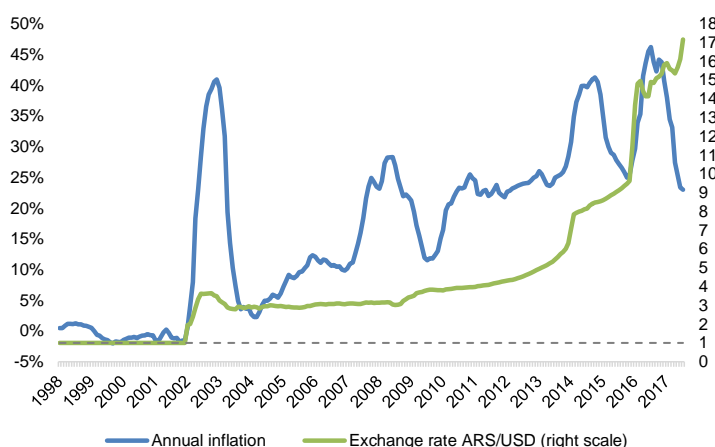


The Argentinian economy – achievements and challenges

- Since President Mauricio Macri's election in late 2015, Argentina is once again gaining ground, following the 2001 economic crisis and a period dominated by a return to protectionism and creeping isolationism with respect to foreign investment. In a bid to deal with a particularly depressed macroeconomic climate and ward off a new currency crisis, the country successfully implemented difficult emergency measures: the peso was allowed to float, capital controls were lifted, talks were held with holdout bondholders to end the default. Implementing structural reforms is a longer-term process.
- One of the keys to macroeconomic normalisation lies in Argentina's ability to quickly rein in inflation and modernise its financial sector. Inflation inertia has been a feature of many of the economic crises that the country has suffered, as stakeholders' preference for the dollar fuels strong resistance to any real exchange rate adjustments.
- Inflation inertia also has structural roots, including rent-seeking behaviour facilitated by trade protectionism and weak enforcement by competition authorities, as well as difficulties in reining in wage costs in the face of trade unions' negotiating power. In a cyclical manner, the removal of distortions linked to public services subsidies is accompanied by a rise in inflation.
- Currently, the Central Bank is faced with a dilemma – should it extend a restrictive monetary policy or, by adjusting the exchange rate in a bid to bolster poor price competitiveness, opt for a more gradual path to disinflation?
- In the short term, the gradual opening up of trade that was initiated by the government is clearly the best way to instil greater discipline in price setting and the formation of expectations, thereby quickly erasing the loss in exchange rate competitiveness. The success of these normalisation efforts after a painful past would be promising for medium- and long-term growth, given Argentina's many strengths (raw materials, human capital and a productive agricultural sector, among others).

Dollarisation means that external adjustment is highly ineffective for Argentina



Source: Central Bank of Argentina, Indice Congreso.

1. The legacy of past crises – a strong resistance to changes in the real exchange rate

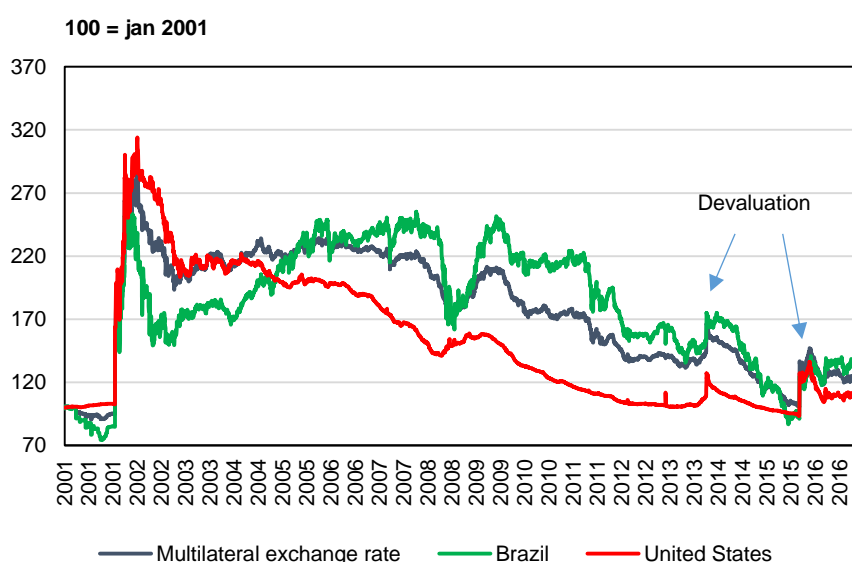
Argentina's history has been marked by eight economic crises between 1946 and 2002¹, 14 recessions, a bout of hyperinflation in 1989, and the collapse of the banking sector in 2001, among other incidents. This very high cyclical volatility, which has been correlated or amplified by commodity price volatility (processed and unprocessed commodities represent 60% of exports, with soybeans accounting for nearly 30%), has had a long-term impact on the country's economic performance (2.7% average annual growth between 1950 and 2014 and an investment rate of only 16% of GDP) and how economic players behave. The many crises and endless attempts to rein in inflation have sapped stakeholders' confidence in the national currency, for whom the dollar acts as an anchor when it comes to setting prices and wages. Resistance to the depreciation of the real exchange rate is a remarkable stylized fact in Argentina, which complicates the absorption of macroeconomic shocks.

