

The Crux of the Argentine Paradox: A Sectoral Financial Balances Perspective

SASHI SIVRAMKRISHNA
AKSHAT SEN

Abstract

This paper seeks to determine the crux of the Argentine Paradox in a contemporary context from a Sectoral Financial Balances (SFB) perspective. Since 2007, under President Cristina Fernandez Kirchner and subsequently, under President Mauricio Marci from 2015, Argentina has experienced severe macroeconomic crises characterized by high inflation, increasing unemployment, erratic GDP growth and a depreciating peso. This is surprising for a country that was around a century ago, one of the richest in the world. While many answers have been discussed in academia and the popular media, we carry out a sectoral decomposition of the Argentine economy to show that the essence of the problem is the structural stagnation of the private domestic sector, which has been unable to develop adequate economic complexity and turn Argentina into a globally competitive player so as to increase its export capabilities or attract autonomous capital inflows to cover the current account deficit. Instead, successive Argentine governments have had to turn to either autarkic policies or accommodate the current account deficit through issue of its own financial liabilities i.e. sovereign external debt, which in turn, have led to either dwindling foreign exchange reserves or has drawn the country into a debt trap, respectively. The Argentine Paradox has important lessons for other emerging economies, including India, which struggles to develop economic complexity even as it falters in attaining a high growth trajectory.

Keywords: *Argentine Paradox, current account deficit, debt trap, sectoral financial balances, macroeconomic crises.*

JEL codes: *E390, E660, F320*

1. Introduction

Although the term “Argentine Paradox” is usually used in a historical context, highlighting Argentina as one of the richest countries at the turn of the twentieth century that experienced decline since 1928 – the final year of its “belle époque” (Glaeser et al, 2018, p. 4) – this paper (re)contextualizes the term in a more contemporary context. Why does a country like Argentina, with a per capita income of US\$ 11,000 and US\$ 20,000 in PPP terms, ranked 47 on the Human Development Index with an absolute score of 0.825, and blessed with abundant natural resources face severe and recurrent macroeconomic crises on a scale and at intervals rarely experienced by emerging economies in Asia or other middle income countries of South America? Argentina's crises are extreme with galloping inflation rates, a depreciating currency accompanied by unemployment, high interest rates, erratic GDP growth, debt repayment defaults and chronic current account imbalance. Many answers have been given to this question; external debt, capital flight, commodity exports, fiscal profligacy, political instability, among others. While all of them are genuine claims, it is difficult to identify the crux of the Argentine Paradox. Without a grasp of the essence of what drives chronic crises, cutting through the maze of information, reports and studies is overwhelmingly confusing. Argentina is a tragic case-in-point.

An economic model which ties several macroeconomic parameters together while at the same time maintains stock-flow consistency, is the sectoral financial balances (SFB) equation developed by the heterodox economist, Wynne Godley (2007). Although a simplistic “application” of the SFB equation is inadequate in identifying the cause/s of crises, a deeper reading of this simple accounting equation in conjunction with analysis of Argentine crises provides rich insights into the crux of the paradox and the limitations of the policy options presently available. From a long-term perspective, the Argentine situation looks bleak; a contraction in the standards of living seems inevitable for a country that was just a century ago, one of the richest in the world.

The Argentine Paradox, furthermore, has important lessons for emerging economies, including India, which struggle to achieve a high growth trajectory while at the same time, containing their current account deficits in order to prevent balance of

payments crises (Sivramkrishna, 2016). Here, as the Argentine case illustrates, economic complexity – that includes directly and indirectly several elements from technology to physical and human capital (Kutasovic, 2017a and 2017b) – can play a major role in addressing these objectives.

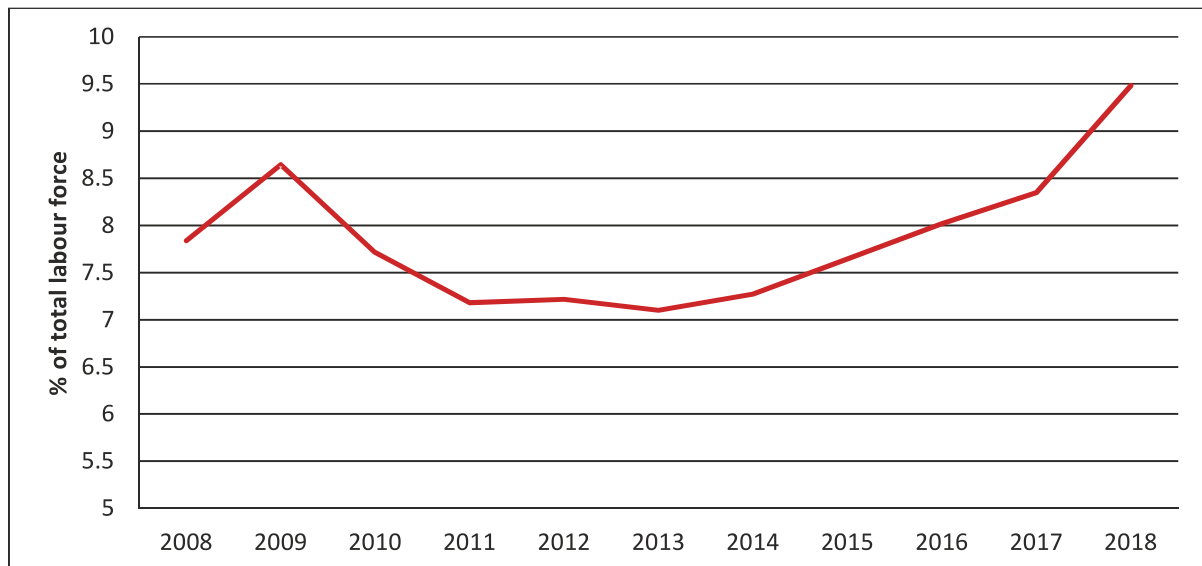
2. The Argentine Paradox

In the recent past, in particular since the global financial crisis (GFC) of 2008, Argentina has witnessed two regimes from almost opposite ends of the macroeconomic spectrum; the first, from 2007 to 2015 when it was under the leadership of President Cristina Fernandez de Kirchner (CFK) and between 2015 and the present, under President Mauricio Macri. The economic policies followed by these successive governments are drastically different with CFK's regime being characterized by protectionist policies, foreign exchange controls, greater state interventions in markets and an expansionary fiscal policy, while Macri has taken Argentina towards a more market-driven economy, greater free trade, dismantling controls over foreign exchange rates, convertibility of the peso as well as fiscal consolidation (Niedzwiecki and Pribble, 2017), although recent reports suggest that he too is loosening the government's purse strings as general elections approach in October 2019. This has perhaps come too late; Macri lost the primary polls held in early August 2019 by a landslide indicating a probable return to CFK-era policies (Gillespie et al, 2019). However, to reiterate, the objective of this paper is to use the SFB model to unearth the crux of the Argentine Paradox rather than judge policy responses to the underlying issue.

Argentina's dismal macroeconomic condition is easily apparent from its key macroeconomic parameters, namely, unemployment, inflation, the peso-dollar exchange rate and growth rate in gross domestic product (GDP), which are individually profiled below.

The unemployment rate in Argentina remained at around 7-8 percent during CFK's regime but shows a sharp upward trend under Macri, from about 7.5 percent in 2015 to almost 10 percent presently. However, these are just average figures; in cities like Buenos Aires, the unemployment rate is reported to be more than 12 percent; in the smaller cities, youth unemployment is slated to be almost 30 percent and the situation for informal work is worse (France 24, 2018). For those employed, lack of new job creation, job insecurity and dwindling social benefits along with falling real wages remains a major concern (Pitchon, 2018). There is also widespread discontent on account of Macri's neoliberal policies, in particular, the austerity measures implemented by his government (Goodman, 2019).

