GRUPO SBS

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The Bayesian Staker

Argentina: close to an upgrade, yet far from IG

Summary and Conclusions

In our last letter we described the global financial setting as warranting prudence, but also as showing investors´ willingness to keep betting for the continuity of a fragile equilibrium. In this context, it was not surprising to observe declining rates following the first sign of discrepancy at the Fed back in August, nor the subsequent jump pushed by confirmation of central banks de-investment policies and progress in the tax reform agenda of the Trump administration. It was neither shocking to see global equities returning 5% in the last two months, high yield bonds delivering 2%, emerging market bonds another 1%, nor that volatility measures remaining at their minimum. More astonishing, however, was the fact that market players have continued to perceive some fundamental contradiction between a global saving glut and depressed investment on one side, and increasing friction in labor markets, especially in the US and Europe, and central bankers anticipating greater tightening in monetary conditions. Such an apparent dilemma has become even more upsetting as we face a potential change in Fed´s leadership ahead, while we read that the US Senate has just approved an important increase in the fiscal deficit for the next decade.

Meanwhile, the global recovery process has re-affirmed its course, and the Fed and the ECB have increasingly signaled their need to continue normalizing monetary policy conditions, not only by hiking rates but also by forestalling a gradual change in their balance sheet management. Worth noting, this policy confirmation was done despite benign inflation behavior in recent months. Abstracting for a fundamental change in the Fed´s board, the US monetary authority is set today to maintain its deleveraging process started earlier this month, hike rates once in December this year, and probably comply with some additional rate hike during 2018 (the official Fed projection calls for 3 more rate hikes in 2018). The Fed´s recent capitulation regarding long term rates has been the most important newness, finally sharing part of the market skepticism regarding much higher terminal rates absent a notable change in general economic conditions, and investment and productivity in particular. In a similar vein, the ECB announced the past Thursday that its quantitative easing program could come to a halt by the end of next year, likely lifting implicit restrictions to introduce its first rate hike during 2019.

There has also been some progress in the fiscal front in the US. The US Senate recent approval of a 2018 budget envisaging USD1.5trn deficit increase in the next ten years (approximately 0.75% of GDP by the end of the decade) beckoned a concrete possibility for the long awaited tax reform to pass Congress barrier. The Senate decision will permit the use of the reconciliation process, allowing the official party to progress with just simple majority, although constrained to the new budget parameters. Nevertheless, Congress discussion is likely to remain challenging, as the expected removal of itemized deductions would impact more negatively the large States, like California and New York, both contributing with a critical number of Republican legislators. This notwithstanding, the new fiscal slippage would simply double the widening of the fiscal deficit projected under status-quo, at least as calculated by the Congress Budget Office, all together representing something like 10% of GDP in new public debt during the next decade.

It is fair to assume that a temporary fiscal expansion of the magnitude under discussion is unlikely to modify the level of long term real rates in the US at least. But its impact on inflation and the debt market might not be negligible. Nevertheless, such a fiscal impulse together with significant deregulation could indeed stimulate a strong investment momentum and accelerate productivity generation, which in turn could certainly modify the long term equilibrium, sustaining stronger growth and real rates consistently higher too. These two possible scenarios, however, could have very different implications for asset markets. The first scenario might be simply characterized by an increase in the risk premium pushing nominal rates higher, affecting negatively risk assets. On the contrary, the second scenario should be positive for equities and credit markets.

US President Trump is about to announce a new leadership at the Fed, further complicating the financial perspective in the coming months. The set of principal candidates includes names with very different profiles, some implying a radical change in the policy path. The most probable candidate is Jerome Powell, member of the Fed Board, and a banker without the formal credentials of the current chairman, Janet Yellen, but with a similar policy type and practical experience in monetary policy and regulatory matters. On the contrary, former Undersecretary and Stanford University professor John Taylor represents the major risk of a substantial policy overturn. Taylor, author of the well-known monetary policy rule, embodies the preference for rules against discretion, and theory versus praxis, or basically the opposite nature of the flexible and pragmatic Fed seen in the last few years. The naming of the two, Powell and Taylor, as chairman and vice-chairman respectively, should not be ruled out, with President Trump trying to maintain some balance, but seniority signaling the leading policy preference.

Based on the previous discussion, and agnostic about the Trump administration's ability to push for a strong reflationary process, we remain concerned about asset valuation. We continue to believe that the US economy is recovering but capped by a slow potential growth pace. Likewise, we acknowledge the Fed´s message regarding more tightening ahead, although with an uncertain endgame; even without incorporating the risk of a changing leadership. The pending question is whether these counterbalancing forces could maintain the dominant optimism without demanding higher real rates, or else push towards higher rates consistent with greater economic dynamism or simply a larger risk premium.

Notwithstanding the consideration above, we do respect market forces, able to maintain for quite some time even unsustainable returns, constantly testing our conviction. In particular, persistent low inflation in the US is likely to keep risk appetite stout and long term rates bounded. Whether demographic forces are strong enough to keep hampered the labor market-wage-price inflation circuit is up for discussion. But it is reasonable to expect this link to regain some sensitivity as labor markets keep tightening, absent a productivity shock or a sizeable investment push. Therefore, buoyant asset prices despite ongoing uncertainties seem to advocate for a prudent investment approach, searching for diversification and not underestimating protection. This continues to be the time to hold no strong conviction and an active and nimble strategy for risk taking.

With the discussion above as a backdrop, Argentina seems to offer a singular prospect nowadays, where a strong idiosyncratic component meaningfully buffers the prevailing global uncertainty. Last Sunday´s electoral result re-confirmed popular support to the ongoing normalization process, reinforcing a constructive outlook for argentine assets. The elections have not only increased the government representation in Congress, but also anticipated a 2019 election without a clear opposition contender. The latter suggests a unique opportunity, insinuating policy stability for at least another 6 years. Likewise, the longer horizon to mature the ongoing process brings higher credibility to the gradual strategy being implemented by the government. For these reasons, while we wait for the government to present a set of structural reforms to Congress in the coming days, we hereby attempt to analyze what Argentina must accomplish in order to achieve sustainability, or at least to start comparing with the regional countries that have reached investment grade status. The preliminary conclusion is that a meaningful increase in investment and saving rates seems a necessary condition for sustainability, while history tells such processes take few years at best. Nonetheless, Argentina has just started to converge, and it is very likely that rating agencies reward recent improvements with the first rating upgrade shortly.

