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**PROSPECTS FOR ARGENTINA UNDER IMF
SURVEILLANCE**

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Johns Hopkins Institute for Applied Economics,
Global Health, and the Study of Business
Enterprise



Prospects for Argentina under IMF Surveillance

By John Greenwood

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About the Series

The Studies in Applied Economics Series is under the general direction of Professor Steve H. Hanke, co-director of the Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise (hanke@jhu.edu). This working paper is one in a series on currency boards and monetary systems. The working papers will fill gaps in the history, statistics and scholarship of the subject. The authors are mainly students at the Johns Hopkins University in Baltimore.

About the Author

John Greenwood is the Chief Economist at Invesco Ltd, a global asset management company. As editor of the Asian Monetary Monitor over the period 1977-96, he is widely credited as the designer of the restored currency board system in Hong Kong at the time of the currency crisis in 1983, a model for numerous subsequent currency board systems. Holding an MA and Honorary Doctorate from the University of Edinburgh, he is the author of "Hong Kong's Link to the US Dollar – Origins and Evolution" (Hong Kong University Press, 2007). He has been a Fellow of the JHIAE since June 2016.

Abstract

Since the end of "Convertibility" in January 2002 Argentina has suffered from persistently rising inflation. From 5% in 2004, annual inflation increased to 40% p.a. by the end of 2014. The underlying source of the problem has been excessive fiscal deficits funded from the Central Bank of Argentina's (BCRA's) balance sheet by successive governments. This paper starts with the key abuses of the BCRA's balance sheet which have undermined monetary stability and proceeds to a wider view of the ingredients of Argentina's current crisis. Despite the accession of the market-friendly President Mauricio Macri in December 2015, the situation has continued to deteriorate. After two and a half years in office, the administration had made little progress in solving the country's macroeconomic problems. Faced with another episode of currency depreciation in May 2018 and rising inflation, the Argentine authorities appealed to the IMF in June for a \$50 billion loan which they were successful in obtaining. The IMF's Stand-By Agreement (SBA) comes with numerous conditions attached: the SBA proposes to strengthen the BCRA's autonomy, stop the direct financing of the government by the BCRA, while maintaining an inflation targeting regime and a freely floating peso. Will the IMF's SBA be enough? The problem is that the IMF's SBA document implies the inflation targets and other reforms can be achieved by means of a gradual reduction of the fiscal deficit -- without pain and without a deep recession. Meantime the growth of the monetary base and M3 growth are still far too high. In my view the current fiscal and inflation targets in the IMF plan are unattainable, and the plan will fail.

More likely, either the current plan will fail and Argentina will once again default on all foreign-denominated debt held by the private sector (the IMF will again be exempted as they were in 2002), or under a tougher version of the IMF plan Argentina will again face financial collapse and high unemployment, causing President Macri to lose the next election, and virtually ensuring a return to populism for another decade.

Acknowledgements

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Keywords: Central banking, inflation, currency depreciation, monetary base, monetary growth

Prospects for Argentina under IMF Surveillance

PREFACE

This brief paper was written in July 2018 soon after Argentina had applied to and obtained from the IMF a three-year Stand-by Agreement of US\$ 50 billion, arranged in mid-June.

The normal reaction to the implementation of such a scheme would be an immediate stabilisation of the currency, an abrupt decline in the economy's sovereign risk premium, and, after an interval, a gradual improvement in economic conditions. However, in my view this kind of favourable sequence of developments seemed unlikely to transpire. The reason was that, in my judgement, Argentina's monetary and fiscal position was much more fragile than widely recognised and too little had been done to overcome the populist legacy of President Cristina Fernández de Kirchner. Moreover, the IMF plan was much weaker than it needed to be. I therefore prepared this paper to focus on the underlying problems that needed to be addressed if the crisis was to be solved.

Since the start of the crisis in April and even since July there has been a series of dramatic developments that need to be taken into account when reading this survey. A key trigger was the authorities' decision to impose a new tax on BCRA debt (LEBACs) held by non-residents, which became effective on April 25th. This led to capital withdrawals by foreigners and required repeated BCRA interventions in the foreign exchange market to stabilise the currency. Reserves fell to US\$ 56.1 billion from US\$ 62.6 billion in March. The BCRA raised rates by 300 bps on May 3rd. Even so, the crisis has escalated inexorably. The Argentine peso fell from around 20.25 per US\$ in March and April to 29 by the end of June, and then to 30 per US\$ on August 13. On the same day the BCRA raised its policy rate from 40% to 45%, but by month-end the currency was hitting almost 40 pesos per US\$. Repo rates rose even more steeply. On August 29 President Macri himself announced on YouTube that he would be requesting the IMF to speed up the disbursement of its \$50 billion bailout package. On August 30 the BCRA again raised rates, this time to 60%, and on September 4th a delegation from Argentina was in Washington to negotiate the restructuring of the IMF plan (updated September 4th, 2018).

INTRODUCTION

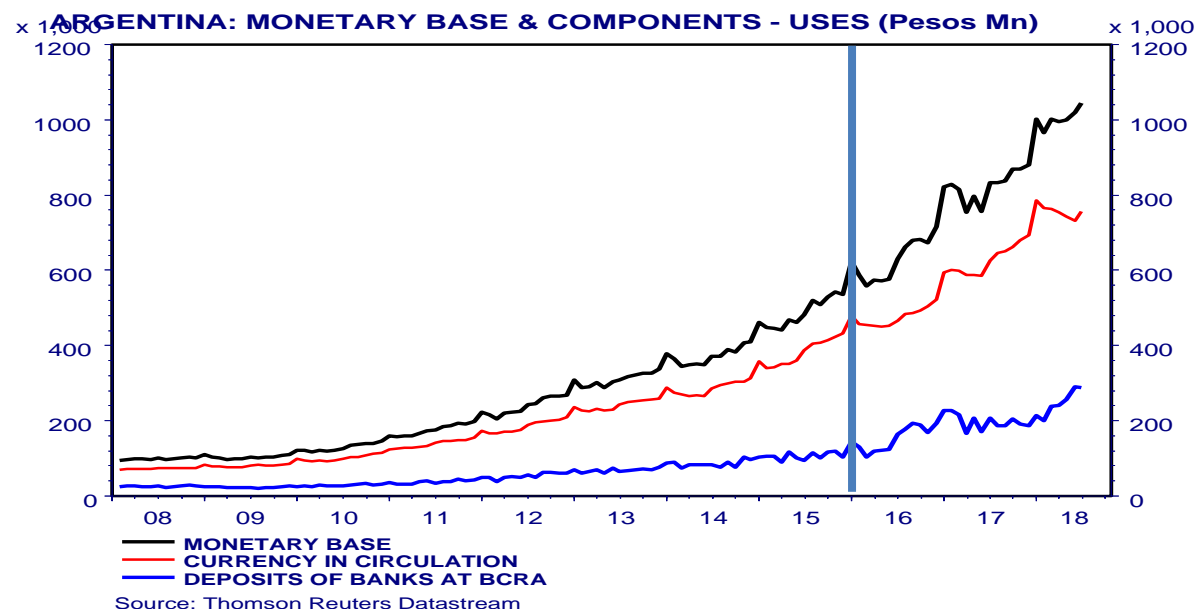
The prospects for the new, market-friendly administration of Mauricio Macri who became President of Argentina in December 2015 were challenging from the outset. Replacing the populist President Christina Fernandez de Kirchner, President Macri was confronted with excessive government expenditure and deficits deriving from subsidies in key sectors such as utilities and fuel, rapid growth of the public sector, inflation of 30-40% p.a., capital controls, and a dual exchange rate system. Having only a bare majority in the legislature and faced with midterm legislative elections in October 2017, the Macri government initially adopted a policy of cautious gradualism in dealing with the economic problems they inherited.

