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Argentina's Deal with the IMF: Will "Expansionary Austerity" Work?

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December 2018

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Contents

Acknowledgements

The authors thank Joe Sammut, Jake Johnston, and Matt Templeton for research assistance, and Dan Beeton and Rebecca Watts for editorial assistance.

Executive Summary

Since July of this year, the International Monetary Fund (IMF) has disbursed more than $20 billion of a $56.3 billion loan package to Argentina. The Argentine government is now the largest holder of the IMF's General Resources Account (GRA) funds. This paper looks at how the policies that the Fund and the Argentine government have agreed upon in their June Stand-By Arrangement (SBA) are expected to lead to an economic recovery; and whether they are likely to succeed.

The IMF program is based on what it calls "a credible and ambitious plan" to "restore market confidence." But by October, just a few months after the IMF agreement was signed, the economy's main indicators fell far below what the Fund had projected. For 2018, the IMF projected positive real GDP growth of 0.4 percent; it now projects negative 2.8 percent, a very large difference of 3.2 percentage points. For 2019, a similar downward revision of 3.2 percentage points has been made, from positive 1.5 percent to negative 1.7 percent.

Consumer price inflation was projected in June at 27 percent for 2018 and 17 percent for 2019. The new estimates are 43.8 percent and 20.2 percent, respectively. The forecast for interest rates for these two years shot up from 37.2 percent and 22.5 percent to 69.6 and 32 percent. And the projected federal public debt as a percent of GDP, another fundamental target of the Fund program, jumped from 64.5 and 60.9 percent for 2018 and 2019, to 81.2 and 72.2 percent, respectively.

These are enormous changes to the IMF's outlook for Argentina in just a few months. It is possible that the IMF, and also the current government of Argentina — which in its Letter of Intent to the Fund, stated that the recent plan is "designed by, and fully owned by, the Argentine government" — have a flawed understanding of the impact of their policies.

In the October review of the Stand-By Arrangement, the program was revised to double down on fiscal consolidation as a means of restoring market confidence. Instead of running a primary deficit of 1.3 percent of GDP in 2019 as in the original SBA, the revised plan has a balanced primary budget in 2019 and a 1.0 percent primary surplus in 2020. This is a sizable fiscal consolidation, comparable to the average year of austerity in Greece or Spain during their years of budget cutting following the 2009 World Recession. Using the IMF's estimate of the structural primary budget balance, it amounts to a fiscal tightening of 3.9 percent over two years. With a multiplier of 1.3, we would expect this to reduce real GDP growth over the next two years by about 5.1 percent.

The October review also tightened monetary policy severely, with the Central Bank switching from an inflation targeting regime to targeting the monetary base. The monetary base must grow at 0 percent monthly until June 2019, and 1 percent per month for the rest of the year.

In the June agreement, the IMF had forecast that the economy would already be recovering by now. As noted above, those projections have now been lowered substantially, with negative year-on-year growth for 2018 and 2019. The IMF now projects that the economy will return to growth in just a few months, in the second quarter of next year. However, this also seems over-optimistic. The recovery for 2019 is based entirely on net exports, and there are numerous downside risks to the global economy. These include continued rate hikes by the US Federal Reserve — which contributed to the crisis this year and also in Argentina and many other countries from 1994 to 1997 — and trade frictions between the US and China, as well as volatility in financial markets.

Furthermore, there are no signs of a nascent recovery. Industrial production has declined sharply since May. Consumer confidence has fallen over the past year and has continued falling in recent months. Real wages have fallen sharply. The IMF warns that both of the latter problems are "likely to continue to hinder consumption."

Domestic investment is also projected to be weak in this recovery, falling from 13.8 to 11.5 percent of GDP as the economy is projected to return to growth from 2018 to 2019. Private investment is forecast at just 8.5 percent of GDP in 2019. For comparison, investment was at 14.6 percent of GDP in 2016, when the economy was in recession. For the 13 years from 2002 to 2015, investment averaged 16.1 percent of GDP. The relatively low level of investment projected for 2019 and 2020 casts further doubt on the multiyear growth projections in the IMF's forecast recovery.