1.1 Argentina normalised its exchange rate regime in December 2015, but this did not restore price competitiveness

At the end of 2015, the newly-elected government introduced bold measures to correct financial and trade distortions, in particular by lifting capital controls. It managed to remove the strong restrictions on foreign currency purchases that had been brought in four years earlier without causing panic. Concurrently, it allowed the peso to float, which resulted in a 35% devaluation. Subsidiaries of foreign companies were free to repatriate dividends and settle their commercial debts. Normalisation of the capital account was achieved by resolving the dispute with a group of holdout New York bondholders. Since then, the Argentina central government and provinces have successfully raised more than USD 35bn on the markets.

However, the devaluation of December 2015 and the freeing up of capital movements did not make it possible to permanently reverse two basic trends that have existed since the 2001 crisis: **ongoing depreciation of the peso against strong currencies, particularly the dollar, and an appreciation of the real exchange rate – independent of the performance of the real economy** (see Chart 1). Thus, more than two-thirds of the competitiveness gains linked to the December 2015 devaluation were erased in 16 months by high inflation, similar to what had been observed following the January 2014 devaluation. Under the current high real effective exchange rate², exports could not help kickstart the economy (in 2016, foreign trade contributed –0.7 points of GDP to growth).

Chart 1: Argentina's real effective exchange rate



Source: Central Bank of Argentina.

¹ See, for example, Miguel A. Kiguel, *Las crisis económicas argentinas. Una historia de ajustes y desajustes*, Sudamericana (2015).

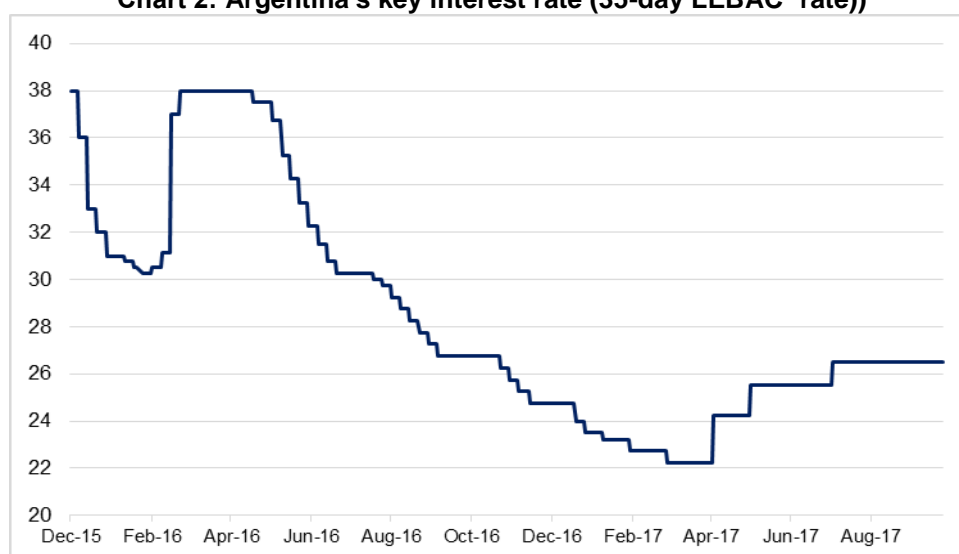
² The Central Bank of Argentina's real effective exchange rate is thus at a level close to that prior to the 2001 crisis.

1.2 At a time of high inflation and the end of recession, the thorny issue of monetary policy is more prevalent than ever

This basic trend is linked to a persistently very high rate of inflation. The peak moment, which reached 40% in 2016 – a 14-year high – is a direct consequence of "the legacy": an upswing in the money supply (+40% at the end of December 2015) to finance the budget deficit, the devaluation of the "official" peso to converge exchange rates with a very high pass-through rate in the case of depreciation (including for non-tradable goods), and finally reduced subsidies for public services (transport, energy, water), which accounted for 6.8% of GDP in 2015.