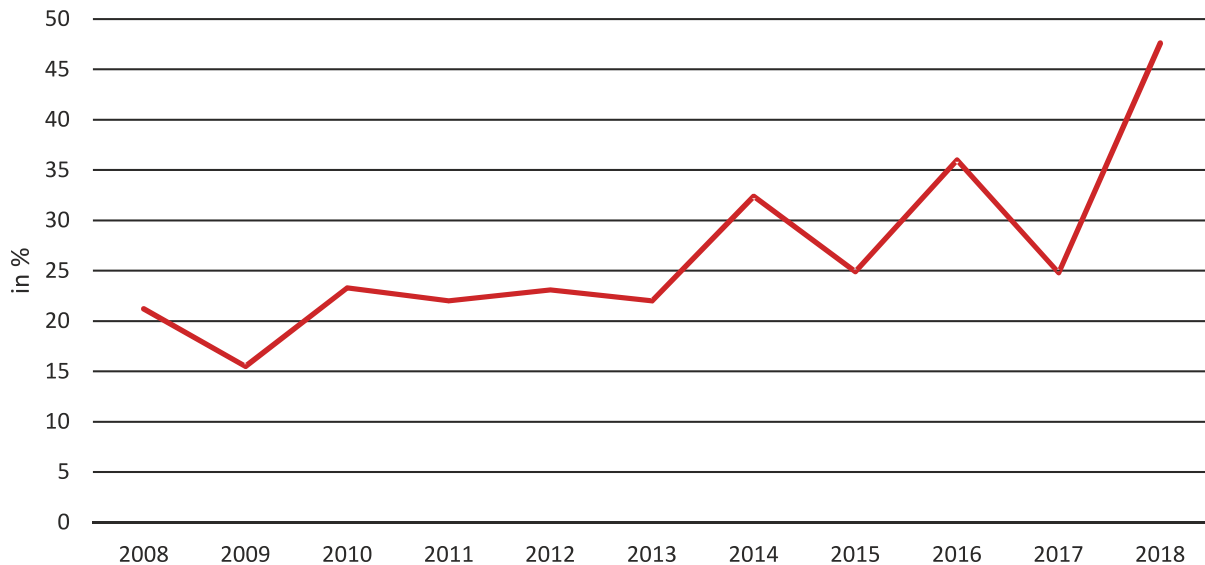
Figure 1: Argentina's unemployment rate as a percentage of labour force



Source: World Bank Data,
<https://data.worldbank.org/indicator/SL.UEM.TOTL.ZS?end=2018&locations=AR&start=2006>

Although Argentina has experienced hyper inflation episodes in its history, the recent past is characterized by high and accelerating inflation. The CFK government, it has been widely argued, presented manipulated figures for inflation, keeping it below or at just about 10 percent throughout its rule. Once again, although inflation during CFK was at roughly 22 percent, shooting up to 33 percent in 2014, the upward trend seems to be continuing under Macri, hitting a high of 47.6 percent in 2018. Figure 2 presents the inflation rate for Argentina with straightened figures under CFK.

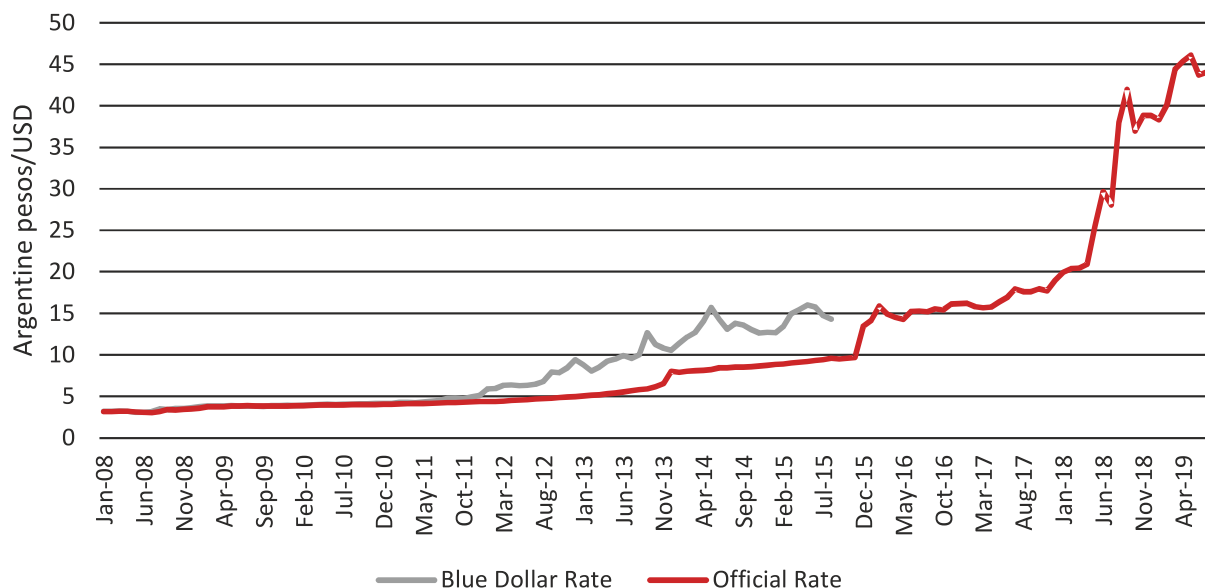
Figure 2: Argentina's inflation rate (with straightened figures under CFK)



Sources: Gonzalez (2017) and Buenos Aires Times (2019)

Interpreting exchange rate data for Argentina is again problematic. The official peso-dollar rate under CFK was a floating peg, controlled by the government, which deviated significantly from the blue dollar or black market rate. Figure 3 shows both these rates between 2007 and 2014; post-Macri, with liberalization of currency market and official convertibility of the peso to dollars, the blue dollar has been obliterated. Nonetheless, the peso has depreciated steeply since 2014 even in comparison to the blue dollar rate.

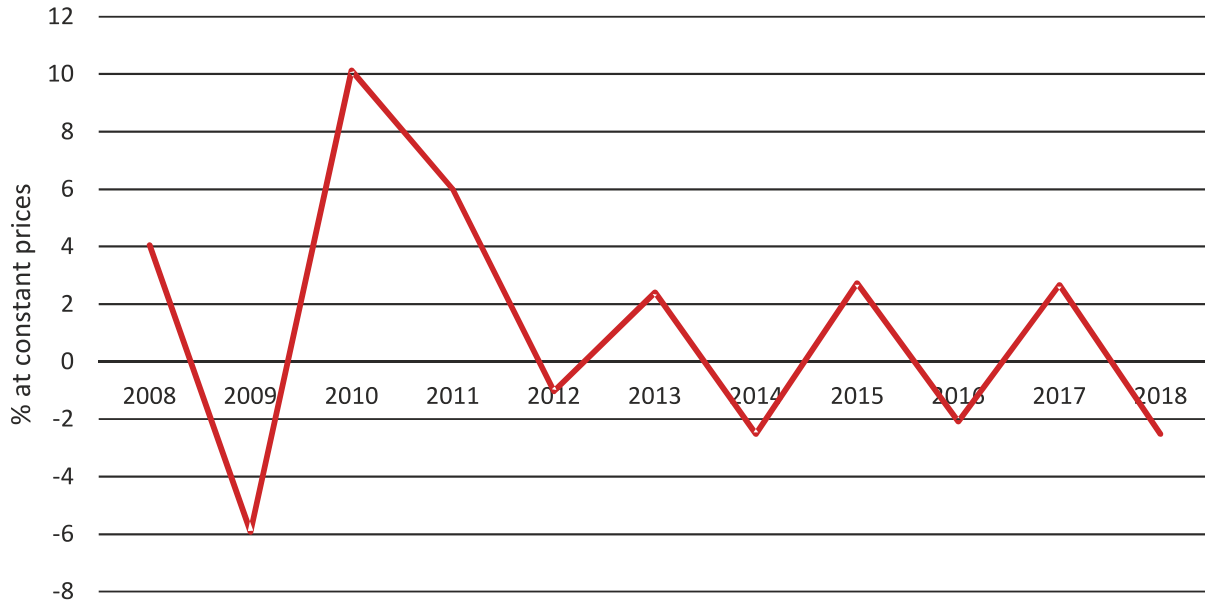
Figure 3: Official and blue dollar peso/dollar rate



Sources: Hager (2014) and Gallas (2018)

GDP growth rate (Figure 4) shows an erratic trend; keeping aside the sharp decline on account of the 2008-GFC and the subsequent boom of 2009-10 induced by countercyclical fiscal policy, Argentina has experienced alternating periods of growth and decline, almost consistently since 2011. However, the most recent figures indicate that Argentina is sliding into a deeper recession, breaching the 5 percent level to more than 6 percent in the last quarter of 2018 (Gillespie and Do Rosario, 2019) and again in the first quarter of 2019 (Reuters, 2019a).