It seems clear that the government made a number of mistakes that contributed to the crisis. The first was the rapid pileup of foreign currency debt, which increased from 35 percent of GDP in January of 2016, a month after President Macri took office, to over 60 percent of GDP in April of this year, just before the financial crisis exploded. Then, when the crisis hit, the government spent about $16 billion trying to prop up the peso, which lost about 52.3 percent of its value against the dollar by September 28.

The IMF states that Argentina's public debt "remains sustainable, but not with a high probability." This is debatable — as shown below, before this year's crisis, the burden of Argentina's federal public debt was not particularly worrisome, and was projected to decline. But in any case, the fiscal consolidation in the IMF's revised program contributes proportionately very little to reducing

Argentina's debt — just 2.7 percentage points of GDP in 2018, and 1 percent in 2019 — from a debt that is projected to increase by 23 percentage points of GDP this year.

Thus the program contributes very little to debt reduction, while hoping to inspire confidence in the economy by demonstrating the government's commitment to deficit reduction and tight monetary policy. In the process, it appears to be aiming to reduce inflation and the current account deficit by shrinking the economy with procyclical fiscal and monetary policies. But in so doing, the program adds the risk that the recession may actually undermine market confidence and result in a recession that is longer and deeper than anticipated — as it already has. The economy can also face a situation where the debt burden relative to the economy grows as GDP falls, and the fiscal targets become increasingly difficult to meet — as happened to Greece, for example, after 2010.

The Stand-By Arrangement and the October review both emphasize that one of the principal objectives of the program is to "protect Argentina's most vulnerable citizens from the burden of this needed policy recalibration."[1] However, given the loss of revenues during the recession and the pressure for expenditure cuts to meet the program's primary budget targets, this is almost certainly not going to happen. There will be increased suffering and hardship for millions of Argentines as unemployment and poverty increase with the recession.

For all of these reasons and more, the macroeconomic policies prescribed in this program are not worth the risks and human costs that they introduce. Argentina would be better off implementing policies that do not rely on recession to resolve some of the current imbalances while worsening others.

1 IMF (2018a), p. 8.

Introduction

On October 26, the International Monetary Fund (IMF) announced that it would augment its lending to Argentina under its June Stand-By Arrangement (SBA) by an additional $6.3 billion, bringing it to a total of $56.3 billion, some $20.4 billion of which has already been disbursed.[2] Argentina is now the largest holder of the IMF's General Resources Account (GRA) funds, with 27.9 percent of outstanding credit (Greece, with 16 percent, is a distant second).[3] This is an enormous investment of IMF resources, by any historical or international comparison.

Will these funds, and the conditions attached to them, help Argentina recover from its current economic crisis and recession? In this paper, we will briefly examine how the policies that the Fund and the Argentine government have agreed upon since the Stand-By Arrangement was signed are expected to lead to an economic recovery; and whether they are likely to succeed.

The IMF Stand-By Arrangement signed on June 20, 2018 provided for $50 billion in IMF lending to be disbursed over 36 months. The program is centered on "a credible and ambitious plan" to "restore market confidence":

> The government has committed to a clear macroeconomic program that lessens the federal financing needs and puts public debt on a firm downward trajectory. This will help create a clear path to strong, sustained, and equitable growth and robust job creation. Anchoring this effort is a fiscal adjustment that ensures that the federal government reaches primary balance by 2020, with a significant upfront adjustment to secure a primary deficit of 1.3 percent of GDP in 2019.[4]

The government also committed to "strengthen the credibility of the Central Bank's inflation targeting framework," and "to bring inflation to single digits by end 2021." Annual consumer price inflation was around 30 percent at that time.[5] This would be done primarily through increasing the independence and autonomy of the Central Bank. The program also aimed to reduce the strain on the balance of payments, including by rebuilding international reserves.

2 International Monetary Fund (IMF) (2018a).
3 Ibid, p.105.
4 IMF (2018b), p.7.
5 INDEC (2018a).

TABLE 1

IMF Macroeconomic Projections in June SBA vs. October Review

	2018	2019	2020	2021	2022	2023
Real GDP Growth						
June	0.4	1.5	2.5	3.1	3.1	3.2
October	-2.8	-1.7	2.7	3.1	3.4	3.6
CPI inflation (year-over-year)						
June	27	17	13	9	5	5
October	43.8	20.2	13	9	5	5
Nominal Policy Rate						
June	37.2	22.5	15.8	11	10	9.7
October	69.6	32	20	15.3	10.8	10.3
Public Debt (Federal) as percent of GDP						
June	64.5	60.9	57.4	55.8	54.1	53
October	81.2	72.2	67	63.7	60.5	59.3

Source: IMF (2018a), IMF (2018b).