The government has introduced a bold inflation targeting policy in the hope of achieving single-digit inflation by 2019 (the target for 2017 is 17%). The Central Bank of Argentina (BCRA) abruptly raised short-term rates in early 2016, with the real rate for underlying inflation clearly entering positive territory. A tightened monetary policy has primarily led to nominal exchange rate re-appreciation but is far from having produced the expected results with respect to inflation. At the end of the first half of 2017, the annual inflation rate was around 25%. Stabilising inflation enabled the BCRA to gradually bring about a decline in the key interest rate.

Chart 2: Argentina's key interest rate (35-day LEBAC³ rate)



Source: BCRA.

The limited effectiveness of the monetary policy channel can be attributed to several factors:

- Argentina is not in a situation of excess demand for goods, services or credit (on the contrary, the recession was -2.3% in 2016) and fluctuations in interest rates mainly affect capital inflows and outflows, including via the Argentinians' arbitrage behaviour and therefore on the exchange rate channel.
- The transmission of monetary policy by interest rates is reduced by the low level of banking (according to the World Bank, one in two adults does not hold a bank account) and development of the banking system as a whole – bank loans to the non-financial private sector accounts for only 15% of GDP (see Section II below).
- The foreign exchange rate channel is highly asymmetric in Argentina: although the pass-through rate is high in the case of devaluations, disinflationary gains of a nominal appreciation are virtually

³ The *Letras del Banco Central* are short-term securities issued by the Central Bank as part of liquidity management operations. Since the exchange rate was allowed to float at the end of 2015 and until the end of 2016, the 35-day LEBAC rate was considered the primary instrument of Argentinian monetary policy. In December 2016, the Central Bank announced that the main monetary policy instrument would be the median of the 7-day repo and reverse repo rate range.

non-existent⁴ (as was observed in Q2 2016 and Q1 2017, when the peso appreciated about 10% against the dollar).

- Lastly, over and beyond the movements encouraged by the tax amnesty law, nominal appreciation has itself encouraged short-term capital inflows. As a result, the share of portfolio flows in capital flows increased from 34% to 62% between 2014 and 2016. These movements are further facilitated by measures to relax the financial account adopted at the end of 2016 and the beginning of 2017⁵: elimination of caps on the purchase and sale of foreign currencies on the local market, lifting of the 120-day minimum holding period of proceeds of disposals of portfolio investments.

1.3 The much-needed reduction in the budget deficit should facilitate disinflation and real exchange rate adjustment

The current government has inherited a highly degraded fiscal position (a deficit of 7.5% of GDP in 2015). The 2016 recession has curbed the government's room to manoeuvre in immediately consolidating the public accounts. Until the end of 2015, an increasing share of the deficit was financed by monetary issuance (about 60% in 2015). The new monetary authorities are committed to phasing out BCRA financing of the Argentinian treasury.

Moreover, budget deficit financing has changed considerably since the new government took power in late 2015. The successful return of Argentina to the financial markets following the resolution of the dispute with holdout bondholders in April 2016 enabled the government to use foreign currency bond issues to finance nearly half of its deficit.

The reduction of the budget deficit and a reduced use of monetary financing should make it possible to limit inflationary pressures and thus make it easier to carry out monetary policy. In addition, lower foreign currency bond issues could reduce capital inflows and hence pressures to appreciate the real exchange rate. Moreover, the country's nascent economic recovery is conducive to faster consolidation.

2. Economic volatility and past crises have also led to an atrophic banking sector with low financing capacity

2.1 The banking sector became concentrated after the 2001 crisis and is now showing high levels of profitability

The 2001 crisis led to a serious adjustment of the financial sector, with the number of actors reduced by half (about 80 today). Although the country's banking system began to expand in the 1990s, it now accounts for little in the economy. The lending rate to the non-financial private sector is the lowest in the region, at just over 15 percentage points of GDP. It is also abnormally low given Argentina's level of economic development⁶.

This atrophy is mainly due to the loss of confidence in the peso and in the financial system as a whole⁷, with most savings being in cash or held in foreign banks. The financial sector has also been exposed to frequent interventionism under previous governments (through the control of interest rates on consumer loans and foreign exchange rates, among others). Lastly, negative real interest rates on deposits since 2001 have discouraged savers from putting their cash in the banking sector. These real rates were all the more negative as inflation was high.

This inflationary environment results in even higher net margins for banks (nominal lending rates follow price trajectories much more closely). Empirically, there is a strong positive correlation between the rate

⁴ This asymmetry can be attributed to the following factors: anchoring to the dollar for wage and price formation with a desire to maintain purchasing power in a "strong" currency, a long-term trend towards nominal depreciation and taking this into account in stakeholders' expectations, and downward price rigidity.

⁵ See BCRA decisions 6137 and 6150.

