Center for Global Development

CGD NOTE
DEC 2018

Global and Local Challenges in Argentina and Brazil

Guillermo Calvo, Augusto De La Torre, Roque Fernandez, Pablo Guidotti, Paulo Leme, Guillermo Perry, and Liliana Rojas-Suarez

1. INTRODUCTION

The last presidential elections in Argentina (2015) and in Brazil (2018), represent a change from populism towards more orthodox economic policies in two important countries in the region. This shift is not only economic but also reflects other fundamental changes in the electorate, in particular the growing dissatisfaction of the population with issues such as weak security and growing corruption in political institutions.

In both countries, there are significant fiscal problems and adjustment is needed. But in modern democracies, the success or failure of economic policy is closely tied to political developments. Notably, both countries face their macroeconomic challenges under a parliamentary minority; a situation that is common to many countries in the region at present.

Economies highly integrated into the international capital markets, with macroeconomic imbalances inherited from populist governments, face a particularly difficult challenge. On the one hand, the required fiscal tightening entails the execution of policies that may result in greater social unrest, thus encouraging a gradual approach. On the other hand, a gradual approach requires a greater funding stream of financial funds thus exposing the economy to higher financial risk. The dilemma of choosing between a shock adjustment and a gradual approach has been central to understanding what has happened in Argentina and is essential to assessing the options available to the next government in Brazil.

The dilemma about the optimal speed of fiscal adjustment has been faced by other countries in the region in the past. In some successful cases of gradualism, the presence of a clear commitment mechanism over the fiscal path, including the implementation of goals agreed with the IMF, has played a decisive role in mitigating the credibility gap typically linked to gradual approaches.

One question that the Committee puts forward throughout this statement is to what extent does Argentina's experience entail relevant lessons for Brazil? In order to thoroughly understand these possible lessons and the challenges that both countries face, it is important to consider the similarities and differences between Argentina and Brazil. There is no doubt that both countries are dealing with formidable fiscal challenges. In both countries, there is a primary fiscal deficit and public debt levels are high in relation to GDP. Also, both economies face low or negative growth rates, partly because of cyclical or temporary factors and partly because of low productivity levels due to complex regulatory regimes and tax systems that hinder investment.

On the other hand, the realities of Argentina and Brazil are very different in some important aspects. Brazil has not had to cope with a currency crisis and external financing problems such as those of Argentina; the latter has had to reduce its hefty deficit in the current account of the balance of payments. In contrast, Brazil's external public debt and external financing needs of the public sector are low. However, while the private sector's foreign indebtedness is quite moderate in Argentina, it is relatively high in the case of Brazil. As regards to monetary policy and inflation, the situation in both countries is also very different. Whereas the inflation rate in Argentina has suffered a substantial increase throughout this year in the context of low credibility in its monetary policy, Brazil has kept a low and stable inflation rate and has significantly improved its central bank's credibility.

These similarities and differences require a differentiated discussion of each country, even if some challenges facing Argentina and Brazil are shared, and whether their experiences provide lessons for each other. The international context plays a fundamental role for both economies in determining the results of economic policy. Before embarking on a more detailed analysis of the challenges facing Argentina and Brazil during the next year, we will analyze how the international context has recently changed, in the next section.

2. THE INTERNATIONAL CONTEXT

In our previous statement in April of this year, the Committee had warned about the possibility that the global economy could face a perfect storm. The storm would be produced by reduced capital flows due to the US Federal Reserve's monetary policy tightening and increased trade frictions, particularly between the United States and China. It is important to mention that even though Argentina and Brazil have been excluded from direct protectionist measures from the United States, these economies are still indirectly affected by other countries' trade conflicts.

Based on recent developments, **the Committee believes that Latin America's external challenges will increase significantly during 2019 for several reasons.** To begin with, there is the slowdown in global growth. Already in the second term of 2018, growth in the global economy has declined, including in regions such as the United States, Europe, and China. Growth in the global economy is expected to fall to 3.5% by 2019, compared to 3.8% in 2018 and 2017. This implies a lower volume in international trade for Latin America and a decrease in commodity prices. The price of oil fell by almost 35% in 2018, because of lower global demand and consequent oversupply, affecting the oil-producing countries in the region.