A year ago, in September 2017, my assessment was that there had been very limited improvements in the day-to-day experience of average Argentinians. In fact the purchasing power of the lower middle class, who were major supporters of Macri, had worsened due to the removal of subsidies for fuel and utilities and the resulting steep rise in their prices.

Subsequently there has been little further progress. Consumer prices have risen 44% since December 2016 and the currency has depreciated from 9.61 per US\$ in November 2015 to 26.56 in June 2018. Meanwhile, partly as a result of the handover recession of 2015-16 (when the fuel and utility subsidies were ended) the real GDP has grown by only 4.3% since the first quarter of 2016, averaging 0.9% p.a. Moreover, in June 2018, following yet another episode of weakness in the currency in May (when the currency fell from 20.55 to 25.15), the government appealed to the IMF for an assistance package. However, instead of obtaining a Flexible Credit Line (FCL) or Precautionary and Liquidity Line (PLL) they were only able to obtain a Stand-By Loan Agreement (SBA) which imposes a high degree of conditionality. In short, being unwilling to bear the pain of an abrupt reform programme, and by failing to implement adequate reforms in a timely manner, Argentina has ultimately been forced to undergo an external supervision programme. But will the IMF's SBA do the job?

Section 1. The Abuse of the Central Bank's Balance Sheet

Figure 1. Argentina's Monetary Base only Tells a Fraction of the Story



A good starting point for the analysis of any economy is the balance sheet of the central bank, in this case the Banco Central de la Republica Argentina (BCRA), and its role in money creation and government financing. As I shall explain, there are **three main problems** with the BCRA's balance sheet.

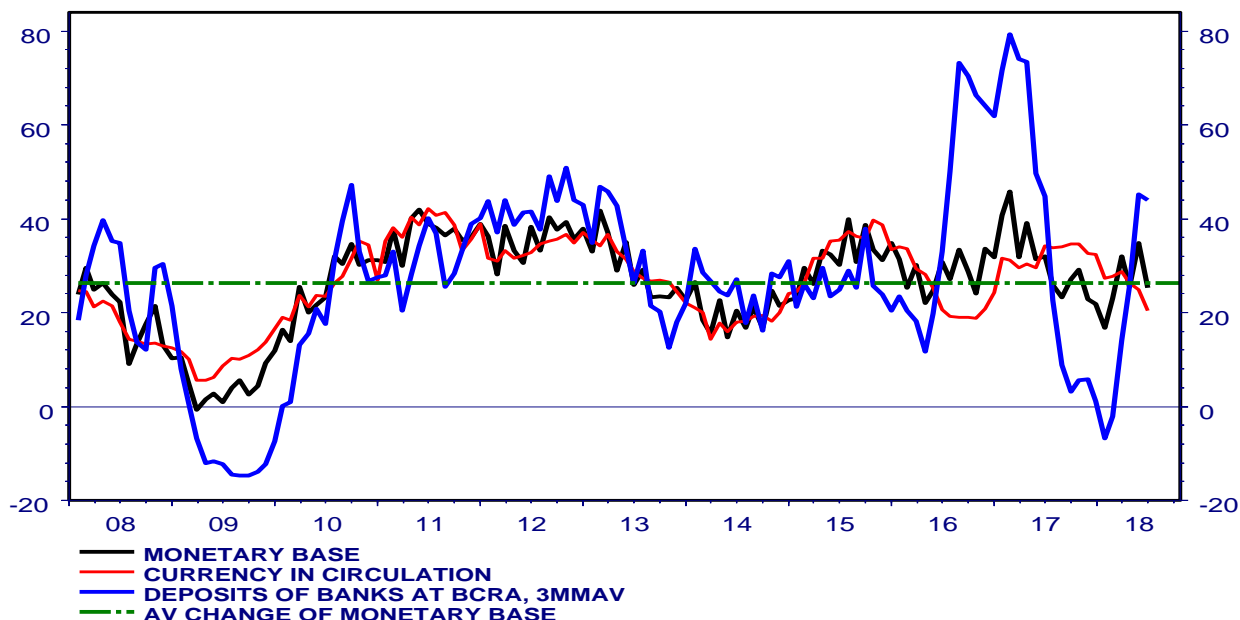
A normal central bank will maintain careful control over the growth of the monetary base (currency issued plus deposits of banks at the central bank) in order to ensure that the broad supply of money -- created largely by commercial bank lending -- remains broadly in line with the economic needs of the economy, i.e. growing sufficiently to finance (1) the potential real GDP growth rate, (2) the targeted inflation rate, and (3) allowing for any increase in the demand for money holdings. In an economy like Argentina such a strategy could be expected to generate a growth rate of money (M2 or M3) and the monetary base of 7-10% p.a. each.

Figure 1 shows the level of the monetary base and its components (or uses) – cash currency and reserve deposits of banks at the BCRA – since 2008. The vertical blue bar indicates the

accession of Pres. Macri in December 2015. It is immediately clear that there has been no slowdown in the expansion of the monetary base under the new administration.