Figure 4: Argentina's real GDP growth rate



Source: CIEC Data,
<https://www.ceicdata.com/en/indicator/argentina/real-gdp-growth>

These facts paint a stark picture of the Argentine Paradox and raise the pertinent question as to how and why an economically sovereign, socially progressive, high-middle income country is perpetually in a chronically dismal condition and is unable to turn around its macroeconomy. To delve deeper into this question, this paper uses the SFB model to serve as the basis for analysis and interpretation of Argentina's macroeconomic parameters.

3. The SFB equation and the Argentine case

The SFB model, developed by the heterodox economist, Wynne Godley, adheres to the most fundamental double entry accounting axioms – every debit has a corresponding credit, and every financial asset should have a corresponding financial liability. This model of macroeconomic analysis has fewer assumptions as compared to other complex macroeconomic models, relying on simple accounting tenets that ensure stock-flow consistency.

Consider a three-sector economy with a domestic private sector, the government sector and an external sector – the latter comprising of both private and government sectors. The net financial asset accumulation across these three sectors must be zero, as financial asset accumulation in any sector outside of itself requires a corresponding accumulation of financial liabilities by at least one of the other sectors. Put differently, the SFB equation does not allow for all sectors to be accumulating net financial assets, simultaneously. Therefore, $(S-I) + (T-G) + (M-X) = 0 \dots (1)$

where S = private sector savings, I = private sector investment, G = government expenditure, T = tax receipts, X = exports, and M = imports. Note that a current account deficit (CAD), i.e. $(X-M) < 0$ implies an inflow of capital into the domestic economy so that foreign investors accumulate assets in the domestic economy, or the domestic sector accumulates liabilities to foreigners. Equation (1) holds true for both, values of each parameter in absolute terms as well as when these parameters are expressed as a percentage of GDP.

Equation (1) can be expressed as: $(S-I) = (G-T) + (X-M) \dots (2)$

In other words, for positive domestic private net financial asset accumulation, either the government must run a fiscal deficit and/or the country must run a current account surplus (CAS) so that foreigners accumulate net liabilities. Two questions arise here; why does the private sector desire to accumulate financial assets and moreover, why would it desire to do so outside of itself? The private sector comprising of households and firms always has a desire to save and earn returns on savings. Savings in physical assets (like gold and property) are either inconvenient to hold, subject to theft and other natural losses, or legal issues as well as severe price fluctuations. Financial assets, while overcoming some of these problems, may not be safe either; liabilities issued by the private sector including equity shares, bank deposits or corporate debt are also subject to financial losses. It is for this reason that the private sector may desire to hold financial assets, which are not the liabilities of other private sector entities, but rather of the government. The liabilities of the government including treasury bills and bonds are safe as they are not backed by physical assets, but the ability of governments to issue their sovereign currencies. In the case of some countries, for instance, Norway, the private sector may accumulate assets (foreign liabilities) by running a CAS ($X - M > 0$). A sufficiently large CAS may even accommodate the government's fiscal surplus ($G - T < 0$ or net financial asset accumulation by the government) along with the private sector accumulating financial assets. However, for countries which accumulate liabilities by running CADs, i.e. ($X - M < 0$), for the private sector to accumulate net financial assets, the government must run a fiscal deficit (accumulate financial liabilities). This is clearly evident from Equation (2).

A negative asset accumulation or accumulation of net financial liabilities by the domestic private sector – also called leveraging – is a possibility, especially during times of booms. However, this is unsustainable over a longer period of time when debt repayments have to be made. This process of deleveraging by the private sector can draw the economy into a recessionary spiral when it reduces consumption and investment spending in order to increase its desire to net save and pare debt.

It should be noted that the government can accumulate net financial liabilities indefinitely, and this is precisely what we find in most countries. These liabilities are nothing but the assets of the private domestic sector and/or those of foreigners that allow a country to run a CAD.

Table 1 shows components of the SFB equation for Argentina between 2009 and 2018. The net financial asset accumulation by the private sector almost throughout the period has been positive implying that neither has it been leveraging nor is there any imminent threat of a deleveraging cycle. In fact, a cursory look at the fiscal deficits and CAD do not present a picture of severe and chronic crisis at all.

Table 1: The SFB equation for Argentina with all figures as percentage of GDP

Year	X - M	G - T	S - I
2009	2.5	1.5	4.0
2010	-0.3	-0.2	-0.5
2011	-1	1.7	0.7
2012	-0.4	2.5	2.1
2013	-2.1	2.6	0.5
2014	-1.6	3.8	2.2
2015	-2.7	5.4	2.7
2016	-2.7	4.6	1.9
2017	-4.9	6.1	1.2
2018	-5.4	5.5	0.1

Source: Trading Economics,
<https://tradingeconomics.com/argentina/indicators>

So, where then is the basis for the Argentine Paradox? Following the SFB model, we undertake a sectoral decomposition of Argentina's macroeconomy; the external sector is perhaps the best one to begin with as it has often been identified as the source of its woes.

4. Argentina's external sector

Using data as a percentage of GDP is problematic for it does not always reveal the changes taking place in absolute terms. For example, the CAD can be the same in two situations with each being quantitatively and qualitatively different. Consider, for example, the following:

Value of imports = US\$ 10, value of exports = US\$ 5 and GDP = US\$ 100 then CAD = 5 percent of GDP

Now suppose there is a domestic and international recession so that,

Value of imports = US\$ 5, value of exports = US\$ 2.5 and GDP = US\$ 50 then CAD = 5 percent of GDP

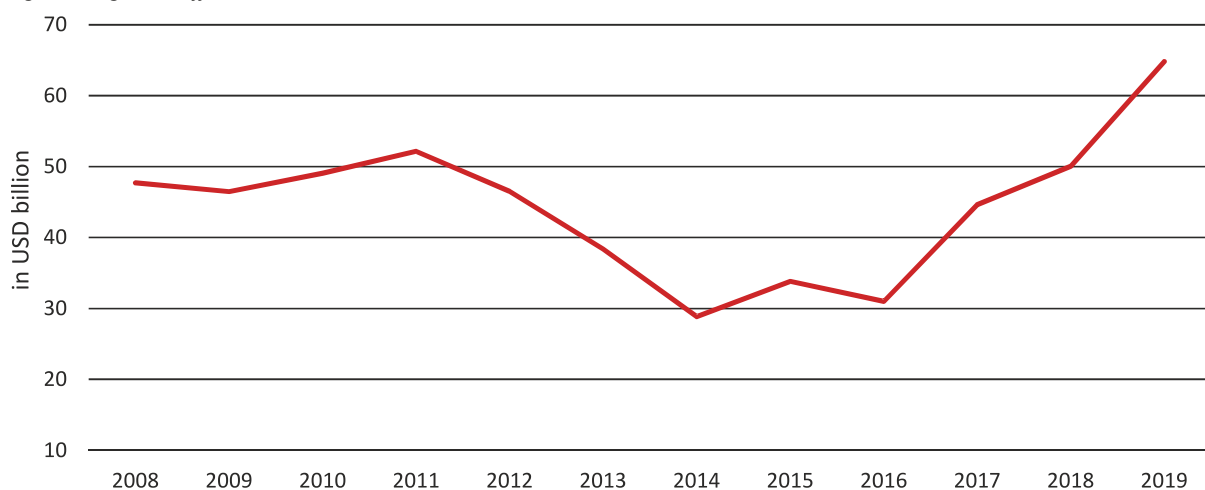
Obviously, in spite of CAD as a percentage remaining unchanged, the country could be facing a very different scenario or even a crisis situation.

In the Argentine case, not only has the CAD been increasing, but a deeper analysis reveals an even darker picture:

- Declining value of exports and imports along with a larger quantum of trade deficit (IMF BOPSY, 2018). It is important to highlight that the contraction of exports in 2015 was due to fall in global commodity prices, in particular, soyabean meal which alone constitutes some 13 percent of Argentina's exports. However, this is actually a more serious issue for Argentina with 9 out of 10 of its top exports being commodities or primary sector related, the only exception being vehicles (Workman, 2019).
- Outflow of foreign exchange on the current account is due to direct and portfolio investment income and interest payments (debit) (IMF BOPSY, 2018).
- Overall, we observe a significant worsening of the CAD from US\$ 1.6 billion in 2010 to US\$ 31 billion in 2017 (ibid).

