



Argentina's Post-Crisis Economic Reform: Challenges for U.S. Policy

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Summary

U.S.-Argentine economic relations have long been mutually beneficial. In recent years, however, they have been strained at times, in part because of Argentina's struggle to maintain macroeconomic stability, and also because of specific policy choices that have made the business environment difficult to navigate since the country's 2001 financial crisis. Following a steep currency devaluation and the largest sovereign default in history, Argentina entered a deep recession with high unemployment and social upheaval. It brought to power a new government, and with it a shift in economic policy away from market-oriented policies toward greater government management of the economy in pursuit of the stated Argentine goal of "social equity." The initial policy responses intended to restore order and address the most pressing social problems evolved into permanent social programs. Government policies introduced many distortions into the economy, including high inflation, which have required regular adjustments in the international accounts to maintain economic stability. These include managed trade, capital controls, and limited currency conversion, among other policies that have earned the ire of international stakeholders.

Argentina's economic policies reflect priority for financial independence, social equity, and what may be considered a commitment to "populist" macroeconomic solutions. Even in recognizing that countries can govern themselves well under alternative policy frameworks, what stands out for many is the sense that Argentina's policy choices with attendant economic distortions increase the risk of a potential financial crisis. The resulting spillovers into international economic policy are unavoidable. Trade protection, managed exchange rates, and capital controls, for example, are policy adjustments required to address problems that materialize in a constrained economic system (e.g., subsidy-driven fiscal expansion, price controls, inability to borrow internationally) that cannot easily accommodate current account deficits, a market exchange rate, or standard macroeconomic responses to high inflation.

Congress and private U.S. stakeholders have opposed many of Argentina's policies that include a sovereign default on debt owed to both private investors and countries, including the United States; refusal to pay awards ordered by the International Centre for the Settlement of Investment Disputes; nationalization of foreign assets; trade protectionism; capital and currency controls; and refusal to abide by International Monetary Fund (IMF) reporting requirements. U.S. investors are suing the government of Argentina in U.S. federal courts; the Obama Administration has invoked financial restrictions, revoked trade preferences, voted against loans for Argentina in the development banks, and filed cases before the World Trade Organization (WTO). Some Members of Congress have expressed dissatisfaction in hearings, resolutions, and proposed legislation.

International stakeholders, both public and private, find themselves challenged by this system, along with some Argentines. One indication of the breadth of international dissatisfaction over Argentina's policies is the call for effectively removing Argentina from the G-20, despite the lack of precedent and formal procedure for doing this. Irrespective of these initiatives, Argentina has not been moved to change course, and the 113th Congress may decide to consider once again U.S. options for addressing bilateral concerns with Argentina.

For details on the sovereign debt issue, see CRS Report R41029, *Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts,"* by J. F. Hornbeck.

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At the close of 2001, Argentina plunged into a devastating financial crisis. Deep recession, high unemployment, and social upheaval brought to power a new government, and with it a new direction in economic policy away from market-oriented policies toward greater government management of the economy. A new stated emphasis on “social equity” placed additional strain on the budget, but economic recovery, strong foreign demand for Argentine commodities, loose monetary policy, and debt repudiation brought six straight years of fiscal surplus. By 2012, however, the creeping deterioration of Argentina’s economic fortunes was undeniable. Slowing economic growth, rising inflation, and a tightening budget constraint raised doubts about the country’s fiscal capacity to meet the now well-entrenched “populist” expectations. At risk is the Argentine economic model itself, as well as the political and social balance it has supported over the past decade.

Supporting an expansive domestic policy agenda has led to a highly distorted economy that in turn has required repeated intervention in the external accounts to maintain a fragile balance. Debt repudiation, expropriation, capital and currency controls, trade protectionism, and refusal to abide by judgments made by international organizations are part of the policy mix that has also created tension with foreign governments, international financial institutions, and private sector interests. In the United States, the federal courts and the Obama Administration have taken action against many of Argentina’s foreign economic policies. Previous Congresses have introduced legislation and resolutions denouncing Argentina’s practices, and the 113th Congress may consider whether to formally respond to Argentina’s foreign economic policy as well. This report provides a framework for understanding Argentina’s economic policies, issues raised for U.S. stakeholders, and implications for the future of U.S.-Argentine economic relations.

U.S. Economic Interests and the Post-Crisis Political Economy

U.S.-Argentine economic relations have long been mutually beneficial, despite bilateral trade being relatively small and U.S. investment stalling in recent years. Argentina is the United States’ 29th-largest export market and 54th in imports, but accounting for less than 0.05% of U.S. trade. The United States is Argentina’s fourth-largest export market and number three in imports, accounting for roughly 8% of Argentine trade, but falling well behind Brazil and China. Equally, if not more importantly, is the U.S. foreign direct investment (FDI) position in Argentina, which is third-highest in South America behind Brazil and Chile, and reflects the many U.S. firms operating for decades in all sectors of the Argentine economy.

Nonetheless, U.S.-Argentina economic relations have been strained at times, in part because of Argentina’s struggle to maintain macroeconomic stability, and also because of specific policy choices that have made the business environment difficult to navigate. For these reasons, elaborated in this report, bilateral trade has remained relatively small and U.S. investment has declined over the past decade. For example, from 1993 to 2000, when Argentina had stabilized its economy from the hyperinflation of the late 1980s, the U.S. investment position rose by nearly 300%, from \$4.4 billion to \$17.5 billion. In response to the 2001 financial crisis and subsequent policy changes, FDI fell precipitously to \$9.2 billion in 2004. Although it has since recovered, FDI stood at \$13.3 billion in 2011, a 25% decline from 2000 levels.¹ These trends reflect many

¹ Foreign direct investment data are available at the U.S. Department of Commerce, Bureau of Economic Analysis (continued...)

problems that have developed for U.S. stakeholders over the economic policies Argentina has adopted since 2000. The problems have become increasingly difficult in recent years because the Argentine government has had to tighten controls over many areas of the economy.

To a great extent, Argentina's approach to domestic governance and international economic relations, including the friction it has caused with the United States and other stakeholders, can be understood as being influenced by the cost of the financial turmoil that followed in the aftermath of the 2001-2002 economic collapse. The fixed exchange rate convertibility program that had anchored the economy since 1991 became untenable, as did the government of President Fernando de la Rúa. In 2001, after three years of nagging recession, economic output collapsed into a two-year free fall (see **Table 1**). Argentina found itself deeply in debt, which forced it to adopt severe austerity measures even as much of the income and wealth of its citizens disappeared virtually overnight. Poverty and unemployment skyrocketed, riots broke out, and violence filled the streets. Intervening presidents (five in twice as many days) oversaw a steep currency devaluation, the largest sovereign default in history,² and highly restrictive management of the financial sector.

Social upheaval led to political uncertainty and ultimately a succession of presidents who shared a vision of major economic policy reform. The Argentine Congress took the first step toward reestablishing political stability by appointing to the presidency Senator Eduardo Duhalde, a long-time leader of the Peronist party (Partido Justicialista—PJ). He assumed office on January 1, 2002, to complete de la Rúa's unexpired term. In the national elections that followed in 2003, Argentines elected another Peronist, Néstor Kirchner, who was succeeded by his wife, Cristina Fernández de Kirchner, in the 2007 and 2011 elections. Each administration took a closer step toward institutionalizing what is frequently referred to as a "populist" economic program that has come to define Argentine political and economic reality in the 21st century.³

President Duhalde made clear from the outset that he blamed Argentina's economic crisis on a failure of the free market system, and he vowed to change course. Under emergency economic powers ceded to him by Congress, he eliminated the currency board that had anchored economic policy, devalued the peso, limited bank and foreign currency transactions, and oversaw the passage of bankruptcy laws that restricted payments to foreign nationals. At the same time, social policy became the new priority. He initiated subsidies for transportation and energy that in time became fully entrenched in the federal budget. Given the lack of revenue options, new temporary taxes were put on exports and financial transactions. In time these grew and became permanent, with proceeds dedicated to social spending.