Table 1 shows the IMF's projections for 2018–2023 in the June Stand-By Arrangement, compared with what the Fund projected a few months later in its October review of the SBA. Clearly, the IMF had a fantastically over-optimistic view of how fast the Argentine economy would be turned around. For 2018, the IMF projected positive real GDP growth of 0.4 percent; it now projects negative 2.8 percent, a very large difference of 3.2 percentage points. It must be emphasized that the year was half over and Argentina was in the midst of a financial crisis when these forecasts were made. For 2019, a similar downward revision of 3.2 percentage points has been made, from positive 1.5 percent to negative 1.7 percent.

Consumer price inflation was projected in June at 27 percent for 2018 and 17 percent for 2019. The new estimates are 43.8 percent and 20.2 percent, respectively. The forecast for interest rates shot up from 37.2 percent and 22.5 percent to 69.6 and 32 percent. And the projected federal public debt as a percent of GDP, another fundamental target of the Fund program, jumped from 64.5 and 60.9 percent for 2018 and 2019, to 81.2 and 72.2 percent.

These are enormous changes to the IMF's outlook for Argentina in just a few months. It is worth noting that in addition to the baseline scenario in Table 1, the IMF also projected a "low probability" adverse scenario; and that for 2018 all of the above indicators in the current projections are worse than even the adverse scenario from the June projections. Furthermore, the IMF does not seem to make the case in its October review that the forecast gaps are the result of truly exogenous shocks.

The IMF has a long history of large forecast errors in Argentina[6] as well as in some other countries.[7] In fact, there were two well-known IMF papers that acknowledged the Fund's forecast errors in the eurozone during the years 2011 and 2012, in particular with respect to the size of fiscal multipliers during fiscal consolidations.[8] This may be of some relevance going forward (see below).

In any case, it is possible that the IMF, and also the current government of Argentina — which in its Letter of Intent to the Fund, stated that the recent plan is "designed by, and fully owned by, the Argentine government" — have a flawed understanding of the impact of their policies and perhaps some of the imbalances that they are trying to fix.

To assess this possibility, we now turn to the latest version of the IMF program as presented in the October review.

In addition to the $6.3 billion increase in the IMF's disbursement, the revised plan notes: "The resources available in the program are no longer expected to be treated as precautionary [i.e., drawn upon only if needed] and the authorities have requested the use of the IMF financing for budget support."[9]

The revised plan doubles down on fiscal consolidation as a means of restoring the market confidence that is seen as central to Argentina's recovery. Instead of running a primary deficit of 1.3 percent of GDP in 2019 as in the original SBA, the revised plan has a balanced primary budget in 2019 and a 1.0 percent primary surplus in 2020.

This is a sizable fiscal consolidation, comparable to the average year of austerity in Greece or Spain during their years of budget cutting following the 2009 World Recession. Using the IMF's estimate of the structural primary budget balance, it amounts to a fiscal tightening of 3.9 percent over two years (as opposed to 2.7 percent in the SBA). With a multiplier of 1.3,[10] we would expect this tightening to take 5.1 percent of GDP out of real economic growth for 2019–20.

The IMF currently projects that GDP will fall by 2.8 percent this year and 1.7 percent in 2019. But what is most remarkable in the IMF's projections going forward from October is that for GDP growth

6 Rosnick and Weisbrot (2007) and Weisbrot (2008).
7 Rosnick (2016), Weisbrot and Ray (2011), Rosnick (2009).
8 Blanchard and Leigh (2013) and IMF (2012).
9 IMF (2018a).
10 IMF (2012). They estimated fiscal multipliers between 0.9 and 1.7 in the two years following the Great Recession. We are taking the midpoint here (1.3).

and inflation there is no difference between a scenario in which the program's fiscal tightening takes place, and one in which it does not. This can be seen in **Table 2**.