Argentina: Close to an upgrade, yet far away from investment grade

After the 2015 elections, the new authorities started tracing a path of structural reforms whose hallmarks were the removal of capital and currency controls, the settlement with holdout creditors, the historical reparation law with pensioners, and the tax amnesty on undeclared assets. Almost two years after that beginning, one by one all of the restrictions that led Argentina to be classified as a frontier market by MSCI were lifted. This notwithstanding, last June MSCI came short of announcing the country´s reclassification to emerging markets, demanding additional evidence of irreversibility in recent policy progress. With this as a premise, last Sunday´s mid-term elections should grant the needed reassurance, anticipating a final reclassification later next year.

Similarly, representatives from the main rating agencies have been recently analyzing the possibility of an upgrade in the credit classification of the government debt. Something the bond market has mostly priced in already, also thanks to the recent election results. Although an important progress, this should be thought as barely a first step towards becoming a more normal and predictable country. In order to continue improving its institutional framework, Argentina must show that it is consistently moving away from the macroeconomic and political cliff in a permanent way. In more concrete terms, along the road towards normalization Argentina mush show policy sustainability.

Targeting economies with investment grade status could be a way to approach policy sustainability. Thus, analyzing investment grade economies by looking at the criteria used by rating agencies could help determine necessary conditions to achieve such a goal. While there are many other ways of representing sustainable policies, bond market metrics for those countries Argentina is trying to resemble seems like a valid and simple exercise. Perhaps a better fit for the country´s reality would be to group all the BBBs in Latin America (currently Colombia, Mexico, Peru and Uruguay), as they represent the minimum threshold to be investment grade. These countries do not only share certain idiosyncrasies and similar shocks, they were also able to overturn a macroeconomic situation similar to Argentina´s not long ago. Yes, it is worth recalling that just a decade ago these countries were experiencing the same difficulties Argentina is facing today and managed to substantially improve their balances in a relatively short time span.

Figure 1 summarizes the main indicators S&P Global follows to determine its sovereign credit ratings (method chosen for the sake of simplicity). Red flashlights represent the most challenging goals in terms of rating distance, while green lights show those items where Argentina does not demonstrate significant weaknesses, which could become strategic allies in the reform process.

Figure 1: Key metrics used to rate sovereign credits

		Argentina	IG BBB	IG LatAm	Colombia	Uruguay	México	Perú
Economic Data								
Per capita GDP (USD)	🟢	**13633**	**13913**	**9832**	6447	17361	8946	6573
Investment (% GDP)	🔴	**17.1**	**22.7**	**22.1**	25.5	18.9	21.2	22.8
Savings (% GDP)	🔴	**14.3**	**20.9**	**20.0**	22.1	18.8	18.9	20.3
Monetary Data								
Inflation (% y/y)	🔴	**22.0**	**3.0**	**5.1**	4.4	7.3	5.5	3.2
Banks' Claims on Resid. (ex Gov, % GDP)	🟢	**15.0**	**67.1**	**38.6**	52.2	29.6	35.6	37.0
Government Data								
Primary Balance, Gen. Govt (% GDP)	🔴	**-5.5**	**-0.4**	**-1.4**	0.5	-2.7	-1.6	-1.9
Revenues, Gen. Govt (% GDP)	🔴	**36.9**	**31.8**	**25.9**	25.0	38.1	22.0	18.5
Expenditures, Gen. Govt (% GDP)	🔴	**44.0**	**34.2**	**29.4**	27.6	42.9	25.4	21.6
Net Debt, Gen. Govt (% GDP)	🟢	**28.5**	**32.3**	**36.4**	37.4	52.1	44.0	12.1
Balance of Payments Data								
Current Account Revenues (CARs, % GDP)	🔴	**14.6**	**46.3**	**26.7**	18.2	21.7	42.2	24.7
Net External Liabilities/CARs (%)	🟢	**-0.2**	**103.0**	**156.4**	255.1	109.5	113.7	147.2

Nota: Net External Liabilities/CARs (%): external debt + direct investment (debt and equity) + portfolio investment - net foreign assets (inc. reserves) - other public sector foreign assets - net of deposits and loans to non-residents - direct and portfolio investment abroad

Source: SBS Research, S&P Global Market Intelligence, Ministerio de Finanzas, Ministerio de Hacienda, Indec, BCRA

Achieving a higher level of investment and saving rates seems to be the main challenge ahead. Argentina is currently 5 points below the investment rate of the regional BBBs, and 6 points lower in savings as well. This means the regional IGs invest almost 30% and save close to 40% more than Argentina, a significant distance. Another unsurprising relative handicap is inflation, where Argentina is, unfortunately, still among global leaders. In this respect, even if the disinflation process of the last two years has been notable, nominal instability in Argentina remains four times the average in regional IGs. Indeed, despite significant institutional and policy progress, inflation in Argentina this year is likely be still above 20%. Furthermore, and obviously related to Argentina`s inflationary story, public sector imbalances are also far from sustainable levels.

