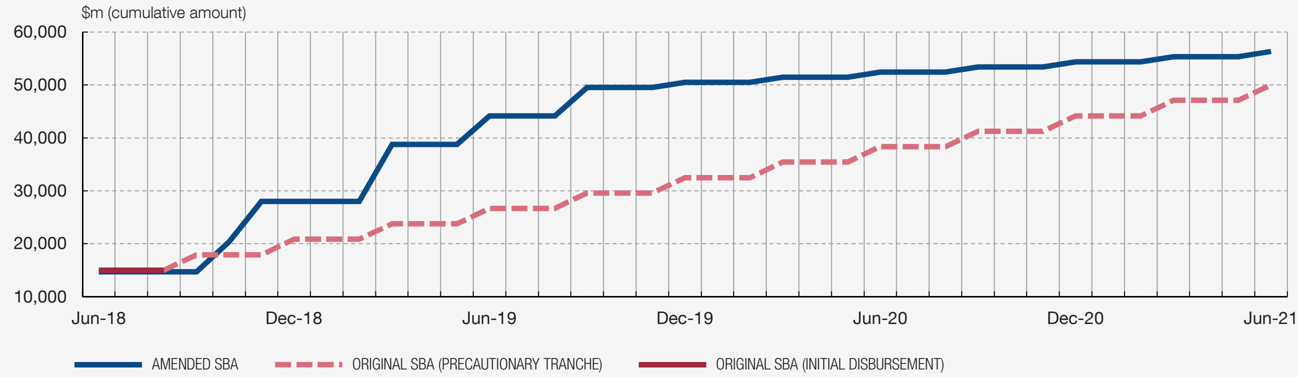
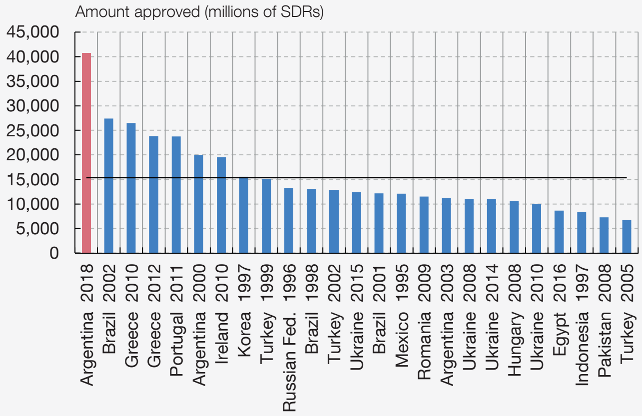
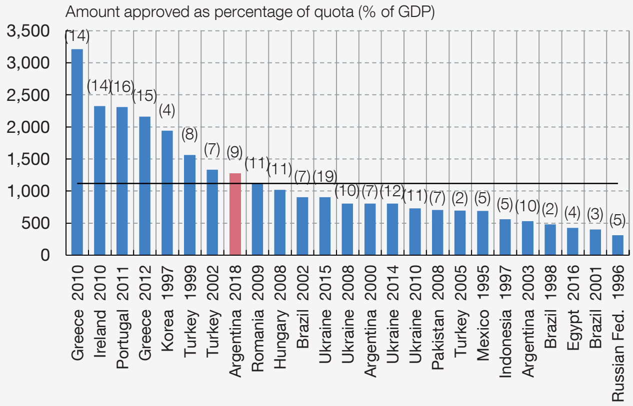


Chart 2
ARGENTINA IS THE IMF'S BIGGEST PROGRAMME IN TERMS OF AMOUNT, THOUGH NOT OF QUOTA OR GDP

1 IN TERMS OF AMOUNT



2 IN TERMS OF QUOTA AND GDP



SOURCE: IMF.

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