The likelihood of an escalation of trade conflicts may further worsen the global outlook, despite the ephemeral signs of détente between China and the United States that occurred during the last G-20 summit. This worsening could occur in two ways: first through a reduced international trade flow, leading to a lower global growth rate. Second, through increased uncertainty in financial markets already evidenced by a sharp decrease in United States and global stock markets' prices.

The normalization of monetary policy in the United States will impact capital flows. To the extent that the Federal Reserve keeps increasing the policy interest rate in 2019, emerging economies will suffer an additional reduction in capital flows. This would create greater difficulties for countries in Latin America planning to issue new debt and equity instruments in the global capital markets.

The capital markets are showing a higher probability of a larger-than-expected slowdown in the US economy and in the global economy, together with an increase in risk aversion. The main signs are a

10% drop in the S&P index and a doubling of the stock market volatility VIX index. The fixed income markets show a flattening, even a slight inversion of the yield curve in the United States Treasury bonds market, and an increase in the risk premium in the high yield corporate bonds market. The worsening of these conditions, which are closely linked to building uncertainty around the unfolding of trade frictions, may lead to a flight towards more liquid and higher quality assets, and consequently, to a sudden stop in capital flows to emerging markets. However, these signs coexist with lagging indicators that point in the opposite direction, such as a dynamic labor market with a historically low unemployment rate, at least in the United States.

In summary, lower global growth, uncertainty about trade policy and a decline in capital flows to emerging economies seem to be the ingredients of a perfect storm for the region in 2019. **For this reason, the Committee believes that Latin America, and Argentina and Brazil in particular, do not have a secure external stream of finance. It would be very risky to postpone the macroeconomic adjustment and the implementation of structural reforms that promote productivity and economic growth.**

3. ARGENTINA

2018 has been extremely difficult for the Argentine economy. The initial gradualist approach to monetary and fiscal policy has led to a significant, multifaceted crisis. It began with an currency crisis leading to an important devaluation which rapidly spilled out into the credit market through a sudden stop of international capital flows and consequently increased the country's risk premium. These events stopped the incipient recovery in economic growth, pushing the economy into a recession, which this Committee estimates will produce a GDP contraction of 1.8% in 2018. Furthermore, the currency crisis has produced an upsurge in inflation that will reach 45% in 2018.

The Committee believes that the government's rapid response in requesting financial support from the IMF, and, at the same time, the IMF's prompt support of the Argentine government, has been crucial, especially in terms of the record amount of assistance, in the order of 57 billion dollars, and accelerated disbursement. This is particularly important in view of the concerns that the Committee had expressed regarding how the official international community would respond to new financial turmoil in emerging markets.

The IMF program implies important changes to fiscal and monetary policy. On the one hand, the government has abandoned the gradualist approach and has decided to accelerate the reduction in the fiscal deficit, aiming to balance the primary deficit by 2019. This will reduce the concerns regarding debt sustainability. Given the high dollarization of public debt (around 70% of total debt), the ratio of public debt to GDP has increased to more than 80% as a result of the devaluation.

On the other hand, the government has substantially changed its monetary policy framework, by phasing out inconsistencies (such as the monetary financing of the fiscal deficit) and shifting from inflation targets to monetary base targets. In addition, the central bank has defined a non-intervention zone for the exchange rate policy.

The Committee believes that the changes implemented in monetary and fiscal policies, together with the massive financial support of the IMF, will be effective to stabilize the Argentine economy and that, if strict compliance with the agreed goals is maintained, it can give rise to an economic recovery, leaving the crisis behind.

However, this positive scenario is subject to significant risks. Particularly, the Committee believes that the improvement in financial conditions and the decrease in risk premium will be very gradual, with uncertainty building midyear, due to a more challenging international context and because of presidential elections by the end of 2019. Still, this Committee believes that the Argentine economy is likely to improve at the beginning of 2019, which would greatly contribute to the credibility and political viability of the economic program.

Therefore, **the Committee recommends the authorities to have a very active role in managing the composition and maturity structure of the public debt during next year's first semester in order to ensure the independence from external financing in 2020.** The IMF's financial support ensures that the needs of the public sector will be satisfied for 2019; but given the political uncertainty, it will be vital to improve the maturity structure of the public debt and to reduce dollarization. Regarding this last point, **the Committee believes that it is most important to significantly reduce the dollarization of the intra-public-sector debt.[1] The Committee finds no justified reasons for the intra-public-sector debt to be denominated in foreign currency.** Since investors and experts focus their analysis on the stock of gross public debt, this situation increases the perception of dollarization of said debt.