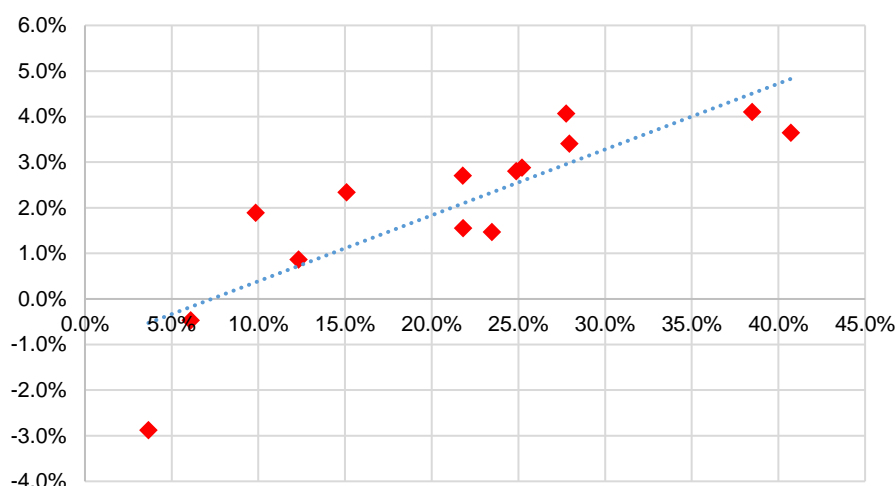
⁶ A simple linear regression using a sample group of 168 countries shows that, given its per capita income, Argentina would be in line with the global average if the private sector credit rate was about 50% of GDP.

⁷ The *corralito* (the informal name for economic measures taken during the crisis of 2001) – which involved limiting withdrawals, banning the transfer of funds abroad, and converting dollar deposits into pesos at the then overvalued official exchange rate – had a profound and lasting effect.

of inflation and the profitability of the banking sector (see Chart 3, ROA is a profitability indicator, calculated as the ratio of net margin to assets: it is therefore corrected for inflation in the numerator). In 2016, when inflation hit its highest level in almost fifteen years, the sector finished the year with an average profitability of 4.1%, while economic activity contracted by 2.4% and inflation topped 40%. This phenomenon of higher margins during periods of high inflation can also be seen in other sectors.

Generally speaking, the sector's concentration partly explains its very good profitability. Interest margins are at very satisfactory levels⁸. The real rate of return on assets is well above global standards – an average of 4% in recent years (compared to about 1% in the US for the banking sector as a whole). Increasing competition within the banking sector is one of the main goals of the new BCRA management⁹

Chart 3: Yearly inflation and profitability levels of Argentinian financial sector assets



Key: abscissa: inflation; ordinate: ROA (real return on assets).

Sources: BCRA, Indice Congreso, calculations by the authors.

In an encouraging move, in 2016 the BCRA breathed new life into mortgage loans by allowing banks to issue loans indexed on the cost of living, which makes it possible to secure the real value of the debt. In the space of a year, according to the Central Bank, mortgage loans represent more than 5% of total outstanding loans to the non-financial private sector. This is very promising, given the very low level of household indebtedness and, more generally, the need to create a credit market in the local currency in order to escape the dollar anchor. In this reform, Argentina drew inspiration from Chile's successful experience (many contracts indexed to a "Unidad de Fomento" since the early 90s).

2.2 A thriving informal savings environment

Stakeholders' lack of confidence in the banking sector and the inflationary aspect of the Argentinian economy have led to a high degree of informality. According to the World Bank, only 50% of those aged 15 and over held an account in a banking institution in Argentina in 2014. In recent years, this trend has been exacerbated by the development of a parallel dollar market, following the introduction of capital controls in 2011 (see above).

The gross saving rate has declined steadily in recent years (-8 points since 2007, reaching 16% of GDP in 2015¹⁰). Savings accumulated outside the domestic financial system, however, totalled between USD 250 and 400bn in assets¹¹, which represents between 45 and 70% of GDP.

⁸ Banking sector profits are divided equally between financial intermediation and returns on securities held by banks (primarily securities and notes from the Central Bank, with a yield of around 30% per year at the end of 2015).

⁹ New regulations call for making public all of the account-keeping and operational rates charged by banks registered in Argentina. In addition, financial institutions must now post the all-inclusive interest rate when they make a loan to a customer.

¹⁰ Source: World Bank development indicators.

¹¹ See Tax Justice Network, cabinet Ferreres and INDEC.