Figure 2. Monetary base growth has continued at 26% p.a. since 2008, 29% p.a. since 2016

ARGENTINA: MONETARY BASE & COMPONENTS - USES (% YOY)

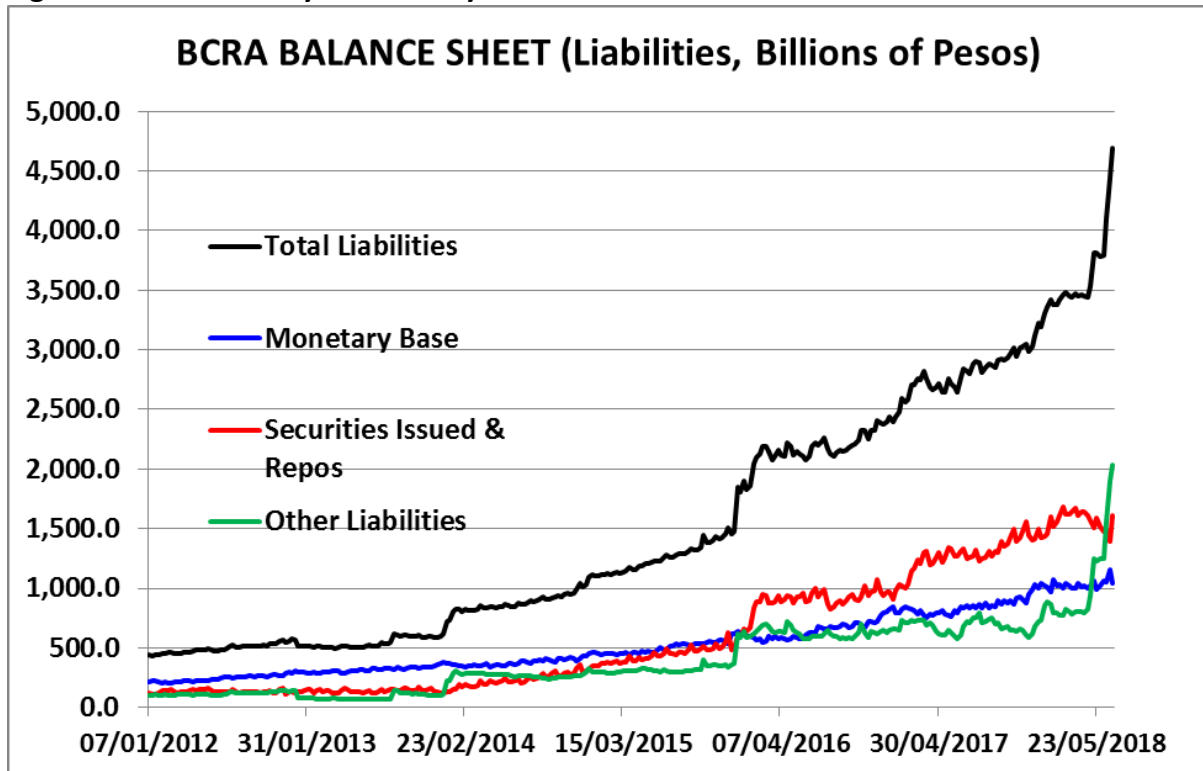


Instead, as shown by the green dashed line in Figure 2, the growth rate of the monetary base has averaged 26% p.a. since 2008. This includes the period of global slump in the wake of the 2008-09 Global Financial Crisis (GFC) when growth of the monetary base declined for a while to zero. As can be seen, the growth rates of its components were roughly similar between 2010 and 2016. In broad terms – and oversimplifying -- this would imply that the consolidated balance sheets of the overall banking system -- and hence the quantities of broad money and credit – were likely to have been growing at approximately the same rate. This growth rate on its own would ultimately have resulted in an inflation rate of over 20% p.a., but probably somewhat higher as velocity increased.

Unfortunately, since President Macri assumed the reins of power in December 2015 the growth rate of the monetary base has actually accelerated from 26% p.a. to 29% p.a. For the past two and a half years the components of the base have behaved very differently, with wide fluctuations in the reserve deposits of banks at the BCRA (in blue), contrasted with continued moderate changes in the rate of growth of peso currency in circulation. Even if the exchange rate had remained stable, the 29% p.a. growth rate of the monetary base would not have been a good basis for bringing down the rate of inflation.

The first problem with the BCRA’s balance sheet, therefore, is that the central bank has presided over an excessively rapid growth of the monetary base over the past decade. Moreover the growth rate has accelerated since the accession of the Macri government in December 2015.