TABLE 2

IMF Macroeconomic Projections, by Scenario, in Percent

	2018	2019	2020	2021	2022	2023
Real GDP Growth						
Baseline	-2.8	-1.7	2.7	3.1	3.4	3.6
Constant Primary Balance	-2.8	-1.7	2.7	3.1	3.4	3.6
Inflation						
Baseline	33.4	32.5	14.9	10.4	6.4	4.7
Constant Primary Balance	33.4	32.5	14.9	10.4	6.4	4.7
Primary Balance						
Baseline	-2.7	0	1	1.1	1.2	1
Constant Primary Balance	-2.7	-2.7	-2.7	-2.7	-2.7	-2.7
Effective Interest Rate						
Baseline	8.2	8.6	8.6	8.5	7.7	7.1
Constant Primary Balance	8.2	8.6	8.7	9	8.2	7.5

Source: IMF (2018a).

The idea that adjusting the primary balance by 3.7 percentage points in 2018–20, from -2.7 percent of GDP to +1.0 percent, would not impact growth does not make much sense. The reasoning appears to be that the contractionary impact of this tightening is exactly counter-balanced by the positive impact of market confidence induced by the move to a primary budget surplus. This is of course possible, but it has almost never been the result of procyclical macroeconomic policy in the past; and there are a number of reasons to think that this would not be the case in Argentina at present.

In addition to the procyclical fiscal policy, the revised program commits the government to a much tighter monetary policy. The central bank must switch from an inflation targeting regime to targeting the monetary base. The monetary base must grow at 0 percent monthly until June 2019, and 1 percent per month for the rest of the year. Furthermore, the Central Bank agreed to keep short-term policy rates at 60 percent "until such time as the 12-month-ahead median inflation expectations fall decisively for at least two consecutive months."[11] What constitutes a decisive fall is not defined. On December 5, the Central Bank announced that this measure of inflation had fallen for two consecutive months and, as a result, they were removing the 60 percent interest rate floor.[12]

11 IMF (2018a), p.19.
12 BCRA (2018a).

Still, this is a very tight monetary policy, one that might be more expected in an economy facing much higher or more rapidly accelerating inflation. Yet in spite of these contractionary fiscal and monetary policies introduced during a recession, the IMF in its October review projects the economy to begin a recovery by the second quarter of 2019 — just a few months from now.

How can this happen? In 2019, as in 2018, the IMF projects that net exports will make the only positive contribution to growth. Of course, this is possible, given the large real depreciation of the currency — a 34 percent fall in the IMF's estimate of the real effective exchange rate so far in 2018 — and an expected increase in agricultural exports. But the boost from net exports is projected to be short-lived; by 2020, the IMF is forecasting a real appreciation of the peso by 20 percent, and net exports subtracting more than 2 percentage points from GDP growth. For 2020, a big jump in private investment (more than 3 percent of GDP) and consumption is expected to counteract the drop in net exports.[13]

Again, this optimistic scenario is possible, but the downside risks seem large and dependent on unpredictable events. The demand for exports is exogenous, as are commodity prices; the world economy is already slowing and plagued by increasing volatility in financial markets and uncertainties due to trade frictions between the US and China. If net exports do not improve as much as needed in the next six months or so, the projected recovery early next year could be delayed, and the confidence-building project could be seriously damaged.

The US Federal Reserve's interest rate hikes undoubtedly contributed to the sudden stop of capital inflows that initiated this crisis in Argentina. If the US expansion continues, and the Fed pursues its planned path of interest rate increases, or if there is unanticipated inflation in the US and the Fed were to raise interest rates even faster, this could cause capital outflows from Argentina as from some other emerging market economies. This is what happened when the Fed raised short-term interest rates from 1994 to 1997, contributing to crises not only in Argentina, but also in Brazil, Mexico, the Asian financial crisis (Indonesia, Malaysia, South Korea, the Philippines, Taiwan), Russia, and other countries.