While a CAD *per se* is not a definitive indicator of crisis, its financing could often be a trigger for one. A careful inspection of Argentina's balance of payments reveals that the CAD has been *accommodated* under Macri with significant inflows of foreign currency from debt securities issued by the Argentine government (resulting in some positive accumulation of foreign exchange reserves) while the CFK government funded its CAD primarily through depletion of reserves (ibid). The Official Reserve Assets (ORA) held by the Central Bank of Argentina show a sharp and consistent decline between 2011 from more than US\$ 50 billion to about US\$ 28 billion by 2015 (Figure 5). The sustainability of CFK's approach to run down reserves to prevent a collapse of the peso is doubtful – was Macri's decision to open Argentina to the IMF and regain access to international capital markets therefore inevitable especially after the export shock of 2015?

Figure 5: Argentine Official Reserve Assets



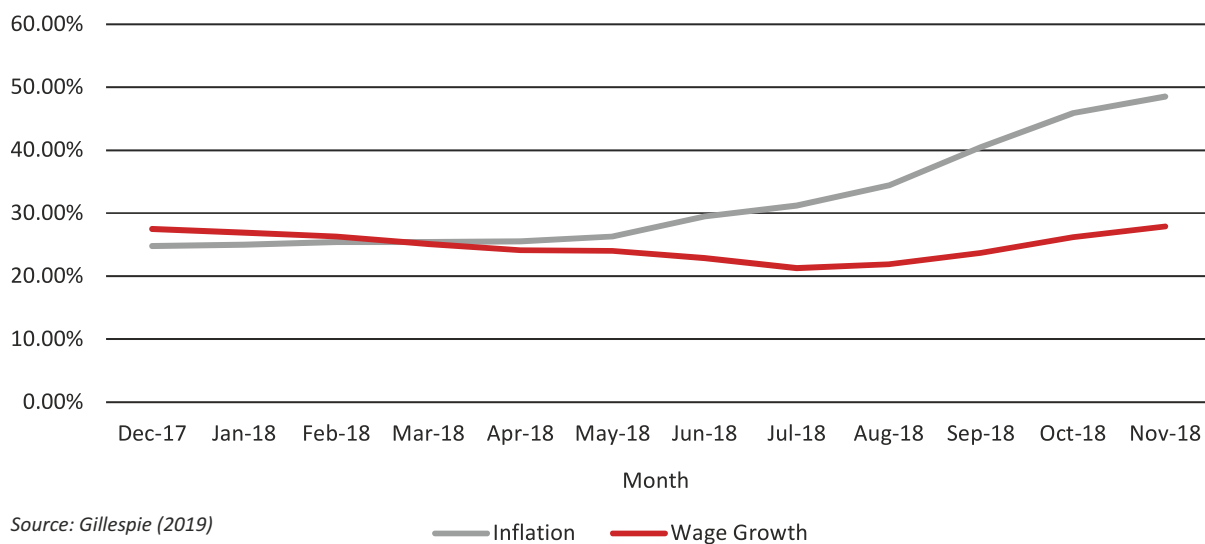
Source: CEIC Data,
<https://www.ceicdata.com/en/argentina/official-reserve-assets/official-reserve-assets-ora>

While this may indeed seem so, dollar denominated debt accumulation is not a long-term solution to Argentina's foreign exchange crisis either, unless the utilization of dollar debt can structurally repair the chronic imbalance in the balance of payments, i.e. sustain the CAD with adequate *autonomous* financial inflows. Instead, the collapsing peso, rising debt servicing costs and adherence to debt repayment schedules implies that Argentina has only postponed another inevitable crisis, without having solved its deeper structural problem. Meanwhile, the accommodating foreign exchange inflows have resulted in mounting external debt (Cibils and Arana, 2018) already turning into a “debt trap” – more debt, rising yields (Henderson, 2019), greater debt servicing costs, a higher CAD, and consequently the need for more borrowing! Argentina is literally scraping the bottom of the pan for dollars, a perpetual dollar cash-flow problem (Marsh, 2014) even as the danger of a 'sudden stop' to financial inflows looms over it (Coppola, 2018).

5. Argentina's government sector

With Argentina sliding into a precarious situation of depleting foreign exchange reserves under CFK, President Macri decided that his country needed to regain access to global financial markets. His first step was agreeing to settle repayments to US hedge funds on debt defaults by Argentina in the early 2000s (Blitzer, 2016) followed by relaxing controls on the convertibility of the peso into foreign currencies and withdrawal of government intervention in the foreign exchange market. At the same time, Macri extended his neoliberal policy agenda of fiscal consolidation by cutting domestic subsidies in order to control inflation and stabilize the peso. However, the consequences were unexpected; higher electricity and gas costs triggered off wage increases and accelerating inflation (Figure 6). With more trouble on the current account front with falling exports, the peso collapsed. To stem the tide, interest rates were increased sharply, dampening any possible growth in private sector investment and consumer spending that Macri had hoped for.

Figure 6: The wage-price spiral in Argentina



Source: Gillespie (2019)

With Argentina sinking into stagflation, Macri turned to the IMF to cover the financial crisis on its external front. In 2018, the IMF agreed to a rescue package – its largest ever – of some US\$ 57 billion. As usual, the loan came with an economic reform package to put Argentina back on track, the core of which is fiscal consolidation – austerity – something that Macri had already experimented with since his coming to power (Reuters, 2019b). The 2016 Article IV Consultation Report clearly outlines the IMF's plan centred on reducing the fiscal deficit, aimed at taming Argentina's accelerating inflation rate:

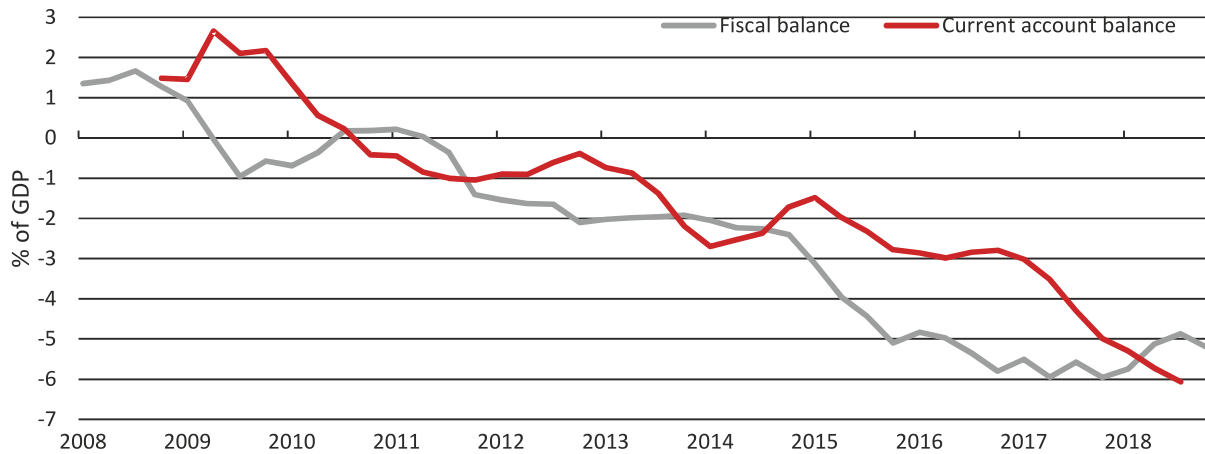
Directors stressed that continuing to lower the fiscal deficit is an important part of the adjustment (IMF, 2016, p. 2).