Figure 3. The Monetary Base is only 22% of BCRA's Total Balance Sheet

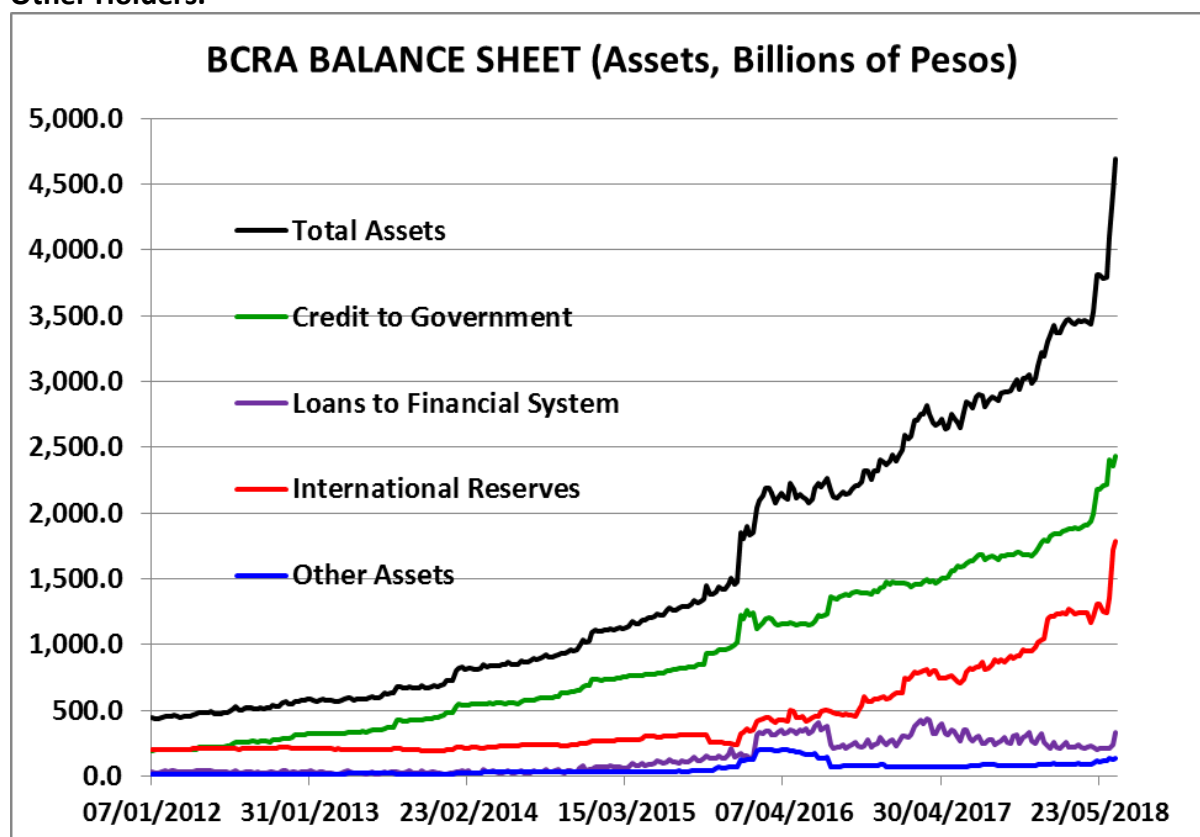


The second problem with the BCRA is that it has been asked to do too much and its balance sheet has massively expanded in line with the growth of these inappropriate functions. Beyond a purely monetary role it plays a large role in funding the government and acting as the government's agent in the sourcing of foreign exchange to meet the government's external obligations, which in turn has required it to sterilise the creation of pesos (that derive from this activity) on a very large scale. This now also involves the payment of very high interest rates to bank and non-bank holders of these instruments.

As shown in the chart above the total balance sheet of the BCRA at end-June was 4.69 trillion pesos (black line). The monetary base (in blue; 1.04 trillion pesos at the end of June) represents less than one quarter of the total liabilities of the BCRA. The largest single item on the liabilities side (shown in red) is debt issued by the BCRA including LEBACs, NOBACs and repos (1.8 trillion). These are the debt instruments issued by the BCRA and used to absorb the excess pesos created by the BCRA's role as a large operator in the foreign exchange market. The final item (in green) is the total of several smaller items: foreign currency deposits of the government and other non-bank entities in Argentina (0.789 trillion – a number that has recently surged in peso terms as the currency has tumbled in value); plus other liabilities and provisions; plus obligations to foreign entities.

In short, the BCRA has been exploited by the government in its search for funds. In any reform program the BCRA's operations should be cut back to the essential monetary functions only.

Figure 4. BCRA's Assets are Bloated with Government Debt and the Foreign Assets of Other Holders.

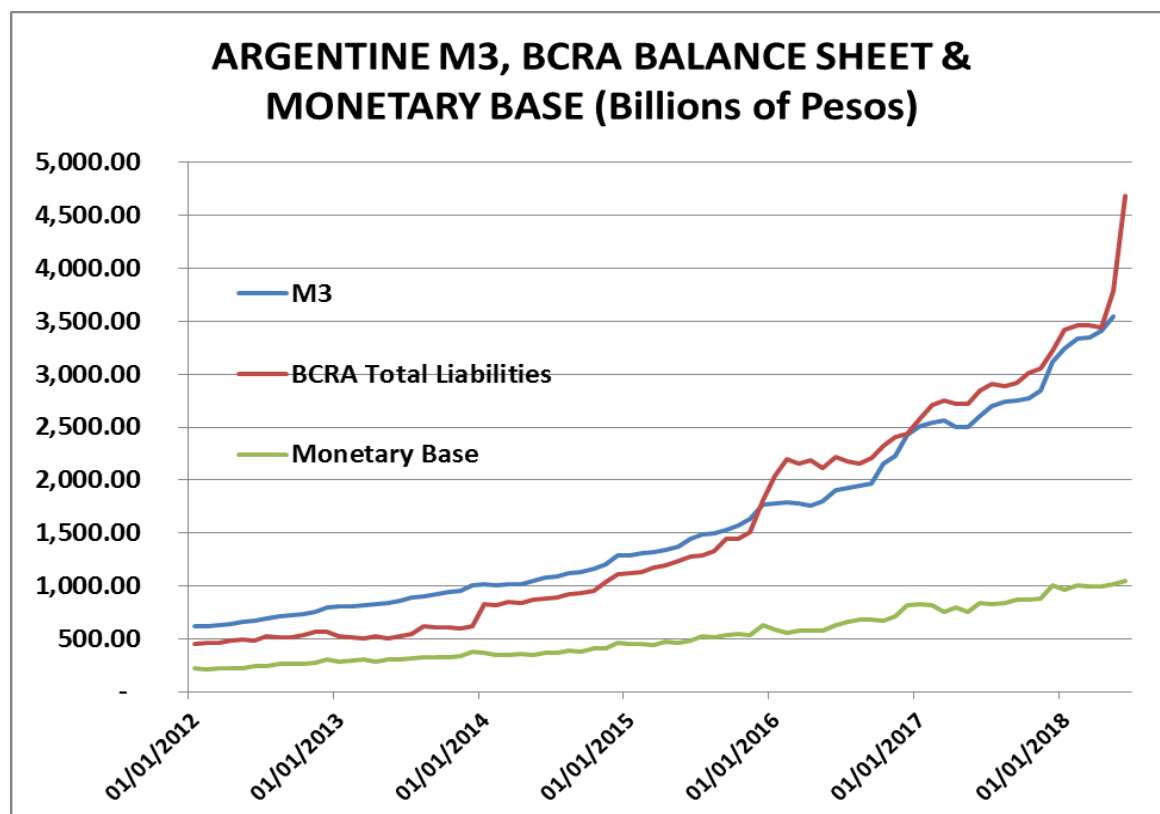


Turning to the asset side there are also problems. First, in green, the largest single asset is credit to the government (consisting of holdings of domestic government debt plus “temporary advances” to the government). In a fiat currency system with a floating exchange rate this is a normal situation and is not a problem so long as these holdings do not grow too rapidly. (An exception in recent years is that the central banks of the US, UK, Japan and the Euro-area have deliberately acquired large amounts of government bonds under QE programmes in an effort to expand the broad money supply because the commercial banks were not expanding credit and hence the money supply was not growing rapidly enough.) However, in Argentina’s case the acquisition of government debt was (1) a direct result of the government first misappropriating the foreign exchange reserves (under President Cristina Fernandez de Kirchner) to finance domestic expenditures and replacing the reserves with domestic, peso-denominated government debt, and (2) the government subsequently leaning on the BCRA to fund its budget deficits directly at artificially low rates instead of the government borrowing funds in the financial markets.

Second, in red, the surprisingly large holdings of foreign exchange (\$55 billion in reserves at end-June, plus other non-reserve holdings) resulted initially from the Kirchner-era capital controls that required exporters to channel all foreign earnings over \$1 million to the central bank. Today, however, they consist of foreign reserves plus the asset counterparts of some of the government’s official foreign obligations, plus the foreign currency the BCRA is holding on behalf of the government, state enterprises and other entities. The two remaining items on the asset side of the BCRA’s balance sheet) are: loans to the financial system (in blue),

together with contributions to international agencies such as the IMF and other assets (in purple).

