Urgent Course Correction: Lessons for Argentina and the US

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Perhaps odd at first glance, comparisons between the United States and Argentina more frequently surface.[1] Today, the respective relevance of each nation for the other is no accident. Emerging market nations such as Argentina provide critical economic policy case studies for advanced economies and vice-versa. Many advanced economies now confront challenges once witnessed largely in less developed countries, such as a dramatic expansion in government spending in excess of revenues, an unusually large creation of money, and specter of default on sovereign obligations.

So, there are unfortunately many parallels between the US and Argentina. **Each nation confronts a serious growth challenge.** Fortunately, examination of history over a nearly four decade period offers actionable solutions to the growth quandary for each nation.

Challenge Argentina: **Argentina risks a collapse in growth**,[2] as commodity prices are no longer increasing. Any economic downturn in Argentina will likely be profound – due to the potential for accompanying capital flight and freeze in available credit.

Solution Argentina: **The authorities would benefit from creating a more welcoming environment for investment.** The windfall of foreign exchange earnings accumulated since 2002 from high commodity prices provides Argentina with a tremendous financial cushion and the ability to constructively shift its policy thrust toward a strong and stable long-term growth path. Argentina must limit the expansion of the public sector, strengthen its institutions and rule of law – creating an environment similar to advanced economies such as the US or Brazil, China, and India in the emerging world, and normalize relations with creditors.

Challenge US: The US risks serious economic stagnation with mounting unemployment. Uncertainty among corporations and consumers is unusually high and the recent recovery is fragile. **Unaddressed, the US economy and financial markets will face even more punishing fluctuations and face further credit downgrades.**

Solution US: The US should avoid measures that promote uncertainty such as overly activist policy intervention and ill-studied regulation. For instance, the "burden of government regulation" is now deemed more troublesome in the US than China.[3] Reactive government intervention and regulation – often characteristic of the Argentine policy thrust over the last several decades – often accentuates business cycle volatility. **The US should embrace a longer-term bipartisan solution to fiscal challenges[4] and regulatory uncertainty. In other words, time is of the essence for the implementation of a self-developed and self-directed comprehensive economic program to restore the damage from a credit downgrade.**

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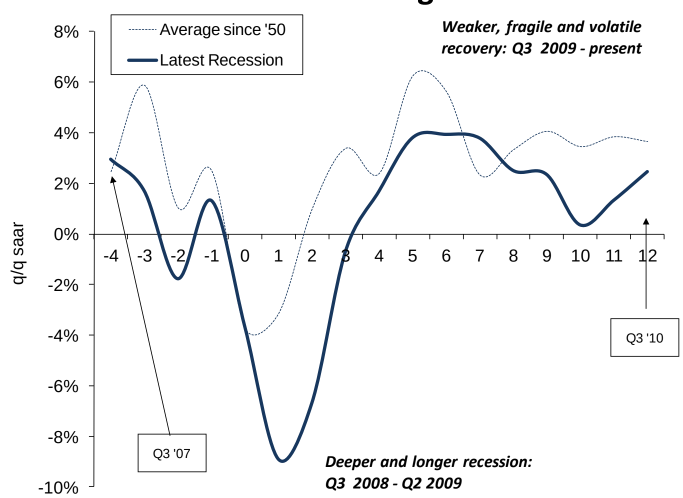
[1] O'Grady, Mary, "Argentina's Warning to America," Wall Street Journal – October 17, 2011 and Mount, Ian, "Argentina's Turnaround Tango," The New York Times – September 1, 2011.
[2] Undersecretary for Finance Adrian Cosentino underscored the priority of "strong, balanced and stable" growth at the Emerging Market Trade Association (EMTA) Forum in Buenos Aires – May 12, 2011.
[3] http://www.weforum.org/issues/global-competitiveness
[4] Hering, Susan and Lawrence Goodman, "Budget Solutions: Then and Now," CFS – July 19, 2011.