Up until the government's last tax amnesty program (whose unquestionable success – with \$120bn declared – is also connected to the introduction of automatic tax information exchanges), a large portion of these assets was not declared. A substantial amount of foreign currency was held by households outside the formal financial system

3. A two-track economy: highly productive agriculture and rent-seeking behaviour in protected sectors

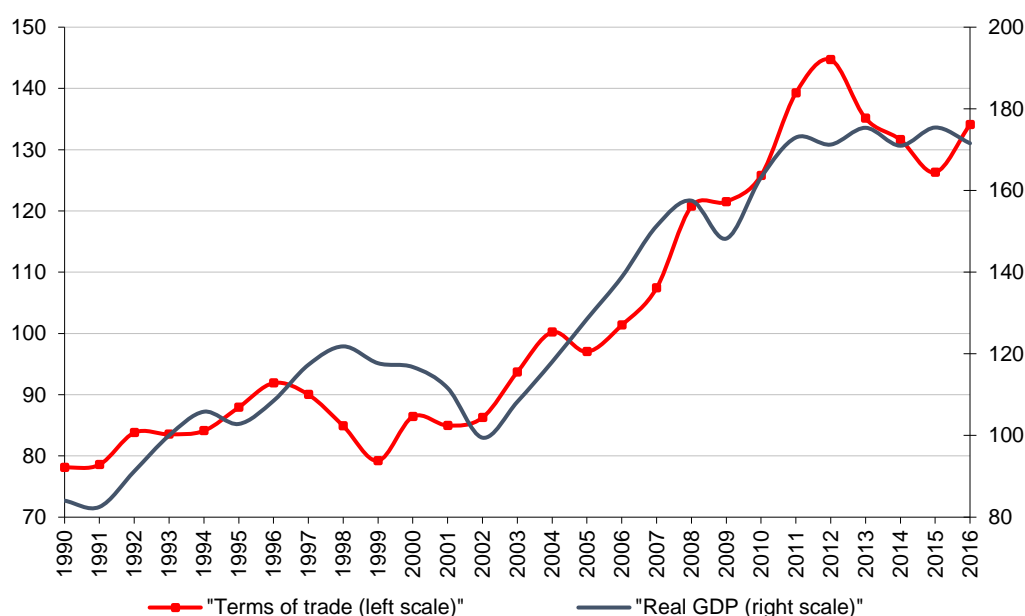
3.1 A significant shock in terms of trade in recent years

Several factors explain the strong adjustment rigidities presented in Part I. In addition to periods of fixed exchange rate regimes¹² or similar measures, continuous productivity gains in the agricultural sector since the mid-1990s, followed by changes in the terms of trade may have contributed to the emergence of a specific "Dutch disease" phenomenon (usually this is more likely to occur in oil or gas economies).

The literature singles out three types of economic shocks that may lead to Dutch disease: i) a discovery of natural resources, (ii) a productivity shock in the export sector and iii) an exogenous positive shock in the terms of trade¹³. In one or more of these cases, if the export sector surplus is spent in the non-tradable goods sector, the price of goods produced in this sector increases and leads to an appreciation of the real exchange rate.

Between 1990 and 2015, the seeded area of soybeans was multiplied fourfold, from 16% of the agricultural area (5 million ha) to 67% (20 million ha). This supply shock was also fuelled by a sharp upswing in productivity, which is already traditionally high in this sector. This was specifically due to the use of genetically modified soybeans and the simpler production technique of direct seeding¹⁴. This movement, which began in the 1970s, expanded in the 1990s and is now the norm. In 2012, according to the Ministry of Agriculture, 98% of soybeans, 20% of cotton and 40% of maize were produced from GMO seeds. From 2003 onwards, the sector benefited from a price shock with a spike in the price of raw materials, especially soy, which led to a very substantial improvement in the terms of trade up to 2010. Today, 60% of exports consist of processed and unprocessed commodities (half for the soybean sector).

Chart 4: Terms of trade and economic activity since 1990



Sources: INDEC, authors' calculations.

¹² Crawling peg with exchange control from 2011 to 2015, currency board and strict dollar/peso parity in the 1990s, notably.

¹³ See, for example, W. M. Corden's seminal paper "Booming Sector and Dutch Disease Economics: Survey and Consolidation", *Oxford Economic Papers* Vol 36. No. 3 (1984).