Figure 5. BCRA Assets Exceed the Size of M3 (including foreign currency).



The third problem is that the balance sheet of the BCRA has become excessively large.

In most monetary systems the size of the central bank's balance sheet is only slightly larger than the monetary base, and typically between one tenth and one quarter of the size of the broad money supply (M2 or M3) or the consolidated assets or liabilities and capital of the banking system over which it presides. For example, in Australia (where there has been no QE), the Reserve Bank's balance sheet is less than one tenth of M3.

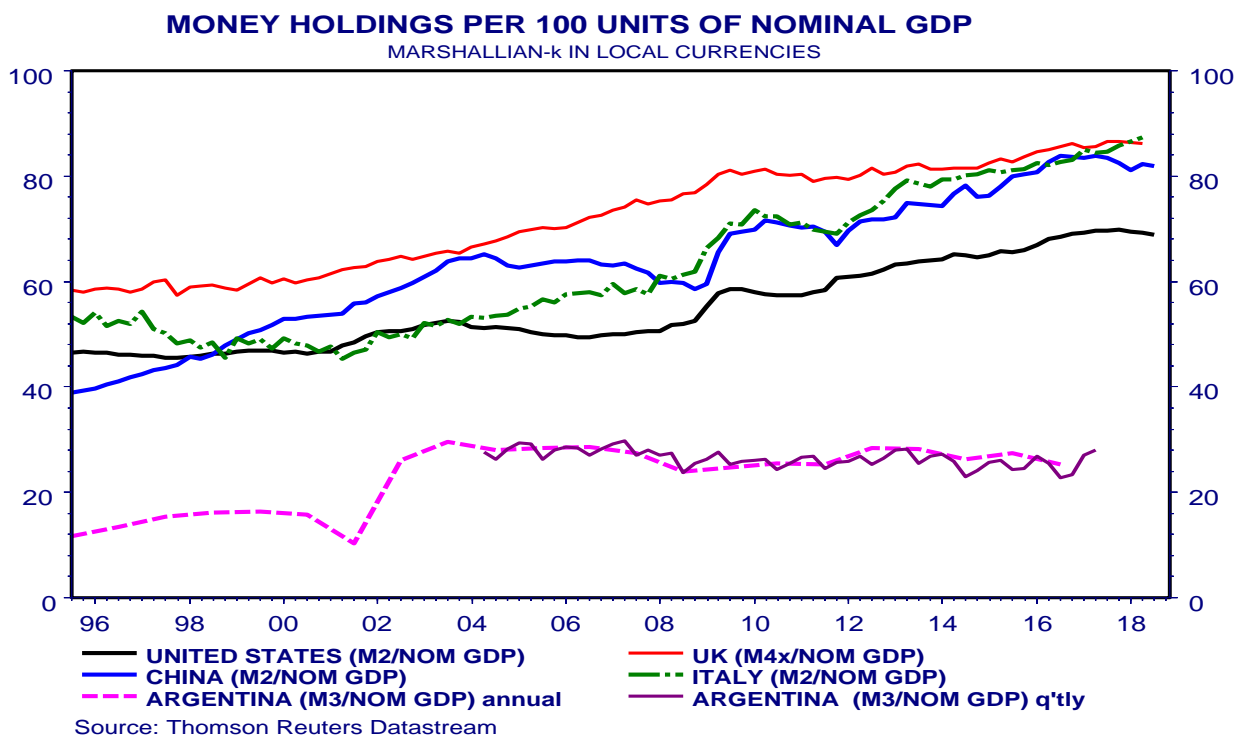
However, as Figure 5 shows, the BCRA's balance sheet is larger than even the widest definition of money in Argentina, the entire "bi-monetary" M3 – i.e. larger than the combined peso-denominated M3 plus the dollar-denominated M3. This is a result of the prolonged abuse of the BCRA by successive governments in the period since 2002 (i.e. since the end of the Convertibility scheme).

To sum up this section, the BCRA's balance sheet has been serially abused over the past decade and a half. First, the Kirchner governments impounded the country's foreign exchange reserves to fund its domestic expenditures; second, excessive expenditures and budget deficits were regularly financed by resort to direct borrowing from the central bank.

Section 2. Some Symptoms and Consequences of Monetary Mismanagement

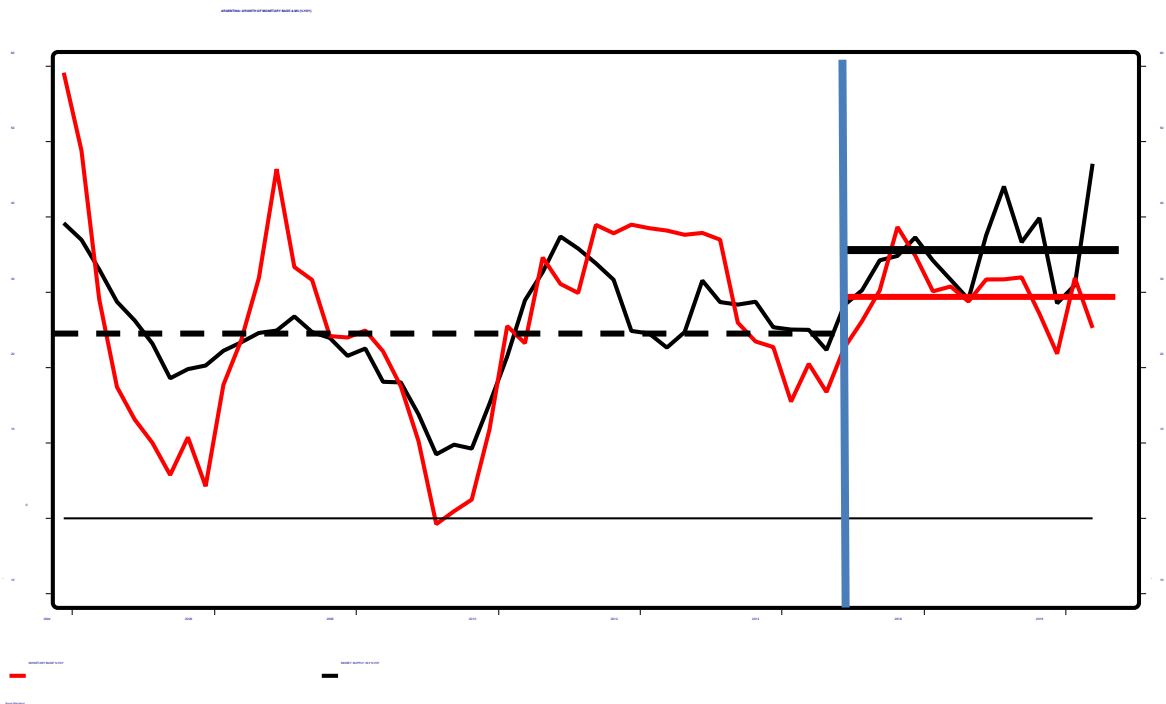
One consequence of Argentina's monetary mismanagement in recent decades is that Argentine citizens have drastically reduced the amount of money they hold in relation to nominal GDP. As Figure 6 below shows, average holdings of money (M2 or M3) in the US, the UK, China and Italy range between 65% and 90% of GDP. In the US and the UK there has been a steadily rising trend over the past two decades, while in China and Italy the rising trends have been even steeper. In Italy's case it was because after joining the ERM and later the euro in the 1999 Italians at last had a stable currency they could hold with confidence, while in China's case it has been because Chinese incomes have risen so rapidly. By contrast, Argentines' money holdings are equivalent to only 25-27% of national income, a major drag on productivity. The BCRA should be attempting to raise this ratio by providing money that maintains its value. Paradoxically, it will do this best by shrinking its balance sheet, not by encouraging more money creation.