Challenges to Economic Growth

The US and Argentina confront serious growth challenges ahead. The US faces the threat of no growth and economic stagnation, whereas Argentina risks collapse of economic activity.

The US faces an uphill road to recovery. The recent recession was far deeper than we have seen historically and extended over a longer period (see Figure 1). For example, the average recession witnessed between 1950 and 2005 lasted for only two quarters and was accompanied by an annualized slide of 3.1% to 3.7%. In contrast, the recent recession extended a full four quarters with a stunning decline of 8.9%. The pace of recovery in subsequent quarters is even more troublesome with growth well below the usual post-recession period and strong evidence of an economy on the verge of a double dip.

Figure 1. Severe Growth Challenge in the United States



Note: The X-axis represents quarters in event time. "0" is the recession start.
Source: Bureau of Economic Analysis and Center for Financial Stability Inc.

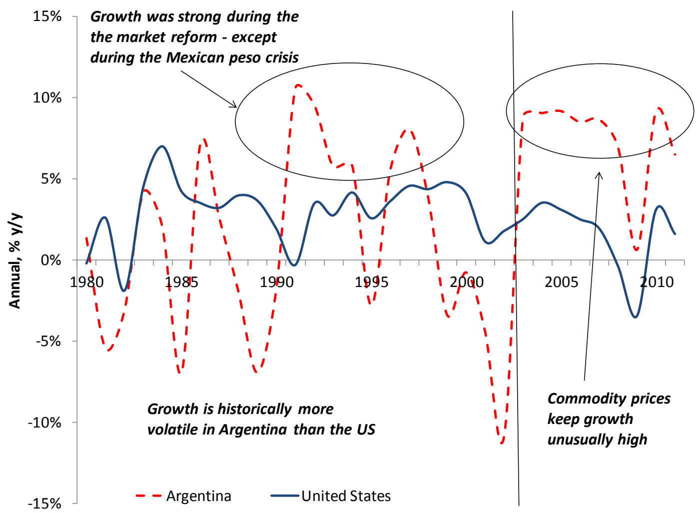
Policy uncertainty is at the core of the restrained recovery in the US. Uncertainty surrounding future policy measures and regulations has clearly sidelined investors contemplating an expansion of business operations. For example, we quantified the level of uncertainty in the US economy through an evaluation of the volatility of the components of GDP in an earlier research report.[5] The conclusion was clear. **The level of uncertainty was higher than at any time since the Korean War.** In fact, previous episodes of high levels of uncertainty often prompted a double dip recession. This is certainly a major risk today.

The performance of Argentina over the last three decades chronicles intense policy uncertainty and an extraordinarily volatile business cycle. Interventionist policy stances by officials coupled with swings in commodity prices often unleashed unusually wide fluctuations in economic activity and financial markets. In fact, growth in Argentina over the last 30 years has been substantially more volatile than in the US (see Figure 2), due to fluctuations in policy and commodity prices.

[5] Goodman, Lawrence and Yubo Wang, "Uneven, Uncertain and Unusual Recovery," Center for Financial Stability - July 29, 2010

The Argentine economy performed at its best during two distinct periods over the last 30 years (see Figure 2). First, the economy performed extremely well during the market reform period between 1990 and 1998. GDP grew on average by 6.3% during this period that even included a recession in 1995 triggered by the Mexican peso crisis. Second, the recent period between 2002 and the present is also exceptional with average growth of 7.5%.

