

# Observatoire des Amériques

## Argentina's Economy

Pablo Heidrich

janvier-avril 2003

### The IMF Deal

After more than a year of negotiations with the IMF, the Argentine government got an agreement signed on January 24<sup>th</sup>, 2003. It was obtained in spite of great opposition on the part of the directorship of the IMF and of several of the members of its advisory council. The reason for the change in position of the IMF were three. First, some of the main shareholders of the IMF (US, Spain, Italy and France) pushed for an agreement to secure the investment positions in Argentina; second, the improvement in economic performance of Argentina during the second half of 2002 took away the arguments from the IMF and the US and European press that no negotiation was possible with a country on a free fall; and third, the IMF itself was in risk of having a US\$1bn loan defaulted by Argentina (plus a US\$680m. default to the IADB and a US\$800m to the World Bank). Therefore, the combination of these three factors pushed the IMF to sign an agreement with Argentina then, and in the following conditions:

1. Agreement is only transitional, until August 2003, when a new one must be negotiated with the new government elected in Argentina in April-May.
2. IMF agrees to refinance US\$6.6bn due to be repaid in 2003 plus US\$4.4bn more owed to the WB and the IADB.
3. Argentina had to pay the amounts listed as defaulted above to the IFIs.
4. Argentina will get a federal fiscal surplus of 1.9% of GDP in these 8 months, up from the 0.5% already obtained in 2002. Furthermore, fiscal expenditure is due to contract by 1.5% of GDP.
5. Argentina must issue bonds to cover the totality of the banking system's cost of the pesification.
6. Social assistance programs must be limited to 1.2% of GDP, to be now audited by the WB and IADB to improve performance and "push people off assistance and back to the job market" (page 9 of Memorandum de Entendimiento listed in the website of the Ministry of Economy).
7. Provincial government budgets must be adjusted to reach a surplus of 0.4% of GDP by August, up from

the 0.5% of deficit obtained in 2002. No further debts can be taken by provinces in lieu of future tax earnings.

8. The Central Bank can not expand monetary circulation by more than 5% in the year, but is allowed to further indebt itself for up to US\$50m in the domestic market to absorb liquidity and reduce inflation.
9. Argentina must adjust privatized utility rates according to the inflation rate and compensate these companies for any losses due to unadjusted rates during 2002. The IMF demands no target but its political pressure on Argentina is extreme in this point. Argentina so far refuses to compensate for past losses but admits some adjustment is necessary.
10. Central Bank officials of restructuring the financial sector in agreement with the current bank owners are to grant total immunity from future legal prosecution and the Congress or the Courts cannot appeal the deals they reach with private bankers. Main points of this restructuring are: a) reduction of the operations of state banks and their preparation for privatization, b) reduction of the number of operating private banks and their transference to "able management with international expertise" (meaning the forceful sale of domestic private banks to foreign banks). This task is to be done under the supervision of the IMF and the WB.

### Economic Policy

#### *Fiscal Policy*

Continuing the tendency from the last semester of 2002, the first quarter of 2003 showed growing fiscal surpluses. This is the result of growing tax collection in nominal terms due to inflation, while most state expenses are frozen. State salaries and pensions have got no increase after the 100 pesos across the board given in October, accumulating a fall in purchasing power of 35% if measured by consumer inflation. Foreign debt payments to private creditors are suspended until the renegotiation takes place after the presidential elections of April. On the state income side, the new taxes on exports put early last year continue to be the star, reaching 12.5% of total revenues in



January-March. The value added tax, a mainstay during the Convertibility years, was reduced to 19% from 21% in October last year to boost consumer spending but failed in that purpose, as producers and distributors simply absorbed it to enlarge their slim margins. By January 2003, it was increased again to 21% but it has stagnated, showing an increase of only 7% respect to the previous January, in spite of all the inflation accumulated since. Wealth and corporate taxes continue to show very little participation and nil increases as tax pressure on the wealthiest has reached a new low, with over 80% of firms and wealthy individual not paying them. Other taxes that contributed, however, were the financial transactions tax and the fuel tax, both recently implemented (2001 and 2002, respectively).