Fiscal consolidation is the IMF's key policy measure as fiscal profligacy is identified as *the raison d'être* of the Argentine crisis; a large fiscal deficit which must be funded through *debt*, triggering high inflation, depreciating currency, a business environment not conducive to private sector investment and consequently, poor growth. Moreover, there is an implicit notion that this fiscal deficit must be funded from *foreign capital inflows* – which, in turn, is possible only with a corresponding deficit in the current account. Theoretically, this argument is legitimized by the twin deficit hypothesis which postulates that the fiscal deficit must be equal to the CAD, i.e. by the equation:

$$(G-T) = (M-X) \dots (3)^3$$

Figure 7 shows a correlation between the fiscal deficit and CAD that may be misread as a cause-effect relationship, in particular, the fiscal deficit as the cause of the CAD. What may easily be missed here is the fact that the IMF-Macri austerity measures may have proved counterproductive in controlling the fiscal deficit as cuts in government subsidies triggered a rise in electricity and transport costs, higher inflation and a wage-price spiral that threw the economy into recession. With government expenditures on account of unemployment transfers and benefits increase while tax collections dip, so that deficit increases, inducing a whole new push for further cuts in spending. Argentina seems to be in the grip of another case of IMF austerity policies dragging countries into a vicious cycle of recession and higher fiscal deficits as a percentage of GDP (Krugman, 2015). While the fiscal deficit did show a sharp increase under CFK from 2012, touching almost 5 percent of GDP by 2015, since then, in spite of tightening of fiscal policy, the deficit has continued to increase as the country slipped into a recession.

Figure 7: Argentina's fiscal and current account deficits as a percentage of GDP



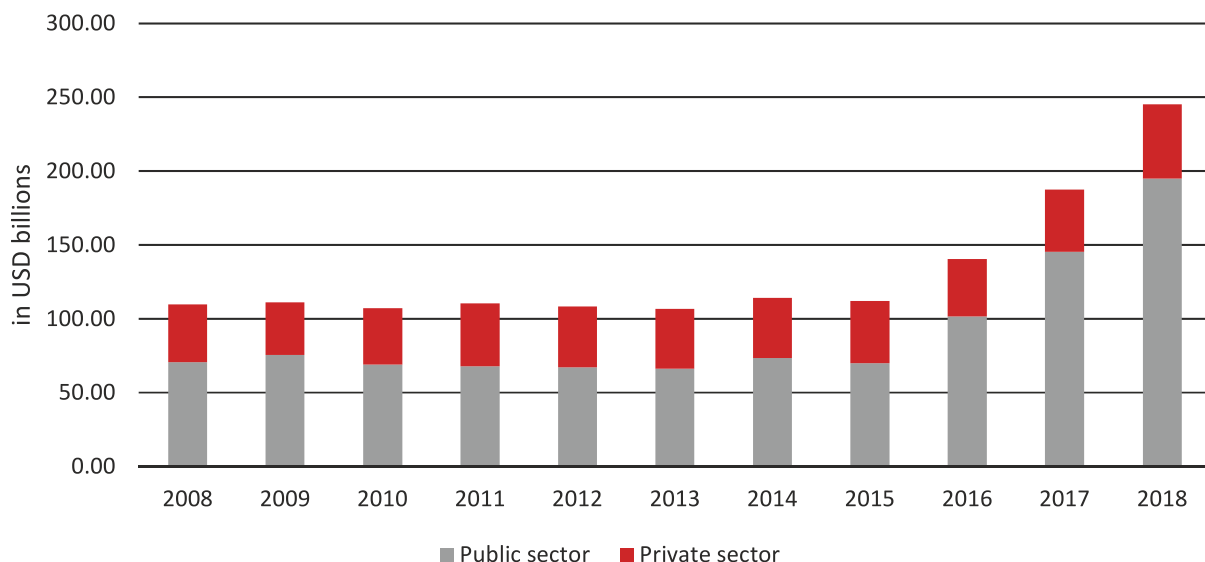
Source: OECD (2019), p. 2

There are two important features of Argentina's fiscal deficits that have undergone change under CFK and Macri's governments; first, the growing external public debt – denominated in dollars – and second, the primary expenditure and interest component of the deficit.

The growth of public debt and in particular, external public debt increased phenomenally under Macri – from 28 percent of GDP in 2015 to a whopping 57 percent by 2018 (IMF, 2018, p.32) – that ultimately resulted in Argentina going back to the IMF. Public external debt stocks before the Macri regime comprised of loan repayments owed to bondholders from the 2001 loan default crisis. It grew marginally throughout the Kirchner regime, since her policies avoided external borrowing. However, the Macri's neoliberal approach has relied on external sovereign debt (Figure 8) since the beginning of his term to repay the remaining bondholders, including vulture funds, and to finance the fiscal deficits.

3 The twin deficit equation is flawed. It does not incorporate the domestic private sector, which is a necessary component as shown by the SFB equation (2). We will return to this aspect in a later section in the paper.

Figure 8: Long term external public debt



Source: Nelson (2018)

While some of the reasons for Argentina falling into a debt trap have been examined above, it is important to mention Macri's decision to also introduce capital account convertibility of the peso. Without success in controlling inflation domestically, liberalization of financial flows resulted in capital flight from Argentina, reducing the net *autonomous* inflow of dollars and consequently increasing the need for *accommodating* dollar debt (Table 2).

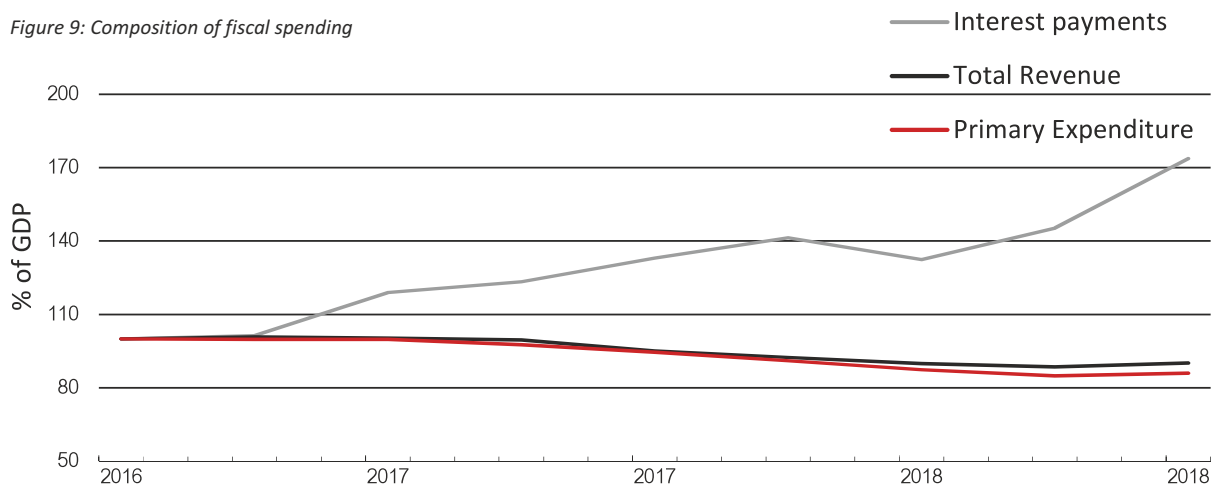
Table 2: Portfolio flows into and out of Argentina, 2010-2017

	2010	2011	2012	2013	2014	2015	2016	2017
Portfolio Investment, Net acquisition of debt securities, Other sectors (excluding general government)	35.0	-204.0	119.0	361.0	147.0	256.0	1764.0	5128.9
Portfolio Investment, Net incurrence of liabilities, General government	3005.9	-135.2	830.9	424.7	-2804.5	-1593.4	31190.1	28381.4

Source: IMF BOPSY, 2018

Figure 9 shows the second feature of the fiscal deficit; while the primary spending, including wages and salaries to government employees, has fallen, interest payments on outstanding debt has increased sharply.

Figure 9: Composition of fiscal spending



Source: OECD (2019), p.9

Given that a significant portion of its debt is dollar denominated, the interest component now dominates the fiscal deficit. As yields on sovereign bonds rise sharply (Henderson, 2019), Argentina's descent into a debt trap will result in even greater economic instability.