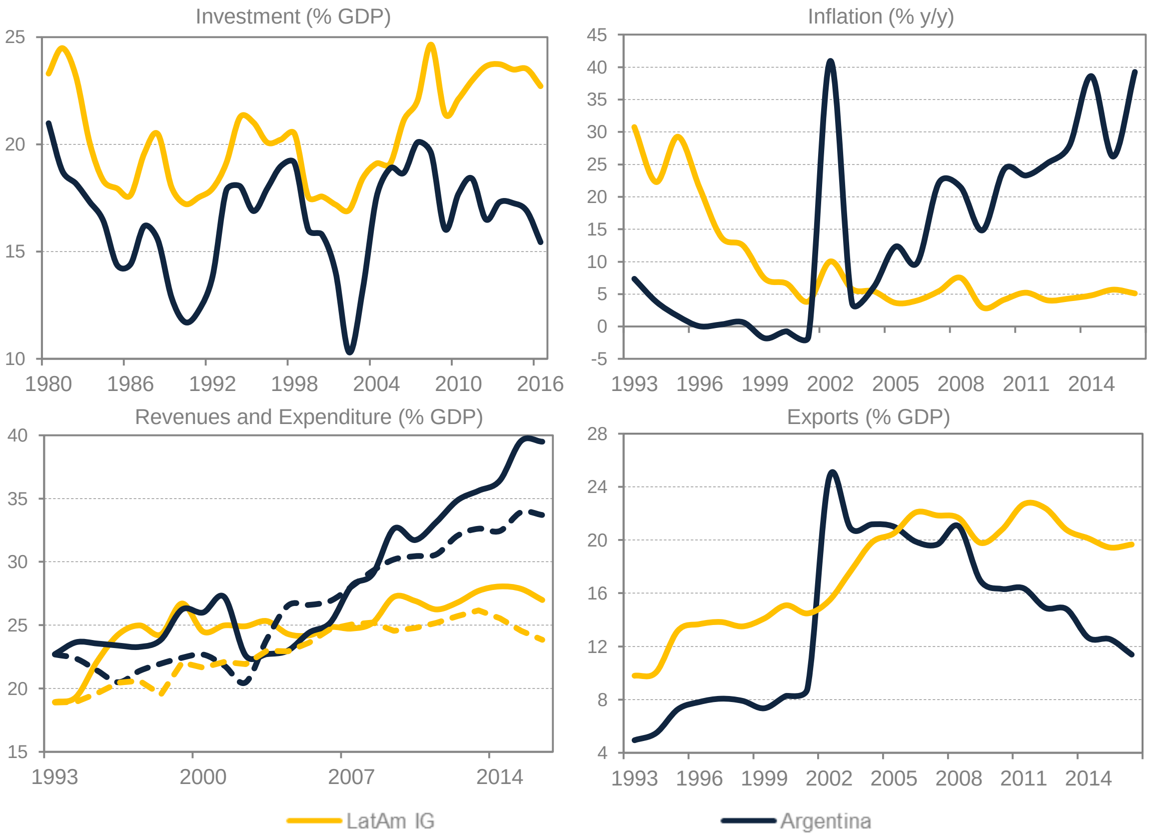
Although the challenges to achieve policy sustainability look substantial, the country does have some relative advantages. Indeed, there are some potential allies that could help throughout the normalization process, such as high per capita GDP levels and the associated elevated level of human capital. Even more importantly seems to be the overall lack of leverage, public and private, a critical ingredient of the government´s gradual policy path. As we will discuss later, gradualism has its costs as well, but it also permits the smoothing of the reform effort, and in some cases an efficient way to prevent permanent costs, such as those implied by evidence of hysteresis in the labor market.

Understanding what separates the argentine economy from sustained growth looks essential, as the cost of stagnation is considerable. In this sense, it suffices to say that while Argentina's GDP fell 1% in 2011-16, Colombia´s grew 19.3%, Mexico´s 13%, Peru´s 22.7% and Uruguay´s 14.3%.

Major defies to sustainability in retrospective

Analyzing Argentina´s relative economic weaknesses in retrospective might help grasping a sense of distance separating the country from its ultimate goal of achieving policy sustainability, or investment grade as a proxy. Looking backwards reveals that Argentina moved very much in tandem with the region until 2005, although it always experienced significantly higher economic volatility. During 2006-07, however, there was a clear break in this relationship, and since then Argentina has started to deviate from the region´s path.

Figure 2: A first look at the deepest structural problems



Note: In the revenues and expenditures chart, revenues are the dotted lines
Source: SBS Research, Bloomberg LP., IMF

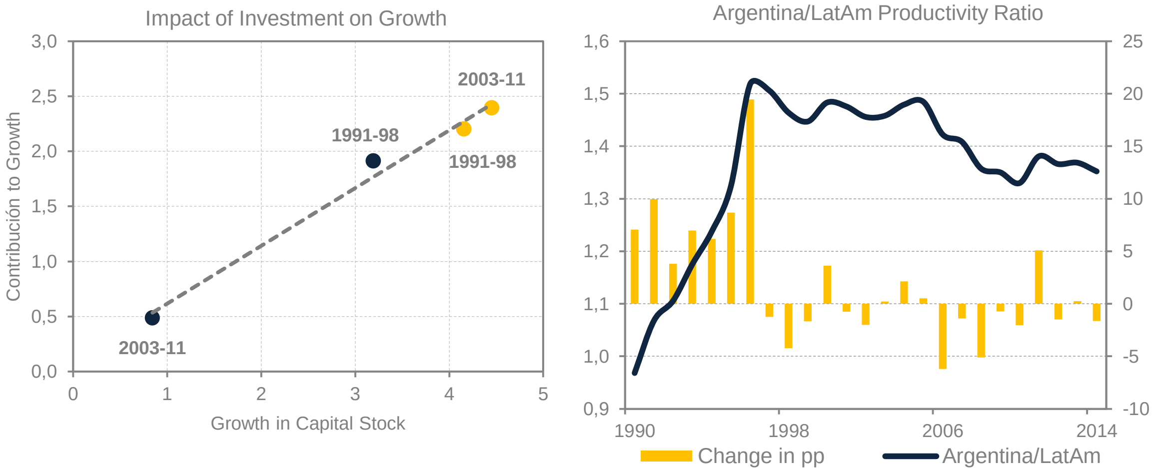
[Figure 2](#) summarizes the main defies confronted by the argentine economy and its performance relative to the LatAm BBB benchmark. Investment clearly reflects the aforementioned behavior over time, enjoying similar levels to the region until 2004-05 (albeit with larger volatility) to later start underperforming in notable fashion. Inflation performance tells a similar tale, within regional levels up to 2005 (excluding the post-convertibility correction), but afterwards showing a strong acceleration and decoupling from the rest of the countries. This pattern is again repeated when analyzing fiscal numbers, with a sizeable state presence throughout the region until 2005-06, or until Argentina in isolation almost doubled the government dimension in the economy. Meanwhile, regional countries were able to prevent the commodity boom of last decade from inflating their respective public sectors. Similarly, export performance pictures comparable dynamics, clearly reflecting much of the structural and competitiveness problems Argentina has to solve. In summary, it appears that the IG countries in the region took much better advantage of last decade commodity bonanza. These countries were not able to maintain the strong growth trend when commodity prices declined, but at least managed to stabilize their imbalances while maintaining high levels of external resources that were basically wasted in the case of Argentina.