The Ministry of Economy sent a fiscal reform package to the Congress in late December and it is still there, being discussed. The main issues at stake are a 2-year extension in the financial transactions tax, a reduction in corporate taxes from 35 to 30% and the extension of income tax to cover export tax rebates, so far exempt; a reduction in the wealth tax for those who had their savings blocked last year in the banking system freeze, the abolition of regional development tax rebate schemes for the poorest provinces, the transformation of the fuel tax from a percentage to an ad-valorem sum to increase the profits of the oil and refining sectors.

#### *Monetary Policy*

The main news in this aspect is the continuation of the de-freezing of funds blocked in the banking system. In December 2002, all saving and checking accounts (*corralito*) were freed, for an amount close to \$20bn but not all at once. First, the smallest depositors and gradually, the larger ones. By April, only the largest were still awaiting for defreeze. Contrary to IMF and neoliberal expectations, these funds did not push the dollar upwards or even, for the most part, left the banking system. Many medium and larger depositors did have their funds moved to time deposits, taking advantage of high real interest rates. In view of that success, the government pushed the envelope and in March, announced a schedule to free the rest of the accounts (time deposits or *corralon*) blocked since December 2001. Small amounts will be freed first, again, and the real test will come as larger amounts are released in May, which is around the time of the balloting of the presidential elections of April. Unless the more neoliberal of the candidates (those would be Menem or Lopez Murphy) looks favored to win then, large depositors are expected to make a show of force pushing the dollar upwards to intimidate voters and the government.

It is precisely in the policies followed to manage the exchange rate that the most curious results have been achieved. As seen in the graph below, the exchange rate increased abruptly in the first semester of 2002, then stabilize around 3.5 pesos per US dollar, to start a descend in December that has continued into the first trimester of 2003. The Central Bank (CB) has made strong efforts (within the limits imposed by the IMF<sup>1</sup>) to slow down the

revaluing of the peso but to no avail. These were the gradual deregulation of the exchange market, eliminating the CB authorization requirement for operations over \$150,000, easing the restrictions on profit remittances and foreign debt payment and eliminating the requirement for exporters to sell their dollars to the CB for operations of less than US\$1m. Given all these liberalizing moves in 3 months in a currency market with only a few million dollars of movement per day, one would expect the peso to weaken after the pressure it had endured before but the opposite happened. The dollar reached 2.9 pesos on average during the first 2 weeks of April. The government has asked the IMF to allow an expansion of the money supply to reach an exchange rate of 3.1 pesos per dollar, which is the rate planned in the 2003 budget and the one which gives the state optimal income from exports taxes. Most of the Argentine production sector strongly supports this idea but the foreign-dominated banking sector and a few manufacturing multinationals with high import bills prefer it otherwise.

#### **Economic Performance**

The first trimester of 2003 continued the trend of the last semester of 2002, when the economy recovered slowly from the tremendous depth of the recession of 1999-2002. While the last trimester of 2002 showed an increase of 2% in the GDP, the first of 2003 added another 3%. That is however a very slow pace when compared with Indonesia's, for example, which also suffered a catastrophic crisis in 1997 and recovered at 8-10% in the first quarters after it. In the case of Argentina, the problem of this slow recovery is that it creates very little net employment. While unemployment decreased from May to October from 21.5% to 17.8%, it still remains very high<sup>2</sup>. While the main industries in the service sector such as banking, education, transport and utilities, expelled workers, only manufacturing took some for import substituting industries such as textile and machine tooling. In fact, the government used an accounting trick to show such decrease in unemployment, by including the 600,000 beneficiaries of the *programa jefes y jefas de hogar*, a minimum income plan started in 2002. The May employment statistics will also show them and only then, one will see how much real employment this economic recovery is creating. Preliminary calculations are around 100,000 jobs created since September 2002 until March 2003. To reach a 10% unemployment level, Argentina would need to create jobs at this pace for 9 more years.