(...continued)

(BEA) at <http://www.bea.gov/international/index.htm>.

² For details on Argentina's default, see CRS Report R41029, *Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts,"* by J. F. Hornbeck.

³ The term "populism" is admittedly a controversial and, for some, a pejorative term. It, nonetheless, has a fairly well-established understanding in Latin American economic history. This report focuses on the populism of macroeconomic policy, which may be defined as "an approach to economics that emphasizes growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints, and the reaction of economic agents to aggressive nonmarket policies." This definition is not meant to diminish in any way the legitimate concern for distributional issues in economic policy, but serves as a type of unifying understanding of policies that historically, often have not ended well for those very groups such policies are intended to benefit. See, Rudiger Dornbusch and Sebastian Edwards, "The Macroeconomics of Populism," in *The Macroeconomics of Populism in Latin America*, ed. Rudiger Dornbusch and Sebastian Edwards (Chicago: University of Chicago Press, 1991), pp. 7-15.

Under Presidents Kirchner and Fernández, these initial policy responses intended to restore order and address the most pressing social problems became permanent programs. As the recovery took hold, Argentina could afford some fiscal largesse because of favorable terms of trade and the strong global demand for Argentine commodities, which contributed to nine years of strong economic growth (see **Table 1**).⁴

Table 1. Argentina: Selected Economic Data, 2000-2012

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP Growth (%)	-0.8	-4.4	-10.9	8.8	9.0	9.2	8.5	8.7	6.8	0.9	9.2	8.9	2.2
Overall Fiscal Balance (% of GDP)	-3.6	-6.8	-2.0	0.9	3.7	2.1	1.9	0.6	0.7	-0.8	-0.1	-2.3	-1.6
Primary Fiscal Balance (% of GDP)	0.4	-1.3	0.7	2.8	5.3	4.4	4.0	2.7	2.8	1.4	1.5	-0.1	0.5
Public Debt (% GDP)	45.7	53.7	166.3	138.2	126.4	72.8	63.6	55.7	48.5	48.5	45.1	41.2	39.9
Inflation Rate INDEC (%) ^a	-0.7	-1.5	41.0	3.7	6.1	12.3	9.8	8.5	7.2	7.7	10.9	9.5	10.2
Inflation Rate (adjusted) (%) ^a									25.0	18.1	22.4	25.1	25.4
Real Avg. Wages (index)			76.0	85.2	93.1	100.0	108.9	118.8	129.2	144.3	163.0	196.1	231.8
Current Acct Balance (% GDP)	-3.1	-1.4	8.5	6.3	2.1	2.9	3.6	2.8	1.5	2.1	0.8	-0.3	0.2
Terms of Trade (index)				91.0	95.3	100.0	106.8	109.6	113.0	103.3	113.4	120.3	119.6
Real Effective Exchange Rate Index ^b			106.9	97.5	100.2	100.0	102.0	101.2	97.2	99.3	98.5	96.0	93.6
International Reserves (\$ bn)	32.5	15.3	10.4	13.8	19.3	27.3	31.2	45.7	46.2	48.0	52.2	46.4	45.3
International Bond Issues (\$ mn) ^c	13,468	2,711	0	100	200	540	1,896	3,256	65	500	3,146	2,193	663

Source: United Nations Economic Commission on Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean*, December 2012. Indexes with 2005 base year do not include data prior to 2003.

- a. Instituto Nacional de Estadística y Censos (INDEC)—Argentina’s official government statistical office, which has come under criticism for understating inflation rates since 2007. The line below presents adjusted annual inflation rates since 2008 that reflect the simple average of inflation rates reported at the beginning of each month as computed by an academic team at MIT. They match closely many other estimates offered by private consultants. See <http://www.InfacionVerdadera.com> and Alberto Cavallo, “Online and Official Price Indexes: Measuring Argentina’s Inflation,” *Journal of Monetary Economics*, vol. 60, no. 1.
- b. A decrease in the index reflects a real appreciation of the peso exchange rate.
- c. Includes sovereign, financial sector, and other commercial debt.

⁴ From 2003 through 2011, the value of Argentina’s soy exports to China (the primary export) rose by 241%, reflecting a 43% rise in volume and 138% increase in price. Similar trends occurred for the other two major exports, soy oil and crude petroleum. Dependence on commodity trade is not new. As one long-time historian of Argentina commented on its economic status in the 19th century, “Prosperity based on good harvests and strong overseas markets obscured a dangerous vulnerability,” namely, the eventuality of a sudden fall in prices and increase in imports that leads to current account and debt problems. Colin M. MacLachlan, *Argentina: What Went Wrong* (Westport: Praeger, 2006), p. 36.

Expansive fiscal and monetary policies reinforced growth and debt repudiation freed up fiscal resources in the name of national economic independence. The government disdained reliance on foreign financing and what it considered the meddling of international institutions and foreign governments, many of which were held to be complicit in the economic catastrophe that befell the country a decade earlier. As a result, Argentina's foreign economic policies were largely subordinated to the domestic political agenda, with limited concern for their impact on foreign interests.

The New Macroeconomic Framework

The new economic policy framework came with many tradeoffs including an increasingly large fiscal burden, rising inflation, and, as discussed below, questionable ad hoc policy adjustments imposed to counter the effects of economic distortions as they arose. A near-term economic crisis in Argentina may not be at hand, but protests over rising costs are becoming more frequent and surveys conducted by the Universidad Torcuato Di Tella point to sharply declining confidence in the government beginning in 2012.⁵ Many economists suggest that it may be too late to engineer a soft landing, raising serious questions about the sustainability of the current economic model, and perhaps stability of the political system as well.

Fiscal Challenges and Constraints

From 2003 through 2011, Argentina's economy grew robustly with the exception of the 2008 global downturn. From 2003 through 2008, the government ran a fiscal surplus, reflective of strong growth in public revenue. At the same time, public debt as a percent of GDP also declined steadily, which on the surface suggests that the Argentine economy had not been performing badly. Nonetheless, there has been a continuing erosion of the fiscal position since 2003, as may be seen in **Table 1**, with the balance turning to deficit in 2009 and thereafter. Also, the public debt ratio stabilized more or less by 2010, and economic growth declined noticeably in 2012, with no expectation of returning to previous high levels. These trends reflect a near-term deterioration in the internal economic situation, in part related to policy distortions, beginning with the fiscal accounts.

The Argentine government directly intervenes in the operation of the economy to achieve, in its own words, "economic development with social equity."⁶ This focus is not new to Argentina and requires extensive fiscal effort. On the spending side, public policy pursues equity through social transfers: setting the price and domestic supply of key consumer goods (e.g., energy and food); providing direct subsidies for energy and transportation; and adjusting salaries to offset inflation. Subsidies began under President Duhalde, in part to meet the basic needs of those thrust into poverty. The cost and array of programs, however, have expanded, contributing to rising fiscal deficits since 2006. Subsidies grew from US\$1.6 billion in 2005 to US\$18.1 billion in 2011,

⁵ Universidad Torcuato Di Tella, *Indice de Confianza en el Gobierno*, <http://www.utdt.edu>.