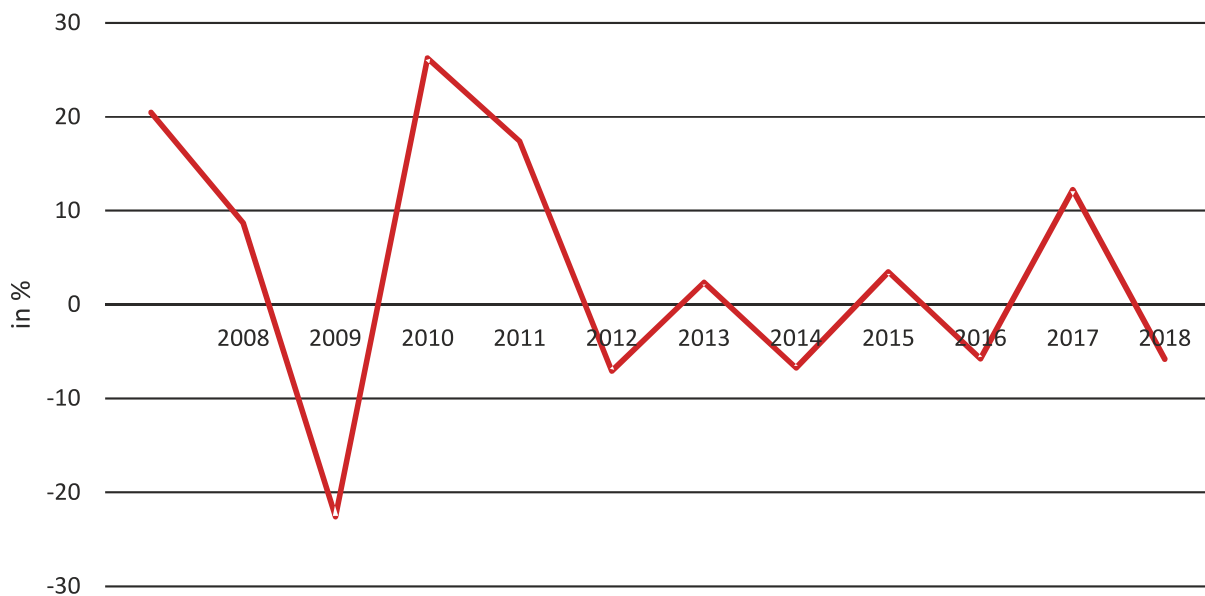
6. The domestic private sector in Argentina

By focusing only on the external and government sectors, the twin deficit hypothesis, i.e. equation (3) overlooks the third sector of the economy; the domestic private sector, which also includes the banking sector. The relative "lack of action" in this sector is a stark feature of the Argentine economy; a feature that makes it more important rather than less. To put it differently, it is not *net* financial asset accumulation that is of concern here, but the low level of savings and investment individually, both in absolute terms and as a percentage of GDP that Argentina should be concerned about.

On several important private sector savings parameters, Argentina ranks one of the lowest in the world with household debt at just about 5 percent and gross savings rate at 14 percent of GDP (OECD, 2019, pp. 51-52). High inflation and inflation expectations combined with a depreciating exchange rate has not only meant falling real wages as can be inferred from Figure 6 so that savers prefer to hold wealth in dollars or dollar-denominated assets like property. Peso-denominated financial assets are simply too risky; these include equity shares and other financial securities including government bonds in spite of high interest rates.

Investment spending suffers from the same reasons; it is easier to earn a higher return on investable funds by investing abroad – capital flight, illegal (usually through over-invoicing of imports) or legal (outward portfolio investment); this has always been a serious concern for Argentina. Indicators related to Argentine private corporate sector activity are abysmal; loans to non-financial private sector at 28 percent of GDP and stock market capitalization at 18 percent (ibid) do not reflect Argentina's status as a high-middle income country. Gross capital formation not only remains as low as 16 percent of GDP but its inconsistent growth rate as seen in Figure 10 is a definitive cause for worry, with periods of zero and even negative growth interlaced with sudden unsustainable spikes.

Figure 10: Growth rate of Gross Fixed Capital Formation in Argentina



Source: World Bank Data,
<https://data.worldbank.org/indicator/NE.GDI.FTOT.KD.ZG?end=2018&locations=AR-CO&start=2009>

The IMF's claims that "Argentina's financial system appears resilient to the ongoing macroeconomic transition" (IMF, 2016, pp. 13-14) is akin to the claim that an already unemployed person cannot lose much if a recession sets in. Moreover, the "stability" of the domestic financial system described by the IMF is more a cause for worry than a positive indication of a robust middle income economy.

Argentina's financial system is mostly transactional and has generally low exposure to credit or exchange rate risk. Banks are well capitalized (total and tier 1 capital ratios are well above regulatory minimum at 16.2 percent and 15.3 percent, respectively, as of June 2016), have low non-performing loans (under 2 percent), and relatively large provisions (above 140 percent of nonperforming loans). The liquidity position of the banks appears comfortable, with the liquidity coverage ratio in 2016 well exceeding the minimum set by the Basel Committee. Currency mismatches are low and banks have an aggregate net long FX position which limits risks from sudden currency depreciation. Corporate leverage is generally low since companies mostly lacked access to external funding and the domestic financial system is small. Household debt is also relatively low (ibid).

Although deleveraging may not be a cause of worry for Argentina, it does not mean that leveraging is irrelevant to an economy. The inactivity in the private sector – or the lack of leveraging through bank credit or borrowings – is more a bane than a virtue. Private sector leveraging driven by a desire for capital formation or investment spending (I) is a key driver of growth and macroeconomic stability. It is important that investment boosts GDP and enhances the quantum of saving in the economy. Of course, as explained above, the private sector would desire to hold a part of its savings outside of itself, which can be met through issue of government liabilities (fiscal deficits) and/or CAS.

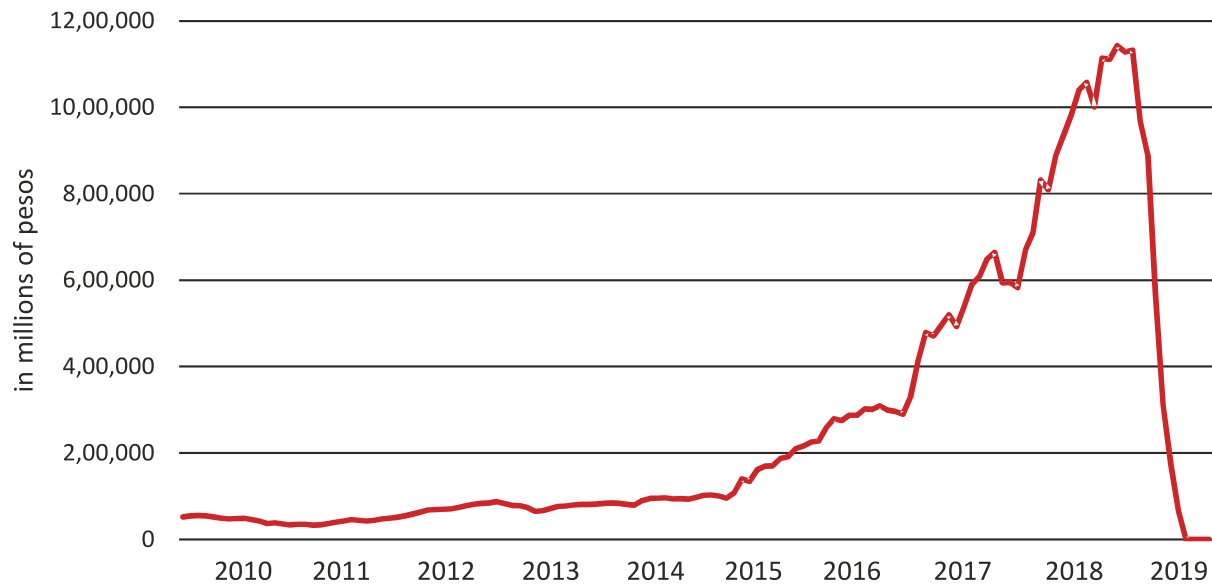
Argentina is rich in natural resources and has other sectors that can grow with adequate investment. Macri intended to do away with regulations of the previous Kirchner (Nestor Kirchner and CFK) regimes, so that investors consider Argentina's infrastructure, petroleum and energy sector as worthwhile investment opportunities. However, external debt stocks of the private sector have remained stagnant (Figure 8) with bottlenecks in key industries while FDI inflows have also remained fairly low at less than 2 percent of GDP.

7. The monetary policy dilemma for Argentina

A brief discussion on monetary policy is essential to have a more holistic picture of Argentina's macroeconomy. Monetary policy in Argentina comes under the purview of its central bank, Banco Central de la Republica Argentina (BCRA), with the objective (among others) of achieving low and stable inflation and exchange rate stability.