---

and it can not expand the money supply as the IMF still fears a return to high inflation.

<sup>2</sup> Unemployment is measured in Argentina only twice a year (May and October) and limited to the largest metropolitan areas. Employed is anyone who has worked full time in the previous week, underemployed is someone who has worked less than that and wanted to work full time. Unemployed is someone actively looking for a job in that week (has gone to see at least two different job offerings). Obviously, this method leads to large undercounting of under and unemployment.

---

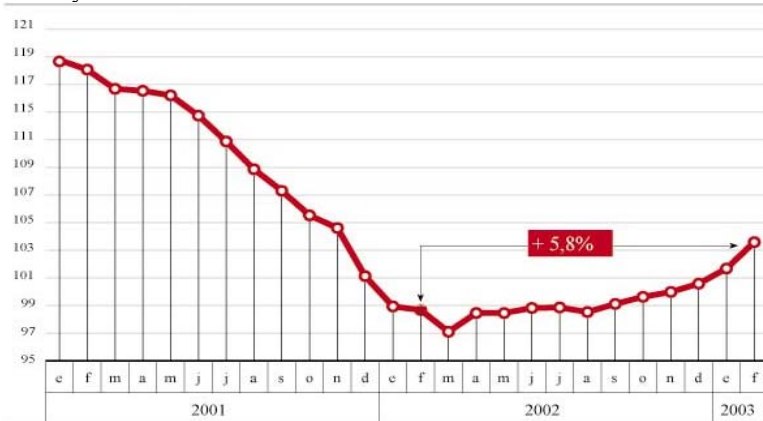
<sup>1</sup> One of the conditions the IMF put to negotiate is that the Central Bank must intervene as little as possible in the exchange market

**Table 1 : Main Economic Indicators, 2002 - 2003**

	Units	2-Jan	2-Feb	2-Mar	2-Apr	2-May	2-Jun	2-Jul	2-Aug	2-Sep	2-Oct	2-Nov	2-Dec	3-Jan	3-Feb
<b>Public Finances</b>															
Total Tax Collection	\$ millions	3,411	3,001	3,077	2,884	4,827	4,615	4,987	4,731	4,344	4,764	5,021	4,814	5,601	4,654
Gross VAT	\$ millions	1,009	1,027	1,036	899	1,511	1,403	1,413	1,364	1,340	1,424	1,502	1,314	1,686	1,354
Corporate Earnings	\$ millions	623	469	480	433	893	833	764	844	683	849	1,111	938	1,095	803
Social Security	\$ millions	749	595	528	528	709	656	915	702	680	741	687	693	1,006	713
Foreign Trade	\$ millions	67	69	168	309	554	710	865	812	609	745	769	653	815	743
<b>External Sector</b>															
Export of Goods (FOB)	US\$ millions	1,823	1,801	2,060	2,146	2,343	2,213	2,211	2,151	2,251	2,229	2,160	1,960	2,126	2,072
Import of Goods (CIF)	US\$ millions	853	627	592	611	862	687	813	764	717	874	807	782	798	777
Trade Balance of Goods	US\$ millions	970	1,174	1,468	1,535	1,481	1,526	1,398	1,387	1,534	1,355	1,353	1,179	1,328	1,295
Liquid Reserves of Central Bank	US\$ millions	13,947	13,871	12,780	12,171	10,185	9,629	8,986	9,102	9,404	9,787	10,022	10,485	9,326	10,226
Exchange Rate (nominal)	\$/US\$	1,40	2.15	2.9	2.95	3.6	3.8	3.68	3.62	3.73	3.53	3.57	3.36	3.24	3.2
<b>Money</b>															
Bank Deposits	\$ millions	78,932	73,541	71,218	64,116	60,153	58,577	56,927	57,612	57,587	58,899	61,510	61,200	64,105	64,771
M3	\$ millions	88,283	82,831	83,418	77,273	73,554	71,610	70,375	70,878	70,484	71,959	75,279	77,576	80,397	81,359
<b>Interest Rate</b>															
Deposits	%	5.53	7.61	15.05	46	64.58	72.17	76.7	65.05	44.46	34.13	19.01	20.72	17.03	17.55
Loans	%	29.53	31.92	-	-	-	-	-	102.38	78.83	55.24	39.41	33.48	27.49	27.43
<b>Capital Markets</b>															
Merval Stock Index (in US\$)	Var.%	-24.1	-14.6	-17.8	-15.1	-33.7	3.8	4.7	7.4	3.9	14.1	12.4	12.6	10.5	8.2
Discount strip	Basic points	3,944	3,663	4,192	3,662	4,268	4,430	5,284	7,748	9,226	4,434	3,779	5,821	5,239	4,260
FRB	Basic points	11,605	12,066	12,276	13,843	21,548	34,020	36,603	45,328	25,090	23,713	27,804	31,628	38,462	31,836