Figure 6. Argentina's History of Inflation Means that Money Balances are far Lower than Elsewhere.



The BCRA should (A) get out of the business of funding the government (other than buying bonds as a by-product of its monetary operations), and (B) also get out of the business of acting as a monopoly or even premier foreign exchange depository. The first is supposed to be ensured under the new IMF agreement which promises greater independence for the central bank, while the second is desirable in its own right.

Figure 7. Monetary Base and M3 have averaged 29% and 35% since December 2015

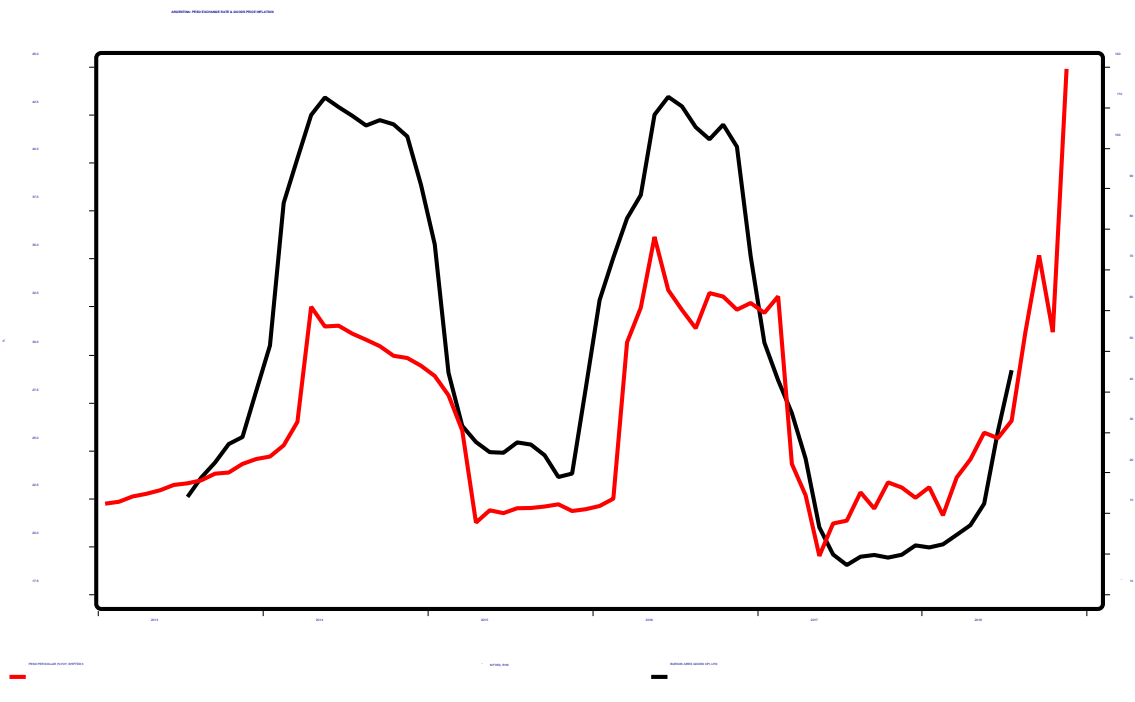


It is clear from the analysis so far that the balance sheet of the BCRA has become detached from any normal relationship to the rest of the banking system such as those that prevail in other, more orthodox economic and financial systems. However, the role of the BCRA as a provider of funds to the government or as collector of foreign currency on behalf of the government has not changed the relation between the monetary base and the growth of broad money (M3) in the economy as a whole.

As shown in Figure 7, growth of the monetary base and growth of M3 have fluctuated together since 2004, with the base averaging close to 25% p.a.(shown by the black dashed line). This has generated an almost identical 25% p.a. average growth of the quantity of broad money (M3) in Argentina. However, since January 2016 and the accession of President Macri the growth rates of the monetary base and M3 have grown even faster, averaging 29.0% p.a. and 34.7% p.a. as shown by the solid red and black lines respectively.

The failure of the monetary authorities to engineer any significant or sustained slowdown since December 2015 means that two and a half years of President Macri's term have been used up without addressing the core source of inflation. In addition, on this basis the inflation rate will not slow down as promised or predicted in the plan agreed with the IMF.

Figure 8. *In the Short Term* Inflation May be Driven by Currency Depreciation or Commodity Price Increases