A critical feature of the Argentine economy is the accommodating financial inflow of dollars to bridge the CAD that remains uncovered after net financial (autonomous) inflows. This has been possible by the issue of sovereign bonds by the Treasury (Government of Argentina). These dollar inflows are purchased by the BCRA for exchange of pesos deposited in the Treasury's account at the BCRA, which when spent by the government, increases liquidity in the economy and consequently pushes up the rate of inflation. To mop up this liquidity in the system, central banks carry out reverse repo operations with banks wherein government bonds are swapped for reserve money held by the commercial banking system. However, with the meagre availability of peso-denominated government bonds, the BCRA issued its own peso-denominated liabilities called Las Letras del Banco Central (LEBAC) with maturity between 30 and 273 days, offered at high interest rates to financial institutions and households to overcome the inflation and currency risk of holding peso instead of its immediate conversion to dollars. Between 2014 and the end of 2017, the quantum of LEBACs held had increased by some 350 percent, from US\$ 18 billion to about US\$ 60 billion. Towards the end of 2017 and in the early months of 2018, the Argentine government introduced a slew of policies that effectively burst the LEBAC bubble; lowering the nominal interest rate and then introducing a tax on income earned on LEBACs. At the same time, interest rate hikes initiated by the Federal Reserve were making dollar-denominated assets more attractive while also strengthening the dollar. Till then, the LEBAC had been an attractive investment for carry-trade, which was no longer so; by April-May 2018, the sale of LEBACs and liquidation of carry trade positions (Figure 12) led to a massive demand for dollars and collapse of the peso (Chaconosky, 2018). To contain the situation, BCRA increased the nominal interest rate from around 28% in April 2018 to 70% by October 2018 (BCRA, 2016, p.50).

Figure 11: Quantum of LEBACs outstanding



Source: Smith and Newbery (2018)

Since then, the BCRA decided to switch from LEBACs to securities with a shorter maturity, liquidity bills – LELIQs. However, with rising interest rate on the LELIQ of more than 60 percent and the accumulation of more than a trillion peso (US\$ 24 billion) worth of LELIQs issued, the BCRA is once again staring down an imminent crisis (Jourdan and Burin, 2019).

Argentina's monetary policy it seems is caught in a loop; it needs a well-developed government bond and treasury market to control liquidity in the system so that inflation can be brought under control. However, to make peso-denominated securities a desired option, inflation, inflation expectations and exchange rate risks have to be tamed. The Macri-IMF plans have not been able to break out of this vicious circle and have only landed Argentina in a quagmire of stagflation.

8. A return to the SFB equation

There is a fundamental question that must be raised on fiscal deficits for a country like Argentina; why or under what circumstances does an economically sovereign country need to fund its domestic fiscal deficit in dollars, and not with its own currency, like the peso? To answer this question, we must go back to the SFB model. Given that the primary driver of the Argentine crisis is the external sector with its large autonomous dollar deficit, we rewrite equation (2) as:

$$(M-X) = (G-T) + (I-S) \dots (4)$$

A CAD essentially implies the net asset accumulation by foreigners in the domestic economy for which either the government accumulates corresponding financial liabilities and/or the domestic private sector must do so through leveraging. With the private sector not doing so, the government must issue debt (liabilities) so that foreigners hold it against Argentina's deficit in its current account. In this way, the CAD could be the driver of the fiscal deficit and not vice-versa as made out to be. Of course, higher deficits do drive up imports and consequently, the CAD, but unless the government and/or the private sector accumulate financial liabilities which foreigners are willing to hold, it is not possible to run the CAD. The parameters in the SFB model will undergo changes until equilibrium is reached.

It may seem from Table 1 that net financial asset accumulation by the private sector is gradually decreasing – a trend that could indicate greater leveraging – however, it is important to keep in mind that these are computed as a percentage of GDP. With Argentina experiencing a recession (or contraction of GDP) in recent times, there could be a rise in net financial asset accumulation as a percentage of GDP although falling in absolute terms. This fact must be kept in mind given that the relative “inactivity” within the private sector is a problematic issue facing the Argentine economy.

9. Argentina's policy options

What then are the policy options open to Argentina? The first is autarky; these policies towards a closed economy with restricted free foreign trade and capital flows were broadly adopted by Argentina under Nestor Kirchner and then CFK (Bendini, 2012). Tracing the historical roots of this policy framework goes back to the dependency theory proposed by Hans Singer and Raul Prebisch in the late 1940s, which called for a shift from export-oriented to import-substitution policies. However, higher inflation triggered by larger deficits to fund domestic spending (without a corresponding increase in supply of domestically produced goods and services), increasing need for imports to keep prices low, fixing the exchange rate at an overvalued rate to keep certain imports cheap, strict controls on the use of foreign currencies, and relying on export of commodities to accumulate foreign exchange reserves were taking Argentina into a crisis by 2013 when reserves hit a low of just US\$ 34 billion (Levine, 2013).

The second policy configuration was used by CFK's successor, Marci, or what is broadly termed as neoliberal policies; open the economy to free trade and capital flows, relying on prices to clear markets as well as fiscal consolidation. However, these policies soon led to an equally dangerous situation as inflation accelerated, the peso crashed, capital flight was now official and the government soon ran out of foreign reserves. Raising dollars through external debt soon took Argentina into a debt trap that sent it back to the IMF for a bailout. The increased pressure imposed by the IMF to adopt austerity measures is essentially meant to deflate the Argentine economy so that inflation cools and imports decline to lower the CAD while the peso stabilizes. With low and stable inflation, interest rates could be lowered to spur private sector consumption and investment spending.

The third option within the neoliberal framework could be to let the peso find its value based on autonomous capital inflows to bridge the CAD. This, however, is not a realistic implementable policy – the peso will go into free fall without any certainty of how much it will depreciate before exports increase adequately and imports decline.

10. Argentina's struggle for economic complexity

The SFB equation captures the essence of the Argentine Paradox; the economy is driven by the need to fund its current account. Usually autonomous inflows of foreign capital into the domestic private sector would bridge the gap to a large extent, as for instance, in the case of Turkey. However, with private sector being unable to leverage capital to boost investment and growth, the responsibility falls on the government to raise dollars either through direct investments in the public sector (autonomous inflows) or through the accommodating inflows through the issue of dollar-denominated bonds. So far, Argentina has fallen back on the latter as the basis for its dollar funding. The SFB perspective also clarifies another important puzzle that the twin deficit equation (3) gives rise to; why an economically sovereign nation like Argentina which issues its own currency, the peso, have had to fund its fiscal deficit with dollars. It is for this reason that the fiscal deficit tracks the CAD so closely, one feeding into the other in a vicious circle. Unfortunately, the problem is often misread simplistically as fiscal deficit is causing CAD, which then percolates into policy directions.

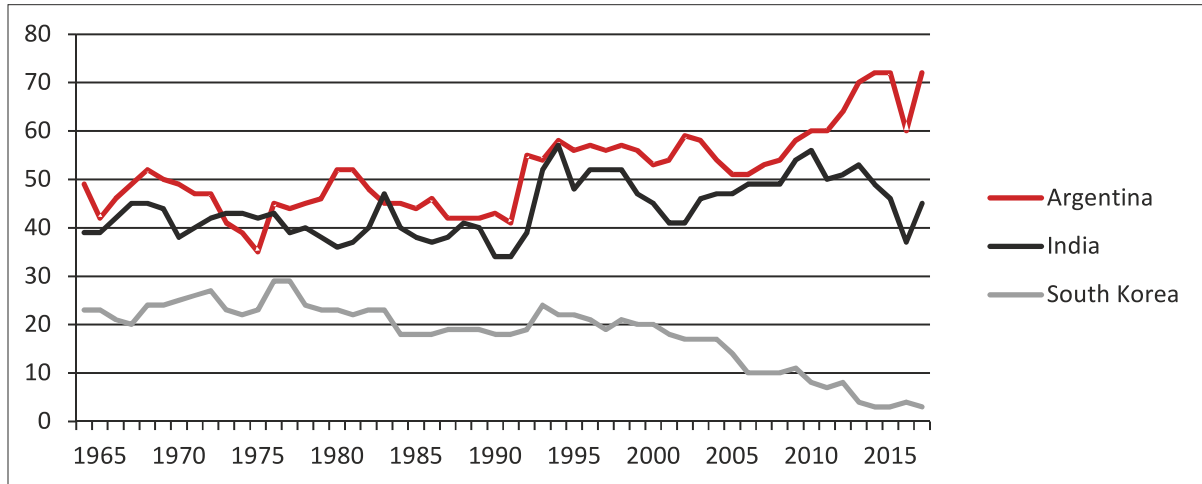
Meanwhile, from a historical standpoint, many economic historians actually question whether there really was a “paradox” in Argentina's development. They argue that Argentina in effect suffered from the resource curse – its large exports of meat and other commodities led to a boom rather than “true economic development” (Glaeser et al., 2018, p.5). Given its social and political history, Argentine governments often resorted to populist policies to redistribute the wealth earned by the elites, who, it was widely believed, earned their wealth through “corruption and favouritism, instead of hard work and creativity.” (ibid, p. 20) Meanwhile, under the populist government of Juan Perón (post World War II), Argentina's strong trade union movement grew stronger (Atzeni and Ghigliani, 2009), a dynamic middle class emerged (Tepepa, 2019) and social policies (ibid) led to improved standards of living among its population.