This is not to say that either Argentina or the world is facing similar initial conditions today as in the late '90s; for example, the fixed, often overvalued exchange rates in middle-income countries of that time — including Argentina — are mostly gone. But the likely external scenarios going forward pose serious risks for a strategy that is dependent on net exports for the initial recovery, as well as so exceedingly reliant on boosting market confidence with procyclical macroeconomic policy. The IMF

13 IMF (2018a), p 17.

notes that Argentina is already facing balance of payments problems "from pressures on the current and capital accounts, stemming from a shift in the global appetite for emerging market assets and idiosyncratic concerns about Argentina. The resulting tightening of financial market conditions has constrained the government's ability to issue new debt …."

Furthermore, there are no signs of a nascent recovery. Industrial production has declined sharply since May.[14] Consumer confidence has fallen over the past year and has continued falling in recent months;[15] real wages have fallen sharply.[16] The IMF warns that both of these latter problems are "likely to continue to hinder consumption."

The confidence-building core of the IMF program is also centered on bringing down the current account deficit, since this is seen as part of the problem that caused the "sudden stop" of inward portfolio investment flows last May. The current account deficit is projected to fall from 4.2 percent of GDP for 2018 to 1.6 percent of GDP in 2019. Of course, a deep enough recession will lower imports, since imports fall with national income; and that is often the unstated rationale of these types of procyclical fiscal tightenings, along with using the recession to reduce inflation. And indeed, more than 80 percent of the forecast reduction in the current account deficit comes from a sharp fall in imports.[17]

But relying on procyclical policies during a recession to reduce the current account deficit has significant weaknesses from a confidence-building perspective. The recession may have a bigger, negative effect on investor and consumer confidence than anticipated; and it may be deeper and longer than projected. This has often been the case historically, especially when the adjustment relies on an export-led recovery.[18]

In addition, about half of the current account deficit is interest payments on foreign currency debt; this is not projected to be much reduced in the near future.

It is also worth noting that domestic investment is particularly weak in this recovery, falling from 13.8 to 11.5 percent of GDP as the economy is projected to return to growth from 2018 to 2019. Private investment is forecast at just 8.5 percent of GDP in 2019. For comparison, investment was at 14.6 percent of GDP in 2016, when the economy was in recession. For the 13 years from 2002 to 2015,

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14 INDEC (2018b).
15 Centro de Investigación en Finanzas (2018).
16 Ministerio de Producción y Trabajo (2018) and authors' calculations.
17 IMF (2018a), and authors' calculations.
18 Krugman (2015).

investment averaged 16.1 percent of GDP.[19] The relatively low level of investment projected for 2019 and 2020 casts further doubt on the multiyear growth projections in the IMF's forecast recovery.

Given all of these downside risks to the procyclical macroeconomic policies in the program, why center the program strategy on fiscal and monetary tightening in order to increase market confidence? It would seem to make more sense to first ensure that the economy returns to growth before looking for ways to reduce the federal budget deficit, and to design policies for a sustained increase in exports to reduce chronic current account deficits, and reduce inflation more gradually. The recent spike in inflation is a result of a sharp depreciation of the peso, not an overheated economy — in fact the IMF estimates that the economy in 2018 is operating at 4.8 percent below its potential GDP.[20] We would expect the exchange-rate-induced inflation to be a one-off effect, with inflation stabilizing as the exchange rate stabilizes. This appears to have already happened, with the peso appreciating by about 7 percent since the end of September.[21]

Debt Sustainability and the IMF Program

The government spells out its strategy for restoring market confidence in a "Memorandum of Economic and Financial Policies" attached to its Letter of Intent for the IMF June Stand-By Arrangement. The first objective is:

> To fully restore market confidence through macroeconomic policies that lessen the federal government's financing needs and put our public debt on a firm downward path.[22]

It further notes that "[a]t the core of our economic program is our intention to accelerate the pace at which we have been reducing the federal government's primary deficit since 2016."[23]

19 Economist Intelligence Unit (2018).
20 IMF (2018a), p.32.
21 BCRA (2018b).
22 IMF (2018b), p.72.
23 IMF (2018b), p.73.