Promoting investment and savings

A low investment rate is one of the main weaknesses of the argentine economy. Depressed investment levels curb potential growth and limit labor productivity, thus representing one of the central threats to sustainability. A growth accounting exercise can help understand the consequences of insufficient investment, checking how it is actually reflected in low productivity and economic grow. In this regards, it is important to compare Argentina not only with the region but also against its own past, attempting to learn some lessons from the country´s own experience.

The first chart in [Figure 3](#) summarizes the impact of capital accumulation (investment) on output. During 1991-98 Argentina´s capital stock grew slower than the region´s IG, but contributing proportionally the same to economic growth. However, during 2003-11 Argentina witnessed a significant investment paralysis, separating conspicuously from the regional performance. While LatAm IG managed to promote investment during the commodity bonanza, Argentina basically stopped investing, barely covering for the depreciation of its capital stock. This notwithstanding, the analysis reveals that, despite being lower, investment in Argentina was not less productive than in the region, as reflected by the contribution of capital to growth. In other words, capital goods in Argentina have been as productive as in the region, but simply insufficient. Unfortunately this lack of investment was echoed in total factor productivity, where Argentina has been underperforming the regional reference since 2006-07, after showing remarkable gains during the 90s.

Figure 3: Under-investment and Argentina´s productivity gap



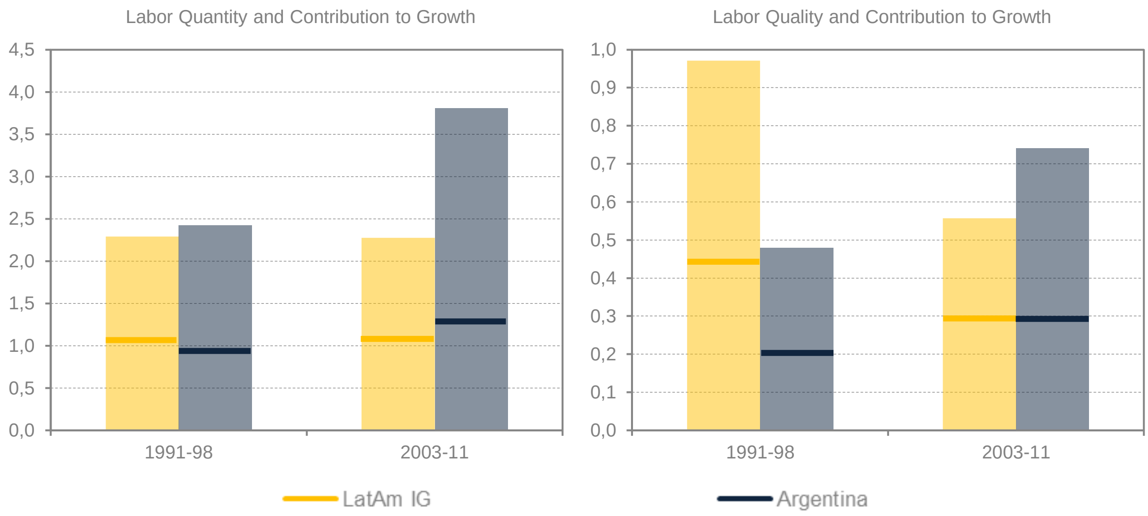
Source: SBS Research, Conference Board, FRED

A detailed comparative analysis documented in reports by the Conference Board, the World Bank, the Fed, and the IMF, suggests that there has been no major differences in public investment between Argentina and the regional IG, as the main deficit has been observed in private investment, with barely 12.3% of GDP in 2016 against 17.5% in the region (or 30% lower). Adding up to this, Argentina´s infrastructure gap is particularly disturbing in some areas, a factor which also hurts the country´s global economic competitiveness.

Low levels of investment have also manifested in poor total factor productivity, especially affecting labor output. Indeed, developments in the labor market deserve a special look, as performance was very similar to the region during the 90's, but employment grew faster in Argentina during 2003-11, partly compensating for the lack of investment. This relative factor performance was neatly reflected in labor contribution to growth (Figure 4), as a much faster worker growth in Argentina ended up lowering labor productivity, reducing its relative contribution to growth. Labor quality has had a similar showing, with an actual improvement in recent years not being reflected in a more productive labor factor. As a digression, Figures 3 and 4 helped recall that during the 90s Argentina invested in line with the regional standard, but obtaining higher capital productivity. However, in the 90s, Argentina was not able to generate more employment than the region neither achieved a more productive labor force. The implicit lesson from this retrospective outlook should be that Argentina not only needs a strong investment process to create employment, but also a parallel conversion of the labor force to the technology embedded in the new capital goods.

Focusing on labor adequacy, it seems essential to promote reforms that can quickly enhance labor productivity without ending up in wage erosions like the ones experienced in the past. In this regard, a reduction in labor taxes should be top priority as they account for over 40% of the payroll cost, almost hovering at OECD country levels but far exceeding 27% in the region. The reduction of labor taxes while suffering high fiscal deficits remains a great challenge for Argentina nowadays. In this regards, it is worth noting that some 2 points of wage taxes could be quickly cut off eliminating special regimes without adding pressure to the fiscal accounts. Moreover, today high tax burden in Argentina lives together with an terrible labor inequality, since labor taxes have practically even weights across all income deciles while in Latin America that weight goes from 11% for the lowest decile to 26% for the highest. Certainly, the Argentine income tax has tried to solve part of that inequality but far from reaching a satisfactory solution. The argentine labor reality is best represented by unit labor costs that are 50-100% higher than the regional average, almost reaching OECD levels.

Figure 4: Poor investment and labor productivity



Bars show average annual growth in factor use while horizontal lines reflect average annual factor contribution to growth
Source: SBS Research, Conference Board

Not surprisingly, such a high labor tax burden in Argentina has led to 34% informality in the labor market. Even if this level of informal labor market does not deviate significantly from the regional average, it is well above that of Uruguay (+25%), Chile (+21%) and Brazil (+10%). Reducing labor informality demands lower labor taxes as well as greater flexibility for new employment and a gradual closing of current labor market segmentation, something that will surely require higher education levels.