⁶ As quoted from the Banco Central de la República, *Inflation Report Second Quarter 2012*, May 2012, p. 59 and *Macroeconomic and Monetary Policy Report*, July 2012, p. 6. Interviews with government officials at the Ministry of Foreign Relations and Ministry of Economy and Public Finance in Buenos Aires September 2012 reinforced this priority.

equaling 4% of GDP. They are distributed among energy (56% of total), public transportation (30%), and other public services (14%).⁷

For years, the Argentine government has periodically capped prices and restricted exports of certain key food products, including at times staples such as beef. On February 4, 2013, it took the added step of negotiating a two-month price freeze on food and other household goods with the major supermarket chains. The Fernández government is also reportedly considering extending the freeze until the fall 2013 election.⁸ These practices reduce costs to consumers, with the intention of stimulating consumption and improving income distribution, but have also distorted market signals for wholesalers and producers. The agricultural sector has borne a large part of this cost, resulting in protests and interruptions in production, reducing profits and taxes paid by food producers.

Energy is the largest of the public subsidies, amounting to over 2% of GDP.⁹ Given that energy production has actually fallen in Argentina, largely due to price controls that have dampened investment, the government has had to make up the difference through imports. In effect, oil and natural gas, the predominant forms of energy use, are imported at international prices, and then deeply discounted and distributed to the population. This policy compromises both the fiscal and current account balances by raising costs to the government and increasing demand for imports.

Finally, many private and public sector salaries, including those for union members and pensioners, have been adjusted annually to the increase in the price level (25% in 2012; see below) to ensure that rising inflation does not erode purchasing power for key constituents. It is perhaps no coincidence that real wages (adjusted for inflation) grew by 5% or more immediately preceding the presidential elections of 2007 and 2011, while declining afterward.¹⁰ In addition, the number of public employees and those relying on public retirement and social programs has risen from 5.3 million individuals in 2001 (14.4% of total population) to 13.2 million in 2011 (32.2% of total population), adding substantially to the fiscal burden.¹¹

Given that the current government has been strongly supported by groups that benefit disproportionately from subsidies, price controls, wage adjustments, and public employment, there is a political rationale for sustaining them, but they come with significant costs and tradeoffs. On the revenue side, Argentina has benefitted from sustained global demand for its export commodities, a major source of tax revenue.¹² The federal government has also relied on monetary expansion, foreign debt repudiation, heavy income taxation, and increased intra-governmental borrowing. These options, however, may be reaching their limits. Argentina's fiscal deficits would be addressed by most countries with a combination of financing options. The government, however, faces a number of constraints that make this difficult.

⁷ In fact, electricity is provided at a fraction of its cost and all forms of public transit (buses, subway, commuter trains), cost no more than US\$0.50 to ride. There are also subsidies in the tax code for families, which reportedly increased some 26% in 2012. IHS Global Insight, *Subsidies Increased in Argentina, Low Official Inflation Rate Unchanged*, September 17, 2012.

⁸ *La Nación*, February 4 and 19, 2013.

⁹ Fundación de Investigaciones Económicas Latinoamericanas, (FIEL), power point presentation, *La Economía Argentina: Situación Actual y Perspectivas*, September 2012.

¹⁰ INDEC, *Nota de Prensa, Las Remuneraciones en la Industria Manufacturera Aumentaron un 7.2% durante el Tercer Trimestre del Año*, October 31, 2012, and FIEL, *ibid*.

¹¹ FIEL, *ibid*.

¹² Some now refer to the effects of the extended commodity boom as the "Milagro Argentino," or Argentine miracle.

To meet its budgetary goals, Argentina must work within three options. It may raise taxes, issue debt, or print money to cover government expenditures. First, income taxation is already heavily skewed toward the upper income groups. The national income tax rate is 38%, but by one estimate, only half the working population actually pays taxes, so the effective rate on average can be twice that, which constrains further tax increases.¹³ This is one reason the government has turned increasingly to alternative sources of revenue, such as taxes on financial transactions, and particularly exports, which rose from 11.8% to 20.5% of tax revenue from 2006 to 2011.¹⁴

Second, since defaulting on its sovereign debt in 2002, the federal government has had no access to international bond markets, nor has it signaled any desire to return to this option. If the government is to increase borrowing, it must continue to do so internally. Third, although Argentina has expanded the money supply to cover shortfalls (see next section), this too may be limited at some point by inflation and the price and social instability it can produce.

Given the constraints it faces, and that tax revenue fell from 19.0% to 11.4% of GDP from 2006 to 2011, Argentina has chosen a policy mix designed to self-finance public expenditures, relying largely on the resources of government agencies and monetary expansion. Pension funds have provided one source of cash. In 2007, the Kirchner government nationalized private pension funds, dedicating their revenue streams, and those of the National Social Security Administration (ANSeS-FGS), to the purchase of government bonds at interest rates set by the Treasury, typically well below the actual inflation rate. The government also relies on loans from the government-owned Banco de la Nación Argentina¹⁵ and “temporary overdrafts” from the Central Bank to meet financing gaps. In 2012, it met most of its financing needs from these sources. This trend is expected to continue, and perhaps be extended to other social and health service institutions (e.g., *Obras Sociales*—Social Works) to finance government operations.¹⁶

Financing government spending in this manner has certain benefits. The government does not have to rely on external sources and is assured that maturing debt can be rolled over on a predictable basis and at an accommodating interest rate. Should the government find itself unable to meet payments, being a creditor to itself allows flexibility for working out financial shortfalls.

On the other hand, Argentina’s financing arrangements also raise many questions regarding long-term sustainability. Although the government points to reduced debt ratios (see **Table 1**), it uses intra-government transfers to place significant amounts of debt in public agencies.¹⁷ Should a fiscal crisis occur, Argentina defaults on itself, potentially forcing the retirement system into insolvency.¹⁸ A tax structure based on exports and financial transactions raises costs, particularly to export, and so can diminish incentives to produce and invest, which ultimately may reduce

¹³ Discussions at the Universidad del CEMA, Buenos Aires, September 2012.

¹⁴ World Trade Organization, *Argentina Trade Policy Review Report*, WTO Secretariat, WT/TPR/S/227, February 13, 2013, p. ix.

¹⁵ It is perhaps a bit ironic that this government-owned bank was created in 1891 out of the ashes of its predecessor, the Banco Nacional, after the former failed trying to service short-term government debt owed to Europe, see MacLachlan, *Argentina: What Went Wrong*, p. 38.

¹⁶ Banco Central de la República, *Inflation Report Second Quarter 2012*, May 2012, p. 54, and *Financial Stability Report: Second Half 2012*, October 2012, pp. 39-40.

¹⁷ *Ibid.*

¹⁸ Argentina defaulted three times on its domestic debt between 1980 and 2001. See, Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, (Princeton: Princeton University Press, 2009), p. 111.

revenue, as well as economic growth. In fact, industrial production fell by 3.8% in 2012 for the first time in more than 10 years.¹⁹ Argentine goods are also less competitive in global markets, suggesting that these financing schemes risk jeopardizing long-term growth and development.

Monetary Policy: Accommodation?

The main feature of Argentina's monetary policy is its expansionist orientation, which supports growth, fiscal, and exchange rate targets. Despite the Central Bank's (*Banco Central de la República*—BCRA's) claims of policy neutrality or what it refers to as "autarky,"²⁰ the preponderance of evidence, discussed below, points to an institution whose primary mission is to accommodate the national government's overall economic policy agenda. This shift has occurred incrementally, a key milestone occurring in 2010, when the then-president of the BCRA refused to use its resources to finance government spending, a showdown that resulted in his forced resignation.