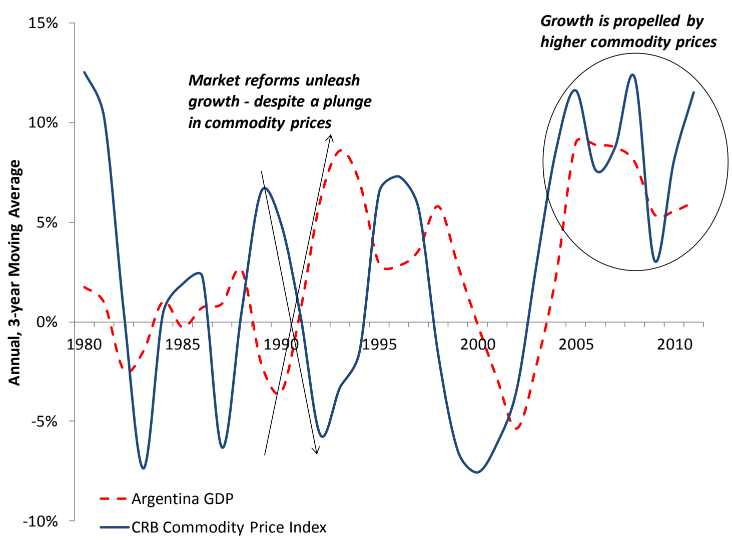
Figure 2. Wide Fluctuations in Argentine versus US Growth



Source: International Monetary Fund and Center for Financial Stability Inc.

At first glance, the present growth burst of 7.5% on average seems far superior to the 6.3% witnessed in the early-to-mid 1990s. However, commodities and commodity related activities drove exports, public revenues, and GDP. For instance, a whopping 165% advance in commodity prices played a major role in driving growth higher between 2002 and the present. Interestingly, commodity prices actually fell by 11% during the market reform period between 1990 and 1998 (see Figure 3), illustrating the favorable impact of policies designed to promote and welcome international and domestic investment.

Figure 3. High Commodity Prices or Sound Public Policies Needed for Growth

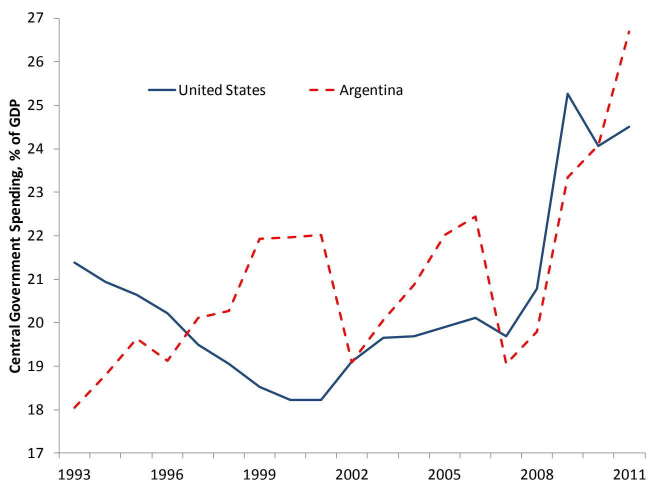


Source: Reuters-Jefferies CRB and Center for Financial Stability Inc.

In other words, Argentina can grow via high commodity prices or a sound policy framework. The former is more variable and subject to the whims of external forces; whereas the latter is more dependable over time.

The Argentine economy is now more dependent on continually increasing commodity prices than at any time over the last 10 years (see Figure 3), especially with the growth in the size of the public sector (see Figure 4). The central government in Argentina now represents nearly 27% of the overall economy up from about 20% before the peso crisis. In fact, public surpluses have already evaporated. Going forward, if commodity prices stabilize at present levels, the expanded public sector will quickly encounter a more pronounced shortfall in revenues. If commodity prices fall, the situation deteriorates dramatically. This is beginning to be the case with respect to wheat, soybeans, and the price of other commodity exports.