Subsidizing the financing of human capital formation could help on this regard, facilitating a progressive actualization of the labor force.

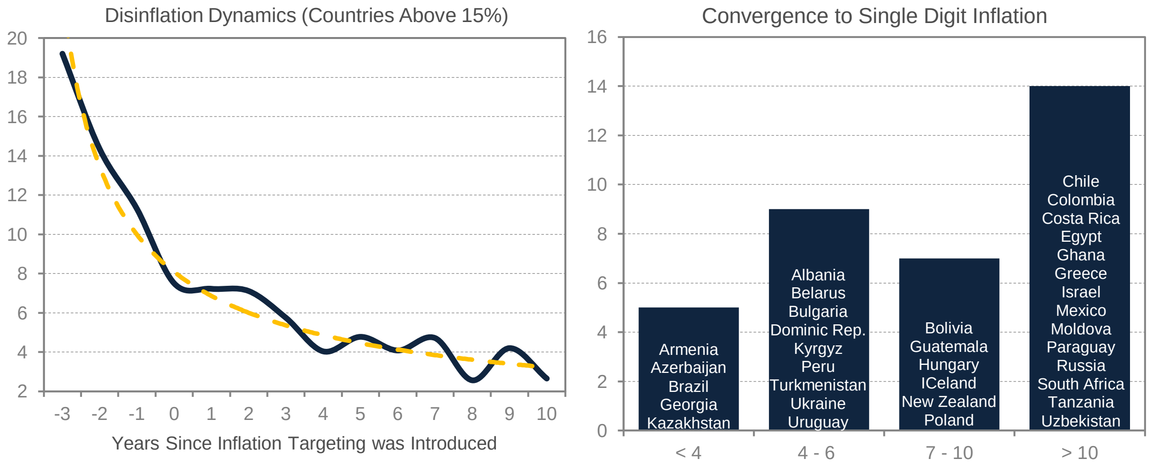
Trying to present Argentina´s investment and productivity task in perspective, it is illustrating to note that in order to sustain long term growth at 3% with the 2016 capital-output ratio would demand 20.5% of GDP in investment, representing a 3pp increase from current levels. A more ambitious goal of 5% sustained growth would demand an investment-GDP ratio of 25%. Alternatively, reaching the region's capital-labor ratio (24% below) could take 15 years if investment grows at 5% per year and the region maintains its 3% growth (trend rate).

To recapitulate: investment seems the cornerstone upon which sustainable growth is based. And while Argentina is gradually trying to set the basis for an investment pick up, much more needs to be done. The last surveillance report by the IMF[1] presented a study covering recent experiences of investment booms, concluding that investment outbreaks have been usually slow and positively associated with a competitive exchange rate, fiscal consolidation and increased domestic savings, three things missing so far from the argentine reality. These experiences have also shown that favorable terms of trade and a constructive global sentiment could be a major help for investment recovering, both factors are present in the current global conjuncture, conditioned by the discussion introduced in the summary and conclusions above.

Converging to more reasonable inflation levels

Inflation seems to be another clear symptom of disequilibrium, and at the same time an obstacle to achieve sustained growth. The new authorities at the BCRA have acknowledged the monetary nature of inflation (something that should not be taken for granted in Argentina given the heterodox practices of the past) and have therefore chosen to introduce an inflation targeting scheme to articulate the anti-inflationary fight. Cutting down inflation to single digit levels is essential to recover the price system as a mechanism to efficiently allocate resources and foster savings, both of which would help increase potential growth. A lower inflation level will also help reduce tax pressure as well as poverty, understanding that the inflation tax is one of the most distortionary and regressive.

Figure 5: Years needed to reach single digit inflation



The left graph reflects the dynamics of the disinflation for the median of a sample of emerging economies that established a regime of inflation targets starting from levels above 15% per year and where 0 represents the formal beginning of the regime.
Source: SBS Research, Bloomberg LP, FMI

It is important to note that the Macri administration is seriously trying to change and set up anti-inflationary institutions in a country known for ignoring inflation as an economic problem for decades. Nevertheless, it is also worth highlighting that in such a society it will take much more than a credible policymaker to facilitate the coordination of inflation expectations. Therefore, anti-inflationary reforms must not only show consistency with other macroeconomic policies, but also enjoy wide

[1] Argentina Selected Issues November 2016 - IMF Country Report No. 16/347 (https://www.imf.org/external/pubs/ft/scr/2016/cr16347.pdf)

popular support. Needless to say, to lower inflation successfully monetary policy must be combined with a credible path out of fiscal dominance.

Thus the evidence suggests that inflation should fall but Argentina´s goal of cutting it to single digits in 4 years seems rather ambitious. Particularly given several factors that conspire against the BCRA´s objectives, such as the high initial inflation levels, the still high (albeit declining) monetary financing to the Treasury, some informal indexation mechanisms, and the need to continue introducing strong relative price corrections. Overall, building credibility around the targets and convincing agents to set contracts with a forward-looking bias will be very important to break inertia and lower the real costs of disinflation. Developing the financial system will also help make monetary policy more efficient.

High levels of public spending continue to be the Achilles' heel

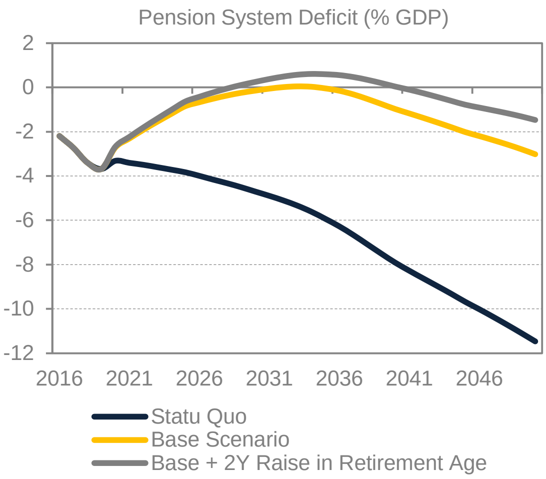
In order to gradually reduce BCRA financing to the Treasury, the government will need to converge towards more moderate spending levels. In addition, there is a large consolidated deficit despite tax collection, while services provided by the public sector are of very poor quality. The consolidated spending on wages, pensions and energy subsidies in Argentina rose by more than 11% of GDP in the last decade, leaving total expenditure at the highest level in Latin America (40,5% of GDP), but also close to the top among emerging markets, and even near the OECD average (42.4%).