Source: Ministry of Economy and INDEC

**Graph 1 : Industrial Production Index**  
January 1<sup>st</sup> 2002 base = 100



Source: National Bureau of Aggregate Accounting, INDEC, 3/2003

The main obstacle to overcome the recession has been the lack of credit. This was related initially to the issue of the blocked deposits and the legal battles that ensued on that last year. Banks were reluctant to lend since they did not know whether they would need that money to pay back depositors back and at what exchange rate for the dollarized deposits. In consequence, they did not lend and recalled as many loans as possible. As the depositor's issues started to be settled in September 2002, banks were a bit more flexible but the monetary policy of keeping the exchange rate stable and reducing inflation pushed the state

to issue a large amount of treasury bonds to absorb pesos. Banks bought those, as they were very profitable and safe. That moved accomplished monetary stabilization but at the cost of lowering crowding out investment and slowing growth. All these sacrifices in the name of monetary orthodoxy were done in order to please the IMF and arrive to an agreement with it. Now that this is done, these policies can not be changed as the IMF fixed them into the written deal. It can be seen in the graph below that deposits have grown much faster than credits since September 2002 until now.

**Table 2 : Industrial Activity, Investment, Labor Market and Inflation**

	Unit	2-Jan	2-Feb	2-Mar	2-Apr	2-May	2-Jun	2-Jul	2-Aug	2-Sep	2-Oct	2-Nov	2-Dec	3-Jan	3-Feb
<b>Industrial Activity</b>															
Industrial															
Monthly Estimator	Var.% 1 month	-3.3	0.8	-1.4	-0.1	2.4	1.7	-1.4	2.7	0.3	1.4	3.3	2.6	3.4	1.5
	Var.% 12 months	-20	-16.9	-22.3	-15.1	-14.6	-15.7	-12.2	-8.5	-4.6	-4.2	0.6	10.7	17.9	17.5
<b>Investment</b>															
Cement Sales	Var.% 12 months	-39	-41.9	-32.4	-38.5	-31.9	-31.3	-30.3	-22	-18.1	-11.7	-22.2	4	21.4	23.1
Import of Capital Goods (CIF)	Var.% 1 month	-27.7	-39.4	-9.9	-24.4	142.9	-54.9	20.8	24.1	-12	69.5	-34.2	13.2	-19.9	19.8
	Var.% 12 months	-62.2	-73.5	-78.4	-83.6	-65.8	-80.1	-74.6	-71.8	-67.4	-44.6	-54.5	-45.6	-39.8	19
<b>Labor market</b>															
Economically															
Active Population	%	-	-	-	-	41.8	-	-	-	-	42.9	-	-	-	-
Employed	%	-	-	-	-	32.8	-	-	-	-	35.3	-	-	-	-
Unemployed	%	-	-	-	-	21.5	-	-	-	-	17.8	-	-	-	-
<b>Price Indexes</b>															
IPC (retail)	Var.% 1 month	2.3	3.1	4	10.4	4	3.6	3.2	2.3	1.3	0.2	0.5	0.2	1.3	0.6
IPIM (wholesale)	Var.% 1 month	6.7	11.3	13.1	19.9	12.3	8.5	4.6	5	2.4	0.5	-1.7	-0.4	0.4	0.4

