The new administration has introduced some sound economic policies, but can the country shake its Peronist past?

About 100 years ago, Argentina was one of the wealthiest countries in the world by virtue of its fertile land. Its economy thrived by shipping beef and grains around the world. But economic and political turmoil through the 1930s sowed the seeds of populism — the effects of which have lasted decades. With the 2015 election of reformist candidate Mauricio Macri as president, Argentina seems to have the best chance of regaining the prosperity it once enjoyed. Will the populace (and its leaders) have the patience and fortitude to allow market reforms to work? The midterm legislative elections in October will provide a critical test.

The legacy of Juan Peron

One cannot understand today’s Argentina without explaining the legacy of its most iconic figure, Juan
Peron. After supporting the winning side of a coup in 1943, he ran for president and won in 1946. During his first term he followed through on his populist (and isolationist) campaign promises to help the working poor by stimulating labor-intensive industries such as manufacturing, construction and domestic services. To fund these initiatives, Mr. Peron introduced multiple exchange rates, restrictions and high duties on imports, and taxes on exports. He also increased government spending dramatically. Predictably, worker wages did rise for a time, but these policies caused stagnation in agricultural production and reduced exports. Mr. Peron was driven into exile in 1955, but still maintained great influence in the country, and returned to become president in 1973. Unfortunately, his ideology hadn’t changed, and he resumed the same destructive policies.

After Mr. Peron’s death in 1974, the stretch between 1975 and 1990 was not kind to Argentina. The economy experienced persistent stagnation — per-capita income was falling at average annual rate of 1.5% annually, compared to average global growth of 1.6% over the same timeframe.¹ There was even a short period of hyperinflation at the end of 1980s, with consumer prices soaring at an annualized rate of 11,000%.¹

This paved the way for Carlos Menem to take over the presidency.

**A brief period of prosperity**

Mr. Menem’s most dramatic move was to introduce a currency board, making one peso convertible into one US dollar (backed by currency reserves). The onerous taxes on agricultural exports and restrictions on imports were eliminated, and many state-owned companies were privatized. The tax system was simplified and government spending was reduced. For the first time in generations, Argentines enjoyed relative price stability, and the economy boomed for most of the decade.

External factors (including the Mexican economic crisis and the devaluation of the Brazilian real) eventually slowed the Argentine economy to the point that this free market “experiment” was ended after Mr. Menem finished his second term as president. Argentina then entered recession and experienced deflation, spiking unemployment, and capital left the country. The International Monetary Fund withdrew its support in 2001 and caused an epidemic of bank runs. There was rioting and renewed inflation, and between 1998 and 2002 gross domestic product (GDP) fell 25%.² In late 2001, the country defaulted on $93 billion in foreign debt.

**Hope on the horizon?**

The back-to-back presidencies of Nestor Kirchner and his wife, Cristina Fernandez de Kirchner, worsened Argentina’s situation. Once again, investors sought the exits — $80 billion in capital left the country between 2008 and 2015. The Argentine people had lived through these conditions before, and they voiced their dissatisfaction loud and clear in 2015 with the election of a new reformer, Mauricio Macri.

President Macri was elected preaching a manifesto of economic reform. But as has always been the case in Argentina, reform is a difficult road. In order to make a break with its Peronist past, Argentina will need to swallow some bitter economic medicine. Previous governments actively intervened in many
markets, supporting some favored industries at the expense of others. By removing many of these subsidies, President Macri has taken a bold step toward creating a free-market economy in his country, but has also enraged many with the price jumps that his actions have triggered. The release of this suppressed inflation has eroded purchasing power, but in theory, it should be a temporary adjustment like the related decline in GDP. At the same time, without the distortions produced by the previously existing labyrinth of duties, subsidies, import/export restrictions and taxes, prices should eventually normalize at global market levels. The recovery should then take hold rapidly.

After two years of Macri-led reforms, here is where Argentina currently stands:

- Inflation (21.4% for the year ended July 2017) is still high but expected to drop to 17% in 2018, within the government target range.
- Direct foreign investment is rising again, up 3.6% in 2016.
- Industrial production has increased 5.3% for the year ended July 2017.
- Money supply expansion (M3) is still too high (almost 37% for the year ended June 2017) but this is due primarily to rising demand for pesos.
- Bank lending is showing a strong recovery (e.g., mortgage lending is up 37% since President Macri’s election.)
- Unemployment continues to rise, but all other signs point to an imminent rebound in hiring.
- Interest rates are expected to drop in 2018.
- Argentina is once again successfully borrowing from global capital markets.

What’s next for Argentina

President Macri’s bold fiscal initiatives had the predicted short-term result of causing a recession; GDP fell 2.2% in 2016. But the Argentine economy seems to have shaken off this temporary shock; GDP growth did turn slightly positive in the fourth quarter of that year and has accelerated since, surging to 3.5% year-on-year growth in the second quarter of 2017.

With economic activity finally on the right track, the president’s next challenge is to reduce and eliminate the fiscal deficit. This is paramount for taming monetary growth and restoring price stability, but there are no guarantees he can reduce government spending or enact meaningful labor market reform. These are difficult to accomplish anywhere, and with its long history of populism and protests, it will be particularly troublesome in Argentina. However, with the other measures already in place and helping to deliver strong growth, the country may have its best chance ever to right its economic ship.

1 Source: “Argentina’s economic reforms of the 1990s in contemporary and historical perspective,” 2017
2 Source: Macrobond

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Based in London, John is Chief Economist of Invesco Ltd. with responsibility for providing economic analysis and forecasts to Invesco portfolio managers and clients.
John started his career in 1970 as a visiting research fellow at the Bank of Japan. He joined our company four years later in 1974 as Chief Economist, based initially in Hong Kong and later in San Francisco. As editor of Asian Monetary Monitor in 1983, he proposed a currency board scheme for stabilizing the Hong Kong dollar. John was a director of the Hong Kong Futures Exchange Clearing Corporation for four years until 1991, and in 1992 became a council member of the Stock Exchange of Hong Kong, a position he held for twelve months. In that same year, he was an economic adviser to the Hong Kong Government. He has been a member of the Committee on Currency Board Operations of the Hong Kong Monetary Authority since 1998. He is also a member of the Shadow Monetary Policy Committee in England, and he serves on the board of the Hong Kong Association in London.

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