The transition continued with the new Central Bank Charter, which entered into force on April 6, 2012. The charter formally restates the mission of the BCRA, eliminating price stability as a key policy goal and replacing it with a new mandate to "promote monetary stability, financial stability, employment, and economic development with social equity."²¹ In addition, the charter emphasizes the BCRA's role in credit allocation, particularly for longer-term productive investments. The required ratio of the international reserves to the monetary base was also eliminated, providing flexibility to manage and use BCRA reserves as needed and determined by the Board of Directors. Monetary policy operates through multiple channels, using both money creation and BCRA reserves to support key government goals of maintaining positive fiscal and current account balances, a stable exchange rate, and credit expansion.

Money Creation

The new bank charter defines the central goal of the BCRA as maintaining "monetary stability," which is a vague concept by conventional standards, but is generally interpreted to mean maintaining a stable exchange rate rather than price stability, the more common goal of central banks. Meeting fiscal, current account, and growth targets are also in the mix. Monetary expansion is at the heart of this strategy, and currently, Argentina has one of the most expansive monetary policies in Latin America.²²

The goal of an expansive monetary policy is to finance the deficit, purchase dollars for the international reserve position, and have the liquidity to manage volatility of the peso exchange rate. The money supply, however, is also the main cause of inflation, which should lead to a depreciating peso if Argentina is to remain competitive globally. The government actively manages the exchange rate. It allows for a steady nominal depreciation, but because it is not

¹⁹ Business Monitor International, *Latin America Monitor: Southern Cone*, March 2013.

²⁰ Banco Central de la República Argentina, *Argentina: Macroeconomic, Monetary, and Financial Outlook*, Power Point Presentation, Buenos Aires, August 2012, p. 62.

²¹ *Ibid.*, p. 58.

²² Banco Central de la República, *Inflation Report Second Quarter 2012*, p. 59-60 and United Nations, Economic Commission on Latin America and the Caribbean, *Macroeconomic Report on Latin America and the Caribbean*, Washington, D.C., June 2012, pp. 70-72.

sufficient to adjust fully for inflation, the currency is actually experiencing a real appreciation. A higher-valued peso makes exporting, already burdened by taxes, relatively more difficult, thereby requiring restrictions on imports at times to maintain a balanced current account.

In recent years, Argentina has relied on the dollar inflows from a current account surplus to balance dollar outflows from the financial account to cover foreign payments.²³ Should the current account also turn to deficit, the alternative is to use international reserves. Reserves levels, however, have already fallen by over 20% since 2010 and stood at \$41.6 billion as of February 28, 2013.²⁴ In addition, there are increasing reports of declines in dollar deposits in the banking system spurred in part over fears that the government will exchange them for pesos if it needs to, as it did in 2002.²⁵

Among the key monetary objectives is to increase the amount of dollars held in reserve and the amount of pesos circulating in the domestic economy. The BCRA fine tunes this process at times by “sterilizing” the monetary growth effect of dollar purchases. That is, if policymakers determine that dollar purchases must continue, causing the monetary base to expand too fast, they can counteract the monetary growth by having the BCRA purchase pesos through the sales of financial instruments such as repurchase agreements and bonds. For example, in 2012, foreign exchange purchases accounted for 85% of the monetary expansion, but were offset in part by short-term sales of these financial instruments.²⁶

Management of the foreign exchange market, as complex and finely tuned as the process is in Argentina, has not fully offset the monetary effects of dollar inflows, reinforcing rapid growth in monetary aggregates. In 2012, M2 expanded by 29% and M3 by 32%.²⁷ In this way, the Fernández government creates financial resources that can be used to cover budget shortfalls. Argentina is effectively “monetizing” public debt on one hand, and managing its external accounts on the other to support spending. The cost is inflation, which should rise with the increase in money supply. The inflationary spiral completes the circle, reinforced by an expansive fiscal policy needed for subsidies, income support, price caps, and other social transfers. Consumers are also enticed to spend rather than save given rising prices. Inflation expectations, therefore, are built into a “vicious cycle,” the sustainability of which is becoming questionable. Inflation also encourages flight to dollars, making them increasingly valuable as a store of value. In response, Argentina instituted foreign exchange controls and limited currency conversion.

²³ Given Argentina’s inability to borrow internationally and the decline in foreign investment, the other major sources of dollars come from exports, export taxes, and forced repatriation of profits.

²⁴ The \$41.6 billion in reserves equals approximately 7 months of imports for 2012, considered more than sufficient to cover balance of payments needs by “conventional” standards. In a country with capital, export, and import controls, as well as a managed exchange rate, indications of capital flight, and a steady decline in reserves, it is less than clear that this is an adequate backstop. See, IMF, *Assessing the Need for Foreign Currency Reserves*, <http://www.imf.org/external/pubsft/survey/so/2011/POL040711B.htm>.

²⁵ Eliana Raszewski, “Disappearing Dollars Compound Default Threat: Argentina Credit,” *Bloomberg*, February 28, 2013.

²⁶ BCRA, *Inflation Report*, pp. 59-60. The financial instruments in question are Letras del Banco Central (LEBACs), which can be issued with short-, medium-, and long-term maturities, and Notas del Banco Central (NOBACs), or medium-term notes or bonds. Both are auctioned regularly and trade in the secondary market. The BCRA may issue them as needed given the ability to sell at will to agencies of the federal government.

²⁷ BCRA, *Ibid.*, pp. 59-60. In Argentina, M2 = cash + checking deposits + savings deposits. M3 adds certificates of deposit (CDs).

Inflation Accounting

Inflation has become a structural element of the Argentine economy and foundational to executing the government's overall economic policy. An issue that has become difficult for Argentina's government is the allegation of official underreporting or outright manipulation of inflation data since 2007. Estimates by many independent economists and other indicators of changes in the price level challenge government reporting. The *Economist*, in an unusual move, has dropped official reporting of inflation data in favor of independent unofficial estimates. A deepening concern has been the pressure exerted by the Fernández government to mute independent economist estimates in Argentina with fines and threats of imprisonment.²⁸

Inflation reported by the *Instituto Nacional de Estadística y Censos* (INDEC), Argentina's official statistical agency, has been challenged since 2007, when the Kirchner government decided to replace the director with a political appointee. Since then, in most years, the discrepancy between Argentina's officially reported inflation rate and other estimates of inflation has grown. In 2012, INDEC reported that inflation rose by approximately 10% annually. Private-sector and provincial government estimates place it above 25%. Government reporting on nominal wage increases reinforces these estimates given that public- and private-sector wages have been adjusted upward by over 25% for both 2011 and 2012, rates presumably in line with maintaining purchasing power.²⁹

An academic team at the Massachusetts Institute of Technology (MIT) has weighed in with more robust statistical analysis by comparing INDEC inflation reporting with indexes they produced from daily online price data. Whereas these data were able "to match both the average level of annual inflation and the long-run inflation trends" for four Latin American countries that produce accurate inflation statistics, they uncovered the large and growing discrepancy in Argentina between INDEC and other price level indicators. They conclude that the online data estimates "tend to be two to three times higher than official inflation," yet dynamic trends, or the movement of inflation upward and downward, are consistent.³⁰

The Argentine government argues that it is difficult to measure inflation precisely, and that a moderate amount of inflation is broadly accepted as a structural element of the economy as part of the tradeoff for meeting economic growth and social equity goals. The government, however, benefits from underreporting inflation in at least four ways. First, it can postpone policy responses aimed at reducing inflation that are typically austere, highly unpopular, and potentially politically difficult. Second, heavy financial regulation means that the government can dictate its financing terms (interest rates, maturity terms) on domestic debt. Third, domestic debt can be inflated away and, fourth, some 25% of Argentina's public debt is indexed to inflation, as are many social spending programs. By underreporting inflation, costs of program spending and borrowing have been lower than they otherwise would have been. To date, estimates of government saving from underreporting inflation are as high as \$2 billion.³¹

²⁸ The *Economist*, *Official Statistics: Don't Lie to Me, Argentina*, February 25, 2012.