Figure 4. Expanding Governments



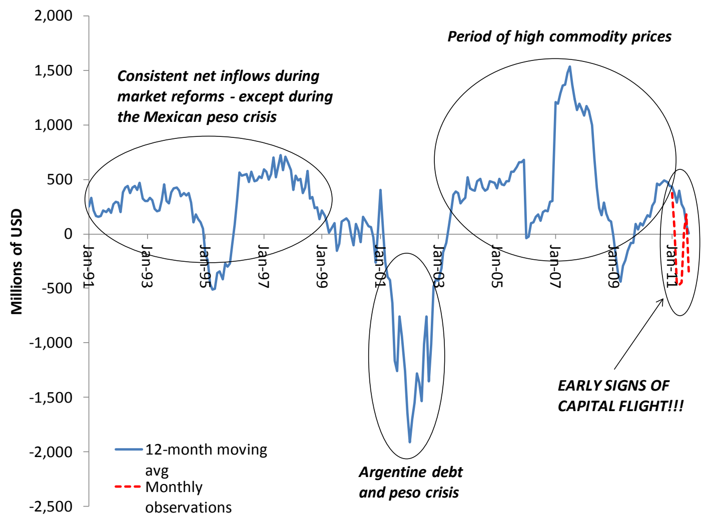
Source: Datastream and Center for Financial Stability Inc.

In Argentina, the public expansion took the form of strong public spending initiatives. In fact, Argentina's public expansion since 2002 was the third largest among the top 37 economies followed by the Center for Financial Stability. Only Ecuador and the UK engaged in a more active expansion of the public sector. Portugal and Greece demonstrated the fourth and fifth most aggressive public spending binges during the period. More directly, commodity exporters similar to Argentina such as Canada, Chile, Brazil, and Australia were 20th, 22nd, 24th and 25th on the list. In other words, most commodity exporters demonstrated a minimal-to-no expansion in the size of their government relative to GDP.

Participants in the Argentine economy are already nervous. "Hot money" is flowing out (see Figure 5). This signals a lack of confidence in the present policy thrust as well as questions regarding the nation's ability to access foreign exchange in the future.

"Hot money" capital **inflows** came to a halt late in 2010 and now **outflows** or capital flight is evident. Consistent capital inflows are vital for emerging economies to spur investment and development. In contrast, capital flight or the reversal of hot money threatens to destabilize production, disrupt consumption, and unleash inflation.

Figure 5. Hot Money in Argentina



Source: Banco Central de la República Argentina and Center for Financial Stability Inc.

The present policy mix in Argentina promotes capital flight. First, there is no incentive for investors to keep funds in pesos, as interest rates are negative in real terms. Second, many respected and independent private research institutes place inflation at more than double (around 25%) the official release of 9.9%. Uncertainty surrounding inflation dents investment prospects, as investors appreciate as much certainty as possible in a highly imprecise world. In other words, the degree to which real interest rates are negative is highly uncertain. Likewise, the existence of alternative measures of inflation that are at odds with official releases damages the credibility of government. Lastly, Argentina's track record of creating an environment conducive to long-term investment is dismal. With commodity price gains on the wane, it is no wonder that capital is beginning to flee.

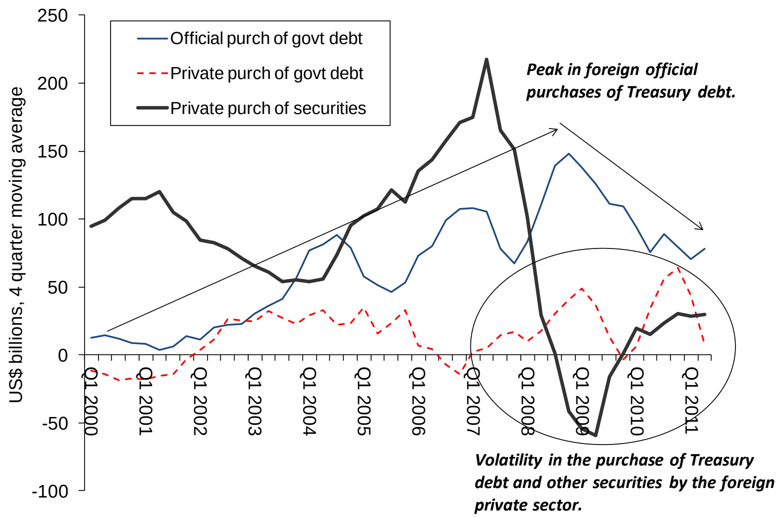
Most fortunately for Argentina, pressing risks potentially leading to instability can be reversed.