Source: *Ministry of Economy and INDEC*

The different economic sectors have had rather distinct performances these last months. Agricultural activities shrank only slightly during 2002 and have expanded along 2003, as the devaluation made dollar earnings from exports a much more attractive proposition. Soybeans harvests grew by 8%, sunflower by 15% while corn and wheat decreased slightly. These are reactions to world prices. Those producers more dependent on the home market, such as dairy farms and poultry factories decreased by 30% their production as the local consumption fell drastically and many of their production inputs were imported. The crisis and devaluation in Brazil during late 2002 also affected these industries. The performance of this sector adds little to the overall economy in terms of employment and local input consumption but their dollar earnings are crucial to maintain a positive balance of payments.

Industry was detailed already but beyond that, a current of import substitution across most production lines is observed. While Argentina used to import more than 60% of its intermediate goods and 95% of its capital goods during the Convertibility years, it is now importing only 30% of the first and 55% of the second. This points to the probable capacity of local industry to generate competitive products in the future. Nonetheless, a clearer picture will be obtained once this year finishes and more firm trends are visible.

The recession in Brazil and the sluggish growth in NAFTA and the EU have also affected the possibilities of accelerated recovery in Argentina. In spite of a devaluation of the peso of over 50% in real terms (discounting inflation), exports actually fell 5% during 2002, compared to 2001. They are however performing better in early 2003, with an inter-annual growth of 10%. The story varies greatly according to destination, with Mercosur falling by more than 20%, EU and NAFTA growing by 10% and the rest, increasing some 15% as well, with Asia as the main market there.

Those industrial sectors most heavily dependent on the home and Brazilian markets and with a large amount of imported inputs such as the car manufacturers are in dire straits. Fiat has not produced a single vehicle since October 2002, laying off 30% of its workforce and putting the rest on half-paid leave. Renault is working at 20% capacity, while Peugeot, Toyota, Mercedes-Chrysler and the rest are in similar conditions. In 2002, the car market in Argentina registered as few sales as in 1959, only 80,000 vehicles. The first trimester of 2003 has seen sales increased only marginally and less than 100,000 sales are expected for the whole year. Unless export markets are found, most of these factories are due to close this year. Other examples of very troubled industrial sectors are paper mills and fishing, where output has so far fallen over 50% from the depressed levels of 2001.

Therefore, a mixed picture remains in terms of economic performance albeit the trend is positive. Depending on the results of the coming presidential elections, this might change for the better or worse. The same applies for economic policy and the coming new round of bargaining with the IMF in August. With depressed incomes, widespread poverty and a huge foreign debt to be renegotiated, the economy is in expectations of the new administration to take office in late May.

## Sources

Economist Intelligence Unit Country Report on Argentina, 1st Quarter 2003 and April 2003 ([www.eiu.com](http://www.eiu.com)).

International Monetary Fund ([www.imf.org](http://www.imf.org)),  
World Bank ([www.worldbank.org](http://www.worldbank.org)).

Latin American News Service ([www.latinnews.com](http://www.latinnews.com)).

Ministry of Economy ([www.mecon.gov.ar](http://www.mecon.gov.ar)),  
Ministry of Foreign Affairs ([www.mrecic.gov.ar](http://www.mrecic.gov.ar)),  
Census Office of the Argentine Government ([www.indec.gov.ar](http://www.indec.gov.ar)).

Newspapers: Clarin ([www.clarin.com.ar](http://www.clarin.com.ar)),  
Pagina12 ([www.pagina12.com.ar](http://www.pagina12.com.ar)),  
La Nacion ([www.lanacion.com.ar](http://www.lanacion.com.ar)).