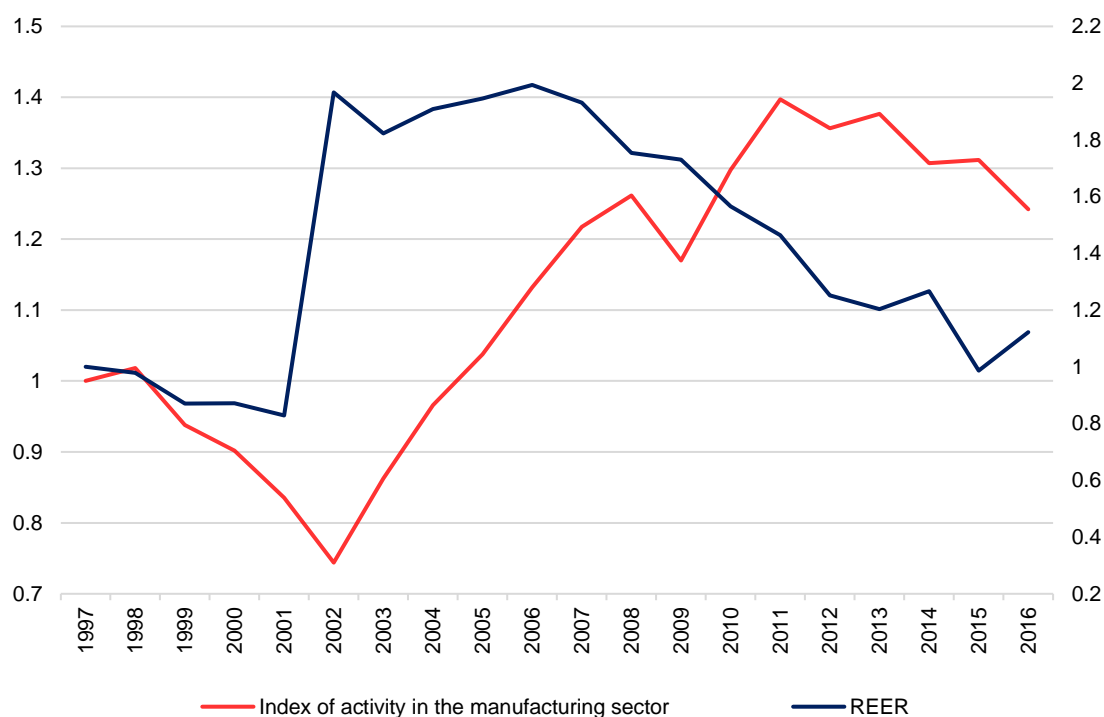
¹⁴ The direct-seeding technique allows grains and oilseeds to be sowed without tillage.

3.2 Competition does not stimulate industrial production sufficiently

At the same time, the performance of the industrial sector continues to lag well behind. Most analysts attribute this to a combination of macroeconomic (exchange rate volatility) and structural factors (limited domestic and external competition).

- i/ The phases of real appreciation – which have been noteworthy over the past 25 years – have coincided with a sharp drop in the manufacturing industry. This phenomenon has been visible since 1997 (see chart). The strong rebound in the manufacturing sector starting in 2003 was broken off in 2011, when growth in nominal wages began to significantly outpace inflation, at a time of zero growth.
- ii/ The period between 2011 and 2015 witnessed the introduction of foreign exchange controls and a shortage of international currencies, in a context of overvalued real exchange rates. This prompted companies to call for maintaining protectionist measures. Heightened import restrictions in 2012 (the "DJAI" import reporting system), however, led to the WTO finding that the country was in breach of international trade rules and a request for compliance by the end of 2015.
- iii/ In addition, numerous barriers to competition impedes the country's competitiveness (see box below).