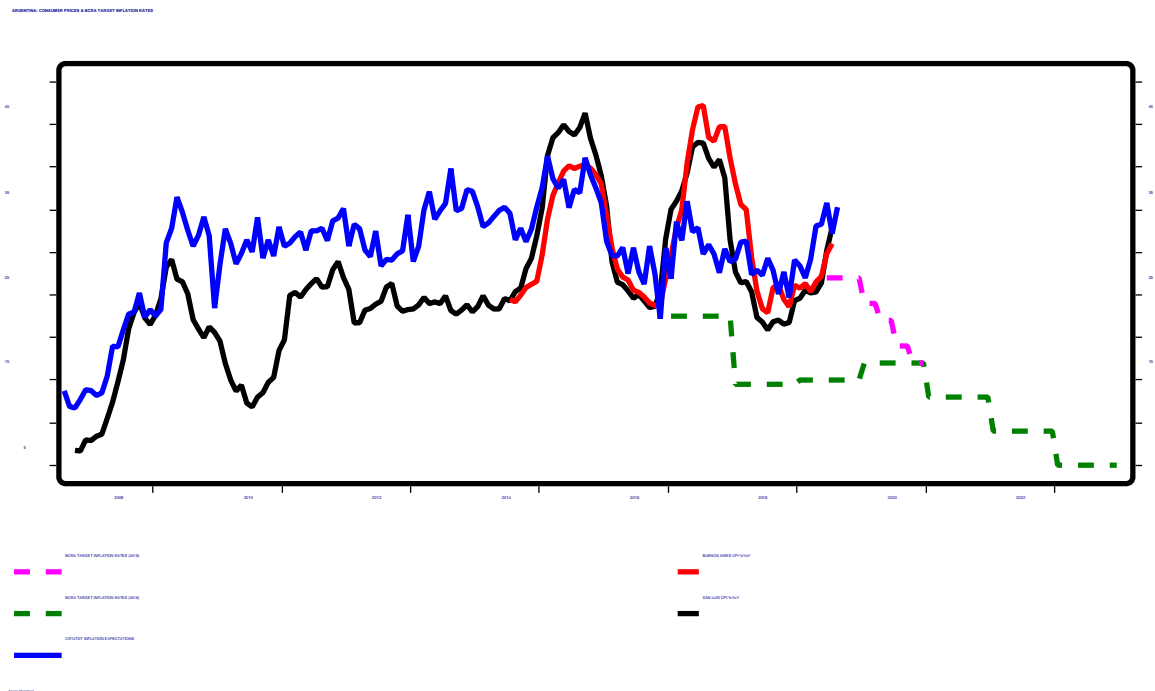
In the short term the inflation rate can be heavily affected by large, sudden exchange rate movements or by abrupt commodity or domestic price changes, but in the longer term the dominant driver of inflation is money and credit growth. As Figure 8 shows, there have been two episodes when the inflation rate (reflected in the goods price index for the Buenos Aires area, shown by the black line) has accelerated sharply to around 40-45% in recent years. The first, in 2014-15 was prompted by the fall in the peso from around 5.50 pesos per US\$ in mid-2013 to nearly 9.60 pesos per US\$ by November 2015.

The second episode, in 2016-17, followed from (1) the abolition by the newly elected President Macri of the controlled or official exchange rates maintained under his predecessor, Christina Fernandez de Kirchner, and (2) from the abolition of price subsidies and other price controls that had distorted the economy. On that occasion the peso depreciated from 9.60 to 15.90 per US\$ by January 2017.

A third episode of imported inflation is currently under way due to the further depreciation of the currency from 17.70 in December 2017 to around 26-27 pesos per US\$ in July 2018¹. Unfortunately this will severely affect the inflation rates going forward and hence the pledges made by the government to the IMF.

¹ At September 4th 2018 the peso exchange rate had fallen even further to 38.48 per US\$.

Figure 9. Argentina's Inflation Targets Submitted to the IMF Unattainable with Current Monetary Growth.

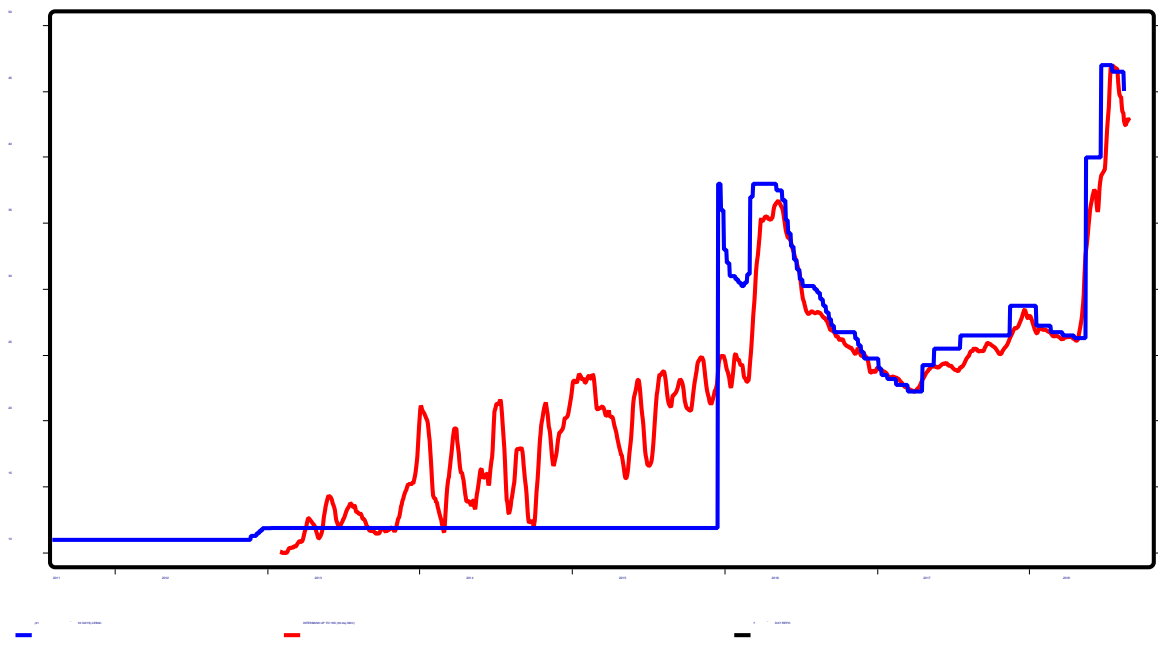


Fundamentally each of the three episodes of inflation highlighted in Figure 8 can be viewed as “once-for-all adjustments” in the price level after peso depreciation or extended periods of suppressed inflation due to price controls or fuel/utility price subsidies. No doubt the abolition of the exchange controls and the ending of subsidies is good economics in itself, but it has had and will have a severely adverse impact on the living standards of lower and middle class Argentines which will erode Pres. Macri’s support at the polls.

Already the BCRA has had to abandon its inflation targets set out (in green in Figure 9) in 2016. Looking forward, the administration made ambitious pledges to the IMF on June 12 to bring down the rate of inflation (to the revised set of figures shown in Figure 9 in pink), but – so far – it has entirely failed to slow to slow the rate of money growth (M3). This means that, combined with the pass-through of imported inflation from peso depreciation this year, the 27% inflation target provided to the IMF for 2018 and 17% for December 2019 are very unlikely to be attained unless **either** there is an immediate and very deep recession, **or** Argentines suddenly decide to hold much higher money balances than we saw in Figure 6, effectively reducing velocity and lowering spending power. Either way, M3 growth needs to slow down drastically over the next two years from its 36% growth rate in May and decline to the 10-15% range. Only then would the BCRA stand any chance of meeting its previous targets for single digit inflation in 2021-22.