TABLE 3

Interest and Principal Due on Public Debt, and Total Debt as Percent of GDP

	2018	2019	2020	2021	2022	2023
Total Interest Due	2.4	2.1	1.7	1.3	1.1	0.9
in Pesos	1.0	0.8	0.6	0.4	0.2	0.2
in Foreign Currency	1.4	1.3	1.1	1.0	0.9	0.7
Total Principal Due	10.1	5.5	3.1	3.7	2.9	2.4
in Pesos	5.4	2.6	1.9	1.3	0.4	0.4
in Foreign Currency	4.7	2.9	1.2	2.4	2.6	2.0
Total Government Debt	54.1	52.7	52.2	52.0	52.5	53.5

Source: Ministerio de Hacienda (2018), IMF (2018c), and authors' calculation.

It is therefore worth exploring the dynamics of Argentina's projected public debt under the current program, and their possible relation to market confidence. **Table 3** shows the projected public debt, as well as interest and principal payments due, for the years 2018 to 2023, as a percent of projected GDP. It is also divided into debt that is in foreign currency (overwhelmingly dollars) and domestic currency.

It is important to note that these projections were made before the onset of the financial crisis in April, and they do not include any borrowing from the IMF. They therefore provide a reasonable look at the sustainability of the federal debt before market panic set in.

As can be seen in Table 3, the foreign currency interest burden was not inordinately high, at 1.4 percent of GDP, and was projected to decline to 0.7 percent of GDP by 2023.[24] The foreign currency debt burden is more important than that of domestic currency debt, since it can lead to balance of payments crises, and the government cannot create the money to pay it in situations where that would be a feasible policy.

The peso-denominated interest burden was about 1 percent of GDP, and projected to be 0.2 percent of GDP in 2023.[25] Clearly this was not a large or unmanageable debt burden.

Furthermore, about 40 percent of the federal government debt is owed to various public sector entities and provincial governments.[26] This debt can therefore be rolled over rather easily; in fact, going forward the IMF assumes that not only is principal rolled over but that interest is also capitalized.[27]

24 Ministerio de Hacienda (2018), IMF (2018c) and authors' calculation.
25 Ibid.
26 IMF (2018a), p. 21.
27 IMF (2018a), p. 52.

If the other 60 percent of the debt could have been rolled over as it comes due, as normally happens, there shouldn't have been any financial crisis this year. The principal due in 2018 was $63.4 billion dollars (10.1 percent of GDP).[28] This was a sizable principal payment, but again there was no obvious reason that it would not be rolled over. It was projected to decline rapidly to $19.8 billion in 2023 (2 percent of GDP).

The causes of the serious financial crisis this year are not clear. The Federal Reserve's continuing and planned interest hikes (eight since 2015 and more expected over the next year), the increasing current account deficit, and the government's large and rapid run-up in foreign borrowing, are among the most mentioned.[29] Other analysts have argued that the government was too weak and inconsistent in fighting inflation.

It seems clear that the government made a number of mistakes that contributed to the crisis. The first was the rapid pileup of foreign currency debt, which increased from 35 percent of GDP in January of 2016, a month after President Macri took office, to over 60 percent of GDP in April of this year, just before the financial crisis exploded. Then, when the crisis hit, the government spent about $16 billion trying to prop up the peso,[30] which lost about 52.3 percent of its value against the dollar by September 28.[31] It seems unlikely that the peso would have fallen further than that if the government had allowed the currency to float from the beginning. The loss of about $16 billion in reserves was therefore unnecessary; it likely contributed to the crisis and also led to the borrowing from the IMF, which not only added to the debt, but as we have seen, restricted the government's policy options going forward.

Nonetheless, it is not clear that the sudden and rapid flight from Argentine debt had a rational basis, other than the same kind of herd behavior that was evident, for example, in some countries as the Asian financial crisis spread in 1997–98.[32]