Unfortunately, the expansion of the US public sector parallels the Argentine experience. As a point of comparison, the US public sector spending spree was the eighth largest between 2002 and 2011. In other words, the US will also encounter serious challenges in coming weeks-to-months as fiscal policy wields less force to lever growth and added expansion potentially results in longer-term damage to the economy.

Capital flight is not presently an issue for the US. However, major central banks have dramatically altered their foreign exchange reserve management strategies to de-emphasize holdings of US dollars in favor of a wider range of currencies – despite the recent "flight to quality" assets by many market participants.[6] For example, official purchases of US government debt have fallen from peak inflows in 2008. Similarly, the foreign private sector is demonstrating more skittishness regarding investment into the US (see Figure 6).

[6] Goodman, Lawrence, "The New "International Currency System," Center for Financial Stability - January 21, 2011.

Figure 6. Less Secure Capital Flows into the US



Source: Bureau of Economic Analysis and Center for Financial Stability Inc.

The Power of Institutions and the Rule of Law

In difficult times, the strength of institutions is vital for attracting and maintaining foreign and domestic capital alike. Fragile institutions coupled with faulty fundamentals present a recipe for volatile growth or excessively deep recessions.

Well before the most recent crisis, Larry Summers highlighted three factors imperative for economic growth. They include a nation's ability to: 1) "integrate with the global economy through trade and investment," 2) "maintain sustainable government finances and sound money," and 3) **"put in place an institutional environment in which contracts can be enforced and property rights can be established."**[7]

Sound macro management and trade policy largely accounts for the first two factors cited by Summers. Although complex, many mechanisms exist to assess macro fundamentals - as we have sketched in the earlier part of the paper. In the first factor, Summers highlights the need for a nation to "integrate" with the global economy via trade and investment. Evaluation in the case of Argentina is somewhat difficult, as the commodity trade naturally helps "integrate" the nation with the rest of the world. However, Argentina's "integration" with the rest of the world is impaired, due largely to its repudiation of contracts as well as restricted involvement with international agencies such as the IMF. From a country analysis and sovereign risk perspective, these shortcomings are more appropriately bunched and addressed in the third factor cited by Summers - the power of institutions and the rule of law.

The power of institutions and the rule of law are more complex to evaluate. However, the World Economic Forum's Global Competitiveness Index (GCI)[8] provides rich detail on 12 "pillars" of competitiveness ranging from institutions to health to innovation, etc. Although the overall GCI index is of interest, details from the survey provide a powerful glimpse into specific structural areas within a nation.

[7] Summers, Lawrence, "Godkin Lectures," Harvard University, Kennedy School of Government, 2003.
[8] http://www.weforum.org/issues/global-competitiveness

We delve deeper into the many GCI components to create our own country indicator of the power of "Institutions and Rule of Law" or IRL (see Figure 7). Although education, health, technological readiness, innovation, etc. are critical for individual investments, a more circumscribed evaluation of the rule of law is vital especially during times when a nation is challenged by the threat of capital flight.

