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Argentina Says No to Financial Dependence—and Devaluation

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Argentina's leadership is focused on defending the nation's trade surplus, which is used to pay down debt. To avoid currency devaluation, policymakers have enacted a string of temporarily effective—but unexpectedly severe—controls.

Cristina Kirchner's landslide victory in Argentina's presidential election late last year left her with no organized political opposition—and a lot of influence in setting the country's direction. That direction will likely be colored by her memories of Argentina's recovery from a credit-intensive period that ended in the rescheduling of outstanding debt and a severe recession in 2001.

Renewed Enthusiasm for More Intervention and Less Debt

From that perspective, dependence on foreign capital is a hindrance to both economic interventionism and a strong state role in income distribution. Heavy indebtedness also precludes the use of an activist program to create a steady recovery in employment and economic activity—developments that would ultimately increase Kirchner's popularity.

After years of an alternative policy program in Argentina, the momentum of Kirchner's win has renewed enthusiasm for state intervention and a reduction in the country's debt burden. In the eyes of many Argentineans, Europe's financial strains illustrate the perils of choosing cheap debt over painful fiscal adjustments. The massive credit extended to peripheral Europe was too good to be true, leading to recession, unemployment, loss of national political control and a chronic financial crisis.

Success with Capital Controls

Argentina was due for a post-election economic adjustment. National and provincial spending was elevated before the election, including outlandish subsidies for energy and transportation. The currency was steaming toward overvaluation, as Argentina's inflation rate of 20% to 30% far outpaced a devaluation rate of 5% to 10%.

The classic prescription for this state of affairs would be massive spending cuts combined with a large-scale currency devaluation that would change relative prices but not turn into general inflation due to soft demand.

Argentina seems to have chosen a loosely related prescription that favors increasingly intrusive economic controls, the first of which were implemented to stop capital flight from investors who feared a devaluation of the currency—the classic prescription referred to earlier. Kirchner and her staff viewed the outflows as a political attack by wealthy investors protesting her reelection, and responded with unexpected vigor.

The response included a novel control requiring that dollars be provided only based on need, demonstrated by consistency with past levels of declared income in local tax records. This consistency is a subjective judgment, but the policy was effective in sharply curtailing capital outflows into January.

This type of micro-intervention is new to Argentina—or anywhere else, for that matter. Improved electronic recordkeeping has facilitated its implementation, as has the use of computers to collect and sort vast amounts of data. The policy has unnerved local residents to an extent that's difficult for outsiders to fully appreciate. But it's also been so effective that it's now looked upon as an alternative to a currency devaluation.

Microregulation of Trade

Perhaps encouraged by the success of this policy, and feeling that a currency devaluation would show political

weakness, the Kirchner administration has defended its recent trade surplus by issuing new microregulations.

Under these new rules, corporate importers can't access foreign currency to pay for parts and supplies unless they show offsetting imports. Any imports must be proven necessary under similar tax-record criteria, but the relationship is arbitrary and applied variably according to trade results in a given month.

In aggregate, these restrictions sharply increase the effective cost of imports, and the new rules add to earlier quotas and taxes. For example, the same iPad or car may cost two to three times more to Argentineans in US-dollar terms than it costs Americans. This is effectively a shadow change in the relative prices of domestic and foreign goods—and is applied in a very distorted, arbitrary and demoralizing way.

These severe import restrictions hurt growth, too. Argentina's small manufacturing sector needs parts and supplies; without them, production suffers—including that of cars shipped to the once-booming Brazilian market. To make things worse, unpredictable impediments to business, including profit repatriation, are bound to cut into future investment spending. But for now, at least, imports will be reduced, preserving Argentina's trade balance.

Reducing Subsidies and Real Wages

A growing bill for fuel imports is also a concern—it's actually the single biggest source of trade deterioration. The government's efforts to fix utility, fuel and transport costs, combined with high inflation, led to high demand and high imports. The difference between local and international fuel costs impacts the country's fiscal balance to the tune of roughly 2.5% of gross domestic product, a common measure of economic output. That puts a big burden on Argentina's trade and fiscal accounts.

In another exercise in microintervention, Argentina plans to reduce subsidies. The goal is to hold down costs for Kirchner's lower-class supporters at the expense of the upper-class opposition. The jury is still out on how the policy will accomplish this without creating further economic complications. It's still a work in progress: so far only a small portion of the necessary subsidy cuts have been identified.

One more instance of the unconventional policy measures adopted in Argentina is an attempt to limit union wage increases, through economy-wide negotiations, to 18%. If this is successful, it will reduce inflation-adjusted, or real, incomes, which rose sharply last year. It would be one more contributor to lower import demand.

Still Paying Down Debt

Through these measures, Argentina should be able to defend a substantial trade surplus without devaluing its currency, but at the cost of a wave of economic distortions—and probably a 2012 recession. It will use that surplus, like the others before it, to pay interest and principal on public external debt. The support for these debt-reduction policies is reinforced by Argentina's awareness of the dangers of financial dependency—as highlighted by Europe's financial crisis.

Of course, the official policy of paying down foreign debt isn't followed to the letter. Outstanding debt litigation makes direct foreign-law borrowing by the national government inconvenient, but provincial borrowing has surged. And the nationalized pension agency has been selling liquid dollar securities in global markets, replacing them with less-liquid peso claims. As long as the trade surplus is big enough to maintain reserves, the net effect of these counterflows across the economy should be minor.

Unfortunately, Argentina has adopted arbitrary and distortion-inducing measures to achieve this trade result while continuing to pay down foreign debt. It's hard to envision these policies supporting long-term economic growth, and they come at the extreme cost of collapsing Argentina's role in global supply chains and financial markets.

Argentina will defend the official value of its currency by becoming an island of sorts—floating off the coast of the global economy. In the meantime, its unconventional policy stance means that the amount of economy-wide external debt will remain small, and Argentina will be very unlikely to encounter difficulties in repaying it. ■