Chart 5: Manufacturing and Real Effective Exchange Rate (REER) since 1997

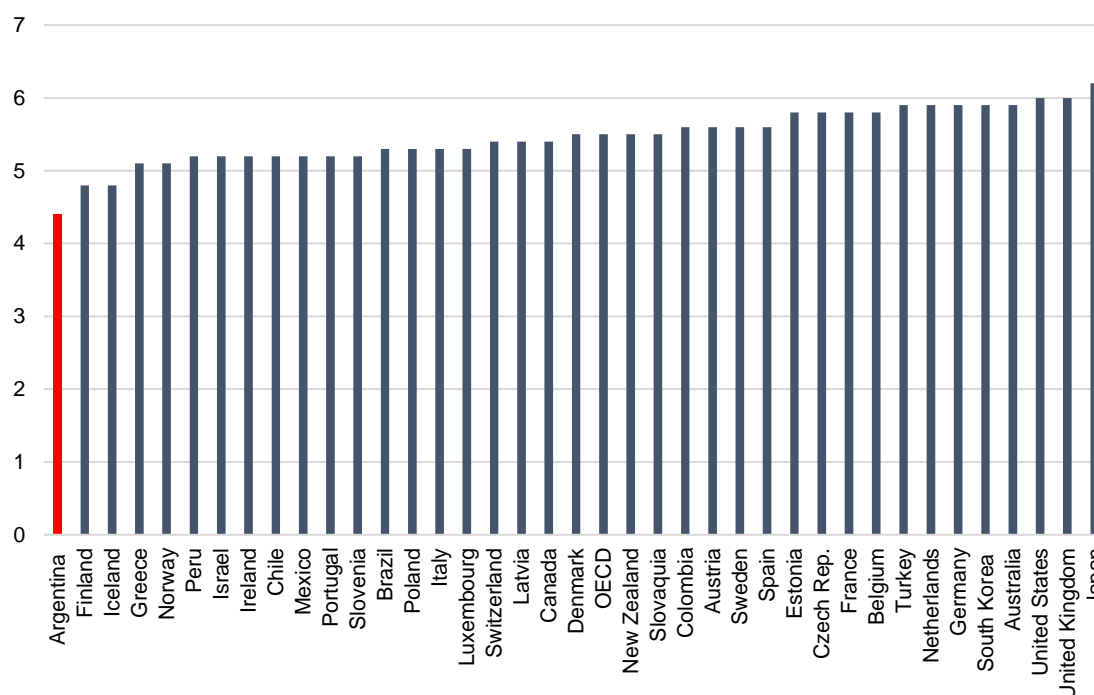


Sources: INDEC, Ministerio de trabajo, BIS, authors' calculations.

Box: Are barriers to competition a drag on competitiveness?

The very low competition in the Argentinian economy and the lack of domestic investment to support transformation of the country's manufacturing facilities¹⁵ result in significant behaviour concerning mark-ups. Compared with the levels observed in OECD countries, Argentina highly regulates the functioning of its markets (its product market regulation (PMR) index is greater than 3, against the OECD average of just under 1.5).

Chart 6: Intensity of competition in different economies (2016–2017)



Source: World Economic Forum Global Competitiveness Index Dataset (after OECD). A score of 7 reflects a very high level of competition, and 0 a very low level of competition.

The National Commission for the Defence of Competition (CNDC), which was set up in 1980, is currently under the Ministry of Commerce. Its remit includes monitoring mergers and acquisitions and sanctioning anti-competitive practices. A draft reform of the Competition Act, adopted in 1999, is currently under consideration. It calls for effective implementation of the National Competition Tribunal (TNDC), an independent enforcement agency that was set up under the 1999 Act but never convened.

In the transport sector, the lack of an alternative to road transport generates considerable logistical costs, making certain internal areas of Argentina much more expensive than very long-distance transport, which also limits domestic competition between the various provinces.

One of the present government's goals is to break with the insufficient openness of the economy (the rate of trade opening was barely 23% in 2015, compared with about 40% in 2005) and its negative effects on productivity. It has abolished the old import reporting system and replaced it with a more flexible system of automatic permits for 80% of tariff lines¹⁶. One of the government's priorities is to conclude free trade agreements, in particular an association agreement between Mercosur and the EU. This type of agreement would bring down the common external tariff in place within Mercosur, which can be as high as 35% for the most "sensitive" goods (cars, toys and textiles).

¹⁵ Over the last 10 years, the average national investment rate was less than 17% (source: INDEC).

¹⁶ Non-automatic permits are approved within 70 days.

3.3 Abundant human and technological capital that has fostered the rise of high-tech sectors, but whose development faces institutional rigidities

- **Argentina has strong assets in terms of human capital.** Argentina is the Latin American country with the highest number of students enrolled in higher education per 100,000 inhabitants (more than 6,500 in 2013). It also has the region's highest percentage of graduates among those aged 25 to 29 (23%). The quality of research in Argentina is also renowned regionally: it had the highest number of researchers per thousand workers in 2012 (3.0), followed by Costa Rica (2.1) and Brazil (1.5). Argentina is also ranked 15th in the world for English proficiency¹⁷.

On the other hand, the resources available for research remain limited, with R&D spending of only 0.6% of GDP (the second-highest in the region after Brazil at 1.15%), despite the emergence of sectors of excellence at the forefront of technology (nuclear, aerospace, IT)¹⁸.

- **Despite these strengths, aggregate labour productivity is low and the unit labour costs are relatively high,** which is also related to a certain number of rigidities in the labour market.

i/ Collective bargaining centralized by major sectors: according to economic theory this type of negotiation is the least efficient¹⁹. Company-level agreements remain limited, covering only 9% of employees in 2016²⁰. The tripartite wage agreements signed between 2011 and 2015 resulted in real wage gains in the formal sector that were well above the economy's growth rate, which was basically zero during that period. Moreover, these agreements rarely cover issues of work organisation or productivity improvement in return for higher wages²¹.

ii/ Conflict at work is high. According to the Occupational Risk Insurers Association (ART), there more than 120,000 lawsuits were filed in 2016 by employees against their employer, but the courts were able to process only 35,000 of them. Unprocessed legal claims currently total 340,000, representing a contingent liability for companies in the sector of 0.8 percentage point of GDP. In February 2017, the government passed a law (strengthening the role of medical commissions prior to proceedings), which showed immediately results (a 20% drop in new cases in two months)²².

iii/ Labour market regulation is not conducive to stimulating productivity gains: there are few variable performance-related pay schemes²³, compared with "fixed" bonuses (13th month calculated on the basis of the highest monthly wage) or seniority bonuses (increased days of leave based on seniority). Moreover, the absence of a unified labour code (labour law is governed by a variety of laws, including the Employment Contract Law, and regulations) is often seen as a source of complexity, leading to excessive "litigation" of disputes²⁴.