Figure 7. Institutions and Rule of Law (IRL) Index, 2010-11

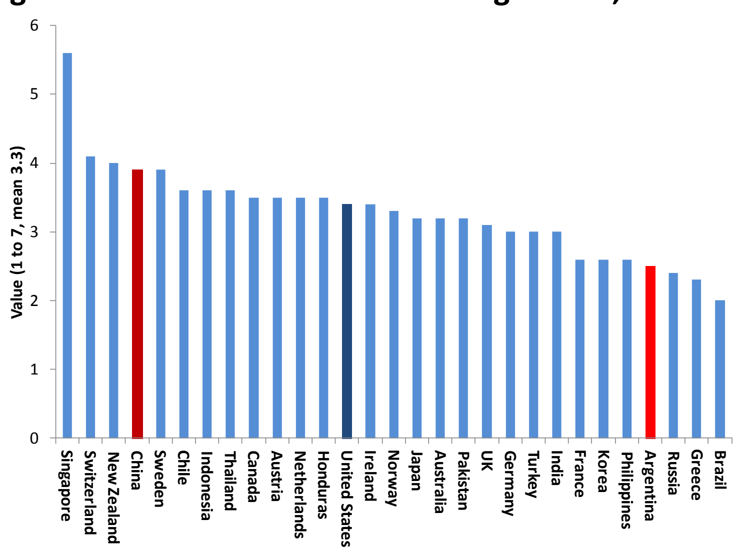
	US	China	India	Brazil	Russia	Argentina
Property rights	39	41	69	59	130	133
Burden of government regulation	58	21	96	142	132	131
Efficiency of legal framework in settling disputes	36	42	64	75	123	124
Efficacy of corporate boards	26	77	80	49	123	110
Strength of investor protection	5	77	36	60	77	93
IRL	**33**	**52**	**69**	**77**	**117**	**118**
GCI	5	26	56	53	66	85

Note: Scores represent rankings. Lower / higher scores represent low / high risk.
Source: WEF Global Competitiveness Index and Center for Financial Stability Inc.

Not surprisingly, Argentina compares poorly vis-à-vis the US. Even a fuller and fairer comparison with Brazil, Russia, India, and China (the "BRICs") demonstrates profound institutional weakness. Argentina has an IRL rank of 118 out of 142 countries or the highest among the countries evaluated in our study. Argentina's performance is the weakest in enforcement of "property rights, "efficiency of legal framework in settling disputes," and the "strength of investor protection." In the evaluation of "efficacy of corporate boards," only Russia demonstrates a modestly poorer performance than Argentina.

Interestingly, the "burden of government regulation" is most pressing in Brazil and Russia. The government regulation category measures how difficult it is for businesses in the specified country to "comply with governmental administrative requirements."

Figure 8. Burden of Government Regulation, 2010-11

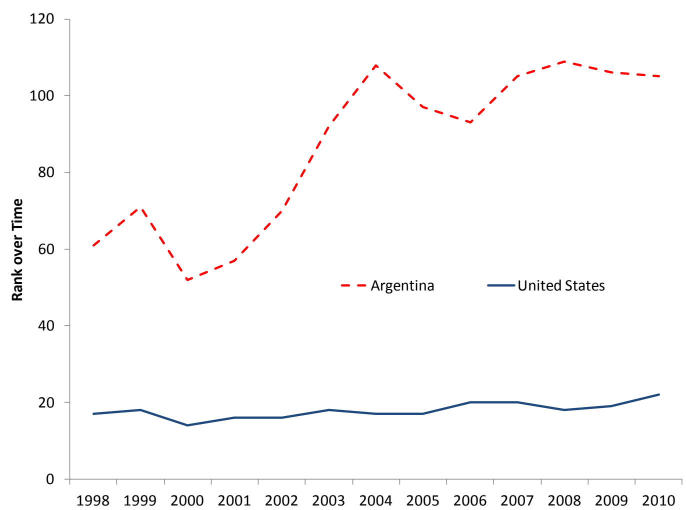


Note: 1 = extremely burdensome, 7 = not burdensome at all
Source: WEF Global Competitiveness Index and Center for Financial Stability Inc.

Surprisingly, government regulation in the US is unexpectedly burdensome especially in comparison with China. The US is the 58th least encumbered by regulation in contrast to China, which is the 21st least burdened nation (see Figure 7). Likewise, government regulation is the area where the US performs the worst among the five components in the IRL index. Regulation in the US is deemed more crippling for business than in many nations such as Singapore, Switzerland, New Zealand, Sweden, Chile, and others (see Figure 8).

Unfortunately, the GCI survey provides a snapshot of only the present situation in a particular nation. Officials and market participants would clearly benefit from an assessment over time – which is virtually impossible to create with the available GCI data. Fortunately, the Transparency International Corruptions Perception Index (CPI)[9] provides a mechanism for gauging shifts over time in relative levels of corruption (see Figure 9). Although the CPI is a highly imperfect proxy for competitiveness or institutions and the rule of law, the concepts are similar in tracking the openness and ease of conducting business.