Section 3. Early Stages of the 2018 Crisis

Figure 10. Interest Rates have had to be steeply hiked after the increase in inflation



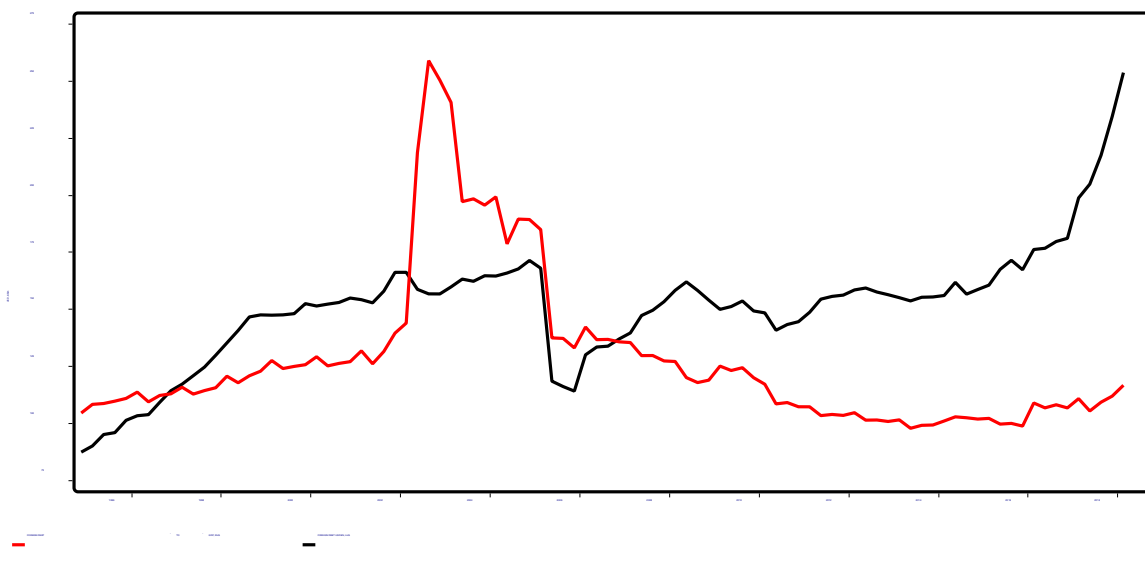
Already the BCRA has had to abandon one set of inflation targets announced in 2016 during the early stages of the Macri administration. That abandonment followed the freeing up of the exchange rate and the steep rise in repo, interbank and LEBAC rates which rose abruptly to 38% between February and May 2016. Thereafter interest rates gradually declined to around 25% in early 2017, but nothing was done to ensure money and credit growth slowed. Consequently there was no progress in bringing down inflation, and the currency began to weaken again from May/June of 2017. Ahead of the election in October 2017 no further tightening was imposed.

After the October election the peso remained moderately stable at 17 per US\$, but then began to fall steeply from January 2018. To prevent further currency depreciation and to minimise capital flight rates were raised again to 40% and 47% in May and June this year.

It is extremely doubtful whether even these rates will be sufficient to stabilize the economy. If the inflation targets recently committed to by the BCRA (as part of the Stand-By Agreement with the IMF) also have to be ditched, this may yet drive rates higher.

The conundrum Argentina faces is this: if the authorities maintain a free float and an open capital account, then in an already largely dollarized system, any expected weakening of the peso will prompt abrupt outflows, which in turn will exacerbate the problem of foreign debt repayment – unless the BCRA enforces extremely high interest rates. However, prolonged high rates would of course precipitate a very severe recession, something the authorities could not tolerate for long given the short (4-year) political cycle.

Figure 11. Under President Macri Argentina has been able to return to the global capital markets



Upon being elected in December 2015, the current government's urgent priority was to reach a deal with the last of Argentina's "holdout" bond holders that had been pursuing the country in the courts since its 2001 default. This task was achieved in late 2016 and has enabled the government to tap international markets once more. In June 2017 Argentina was even able to issue US\$ 2.75bn of 100-year bonds. The century bonds were issued with a yield of 7.9%², with the proceeds going to fund the government's budget shortfall and refinance some of their existing debt.

However, with the depreciation of the peso and the resort to the IMF, foreign confidence in the new government will have been dissipated.

In 2018 Q1 external debt reached USD 253.7 bn (shown in black and on the left scale of Figure 11), 60% higher than when Argentina defaulted on foreign creditors in 2001. In addition, there are the new borrowings drawn down from the IMF in June.

The memorandum agreement with the IMF³ makes numerous pledges on the reporting of economic data, on "reinforcing the BCRA's autonomy" (by December 2019), on cleaning up the BCRA's balance sheet, committing to a "flexible and market-determined exchange rate", the introduction of supply side policies, and warm words about "protecting society's most vulnerable" and "supporting gender equity". All of this is accompanied by forecasts of lower budget deficits in 2019, the reduction of central bank credit to the government and reduced inflation rates (17% by the final quarter of 2019). But there is no mention of reducing the rate of monetary growth, only a target for the net domestic assets of the BCRA.

The Argentine crisis of 2018 is yet another example of the failure of fiscal and monetary discipline in a country where this has become endemic. However, nothing will be solved on any sustainable basis unless the core problems of excessive monetary growth and funding of

² The Century bond was yielding 10.23% on September 4, 2018.

³ <https://www.imf.org/en/News/Articles/2018/06/20/pr18245-argentina-imf-executive-board-approves-us50-billion-stand-by-arrangement>

government expenditures and deficits by the central bank are addressed forcefully and on a permanent basis.

Summary & Conclusions

The BCRA's balance sheet has been abused by successive governments in the past two decades. Under the IMF Stand-By Agreement with Argentina signed in June it is proposed to strengthen the BCRA's autonomy, stop the direct financing of the government by the BCRA, while maintaining an inflation targeting regime and a free floating peso. However, the IMF program was too gradualist, and is likely to be overtaken by market developments.

The problem is that the IMF's SBA document implies the inflation targets and other reforms can be achieved by means of a gradual reduction of the fiscal deficit -- without pain and without a deep recession. Meantime the growth of the monetary base and M3 growth are still far too high. In my view the current fiscal and inflation targets in the IMF plan are unattainable, and the plan will fail. More likely either the current plan will fail and Argentina will once again default on all foreign-denominated debt held by the private sector (the IMF will again be exempted as they were in 2002), or under a tougher version of the IMF plan Argentina will again face financial collapse and high unemployment, causing President Macri to lose the next election, and virtually ensuring a return to populism for another decade. Both the IMF and the government of President Macri owe it to the Argentine people to address the core issues and provide durable solutions, not temporary fixes that will fail at the next set of challenges.