Argentina spends excessively on public employment, pensions, subsidies and healthcare. Specifically, consolidated expenditure on wages reached 12.6% of GDP in 2016, even above the OECD average (10%). In addition, the pension system deficit is close to 3% of GDP but would widen substantially in the years to come absent some corrective reforms (Figure 6). Furthermore, despite a major effort since 2015, Argentina still spends excessively on highly regressive subsidies: the poorest quintile receives 10% of gas subsidies and 18% in electricity, compared to 35% and 20% for the richest decile. In the Greater Buenos Aires area prices for public services still cover only 50% of costs (having started at 25% in 2015). Likewise, Argentina spends 32% of the budget on healthcare against 15% in the rest of Latin America and 12% in emerging economies.

Figure 6: A gradual reduction of a large State

Fiscal Forecasts - Central Government (% GDP)

	2016	2017	2018
Total Income	**20,2**	**19,0**	**18,8**
Tax Revenues	19,1	17,8	17,4
Other	1,2	1,2	1,4
Primary Spending	**24,5**	**23,0**	**22,0**
Social Security	11,9	12,4	12,6
Subsidies	3,6	2,3	1,6
Wages	3,3	3,2	3,1
Provinces	0,9	0,7	0,6
Public Works	2,3	1,9	1,9
Other Spending	2,5	2,5	2,2
Primary Balance	**-4,3**	**-4,0**	**-3,2**
Interest	1,6	2,2	2,3
Fiscal Result	**-5,9**	**-6,2**	**-5,5**



The Base Scenario includes a modification of the current adjustment formula, convergence to 60% of labor formality and an increase in the labor participation rate to 65%.
Source: SBS Research, IMF, Ministerio de Hacienda

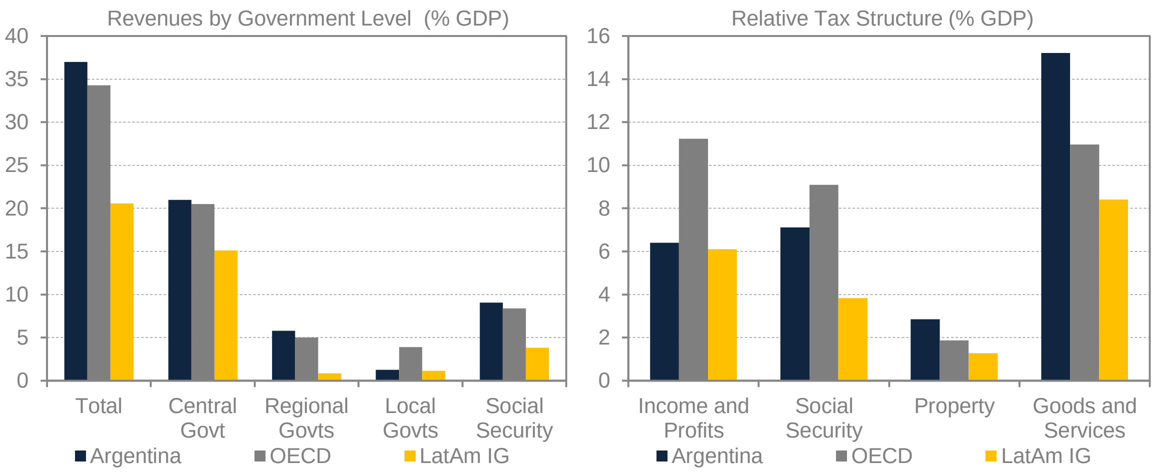
The government of President Macri acknowledged from the very beginning that spending was one of the central problems to tackle, but reiterated that they would move at a gradual pace, adding the provinces to the effort. According to figures in the 2018 Budget, the government would cut primary expenses by 1% of GDP through 0.6pp in subsidy cuts, adding to an extra decrease of 0.6pp in other expenses, and compensating for the 0.2pp projected increase in social benefits. In essence, the long-term strategy of the government is to keep spending constant in real terms while slowly eroding its weight with economic growth. Complementing this move, the government will cut subsidies to gradually lower the primary deficit and more than offset the expected rise in pensions. Regarding the provinces, the Fiscal Responsibility Law recently proposed introduces caps on public employment growth and a freezing of primary spending in real terms; the provinces reported 80% of public employment growth in the 12 years of the previous administration (1.6 million people).

From a long-term perspectives, the pension system represents the main threat to sustainability. Pension spending forecasts are alarming, though demographic trends will give some extra time to face that worsening reality (about 15 years). According to our simulations, if the government does not introduce any systemic reform, the current pension deficit would increase by about 8% of GDP in 30 years. However, some relatively minor changes can achieve significant results. For instance, slightly lowering labor informality and marginally improving labor participation, while modifying the current formula for pension adjustment (to follow just inflation!) leads to a scenario where the deficit stays at current levels (Base Scenario). Adding a 2-year increase in retirement age would cut the projected deficit to 1.5% of GDP deficit. As a reference, cutting contributions by 5pp (on gross salary) would lead to a 4pp increase in long-term pension deficit. On its July 2017 country report[2] on Argentina, the OECD recommended adjusting pensions using the CPI and matching women and men retirement age (65).

Tax reform and competitiveness

A heavy burden of distortionary taxes is another major structural problem in Argentina, and probably the biggest toll against competitiveness. Argentina currently collects more fiscal revenues as % of GDP than the OECD average (Figure 7), even despite experiencing very high levels of tax evasion. This problem is not limited to the central government as it reaches provinces and municipalities. The tax system is also inefficient, highly taxing goods and services, and negatively affecting competitiveness and excessively penalizing production. Likewise, the tax system is complex, income taxes are low, but there are huge distortions with a large number of exemptions and special regimes promoting informality. Out of the 35 different existing taxes, 15 collect less than 1% of GDP. Furthermore, contributions to health and social security currently represent 40-45% of wages. All these handicaps are expected to be addressed by the tax reform the government is scheduled to present this week, together with tax incentives to promote investment.

