A Case of "Reverse Convergence"

Miguel Kiguel

Former Under Secretary of Finance and Chief Advisor to the Minister of the Economy, Argentina; Former President, Banco Hipotecario; Director, Econviews; Professor, Universidad Torcuato Di Tella

Argentina's growth performance in the last century represents one of the largest mysteries within the world economy as it has moved from being a prosperous, developed country at the beginning of the 20th century to joining the group of emerging countries 100 years later. Perhaps it is a unique example of reverse convergence.

Argentina's big success story took place between the 1880s and the 1920s. When the country was integrated into the world economy, it was one of the major suppliers of food and raw materials to the world. It was also a magnet for foreign direct investment and for poor workers who were leaving Europe and searching for opportunities in the new world. Those were the golden years.

The Great Depression of the 1930s marked a turning point. The drop in commodity prices, the trade barriers that developed countries imposed on Argentina's exports, and the sudden stop of capital flows from the large financial centers to countries like Argentina created the conditions of a change in the development paradigm.

The new world economic order at that time was characterized by more protectionism in Europe and the U.S., and the policy response in Argentina was a shift towards industrialization and import substitution. The new policy approach created tensions between the traditional export sectors (mainly the agricultural/beef sectors) that were efficient and for many years continued to be the main suppliers of foreign exchange, and the infant industrial sector that needed the foreign exchange to import intermediate and capital goods.

The second change in the economic paradigm was a relaxation of fiscal and monetary discipline, a trend that became more pronounced since the mid-forties during the Peronist administration. This was the beginning of the era of inflation, and of the so called "stop and go" macroeconomic cycles in which there was typically an expansionary phase stimulated by fiscal and monetary policies that always ended in a balance of payments crisis due to the lack of reserves and an overvalued exchange rate.

These cycles became more intense over the years. They reached a new dimension as of the mid-1970s when inflation reached three digits and the nature of the macroeconomic problems moved from business cycles linked to the international reserves to macro-financial crises. Devaluations in these crises typically had perverse effects on the soundness of the banking system and led to debt restructurings or outright defaults.

In fact, since the mid-1970s Argentina suffered a large crisis approximately every seven years,[1] including two macro-financial crises in which there were widespread bank failures and sovereign debt defaults and another, in 1989, in which the country suffered traumatic hyperinflation. These were disruptive episodes in which there were sharp redistributions of income and wealth. Between 1975 and 1991, GDP per capita dropped 22 percent, representing the worst period in Argentina's economic performance.

This hyperinflation marked a new turning point as it triggered a new change in economic policies and put the economy back on a growth path. Between 1992 and 2013, the economy grew at an average rate of around 4 percent, faster than that of most Latin American countries. It is true that there was a deep crisis in 2001, and since then there has been some shifting of policies and a rebound of inflation. In addition, there are some concerns about the near-term outlook as the country is once again in default, with large fiscal deficits and facing balance of payments problems. Nevertheless, when one looks at the post-hyperinflation period as a whole, there seems to be evidence and hope that Argentina could well be on a new secular growth cycle that is now on a pause due to macroeconomic problems.

The Argentine long-term cycle, which was characterized by high growth until the Great Depression, relative stagnation till the late 1980s and a rebirth of growth in the last two decades, raises important lessons, but also a number of questions about the prospects for growth.

The first lesson is that Argentina grew faster in periods in which it was more open and more integrated within the world economy and when it followed an export oriented growth strategy as opposed to those in which it adopted import substitutions.

A second lesson is that the abuse of stimulus policies, namely fiscal deficits primarily financed by printing money in an environment of a fixed exchange rate, started a new era characterized by high inflation and business cycles that were closely tied to the abundance or scarcity of reserves. In a typical stop and go cycle there was an expansion driven by macroeconomic policies that led to higher imports and inflation. As a result, the currency strengthened and eventually became grossly overvalued, and when reserves reached a lower bound, the government was forced to adjust through devaluation and contractionary macroeconomic policies. This "stop and go" period introduced significant volatility with regards to economic activity and, on the whole, reduced the trend rate of growth.

A third lesson is that exchange rate policy matters, and that most crises occurred following a period in which the currency became overvalued. When, in the end, the government was forced to devalue, it was recessionary because it affected domestic income. This also happened more recently—especially since the late 1970s—because it had a negative balance sheet effect that affected the ability of the government and of banks to service foreign currency debt, which generated a link between devaluations and financial crises.

A fourth lesson is that the largest macro-financial crises that were very disruptive for growth (i.e., 1982, 1989 and 2001) shared three key elements: a grossly overvalued currency, large budget deficits, problems with debt sustainability (especially in the aftermath of a devaluation) and major vulnerabilities in the banking system. Typically, the crises were deepened by deterioration in the external environment.

In spite of this history of high volatility and of the fact that Argentina is once again in a recession that in many ways resembles the early stages of prior crises (including an overvalued currency, a new default on part of the debt, and scarcity of international reserves), one could argue that this time could be different.

There are at least three reasons that raise hope about Argentina's next cycle. First, although Argentina is in default, this time is clearly related to legal and perhaps political issues as opposed to the actual ability to pay. Most investors believe that the default could be cured either when the new government takes over at the end of 2015 or, alternatively, earlier by the current administration. Once this happens, Argentina's country risk should drop drastically and open the way for large capital inflows that should help to rebuild international reserves and reignite growth. The second reason is that Argentina has a sound banking system that this time is not a source of vulnerability, as it remains solvent, liquid, profitable, and with a very small amount of foreign currency liabilities. Finally, the key macroeconomic imbalances (the fiscal deficit and the overvaluation of the currency) have increased but have not yet reached unmanageable levels as in previous crises.

While solving the macroeconomic imbalances will be a large part of the story, if the country wants to take full advantage of the growth opportunities, it will also need to address sector policies. During the Kirchner years there was a shift toward more interventionist policies such as new trade restrictions that favor import substitution, directed credit lines at subsidized interest rates, numerous controls to access foreign exchange and an almost freeze on utilities rates, that brought to a halt investment in energy generation, transmission, and distribution. The country needs large investments in infrastructure and in many sectors including mining, oil and gas, and agriculture, among others. Argentina has one of the largest world reserves of non-conventional gas which is just waiting for exploration but requires large investment."

From a political economy viewpoint, there seems to be more consensus regarding the necessary changes to exchange rate and debt management policies than there is regarding sector policies. Opinion polls indicate that a large percentage of Argentines still favor a strong state and government intervention. However, if the new administration does not address head on the incentives to invest in infrastructure and in key sectors, the macroeconomic improvements will provide short-term relief but will not foster long-term growth.

Argentina has an opportunity to restore growth at relatively high levels and get back on a convergence path. Even with some deterioration in the external environment, the country has good potential to grow. The big question is whether the next government will be willing and able to grab the opportunity that will have to attract investment and external financing, to develop the great prospects the country has in shale gas, mining and agribusiness or if it will once again get trapped in domestic politics.

Endnotes

1. The main crises occurred in 1975, 1982, 1995 and 2001.