Perón decided to consolidate the social base of his movement by redistributing income to the working classes. In fact, he saw industrialization as a means of achieving the goals of his nationalistic and populist policy of increasing the real consumption, employment and economic security of the masses of workers ... (Galiani and Somaini, 2018).

Even as standards of living rose in Argentina, import-substitution and autarkic economic policies discouraged the development of competitive industry (Brambilla et al., 2018), which even today remains non-competitive in a globalizing world; for instance, the Global Competitive Index ranks Argentina at 92 out of 137 countries (WEF, 2017), probably the lowest among middle income countries. Another useful method to measure the “productive capabilities” of countries is the Economic Complexity Index (ECI) developed by Ricardo Hausmann and Cesar Hidalgo (Ortiz-Ospina and Beltekian, 2018). Given the difficulty in measuring such capabilities – which is a combination of ideas, knowledge, technologies as well as physical and other

infrastructure – they use the number and quality of products that a country exports as a proxy to ascertain ECI. Figure 12 shows how Argentina has deteriorated in its ECI rank from 50 to about 72 in world rankings in comparison with India (which has remained at about the same) and South Korea (which has shown tremendous improvement from 23 to 3) between 1964 and 2017.

Figure 12: Changes in ECI rank, 1964-2017



Source: <https://ourworldindata.org/how-and-why-econ-complexity> and <http://atlas.cid.harvard.edu/rankings>

With private and public industries unable to attract autonomous foreign exchange flows, it must rely on the government debt to fund its CAD. This will continue to remain a perpetual problem even in the long term. In the meantime, Argentinians will probably witness a compression of GDP and a slow decline to lower standards of living, a reflection of their level of competitiveness in today's world.

11. Applicability and Generalizability of the Argentine experience to India

Developing complexity, capabilities and competitiveness is not something that a country can do within the span of a few years or even perhaps decades. A recent study by the National Science and Technology Council (2019) gives a broad-brush view of the complex strategies required to achieve leadership in advanced manufacturing capabilities that is the cornerstone of complexity enhancement. While South Korea's achievement is clearly outstanding, the Argentine situation is dismal. The lack of improvement in India's rank over the last 50 years is a cause for concern too as Figure 12 clearly illustrates. However, it is important to highlight the difference between Argentina and India; unlike the Argentine situation, India's external debt is predominantly held as external commercial borrowings by the private sector rather than as sovereign debt. This can be inferred from Table 3.

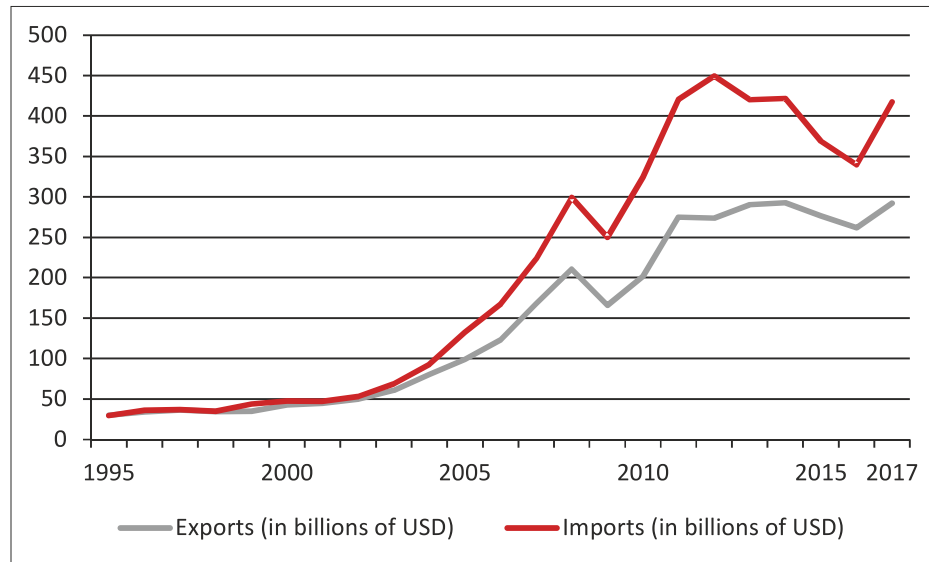
Table 3: Composition of India's external debt (2017)

Component	Short term (up to 1 year)	Long term	Total	Percentage of total
Sovereign debt (long term)	4.6	91.1	95.7	20.3
Commercial borrowings	24.0	147.3	171.3	36.4
NRI Deposits	79.3	37.6	116.9	24.7
Short term (original maturity)	88.0	-	88.0	18.6
Total (by residual maturity)	195.9	276.0	471.9	100

Source: RBI Bulletin (2017)

Prior to India's balance of payments crisis in 1991, its external borrowings predominantly consisted of a large share of short-term sovereign borrowings to fund its imports of petroleum, petroleum products and fertilizers. Imports of consumer goods were restricted. Post-1991, significant efforts were made to reduce short-term external debt through prudent external debt management policies. However, the significantly high growth trajectory that India achieved between 2001-02 and 2011-12 induced a strong growth in imports, which averaged about 26 percent as compared to 8 percent growth in the previous decade, 1991-92 to 2001-2002 (RBI Bulletin, 2017). This concern is also reflected in India's balance of trade deficit figures (Figure 13), which has over the years showed a marked increase, in particular, during a period of high GDP growth.

Figure 13: India's growing balance of trade deficit (1995 – 2017).



Source: https://oec.world/en/profile/country/ind/#Trade_Balance

Perhaps it was this concern over trade deficits and its consequent impact on foreign exchange rates that drove the Indian government to consider for the first time ever an external sovereign bond issue of US\$ 10 billion (Balachandran, 2019), that has been shelved, at least for now, over concerns of its longer-term impact. However, the stark reference to Argentina's external debt crisis amongst other countries like Greece and Brazil by several commentators in the popular media was a reminder that the Argentine Paradox is not completely irrelevant to the Indian situation. A rapidly growing economy, which is unable to maintain its trade account deficit can subsequently become dependent on foreign capital inflows. Without a globally competitive private sector that can attract adequate capital inflows, the government may have to fill the gap through external sovereign debt. These are certainly important lessons to take cognizance of, even if it may not be applicable or generalizable to the immediate Indian condition.

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Sashi Sivramkrishna completed his Ph.D. from Cornell University and is presently Professor of Economics at Kautilya Entrepreneurship & Management Institute, and Director, Foundation to Aid Industrial Recovery in Bengaluru. His research interests include economic and environmental history and contemporary macroeconomics. Sashi has published several papers in journals like *Business History* and *Journal of Post-Keynesian Economics*, popular articles in *The Wire* and *Newslick* as well as three books including one on the History of the Rupee and another on the current macroeconomic narrative in India. He is also an avid documentary filmmaker with screenings at the Royal Anthropological International Film Festival (UK), Festival of Documentary Cinema (Russia) and many others. He can be reached at sashi.sivramkrishna@gmail.com

Akshat Sen is a final year B.Sc. student at the Sarla Anil Modi School of Economics, Narsee Monjee Institute for Management Studies, Bengaluru. He interned at the Macroeconomic Analysis & Policy Studies (MAPS) Initiative, Foundation to Aid Industrial Recovery, where he contributed to this study. He is currently contemplating further studies in behavioural economics, development economics and policy studies from a heterodox perspective. He can be reached at akshat.sen@gmail.com