²⁹ INDEC, *Nota de Prensa, Las Remuneraciones en la Industria Manufacturera Aumentaron un 7.2% durante el Tercer Trimestre del Año*, October 31, 2012, Banco Central de la República Argentina, *Argentina: Macroeconomic, Monetary, and Financial Outlook*, and *Inflation Report*, pp. 67 and 72.

³⁰ See, Alberto Cavallo, "Online and Official Price Indexes: Measuring Argentina's Inflation," *Journal of Monetary Economics*, vol. 60, no. 1 and <http://www.InflacionVerdadera.com>.

³¹ Paula Diosque, *Argentina: Country Intelligence Report*, IHS Global Insight, August 24, 2012, p. 9.

There are also costs to the bias in inflation reporting. It affects income bracket measures for purposes of taxation and poverty determinations, effectively understating both, and calls into question the credibility of real GDP calculations.³² In addition, for all practical purposes, there is no easy correction to the inflation reporting system given that much of economic policy rests on the assumption of lower official inflation estimates. The alternative would be to recognize the real inflation rate, which would likely require a policy correction through monetary contraction, a likely politically disastrous option.

Credit Rationing

The BCRA has taken an active role in using its regulatory power and banking reserves to extend credit to the Argentine economy. In 2007, the Fernández government required the BCRA to create the Bicentennial Productive Financing Program. The BCRA auctions bonds, lending the proceeds for medium- and long-term capital investment, at fixed, and effectively, subsidized interest rates. To date it has allocated US\$4.4 billion and disbursed US\$2.4 billion.³³ A 2009 law created the Bicentennial Fund for Stability and Debt Reduction and a follow-on decree established the Argentine Debt Reduction Fund to assure creditors that finances would be available for scheduled payments by setting aside international dollar reserves. In 2013, Argentina set aside \$8.0 billion of international reserves to guarantee international payments.³⁴

The BCRA also relies on temporary overdrafts of international reserves to provide short-term financing to the treasury. In addition, the central bank charter reform permits the use of “free available international reserves” to “subscribe” to the Argentine debt relief fund. These funds are used to retire public debt held by the private sector, international financial institutions, and other official bilateral entities.³⁵ In 2012, the BCRA also created a credit line for private sector “productive investment” in which the largest “financial entities,” public and private, are required to finance capital goods and other long-term investment projects. The new program provides medium-term private sector loans for projects that the market is otherwise unwilling to do. A minimum of 50% of loans under this program must be made to micro-, small-, and medium-sized firms. The BCRA justifies this approach as part of its mandate to take on the tasks relegated to development banks in other countries.³⁶

Ultimately, these various programs stretch central bank resources in highly unusual ways and distort credit allocation relative to market signals, which no longer fully function in the financial sector. In effect, the government acts to ration credit, financing voids that it has created in a highly regulated economy with a high inflation rate that discourages saving and long-term investment. In 2012, most credit was short term and offered at interest rates of 30%-35% for consumer and credit card loans. Despite the high cost, from 2003 to 2012, consumer loans have grown from 15% to 40% of total private lending, reflecting an increasing bias toward consumption driven by a policy (and hence expectation) of rising inflation.³⁷ Other loan rates

³² Cavallo, *op. cit.*, p. 12.

³³ BCRA, *Inflation Report*, p. 63.

³⁴ Banco Central de la República Argentina, *Financial Stability Report: Second Half 2012*, October 2012, pp. 39-40. Global Insight, December 2012, p. 11.

³⁵ *Ibid.*, p. 59.

³⁶ BCRA, *Macroeconomic and Monetary Policy Report*, pp. 5-6.

³⁷ Banco Central de la República Argentina, *Argentina: Macroeconomic, Monetary, and Financial Outlook*, Power Point Presentation, Buenos Aires, September 2012, p. 70.

ranged from mortgages at 14.7% to pledge-backed debt of 22.0%, which amounts to negative real interest rates or subsidized lending given an annual inflation rate of 25%.³⁸ As such, the government uses the BCRA to execute a policy bias toward targeted credit expansion, which is inherently contradictory to what is generally considered a conventional central bank mission of maintaining price stability.

Finally, in an economy that is experiencing both inflation and interest rate caps, such as on government bonds and bank accounts, the requirement that pension funds and other financial institutions hold assets with “artificially suppressed returns” amounts to what economists refer to as financial repression. Argentina’s bonds have interest rates far below the actual inflation rate. Research suggests that historically, a high level of domestic debt has been a major incentive to use inflation to reduce the value of that debt, and combined with financial repression amounts to what some experts refer to as a “de facto default,” as the real value of financial assets falls.³⁹ There are also longer-term costs. Currency and capital controls inhibit investing abroad, requiring locals either to spend or invest at a loss at home. In this situation, there is no incentive to save and every incentive to borrow, leading to lower investment. In fact, BCRA statistics show that whereas consumption has grown to 80% of GDP in 2012, investment has stagnated or declined to 22% of GDP.⁴⁰

International Economic Policy

Given the domestic economic policy goals and constraints outlined above, the challenge for Argentina’s international economic policy is to maintain sufficient dollar inflows to preserve adequate reserve levels needed to make future international payments. Exchange rate, trade, and foreign investment policies are all managed to achieve this end. The Fernández government has also prioritized reducing foreign debt to reduce future foreign payments as part of the policy to meet this goal, and setting aside a guaranteed portion of Central Bank reserves to ensure that future payments will be met. It is in this constrained context that Argentine foreign economic policy and reactions by foreign stakeholders can be understood.

Argentina faces a number of constraints in trying to maintain its foreign reserves position. First, as discussed above, it has not been able to borrow internationally since the 2001 default. Second, there are limited portfolio and foreign direct investment inflows to Argentina. Third, borrowing constraints require that Argentina run a current account surplus or small deficit. Exchange rate, trade, and investment policies have all had to be repeatedly fine-tuned to accomplish this goal.

Argentina has benefited from multilateral trade, with the trade account contributing most of the dollar inflows required to meet Argentina’s needs. It does maintain, however, relatively high tariffs and numerous nontariff barriers. The government has also resorted to a number of controls to maintain dollar liquidity. Oil export taxes, forced repatriation of foreign currency earnings by insurance and extractive industries, import tariffs, capital controls, and restrictions on the exchange of pesos for dollars have contributed to maintaining foreign exchange reserves. In short, trade policy has leaned protectionist in large part to ensure a current account surplus is

³⁸ Ibid.

³⁹ Reinhart and Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, pp. 106, 111 and 117 and Alan M. Taylor, “Capital Accumulation,” in *A New Economic History of Argentina*, ed. Gerardo della Paolera and Alan M. Taylor (Cambridge: Cambridge University Press, 2005), pp. 340-346.

⁴⁰ Banco Central de la Republica Argentina, *Argentina: Macroeconomic RADAR*, updated March 15, 2013.

maintained and that revenue will be generated to meet fiscal and international reserve goals. While strong exports of commodities may point to a relatively open trade posture, import constraints and export controls argue otherwise.