¹⁷ Source: Education First (2015).

¹⁸ See, for example, Crespi and Zuniga (2012).

¹⁹ See, for example, Calmfors and Hoel (1988), Carlos Lamarche (2013) and Pierre Cahuc (1990).

²⁰ Data from the Ministry of Labour, Employment and Social Security, see the document "Estado de la negociacion colectiva durante el año 2016".

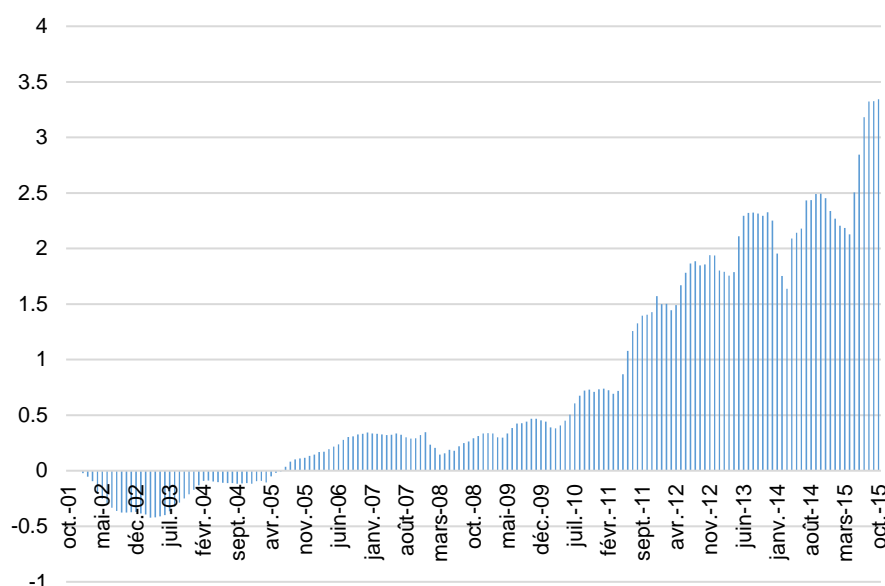
²¹ On the issue of productivity in Argentina, see the BID's working document by Urbitztondo, Cristini, Moskovits and Saiegh (2009).

²² To relieve the courts and restore the financial equilibrium of the sector's insurers, which are coping with an unsustainable model, every insured individual must now, before initiating legal proceedings, undergo a medical examination to certify his or her level of disability. "Jurisdictional medical committees" should thus constitute a mandatory prerequisite prior to initiating proceedings.

²³ See Adriana Marshall (2015), "La relacion salarios-productividad: los incentivos salariales en los convenios colectivos industriales", Trabajo y Sociedad.

²⁴ <http://www.iprofesional.com/notas/107138-Buscan-por-ley-sancionar-un-Codigo-de-Trabajo>

Chart 7: Growth in real wages (2001–2015, year-on-year)



Source: INDEC, IPC congresso, authors' calculations.

- Given the lack of competitiveness and the weakness of the economic recovery in early 2017, the Argentinian government is working with the various industrial sectors and trade unions to raise the issue of the relationship between productivity gains and wage increases. For example, a tripartite agreement was reached in late 2016 to improve the profitability of the part of the petroleum sector focused on exploiting unconventional gas and oil fields in the province of Neuquen²⁵.
- At national level, there is also the issue of introducing a wage bargaining system that limits the impact of a "wage-price loop". The government wants the Central Bank to be credible so that its inflation target is taken into account during wage negotiations, shifting from a backward-looking approach to a more forward-looking one²⁶.
- Progress in reforms to increase competition in the goods market and the government's planned labour market reform, together with the gradual effects of trade liberalisation, will play a key role in achieving real discipline in price formation.

Christian GIANELLA, Leonardo PUPPETTO, Sophie WIEVIORKA

²⁵ See https://www.clarin.com/ieco/macri-pereyra-solas-olivos-convenio-vaca-muerta-cumple-normalmente-dijo-gremialista_0_BkgeMB8b-.html. The planned revision of the collective agreement will no longer include remuneration of employees during transport to the production site, lower wages for weekend work, and the possibility of night work.

²⁶ In addition, the government has the option to not approve wage agreements if it considers that the adjustment negotiated by the stakeholders is too far from its goal (the government intervened several times in 2017 in issues involving minimum wage increases).

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