

## **Argentina's Latest Tango**

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As anyone who has ever tried to tango knows, the first few steps are fairly easy and can lull someone into a false sense of accomplishment before the more complicated steps begin. Similarly, Argentina is in the midst of the first few steps of a recovery—the easy part. If Argentina wants to successfully complete this dance and have a sustained economic recovery, it needs to undertake the more difficult steps and tackle a number of fundamental economic reforms.

Argentina's recent economic performance—although impressive—should not be interpreted as evidence that Argentina has ended the boom-bust cycle and will be able to sustain its recovery. Granted, Argentina has taken some important economic steps—such as running a sound monetary policy that has helped contain inflationary pressures—and these steps have helped support the current recovery. But the recovery has also largely been driven by two other factors—the traditional rebound after a crisis and the supportive global environment—which may not persist.

When countries undergo devastating crises and sharp recessions, especially if combined with large devaluations of their currencies, it is not unusual to have a brief period of strong recovery. For example, after Korea's 1997 crisis and devaluation (during which real GDP contracted by almost 7% in 1998), growth rebounded to over 9% in 1999 and over 8% in 2000. After Russia's 1998 crisis and devaluation (during which real GDP contracted by over 5% in 1998), growth rebounded by over 6% in 1999 and 10% in 2000. Most recently, after a series of devaluations and sharp real contraction of almost 9% in 2002 and nearly 8% in 2003, Venezuela's growth is expected to rebound to over 12% in 2004.

Although some of these impressive recoveries occurred in conjunction with improved economic policies to help sustain growth—others occurred with relatively little reform and no fundamental changes to ensure the recovery lasted. A rather morbid term, the “dead-cat bounce” has been used to describe this traditional bounce after a sharp recession—a term meant to show that anything, even an inanimate object, will bounce back if it falls from high enough. A “dead-cat bounce” is no indication that a recovery will last.

Just as important as this traditional post-recession bounce in explaining Argentina's recent recovery is the extremely supportive global environment. The global economy grew by about 5% in 2004—the fastest rate of global growth in about 25 years. This has helped spur demand for Argentina's exports and increased demand for commodities, driving up prices for commodities such as soy beans and grains—which are important Argentine exports. Argentina's exports increased by 14% in 2003 and by 15% (year-on-year) through the first three quarters of 2004. Strong global liquidity and low global interest rates have also helped spur growth in Latin America.

Most of these factors that have supported Argentina's recent recovery, however, are likely to fade. The traditional bounce traditionally experienced by emerging markets after a recession typically diminishes without fundamental economic reforms. Global growth is expected to slow from its recent record pace to about 3.5% to 4.5% in 2005. Many commodity prices are expected to fall. Although global growth will still be strong, and commodity prices higher than compared to historic averages, these factors will be less important drivers of growth in Argentina. Potentially even more important, the United States and many other large economies have already started to raise interest rates or are considering interest rate increases, and most analysts expect the U.S. to continue to raise rates, suggesting that the period of unusually low borrowing costs for emerging markets will not continue. Moreover, once its debt restructuring is completed, Argentina will soon need to resume payments on external obligations.

All of these changes, however, do not mean that Argentina will necessarily slip back into a period of slow growth—or even a crisis. Instead, these changes mean that it will be more important for Argentina to adopt the fundamental reforms necessary to provide a basis for self-sustaining growth. The most immediate priority is for Argentina to successfully complete its debt restructuring and normalize relationships with the investor community. Financing for investment is critical to support growth and provide incentives for companies to operate efficiently.

Another important area of reform is the tax system. Key priorities in this area include reducing tax evasion, reducing the use of distortionary taxes like the Financial Transactions Tax, and further broadening the Value-Added Tax base. Perhaps the most important tax reform, however, continues to be following through on commitments in its suspended IMF program to strengthen fiscal discipline among provincial governments. More specifically, Argentina should strengthen the Fiscal Responsibility Law to help promote long-term fiscal discipline among provinces. It should also work to reform the Co-Participation Law (that codifies revenue-sharing arrangements between the central and provincial governments) to strengthen incentives among provinces to raise a larger share of their future revenues rather than relying on fiscal transfers. Although tax revenue has recently improved in Argentina, this largely reflects the economic rebound and should not be used as a justification to delay tax reform.

There are many other important reforms that Argentina should undertake in order to see a sustained period of strong economic growth. For example, Argentina will need to ensure that its banking system is well capitalized and well regulated. This may involve measures such as decreasing the use of regulatory forbearance, improving procedures related to bank closure and resolution, and restructuring its public banks to make them more commercially oriented. The government will also need to renegotiate contracts with utility companies to reflect price adjustments that have occurred over the past few years and ensure the companies are able to continue operating.

In fact, the recent electricity and gas shortages hint at the problems that Argentina will face if it does not tackle these difficult reforms soon. In 2004, Argentina experienced widespread electricity and natural gas shortages. The shortage of natural gas was so extreme that between

April and June of 2004, Argentina reduced daily natural gas exports to Chile by 20% to 47% of the volumes agreed to in contracts—a serious blow to Chile which imported roughly 90% of its natural gas from Argentina. Companies will be less willing to invest in Argentina and expand production if they can't rely on dependable sources of energy and electricity—and especially if they can't rely on the Argentine government to respect contracts. Lower levels of investment will translate into fewer employment opportunities and lower growth.

Many of these challenges are not new to Argentina. Between 1960 and 2001, Argentina experienced negative GDP growth in 15 of those years – that is, nearly 40% of the time. In over half of these episodes, real GDP fell by a rate that was either equal to or approaching 5%. In fact, since 1801 Argentina has defaulted on its debt (or undergone a major restructuring) on 5 different occasions—and has been in a state of default or restructuring for 26% of the years between 1824 and 1999.

This does not, however, mean that Argentina is doomed to another century in-and-out of default and recession. It is possible to end this cycle by tackling a number of important reforms necessary to sustain the recovery. The recent rebound in Argentina and strong global environment provides a supportive environment in which to tackle the reforms. But the honeymoon is over. Accomplishing the next set of reforms will not be easy—just as learning the tango is not easy—but without these steps the recovery could easily be derailed and Argentina may not be able to embark on a sustained period of economic growth.