Managing the exchange rate is even more complicated. To remain competitive globally, inflation would have to be largely offset by depreciating the exchange rate. The Argentine government has allowed the nominal exchange rate to depreciate over time, but the competitiveness problem remains because of the real appreciation discussed above. This trend is evident in the dual exchange rates that have developed. Although the government maintains an official exchange rate against foreign currencies (Brazilian real, U.S. dollar, the Euro), an overvalued peso encourages the creation of informal parallel currency markets. In the case of the U.S. dollar, the so-called Blue Rate is some 30% higher than the official rate.⁴¹ To counter the demand for dollars, since November 2011 Argentina has restricted the amount of dollars that can be purchased.

The cost has been a large contraction in the trade surplus in 2012 due largely to the fall in exports, risking reserves levels and increasing the fear of devaluation.⁴² While the Argentine government so far has been able to balance domestic and international economic policy priorities, the tradeoff has been heavily controlled international trade policy and financial markets. This result ultimately leads to unwieldy distortions in the overall economy, many of which have played out as contentious economic decisions in the international arena.

Policy Issues

Argentina's macroeconomic framework provides a lens from which to evaluate economic priorities of Argentina's administrations since 2002, and the policy tensions they have created for Argentina and the world. This framework appears to be in part constituent driven, grounded in economic nationalism and redistributive social policy, two themes common to Argentina's political history.⁴³ The extended pursuit of this strategy, however, runs the risk of it becoming unsustainable as instability creeps into the macroeconomic framework, making it increasingly difficult to manage. High inflation, government price controls, an appreciating currency, a loose monetary program, and the ultimate driver, fiscal deficits, all point in this direction.

Foreign stakeholders have borne much of the cost of these policies, many of them adopted as adjustments necessary to make the domestic agenda and internal accounts balance, at least for the short to medium term. Debt has been repudiated, trade has been constrained, dollar investments are not easily transferred, and other international obligations have been postponed indefinitely or repudiated outright. The major points of contention are discussed below.

⁴¹ The extent of the peso's possible overvaluation is subject to debate. The dollar exchange rate may not be the most relevant. Argentina trades more with Brazil than the United States, which suggests the Brazilian real would be a more relevant comparison, and for which there is a smaller differential. A basket of currencies yields a similar result, suggesting to many that there may still be room for appreciation in the Argentine peso. The government argues there is no strong evidence of an overvalued peso. Nonetheless, the pure arbitrage opportunities and exchange rate controls point to some significant degree of exchange rate misalignment.

⁴² Latin America Monitor, *Southern Cone*, April 2013, p. 3.

⁴³ MacLachlan, *Argentina: What Went Wrong*, p.189.

Sovereign Default and Private Bondholders⁴⁴

One of Argentina's first acts during the 2001 financial crisis was to default on its sovereign debt. This action brought claims against Argentina from private bondholders, who have sued Argentina in U.S. federal (and other national) courts. Although Argentina's inability to pay in full was, for the most part, accepted, Argentina effectively rejected what at the time were considered standard procedures for organizing a mutually agreed debt resolution. This process typically included developing realistic expectations of macroeconomic adjustments feasible for meeting certain debt repayment terms under the guidance of the International Monetary Fund (IMF). In the past, the "blessing" of the IMF has led to debt restructurings that have avoided costly legal battles. For various reasons, Argentina eventually decided to spurn the IMF negotiating process, opening the door to protracted litigation.

In the lengthy and one-sided debt restructurings that Argentina orchestrated in 2005 and 2010, 91.3% of the defaulted bonds were exchanged for new ones at approximately \$0.27-\$0.30 on the dollar. Argentina has repudiated bonds not exchanged in an estimated amount of \$6.8 billion in principal plus past due interest. The Argentine government estimated past due interest to be \$4.4 billion at the close of the 2010 exchange, not acknowledging interest after that date. As of January 2013, holdout bondholder groups (largely hedge funds specializing in distressed sovereign debt) put the total value at some \$15 billion with past due interest, of which \$1.3 billion is in litigation in New York federal court.⁴⁵ Although "holdout" bondholders remain unpaid, Argentina is current on its obligations to exchange bondholders, an outcome that is being challenged in court under the equal treatment (*pari passu*) provision of the bonds.

The "holdouts" have also lobbied the U.S. government to pressure Argentina to honor its defaulted debt. The Obama Administration invoked financial restrictions against Argentina as defined in U.S. law that include prohibiting official lending and foreign aid and voting against loans to Argentina in the World Bank and the Inter-American Development Bank. In addition, punitive legislation has been introduced in the last three Congresses. Various versions of the Judgment Evading Foreign States Accountability Act cited Argentina for ignoring multiple judgments against it. Its major provisions would have required that such states be labeled "judgment evaders" and that they also be restricted from issuing debt in the United States.

The House Committee on Foreign Affairs, Subcommittee on the Western Hemisphere marked up the bill at the close of the 112th Congress, after which no further action was taken. Opponents of the measure argued that, although sympathetic with the concerns of U.S. stakeholders, the committee lacked jurisdiction, it was imprudent to move ahead while the issue was before federal courts, and that it should be considered in a broader context of U.S.-Argentine relations. To date, similar legislation has not been introduced in the 113th Congress and opinions differ as to whether Congress should take a formal position on supporting the holdouts legislatively.⁴⁶

⁴⁴ This is a short summary of a complex issue. For details on the default, see CRS Report R41029, *Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts,"* by J. F. Hornbeck.

⁴⁵ Robert J. Shapiro, *Decision Time for Argentina*, congressional staff meeting, December 6, 2012, and SEC Form 18-K, p. 140.

⁴⁶ U.S. Congress, House Committee on Foreign Affairs, *Markup Before the Subcommittee on the Western Hemisphere on H.R. 1798 Judgment Evading Foreign States Accountability Act of 2011*, 112th Congress, 2^d sess., November 29, 2012, Serial No. 112-188, (Washington: GPO, 2012), p. 38.

Paris Club Debt

Argentina has also defaulted on bilateral official (government) debt owed to members of the Paris Club, an informal consortium of 19 countries that have agreed to adopt a common set of rules for addressing official debt relief of developing countries. Congress has authorized the executive branch to negotiate certain debt relief under Paris Club guidelines since 1993 under Foreign Operations Appropriations Acts. This authority covers lending programs such as those under the U.S. Agency for International Development (USAID), military aid programs, the Export-Import Bank, and the Commodity Credit Corporation.⁴⁷

As of December 31, 2010, Argentina owed the Paris Club countries \$6.3 billion, plus past due interest and possibly penalties. The United States is owed approximately \$550 million. Argentina has at least twice signaled a desire to address Paris Club debt, but not followed through. Members of Congress have expressed concern over Argentina's failure to resolve this long-standing debt issue, and have supported the Obama Administration's attempts to press the issue with the Argentine government. Argentina could make payments using either its international reserves or current revenue, which some argue it is capable of doing. The Argentine government argues to the contrary. Failure to address this issue is another reason the Obama Administration invoked various financial restrictions on official lending and aid to Argentina.

ICSID Claims

A total of 42 cases claiming \$65 billion in damages have been filed against Argentina in the World Bank-sponsored International Centre for Settlement of Investment Disputes (ICSID). ICSID was set up specifically to address grievances taken up under bilateral investment treaties (BITs). Argentina and the United States have had a BIT since 1994. In the 1990s, privatization of state-run agencies became the norm, attracting foreign investment in service industries such as electricity, airlines, and petroleum extraction. Foreign direct investment was further encouraged by the U.S.-Argentina BIT, with net inflows rising rapidly until the crisis. The 2001 financial crisis and changed policy orientation reversed these policies under a public emergency law that eliminated the convertibility regime and allowed the government to renegotiate contracts for utilities. Between frozen utility rates and the huge currency devaluation, foreign investors incurred deep losses, causing them to seek relief at ICSID.⁴⁸

The ICSID panel process is highly complex and rulings on individual cases are not bound by case precedent. This process has led to conflicting opinions, some ruling in favor of plaintiffs, others ruling for Argentina, effectively excusing it from its obligations under the BIT because of the drastic circumstances under which it invoked emergency laws. Given the ICSID process has no appellate review, such inconsistency has caused uncertainty and confusion in the legal community to the point of raising questions over the legitimacy of the ICSID system as it currently operates.⁴⁹ In addition, Argentina has taken full advantage of the extensive procedural process, filing for annulments of awards granted by ICSID panels, with both partial and full success in some cases.