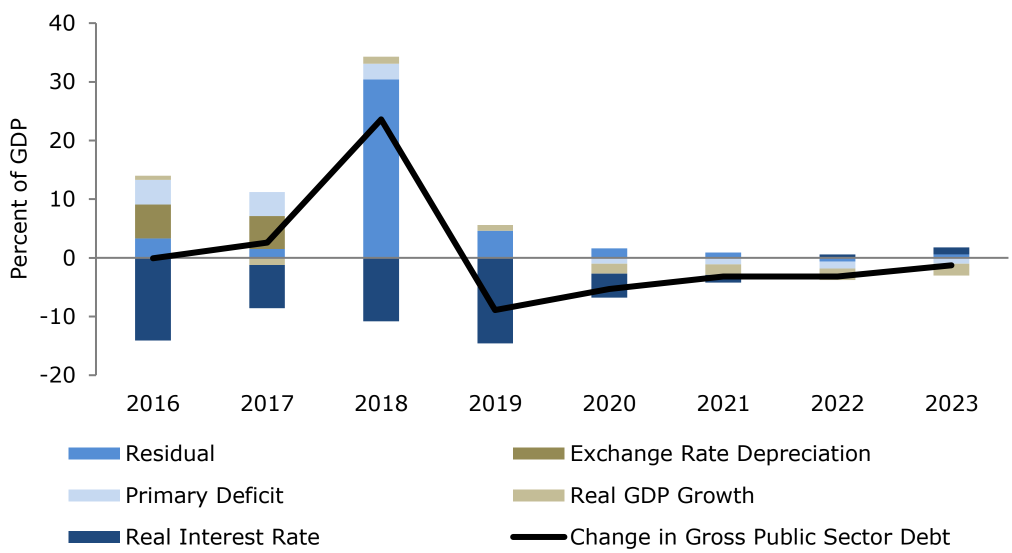
As noted above, if the principal had continued to be rolled over this year, the burden of the debt would not have become unsustainable. While it is true that the increase in interest rates by the US Federal Reserve would be expected to gradually increase Argentina's borrowing costs in foreign currency, this would not be expected to set off a panic as happened in May, as the country's debt burden remained moderate and sustainable, even with some increases in interest rates that followed the Fed's recent and projected rate hikes.

28 Ministerio de Hacienda (2018).
29 See, e.g., Miller 2018.
30 Graham and Misculin (2018).
31 BCRA (2018b).
32 Sachs and Radelet (1998).

Figure 1 summarizes the most important debt dynamics in the recent past and going forward, based on the IMF's most recent projections.

FIGURE 1

Contribution to Changes in Public Debt



Source and note: IMF (2018a). For projections, which begin in 2018, the impact of exchange rate depreciation is included in the residual.

In 2016, the first year of the current government, there was no change in the public debt as a percentage of GDP. This is because the negative real interest rates — inflation as measured by the GDP deflator was 37.5 percent in 2016 — reduced the value of the debt relative to GDP. This cancelled out the other factors that increased the debt-to-GDP ratio: depreciation of the peso,[33] real GDP growth,[34] the primary budget deficit, and a residual (3.3 percent of GDP) that includes asset changes. The story was similar in 2017, with the debt-to-GDP ratio increasing by just 2.6 percentage points, mainly because inflation was lower and so the debt-reducing effect of negative real interest rates was smaller.

In 2018, there is a large jump in the debt-to-GDP ratio, which increases by 23.6 percentage points, from 57.6 to 81.2 percent of GDP. What caused this jump? It is almost all the result of the depreciation of the peso,[35] which fell from 18.8 pesos per dollar at the end of last year to 38.2 by mid-December — losing more than 50 percent of its value against the dollar.

33 This increases the value of the foreign currency debt relative to GDP.
34 Real GDP growth was negative in 2016, and therefore added to the debt-to-GDP ratio.
35 For 2018 and subsequent years, the IMF includes the contribution of exchange rate changes in the residual, in Figure 1.

Most if not all of this depreciation was necessary to restore a competitive exchange rate to Argentina. But this illustrates a serious disadvantage of having such a large amount of debt in foreign currency.

Most importantly, Figure 1 shows that the primary federal budget deficit contributed just 2.7 percentage points of GDP to the increase in the debt-to-GDP ratio in 2018. Eliminating this by next year, by itself, will have a negligible impact on the size of the debt or its long-term sustainability. And running a primary surplus over the next four years will be even less significant.

The professed justification for this currently procyclical policy, which even under the best case scenario will initially slow an economy that is already in recession, is again based on confidence building. The idea is that such tough measures will convince the financial markets that the government is serious about reducing the federal budget deficit before its debt becomes unsustainable. On this basis, which some may find ironic, the IMF program is accelerating the fiscal and monetary tightening after the economy sharply underperformed what the IMF projected just a few months earlier on the basis of the initial program.