In order to reinforce the central bank's credibility, the Committee believes that it is convenient to phase-out the debt issued by the central bank. Progress was made in this direction during 2018, by virtually eliminating the stock of debt issued by the central bank and held by non-bank institutions (Lebacs). The Committee believes that it will eventually be convenient to do the same with the stock of debt issued by the central bank held by financial institutions (Leliqs); and replace them with financial instruments issued by the Treasury in open market operations for monetary policy purposes. Although the exchange market has remained calm for the past few weeks, and the exchange rate has approached the lower bound of the non-intervention zone, the presence of a still very high central bank's reference rate (Leliq's rate) shows that the confidence in the local currency is still weak. The rebuilding of credibility must be accompanied by a non-inflationary decline of interest rates.

The Committee believes that the current monetary framework will allow the central bank to achieve a faster disinflation rate. This could require a further decline in the adjustment rate of the non-intervention band to 1% per month starting April 2019.

4. BRAZIL

In January 2019, Jair Bolsonaro will begin his four-year presidential term. The Committee believes that his three major challenges will be in implementing a strong fiscal adjustment to stabilize domestic public debt, incorporating structural reforms to increase productivity and economic growth and improving public services related to security, health and education.

Factors supporting the new administration are the solid monetary and financial institutions, a low inflation rate that is within the central bank's target (4%). Brazil has a strong external position, marked by a low current account deficit (0.8% of GDP), high international reserve levels in relation to short-term foreign debt (US$382bn), and manageable external financing needs for the next year. Additionally, Brazil has the potential to experience a short-term economic recovery because of its high level of unused industrial capacity, very high unemployment rate (12.2%) and low real wages.

1 Argentina has an important stock of public debt held by government institutions where a part of it is denominated in foreign currency; the reason for this is partly historical.

Yet, the new government will have to face important challenges. The main issue is the serious fiscal problem at all government levels (federal, state and municipal) which reflects the prevalence of inefficiency in an oversized state. Domestic public debt is high, increasing, and of very short duration, although the participation of foreign debt holders is relatively small. Additionally, the fiscal deficit is one of the highest among emerging markets, around 7.5% of GDP, of which two-thirds are attributable to interest payments. In order to stabilize federal public debt, the government will have to implement a primary adjustment of 5-6% of GDP.

The fiscal adjustment will require a difficult and immediate implementation of a social security reform, cuts in subsidies, eliminating the indexation of salaries and pensions, and decreases in the degree of revenue earmarking. All these reforms will face strong political resistance. In addition, the government will have to implement a broad program of privatizations and concessions, not only to generate revenue but also to reduce the size of the state and increase the quality of public services.

A second major challenge is the low rate of economic growth, which reflects insufficient investment and low productivity. Restoring growth will be key to Bolsonaro's program to make it politically viable. This will require a set of politically difficult reforms, which should prioritize three areas: trade opening, financial reforms to promote credit growth and reduce bank spread, and the reduction of the so-called "Brazil cost". The last point is a consequence of multiple factors, among which stand out a costly, complex and distorting tax system, a labor market with high labor unit costs, and a tangle of regulations that hinders competition, investment and market efficiency.

The appointment of a competent economic team, set to follow pro-market, and liberal guidelines, sends an important and positive signal. However, the new government will face a difficult political challenge in negotiating a set of potentially contractionary (in the short-term) structural reforms with Congress. Many of these reforms will require approval in the Chamber of Deputies and in the Senate in two rounds with a majority of at least 60%. This will be especially challenging since Bolsonaro's party (PSL) has a representation of no more than 10% in the Chamber of Deputies and 5% in the Senate, that too in a Congress divided into more than 30 different political parties.

In this sense, having a good program and a good economic team are necessary but insufficient conditions to assure the government's success. **The Committee believes that it will be extremely important to coordinate the sequence and intensity of reforms and adjustments with measures to regain the confidence of the markets and the private sector, so that the government can stimulate growth through private investment and exports.** Of equal importance will be the government's ability to attract foreign capital to rebuild infrastructure and to finance private investment.

