



ECONOMIC VIEWPOINT

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Macro, Micro and Macri: What Argentina Is Facing Today

The election of Mauricio Macri as Argentina's president came a welcome surprise to many in Argentina and abroad, and it was especially welcome by economists long used to seeing bad economic policies put in place in the country. Now the government faces the tremendously difficult problem of trying to fix the problems of the last decade, and doing so in a stressed global economic environment. Macri's challenges are both macro and micro.

On the macro-economic front, his very capable economic team unified the exchange rate, a risky but necessary move, risky because of the limited level of international reserves and necessary because the artificial exchange rate of the past was managed with capital controls that introduced major distortions in the economy. Second, his team negotiated a solution with holdout creditors, albeit at a substantial price, which was necessary to remove the albatross of the vulture funds and the legal backing they received, and was also a prerequisite for re-entering capital markets. Indeed, the payment to the holdouts was quickly financed by a \$15 billion bond issuance, following agreement by Argentina's congress in support of the deal. So far, so good.

The not-so-good news is that inflation is rising, not falling, with official estimates ranging between 25-35 percent, and April's figures chalking up 7 percent for the month alone. How to bring inflation down, while stimulating renewed economic growth creates a major conundrum for policymakers. The Argentine central bank legitimately wants to keep interest rates high to attract needed short-term capital, incentivize savings, and signal the direction of inflation-control. Government needs to promote investment and economic activity, helped by the exchange rate but not by high interest rates. All agree that a gradual approach to inflation control is advisable; however, unions fearing a continuation of inflation, negotiate for wage increases at least equal to expected inflation, which further engrains price rises in the economy.

When macro challenges are paramount, the tendency is to turn to micro-economic reforms, those aimed at raising productivity, reducing distortions in prices, and improving the flexibility to move resources by removing impediments. One such measure was a proposal to increase flexibility in the labor market—Argentina resembles France with respect

to labor laws—but the Peronist opposition has blocked these reforms in congress. Other efforts at the micro level will also face resistance, and with limited new investment, it is hard to see where productivity gains will come from.

With taxes already high, but expenditures—led by pensions, revenue sharing and hard-to-reduce budget components—even higher, and imports responding at least as much to a depreciated exchange rate as exports, the picture is complicated. Brazil, Argentina's major trading partner, is in recession and is itself facing a weak currency. The answers appear to lie in the attraction of external capital; however, this solution is a risky one, especially if the means is a new round of bond sales rather than a major inflow of foreign development investment. A number of provinces, in addition to the federal government, have signaled a return to the market, at rates that will cost 7.5-8.5 percent in U.S. dollars, a hefty price to pay for capital. This raises many red flags.

First and foremost, the ink is barely dry on the holdout creditor deal and Argentina is out borrowing again—for what purpose? Do we know that provinces will use these funds for new capital expenditures rather than simply to cover recurrent budget deficits? For which projects will the federal government borrow, and if they are legitimately high-return investments, why can't the external private sector be induced to invest? After all, sovereign wealth funds, pensions funds, and other holders of global liquidity are in search of yields. The rub is the exchange rate, apart, of course, from a history of national regulatory reversals and policy shifts associated with Argentina's past policies. Government can hardly afford to guarantee returns in dollars, although if the price is lower than bond yields, it may be a negotiable issue.

One thing is clear. President Macri and his economic team are facing an uphill battle to turn Argentina around. What is perhaps needed is a "Marshall Plan" for Argentina, funded by foreign governments, firms, and investors. International financial institutions can help lower risks, but domestic political forces also need to signal that they are not just temporarily turning the page on the bad policies of the past. In the end, Macri will need to deliver on both macro- and micro-reforms, and do so quickly.