In fact, the contraction due to procyclical macroeconomic policy can — instead of increasing market confidence — undermine it. This has happened many times, including in a number of countries in the eurozone (and therefore the eurozone economy as a whole) post-2010.[36] In Greece, for example, the procyclical fiscal policies pushed the economy further into a depression that lasted more than six years, with the debt-to-GDP ratio increasing as the economy shrank. While it is true that Argentina — unlike Greece or Spain — has its own central bank and currency, and therefore should be in a situation to use macroeconomic and exchange rate policies to avoid such an adverse outcome, in this agreement it is giving up most of the use of these policies in exchange for the IMF loan. Fiscal and monetary policies are delineated in the program as described above; exchange rate policies are also circumscribed in the agreement, as the Central Bank is only allowed to intervene in foreign exchange markets under certain, fairly restrictive conditions. It is worth noting that in the recovery from the 1998–2002 depression, the Central Bank's pursuit of a "stable and competitive real exchange rate" played a significant role;[37] it is possible that, going forward, with the real exchange rate expected to appreciate, this policy restriction could matter. This is especially true given the need for export growth as a solution to the current account deficit.

36 See e.g., Weisbrot (2015).
37 See e.g., Frenkel and Rapetti (2008).

Conclusion

The capital flight that accelerated at the beginning of May brought home the need for policy changes from the government. There is a need to bring down inflation to avoid a continuing cycle of peso depreciation and price increases that feed into each other; as the peso depreciates, it raises import prices, which increases inflation and causes further flight from the peso. As we have seen, the peso depreciation also increases the burden of the large and growing foreign currency component of the debt. The government also has to arrest the growth of the current account deficit.

But the IMF-backed program addresses these problems primarily through shrinking the economy. This has created a new set of risks and problems that may make it even more difficult to resolve the other imbalances. As we have seen, the Fund's projections for a speedy recovery beginning just a few months after the implementation of its program in July were quite far off the mark. The government and the Fund then doubled down and intensified both the fiscal and monetary tightening. There is good reason to believe that the projected recovery in the second quarter of next year — a few months from now — will also turn out to be over-optimistic.

The Stand-By Arrangement and the October review both emphasize that one of the principal objectives of the program is to "protect Argentina's most vulnerable citizens from the burden of this needed policy recalibration."[38] However, given the loss of revenues during the recession and the pressure for expenditure cuts to meet the program's primary budget targets, this is almost certainly not going to happen. There will be increased suffering and hardship for millions of Argentines as unemployment and poverty increase with the recession. If the government sticks to the program targets — or intensifies them, as in October — there is a risk of prolonged recession as in other countries that have attempted "expansionary austerity."[39]

From 1998 to 2002, Argentina experienced a deep depression, losing more than 20 percent of GDP with poverty rising from 18.2 to 42.3 percent.[40] Unemployment peaked at 21.5 percent.[41] The vast majority of these losses occurred before the devaluation (December 2001) and default (January 2002), as the authorities — under agreements with the IMF for much of this period — attempted to bring about an economic recovery through fiscal and monetary tightening.

38 IMF (2018a), p. 8.
39 The term is from Paul Krugman — see e.g., Krugman (2015).
40 Poverty data are for the Greater Buenos Aires Area, which has about 35 percent of Argentina's population; comparable data for all urban centers or the country were not available for this period.
41 Weisbrot and Sandoval (2007).

Unlike at the end of the last century, Argentina today has not reached the point where its public debt is unpayable, although the IMF's assessment is that the "debt remains sustainable, but not with a high probability."[42] Nor is the government locked into an overvalued currency with a doomed convertibility system as it was at the end of the last century. But things could get a lot worse if the current fiscal consolidation and monetary tightening, and accompanying recession, fail to inspire the market confidence that is sought. The recession could be deeper and/or much more prolonged than projected, and if the fiscal consolidation is continued, the economy could get caught in a trap where the burden of the debt increases with austerity. For all of these reasons and more, the macroeconomic policies prescribed in this program are not worth the risks and human costs that they introduce, and alternatives that do not rely on a recession to resolve the current imbalances should be sought.

42 IMF (2018a), p. 21.

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