⁴⁷ CRS Report RS21482, *The Paris Club and International Debt Relief*, by Martin A. Weiss.

⁴⁸ Eric David Kasenetz, "Desperate Times Call for Desperate Measures: The Aftermath of Argentina's State of Necessity and the Current Fight in the ICSID," *George Washington International Law Review*, vol. 41 (714), January 2011.

⁴⁹ *Ibid.*, pp. 724-27 and 733-735. This discussion does not constitute a legal analysis of the cases, but presents only a summary of key points.

In two highly publicized cases, however, ICSID panels awarded specific monetary damages that survived annulment challenges. In September 2007, an ICSID panel ruled in favor of CMS Gas Transmission Company of Michigan for operating losses incurred from the emergency laws and regulations, awarding \$132 million in damages. In September 2009, another panel found in favor of Azurix Corporation (water and sewer contract) for \$165 million.⁵⁰ In a controversial stance, Argentina has declined to pay any ICSID awards, in part over fear of setting a precedent that could be costly given the many cases filed against it in ICSID. Among the tactics it has adopted is to interpret Articles 53 and 54 of the 1965 ICSID Convention as allowing Argentina to require that plaintiff submit its judgment award to an Argentine court for final settlement.⁵¹ Argentina has applied this rationale to both U.S. cases, among others where damages have been awarded, but the United States and many other countries do not recognize this line of reasoning.⁵²

Legal representatives of the Argentine government have further stated that it will continue to refute ICSID claims and consider taking the additional step of adopting legislation that would annul most of its bilateral investment treaties as unconstitutional.⁵³ In response, and at the request of U.S. claimants, the Obama Administration on March 26, 2012, decided to suspend Argentina from tariff preferences provided under the U.S. Generalized System of Preferences (GSP).⁵⁴ In 2011, 11% of U.S. imports from Argentina entered duty free under GSP.

Nationalizations and Expropriations

Part of the Argentine economic strategy since 2001 has been to reassert government control over a select group of firms, essentially expropriating and nationalizing their assets. This has applied to both Argentine and foreign firms. As discussed above, Argentina nationalized private pension funds in 2008 in order to expand the government financial assets and took over Aerolineas Argentinas, which was partially owned by a group of Spanish investors.

On April 16, 2012, Argentina initiated the renationalization of Yacimientos Petroliferos Fiscales (YPF), the largest oil company in Argentina. It produces one-third of national crude output and half of refined fuel. YPF was organized in 1922 under state control, where it remained until privatized in 1992. The nationalization was accomplished by legislation calling for the expropriation of controlling interest of the 57% ownership by Spanish firm Repsol. The government argued that a decline in oil production had negative effects on tax revenue and raised the cost of energy subsidies, which had to be continued with high-priced foreign imports, further hurting the trade balance. In addition, lower oil production threatened Argentina's goal of energy self-sufficiency. Argentina, however, has long thought of YPF as a source of public revenue and energy self-sufficiency. Its long history of state control also created a strong national brand identity that may have played a part in the broad public approval of its renationalization in 2012.⁵⁵

⁵⁰ Case summaries are available at <https://icsid.worldbank.org/ICSID/Index.jsp>.

⁵¹ SEC, Form 18-K, pp. 189-190.

⁵² Kasenetz, op. cit., pp. 740-741.

⁵³ MercoPress, South Atlantic News Agency, *Argentina Faces 65bn Dollars in Claims; Plans to Abandon International Litigations Court*, November 28, 2012.

⁵⁴ The Economist, *Come and Get Me: Argentina Is Putting International Arbitration to the Test*, February 18, 2012.

⁵⁵ Martin Castellano, Ramon Aracena, and Todd Martinez. *Argentina: Chronicle of a Nationalization Foretold*, Institute of International Finance, April 23, 2012, and MacLauchlan, *Argentina: What Went Wrong*, p. 84.

Opponents of the expropriation argue that government policies played critical roles in the decline of oil production that actually began in 1998. After the 2001 financial crisis, the government introduced oil export taxes and oil price controls in 2006, reducing the YPF profitability and competitiveness of Argentine energy exports. These measures directly affected YPF's profitability and incentives to invest and produce. In effect, they argue that the Argentine government set up YPF to fail, and thereby orchestrated the conditions that would justify its nationalization.⁵⁶ The settlement issue remains unresolved and has caused a severe deterioration in relations between Spain and Argentina. It has also raised the question of whether other firms may be at risk.

Trade Protectionism

Argentina practices an increasingly complex strategy of trade protectionism, largely to support macroeconomic goals. Relatively high tariffs, import restrictions, export taxes, and limits on foreign exchange transactions are all employed to manage the current account balance, prices and supplies of consumption goods, and political support. The Global Trade Alert, in its most recent annual report, notes that Argentina and China are the only two countries in the world that are in the top 10 list of offenders for all four major categories of discriminatory harm they measure by the number of (1) discriminatory measures, (2) tariff lines, (3) sectors affected, and (4) trading partners involved. Argentina is at the top of the list globally for most sectors affected by protectionist measures.⁵⁷ The WTO cites similar problems in a recent trade policy review.⁵⁸

The Office of the United States Trade Representative (USTR) lists a host of discriminatory import practices affecting U.S. exporters that include high import duties. The WTO indicates that 27% of Argentina's import tariff lines have average applied tariffs exceeding 15%, with 4% of tariff lines having a tariff of 35%. Textiles, clothing, footwear, and oil seeds are the most protected sectors.⁵⁹ In addition there are or have been numerous nontariff barriers including automatic and non-automatic licensing requirements, port-of-entry restrictions, cumbersome customs procedures and documentation, and restrictions on imports of used capital goods. Exceptions are given for specific goods when viewed in the national interest of Argentina, but many import restrictions are not codified and are apparently applied in an arbitrary fashion. Many restrictions are openly applied to protect domestic industries and promote local production. These affect many of the major U.S. export categories including metallurgical products, automotive parts, chemical products, and general purpose machinery.⁶⁰

The United States, the European Union (EU), and Japan filed dispute settlement cases against Argentina in the World Trade Organization (WTO) on December 6, 2012, challenging Argentina's non-automatic licensing policies, and government requests that firms balance imports into Argentina with exports, or make investments of equal value in productive operations. In response, Argentina repealed the non-automatic licenses on January 25, 2013. The WTO agreed on January

⁵⁶ Ibid.

⁵⁷ Simon J. Evenett, ed., *Debacle: The 11th Global Trade Act Report on Protectionism*, Global Trade Alert, Centre for Economic Policy Research, London, June 2012, p. 6.

⁵⁸ WTO, *Argentina Trade Policy Review Report*, p. xi-xii.

⁵⁹ Ibid.

⁶⁰ Ibid and Office of the United States Trade Representative, *2012 National Trade Estimate Report on Foreign Trade Barriers*, Washington, D.C., March 2012.

28, 2013, to establish a dispute panel nonetheless. Plaintiffs argued that the problem was not fully addressed and that additional information was necessary to resolve the issue.