Figure 9. Corruption Perceptions Index, 2010-11



Source: Transparency International and Center for Financial Stability Inc.

The results of the CPI over time are somewhat concerning for the US and highly troubling for Argentina. The US went from the 14th to the 22nd least corrupt nation at present in survey of 178 countries. Similarly, Argentina went from the 52nd to the 105th least corrupt nation by 2010-11.

The Future: Practical Policy Measures

Ironically, the solution to Argentina's growth risks is easier to implement and more direct than comparable measures requisite to meet presently pressing challenges in the US.

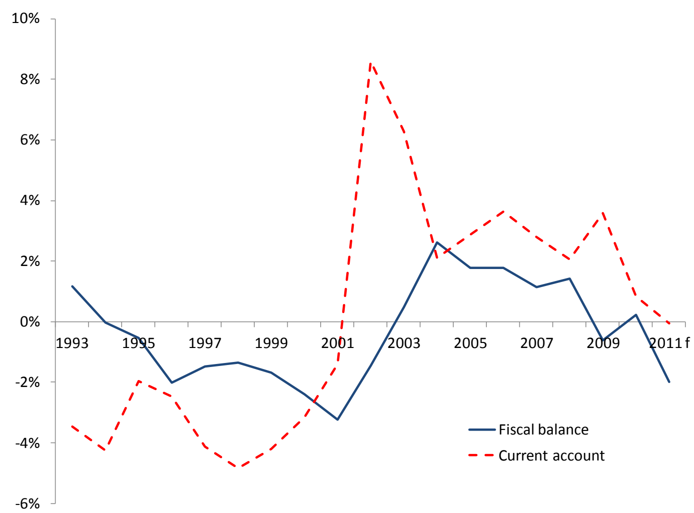
Argentina must welcome investors. Opportunities in Argentina are vast and potential rewards (for society as well as investors) are handsome. Argentina is a prosperous nation, with potential for sustained and consistent growth in commodity and non-commodity sectors alike. **To unleash the potential of the Argentine economy:**

[9] http://www.transparency.org/policy_research/surveys_indices/cpi

- **First, the authorities must immediately limit the expansion of the public sector.** Growth in government spending is prompting a shift in the fiscal balance from a surplus of 2.6% in 2004 to an expected deficit of 2.0% in 2011 (see Figure 10). Similarly, public spending is boosting demand for imports. With a halt in commodity price gains, export growth is suspended and the current account balance is now expected to register a deficit of 0.1% of GDP in 2011 – down from a surplus of 8.6% in 2002.

  Based on our estimates, the Argentine peso is undervalued based on official inflation estimates and appropriately valued based on assumptions from private entities. This should help restore stability to the external accounts. Similarly, if restraint is restored to public spending, import demand will remain limited and capital flight will cease and potentially be reversed.

Figure 10. Surpluses Swing to Deficits



Source: International Monetary Fund and Center for Financial Stability Inc.

- **Second, Argentina would benefit from strengthening its institutions and demonstrating leadership in resolving international and domestic legal disputes.** Presently, disputes with the government of Argentina exist in countries as far reaching as the United States, Germany, Italy, Japan, France, Belgium, Switzerland, Luxemburg, and even Argentina.[10]

- **Lastly, Argentina would benefit from normalizing relations with creditors.** At present, the timing is ideal. Argentina will need future access to international capital markets as well as credit from friendly bilateral nations. Meaningful credits will be difficult to secure with arrears of $6.4 billion to the Paris Club group of official creditors.[11] Similarly, relations with creditors will improve via repaying or rescheduling arrears to private creditors of $11.3 billion. Balance of payments surpluses earned over the last few years coincident with strong commodity prices positions the nation well to use resources to restructure past due obligations to other governments as well as private creditors.