Figure 7: Hight tax burden with distortionary taxes



Information for 2015 (chosen for availability of data).
Source: SBS Research, OECD, Mecon, DNCFP, Indec

Indirect taxes certainly deserve a special discussion, with the largest representative being VAT at the national level and gross income at the provincial level. On the VAT side, low efficiency[3] stands out and broadly relates to high evasion (around 30%), lower rates for some products and many exemptions. Specifically, OECD estimates suggest that VAT efficiency in Argentina is only 46%, while in Latin America the tax base is much higher and so is compliance. This means that over half of the VAT revenue is

[2] "Estudio económico multidimensional Julio 2017" (http://www.oecd.org/eco/surveys/Argentina-2017-OECD-economic-survey-overview-ESP.pdf)
[3] Arises from comparing actual collection with the potential income of a general rate on all consumption

actually not being collected. At the same time, FIEL estimates[4] suggest that 2/3 of these revenues lost are due to non-collection or evasion and the rest are due to special exemptions and rates. Therefore, a straight way of increasing VAT collection would be a simplification of the system, with a general rate to all consumption and the removal of special regimes. In this respect, the VAT refund introduced last year by the new government seems like a much more efficient tool in terms of allocation, as it allows for the exemptions to be targeted properly, making VAT more progressive and less distortionary.

Addressing changes in the tax on gross income will require provincial cooperation. Ideally the provinces could accept to replace it with a sales tax that prevents the cascading effect of the former. In its current structure, the gross income is serving as a tariff between provinces, reducing competitiveness and generating incentives for vertical integration, or the opposite to recent global trends.

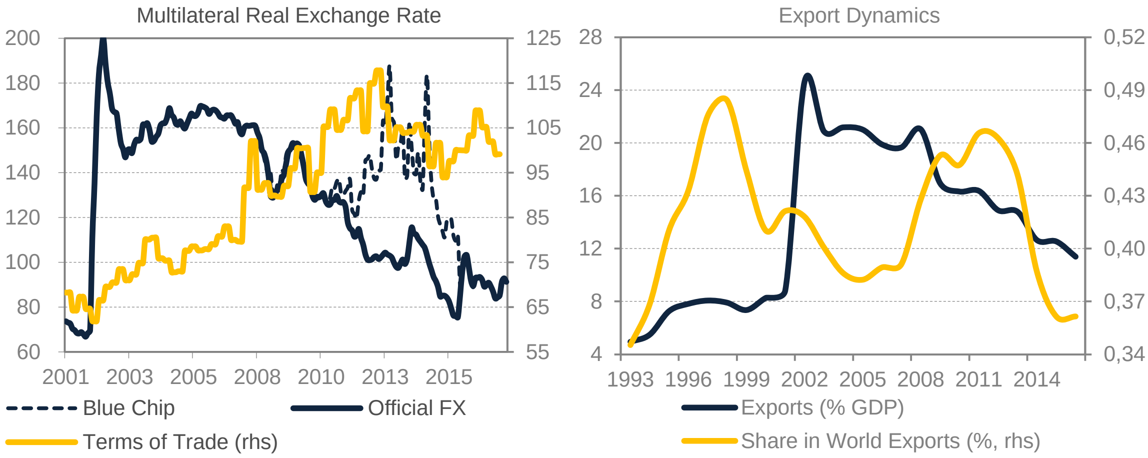
Additional tax suggestions should include a reduction of the marginal rate on new investment, inflation adjustment, and a higher depreciation rate, something the government seems to be working on. Removing the tax on financial transactions is also a top priority, since it is highly distortionary and generates incentives for informality. On the labor market, as mentioned earlier, a 2pp reduction in labor costs can be financed by removing exemptions, while a scheme for youth employment could further add to promote higher labor participation and formality. There is also some scope for cutting non-wage costs by revising, for example, the cost of labor insurance. At the same time, introducing greater progressivity in social security contributions and revising the whole scheme could certainly help, especially since 4pp of wages currently finance healthcare plans ran by unions, known by having poor disclosure of their activities.

Regarding new taxes, the OECD recommends increasing taxes on real estate as it weighs less on growth relative to income taxes, as well as introducing inheritance and environmental taxes. These, combined with the above suggestions on VAT exceptions, could help reduce distortions and provide some room to avoid compromising fiscal targets.

External sector: the sum of all evils

As expected, the main economic weaknesses are reflected in the performance of the external sector, especially in the exporting sector. Export performance in Argentina has been very poor in recent years, both in terms of the size of the economy and in relation to global trade. Certainly, part of this has been related to the behavior of commodity prices, but there have been structural factors as well. Exporting to a competitive world while facing high taxes, high borrowing costs, lack of infrastructure, and an appreciated real exchange rate seems challenging. Therefore, the main test of this new cycle will be to combine sustained growth with greater generation of hard currency resources, ability apparently lost in the last years.

Figura 8: Export dynamics reflect all of the macro imbalances



Fuente: SBS Research, BCRA, Indec, Comtrade

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[4] El sistema tributario argentino. Análisis y evaluación de propuestas para reformarlo - Documento de Trabajo Nº 123 (http://www.fiel.org/publicaciones/Documentos/DOC_TRAB_1440549015218.pdf)