Although Argentina lifted the non-automatic licensing requirement, it simultaneously raised tariff levels to 35% on 100 other products and retains a cumbersome automatic import licensing regime. In retaliation, Argentina requested and secured a WTO dispute panel on the same day to rule on its complaint that U.S. restrictions on Argentine beef and lemons are contrary to WTO rules. Argentina also has a complaint against Spain, which is blocking imports of biodiesel fuel in retaliation for the nationalization of YPF.⁶¹

Exports are also controlled to meet broader economic objectives. In particular, there are high export taxes on hydrocarbon and agricultural commodities, often pricing raw exports higher than processed goods, encouraging value-added production in Argentina. Soybean exports are taxed at 35%, wheat at 23%, and corn at 20%. In addition, there are also cumbersome export registration procedures in some cases, with government policy openly delaying or denying shipping to meet domestic price and supply needs. For example, the Argentine government imposed wheat quotas in 2006, adjusting the level periodically to meet domestic needs. In June 2012 it increased the quota to appease farmers and increase government revenue. By December 2012, the quota had again been adjusted downward because a low harvest threatened prescribed domestic price and supply levels. These policies resulted in strikes and protests by farmers in 2012 over export quotas, high export taxes, and administrative costs.⁶²

In addition to domestic resistance, Argentina's trade policies have brought retaliation from countries around the world. In April 2012, 40 members of the WTO, including the United States, denounced Argentina at a WTO meeting for the rise of protectionist practices. On May 25, 2012, the EU took the next step and filed a suit against Argentina in the WTO over its import restrictions for being inconsistent with international trade rules.⁶³

Capital and Currency Controls

Since the financial crisis, Argentina made a sustained effort to build up its international reserves. From 2002 to 2010, these rose from \$10.4 billion to \$52.2 billion. As confidence in the economy and policies of the Fernández government began to slide, capital began to exit the country, as evidenced by the \$6 billion decline in reserves in 2011, followed by a \$1 billion fall in 2012 to \$41.6 billion as of February 28, 2013. The government countered by tightening capital controls in 2011 to increase dollar inflows and stem capital flight through forced repatriation of export revenue and investments by mining and insurance companies (requiring conversion to pesos), restrictions on the purchase of foreign currency, addition of fees on use of credit cards in foreign countries, imposition of import controls, and reserve requirements on certain foreign investment.

⁶¹ http://www.wto.org/english/news_e/news13_e/dsb_28jan13_e.htm, David Haskel, "Argentina Lifts Some Import Restraints, But Imposes Maximum Duties on 100 Items," *International Trade Reporter*, and Daniel Pruzin, "U.S., EU, Japan Secure WTO Panel To Rule on Argentine Import Restrictions," *International Trade Reporter*, Bloomberg BNA, January 31, 2013.

⁶² The Wall Street Journal, *Argentina Cuts 2012-14 Wheat Export Quota*, December 10, 2012, IHS Global Insight, *Argentine Government Lifts Ceiling on Wheat Exports*, June 25, 2012, David Haskel, "Argentine Farmers' Strike Goes Nationwide, Temporarily Halts Grain, Soybean Deliveries," *International Trade Reporter*, Bloomberg BNA, June 14, 2012.

⁶³ Ken Parks, "Argentina Challenges U.S. Ban on Its Beef," *Wall Street Journal*, September 1-2, 2012, *International Trade Daily*, April 2, 2012, and *Washington Trade Daily*, May 30, 2012.

As discussed earlier, there may be reason to question, given recent trends, whether the reserve level is sufficient to maintain confidence in the peso.⁶⁴

U.S. and other foreign investors and firms operating in Argentina are hurt by these restrictions and requirements, and some may be challengeable under the U.S.-Argentina BIT rules that govern free movement of capital.⁶⁵ Continued restrictions on the exchange rate may provide temporary relief, but ultimately the real appreciation of the peso suggests limited opportunity for a soft correction and increased probability of a major devaluation at some point. Such a policy environment further entices the movement from pesos to dollars and Euros, continued capital flight, and relatively weaker foreign investment in the future, compounding Argentina's problems.

IMF Reporting Requirements and Article IV Reviews

Under the Articles of Agreement of the IMF, member countries are required to meet high standards in economic data reporting and submit to Article IV reviews of their economy. Argentina has failed to meet both of these requirements. Inflation reporting has been discredited since 2007, and GDP figures more recently. Argentina has been further criticized for fining and harassing independent economists who have seen fit to produce their own inflation statistics. Argentina has failed to submit to an Article IV review since 2006. The IMF has warned Argentina that its membership in the institution may be at risk if it does not accommodate requests to conform to IMF requirements by September 30, 2013. On February 1, 2013, the IMF issued a formal declaration of censure to Argentina for failure to live up to its obligations under the Articles of Agreement and gave Argentina until September 29, 2013, to upgrade data reporting. The Managing Director is scheduled to issue a status report to the Executive Board by November 13, 2013.⁶⁶

Outlook

Argentina's economic policies reflect a certain distrust of international institutions and the government's priority for financial independence, social equity, and what may be considered a commitment to "populist" solutions. This review of these economic policies is not meant to suggest that there is one ideal macroeconomic model that is being violated. Rather, even in recognizing that countries can govern themselves well under alternative policy frameworks and priorities, what stands out for many in the case of Argentina is the sense that policy choices have introduced major distortions in the economy and that deteriorating external accounts, among other factors, are increasing the risk of financial crisis, particularly if history is any judge. Trade protection, managed exchange rates, and capital controls are policy adjustments required to address problems that materialize in a constrained economic system (e.g., subsidy-driven fiscal expansion, price controls, inability to borrow internationally) that cannot easily accommodate current account deficits, a market exchange rate, or standard macroeconomic responses to combat high inflation.

⁶⁴ USTR, *2012 Foreign Trade Barriers* and IMF, *Global Markets Monitor*, February 17, 2012.

⁶⁵ *Ibid.*

⁶⁶ International Monetary Fund, *Statement by the IMF Executive Board on Argentina*, Press Release No. 13/33, February 1, 2013.

Among the more obvious policy corrections would be to introduce more flexibility in the exchange rate, ease away from an expansionist monetary policy, and begin correcting fiscal deficits. In their absence, Argentina increases the risk of eventually experiencing a more serious economic adjustment. It may be premature, however, to foretell the demise of the Argentine economy. Despite increasing bottlenecks, thresholds that predict collapse so far appear not to have been breached for inflation, current account and fiscal balances, or debt, and Argentina has shown a proclivity for surviving economically. The expected strong soy crop for 2013 and lack of external shocks may allow the Argentine government to continue with the current economic program for some time.

Even if there were a desire for a policy correction in Buenos Aires, however, it could be difficult to implement and still avoid a “hard landing” and attendant political and social ramifications. In fact, it may be that a change in policy toward foreign stakeholders will not occur until either a new government takes office, a new crisis erupts in the wake of large and unsustainable macroeconomic distortions, or both.

International stakeholders, both public and private, find themselves challenged by this system, along with some Argentines. Stakeholders, including the United States, criticize Argentina for eschewing standard norms of economic behavior and the rule of law, and in response, have sought remedy in national courts and international arbitration, eliminated financial and trade benefits, and previously introduced hardline legislative resolutions. One indication of the breadth of dissatisfaction over Argentina’s policies is the call for effectively removing Argentina from the G-20, despite the lack of precedent and formal procedure for doing this. Notwithstanding these initiatives, Argentina has not been moved to change course, and the 113th Congress may decide to consider once again U.S. options for addressing bilateral concerns with Argentina.

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