[10] "Annual Report of the Republic of Argentina," United States Securities and Exchange Commission, September 30, 2011.
[11] http://www.clubdeparis.org/en/

> Argentina has the financial wherewithal to make a down-payment on prior obligations. For example, total past due credits of $17.7 billion represent just over two months of import coverage – which readily exists in the $50 billion in foreign exchange reserves. To be sure, the Republic would not be compelled to whittle reserve coverage by even close to 2 months of import coverage to restore credibility. Nonetheless, substantial capacity exists to normalize relations with creditors for Argentina and to move on.

Normalization of relations with creditors is vital for growth especially in the new era of inevitable future sovereign defaults and debt restructurings. Quite simply, nations that maintain favorable relations within the international economic system perform better during good and bad times. Nations outside of the system, perform worse in all times. The examples of Chile and Ecuador during Brady debt negotiations immediately surface. Chile last restructured its debt in 1988. Negotiations began in May and concluded fairly for debtors and creditors in August of the same year.[12] In contrast, Ecuador suspended payments on interest in 1987 negotiated with creditors between 1988 and 1995 finally reaching a Brady deal and subsequently defaulting in 1999.[13] Since 1988, growth has averaged 5.4% in Chile and 3.5% in Ecuador. To be sure, liability management alone does not make growth, but it helps.

There is more to the story than simply growth differences from varying debt management strategies. During the Brady negotiations, Ecuador was a relatively small debtor and not of systemic importance. In other words, private and official creditors were firmer with Ecuador and more likely to withhold credit from the nation to set an example for larger debtor nations. **Today, Argentina risks slipping into the position once occupied by Ecuador and bearing the wrath of bilateral nations willing to restrain credit in a potential future time of need.** As the specter of larger European defaults and restructurings loom, Argentina can readily be made the example to avoid precedent setting behavior. **This would starve the nation from medium term credits as well as potentially vital trade lines during the next few years when maturing principal repayments mount.**

Challenges for the US remain severe. One needs to look no further than the Standard & Poor's downgrade of the US sovereign credit below the coveted AAA rating for the first time in 70 years as evidence that serious structural shifts are beginning to adversely impact the structural integrity of the US economy and for that matter the nation's long-term growth prospects.

Time is of the essence for the implementation of a self-developed and self-directed comprehensive program to restore the damage from a credit downgrade and reverse an unsustainable course in public spending. First, a medium to long term program would prioritize a move toward fiscal equilibrium with immediate and credible measures to put the fiscal balance on a path toward sustainability.[14] Second, debt management would need to take advantage of market demand for long

[12] Arteta, Carlos and Galina Hale, "Sovereign Debt Crises and Credit to the Private Sector" Board of Governors of the Federal Reserve System – December 15, 2006.
[13] Sturzenegger, Federico and Jeromin Zettelmeyer, "Debt Defaults and Lessons from a Decade of Crises," MIT Press, 2006.
[14] Hering, Susan and Lawrence Goodman, "Budget Solutions: Then and Now," Center for Financial Stability – July 19, 2011.

duration obligations and simultaneously develop a safer debt amortization profile.[15] Lastly, the authorities would need to develop measures to safeguard the nation from future financial crisis yet fall far short of strangling the availability of credit for growing organizations. Officials should strive to implement regulation to provide clear rules of the game for businesses – while prioritizing retention of incentives – to promote confidence for future investment.

Final Thoughts

In conclusion, the surprising coincidence of economic challenges in Argentina and the US provides each nation with an opportunity to revamp respective policies with a clearer focus on restoring economic growth and stability.

Argentina has a unique ability to orchestrate leadership to gain more control of its economy and reenter the world of international economics and finance.

The US has a steeper climb with needed focus on a credible plan to reverse factors that led to a slide in the coveted AAA credit standing.

With thanks to Robin Lumsdaine and Bruce Tuckman for comments.

[15] Goodman, Lawrence, "Treasury Maturities: The Other Fiscal Problem," Center for Financial Stability – March 10, 2011.