The Committee maintains that a valuable lesson from the Argentine experience is that the severity of the fiscal problem will not allow the new government of Brazil any room to adopt an excessively gradual approach in the implementation of its economic program. This is especially important as Brazil currently faces a more adverse external environment than Argentina did between 2016-2017.

5. BEYOND THE ADJUSTMENT

The good news is that both Argentina and Brazil have room to begin a cyclical economic recovery, as long as the macroeconomic programs are credible. An economic rebound is quite feasible, simply because both countries come from negative or very low growth. However, recovery does not imply higher growth rates in the medium and long term. The bounce back is the relatively easy part; the greater challenge is to consistently raise standards of living and to close the gap in per capita income with developed countries. This agenda goes beyond macroeconomic policies and requires great efforts in structural reforms.

Structural reforms to promote growth will have to be determined according to each country's circumstances. There is no uniform policy prescription. Still, it is essential that reforms be designed to effectively mitigate downside risk (i.e., reduce the likelihood of macro-financial crises, with persistent adverse effects on potential growth), ensure welfare is maximized, and not exacerbate the inequality of opportunities that mark the region. These are common areas in both countries that cannot be ignored.

In particular, it is essential to promote a greater and deeper integration to the international markets of goods and services and factors of production. Historical evidence shows that the emerging countries that have reached high and sustained growth are those that have had a strong performance in their export sector and could timely and adequately connect to large global value chains, and/or to countries that are engines for global growth.

In previous statements, the Committee has emphasized the concept of Open Regionalism, understood as a virtuous cycle in which the process of trade integration into the world is designed to enhance the strength of regional integration and investments in regional public goods. In this regard, **the Committee notes that both, the change of government in Brazil, and the Argentine government, provide an extraordinary opportunity to promote a substantial transformation of Mercosur and its convergence towards the standards of the Pacific Alliance. This will shift the region towards Open Regionalism.**

Trade integration will be easier when domestic macroeconomic policies are more stable and particularly with the consolidation of the credibility of central banks. This has been improving considerably in Latin America. Despite the great advantages of having a credible and professional central bank, Latin American countries, including Brazil and Argentina, are not issuers of reserve currencies, so this has led to a hoarding of international reserves to reduce vulnerability against shocks from international capital markets.

Some emerging countries have mitigated these risks with regional coordination agreements. For instance, southern Europe has access to the European Central Bank and the European Stability Mechanism (ESM). Emerging Asian countries and Japan have established a liquidity fund called the Chiang-Mai Multilateralized Initiative. **The Committee believes that Latin America could strengthen its regional financial safety network by extending and modernizing the Fondo Latinamericano de Reserva (FLAR).**[2]

2 CLAAF has issued a statement about the role of FLAR on December 2012. See https://claaf.org/wp-content/uploads/2016/06/27_statement.pdf

The Committee on Macroeconomic and Financial Issues (CLAAF) is grateful to the Center for Global Development (CGD) for its overall support; and to the Banco de la Ciudad de Buenos Aires, the Central Bank of Chile and the Latin American Reserve Fund (FLAR) for financing their activities. The Committee is fully independent and autonomous in the drafting of its Statements.

GUILLERMO CALVO, Professor, University of Columbia; former Chief Economist, Inter-American Development Bank

AUGUSTO DE LA TORRE, Adjunct Professor, School of International Public Affairs, Columbia University, USA; Former Chief Economist for Latin American and the Caribbean, World Bank and Former Governor, Central Bank of Ecuador

ROQUE FERNANDEZ, Professor of Economics, CEMA University and Former Minister of Finance, Argentina

PABLO GUIDOTTI, Full Professor of the School of Government, University of Torcuato di Tella; former Vice minister of Economy, Argentina

PAULO LEME, Professor of Finance, University of Miami School of Business, USA, and former CEO of Goldman Sachs Brazil.

GUILLERMO PERRY, Non-resident Fellow, Center for Global Development; Professor, University of the Andes; former Minister of Finance, Colombia; former Chief Economist for Latin America, the World Bank

LILIANA ROJAS-SUAREZ, Senior Fellow at the Center for Global Development, and President of the Latin American Committee on Macroeconomic and Financial Issues (CLAAF)

Center for Global Development

Ideas to Action: Independent research for global prosperity

WWW.CGDEV.ORG