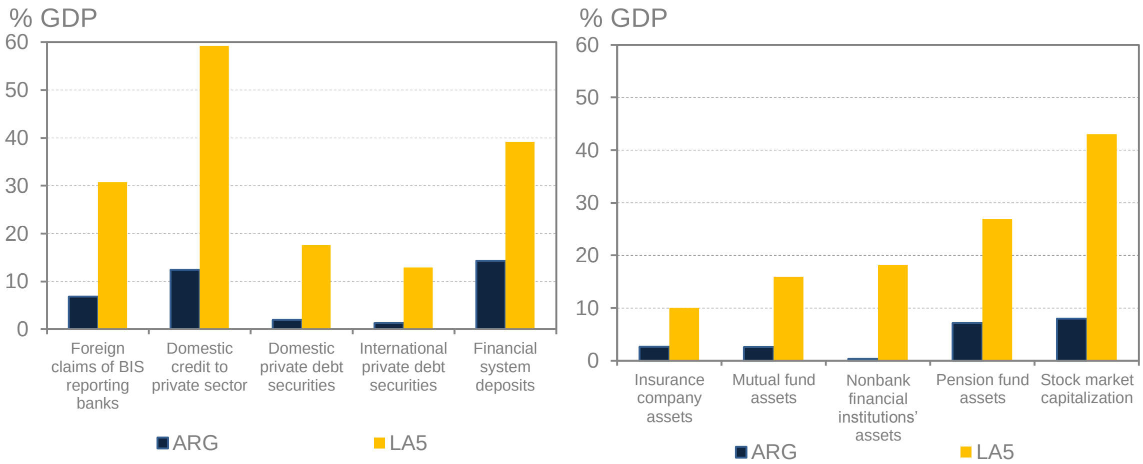
In general, peso appreciation is often emphasized when explaining the lack of dynamism of the export sector. However, as Argentina has lifted all currency and capital controls, real exchange rate levels mainly reflect favorable terms of trade and the government´s policy choice for a gradual path of fiscal consolidation, covering financing gaps with external debt during the transition. Nevertheless, currency overvaluation could be acting as a factor that deepens and exacerbates other fundamental problems. On its November 2016 Staff Report[5], the IMF concluded that a 10% real depreciation would raise exports by less than 1%, though its impact would be high in sectors such as automotive, machinery and equipment and negligible in others such as cereals or soybeans. On the contrary, an additional 1% growth in Argentina´s trading partners has a positive effect on exports equivalent to a 20% depreciation.

Export performance across different products has been rather uneven in recent years. The aforementioned study points out that in 2004-14, the 22 main export goods (90% of total exports in 2014) actually gained share in world exports. Perhaps contrary to expectations, motor vehicle sales clearly outperformed during that period (mainly reflecting the effects of bilateral agreements with Brazil), while exports of processed soy products were in line with global performance, and primary products such as soybeans and cereals underperformed the rest of the world. Clearly, this poor showing in primary good exports reflects high taxes and strong quantitative restrictions (quotas) binding up to December 2015. A terrible energy export performance is noteworthy, sector been heavily damaged by a scheme of regulated prices and subsidies that greatly discouraged investment. The new administration is making a meaningful effort to improve competitiveness in general, and in the agriculture and energy sector in particular, but this seems to be just the first draft of a long term strategy.

Argentina´s possible allies in the consolidation process

Low level of debt, public and private, appears as the principal asset holding Argentina in its goals to consolidate a sustainable economic and political path. The previous government deleveraged mostly because markets were shut down for Argentina. Actually the Kirchners´ administrations followed an economically equivalent trajectory to net indebtedness by liquidating assets. In any case, Argentina now shows a much lower leverage level than the region. This was a key factor behind the government´s choosing of a gradual approach to fiscal consolidation, as it eases the transition and allows to smooth real costs. Adding up to this, household debt levels are below 20% of income while services are under 12%, according to OECD estimates.

Figure 9: Low debt levels might become a growth accelerator



Source: SBS Research, BIS, BCRA, Indec

The very low level of credit to the private sector seems as well another important asset favoring Argentina today. Historically, credit penetration in Argentina was similar to that in the region, but in the last 10 years regional credit markets expanded strongly, while in Argentina credit to the private sector stagnated or contracted. Anti-inflationary success partly explained regional achievements in the credit markets. Similarly, macro sustainability critically collaborated with the development of the financial

[5] IMF Country Report No. 16/347 (https://www.imf.org/external/pubs/ft/scr/2016/cr16347.pdf)

market in countries like Chile, Colombia, Peru, and Uruguay. The latter grossly contrasted with Argentina´s institutional weaknesses.

In parallel, and despite its economic instability in the last 60 years, Argentina´s has maintained a relatively high per capita income, which has some positive advantages. In addition, terms of trade have remained broadly favorable despite recent deterioration, which should help translate recent competitiveness gains into better export performance. Also a comparative advantage, Argentina´s primary exports show a greater degree of diversification than the average in the region, less exposed to oil prices which have explained the bulk of the region´s recent economic performance.

The dilemma of gradualism

The analysis above reveals the argentine government principal battles ahead, as well as the tools and policies at hands. In order to minimize social confrontation and political cost, the government has opted to move gradually. Such strategy, however, is not free of costs. In particular, gradualism will maintain the embedded macroeconomic fragility for longer, increasing the country´s exposure to potential changes in global market conditions.

Nevertheless, gradualism has allowed the government to buffer political rejection to changes, slowly fortifying the mandate for reform. A longer transition period could also facilitate the needed education and training of human capital, minimizing the potentially negative impact of sudden changes, in particular in the labor market, as learned in the 90s. Meanwhile, falling inflation and fast credit growth are the main short-term benefits, allowing to accumulate political capital to deploy in more fundamental reforms to come.

The envisaged rapid disinflation process represents some cost as well. In particular, the government decision to combine a fast disinflation with a gradual deficit reduction necessarily implies higher real rates and a more appreciated currency than otherwise. This maintains significant sustainability risks by keeping financial/external fragility high regardless. Furthermore, the slow reduction of uncertainty and a strong peso delay investments as they raise initial costs and reduce expected returns. The actual policy mix, combined with a rigid labor market and high labor costs could also conspire so that new technologies could be biased towards saving labor costs, deepening the short and long term employment problem. Only sustained progress over time will permit a measured but steady reduction of the above mentioned costs, demanding the government strong discipline not to mutate gradualism into complacency.

Yes, it can be done

Paraphrasing President Macri, the main conclusion of this analysis must be that Argentina could well be close to start a reform process that will ultimately allow the country to gain competitiveness and achieve sustained growth. However, the transition will require significant effort and political consensus, especially regarding federal rules on pensions, health and education expenditures, and subsidies. Rebuilding and restoring credibility on institutions will also be fundamental, as well as strengthening property rights in the meantime. Likewise it will be key to sustain a strong process of infrastructure investment that can help boost productivity fast. Another challenge will be to achieve some flexibility in the labor market, lowering labor taxes and trying to eliminate the existing segmentation between formal and informal markets.

Perhaps, the renewed political mandate strongly demanding greater institutionalism is the most important novelty in Argentina. An increasing fragility in the provincial fiscal setting might also represent a unique opportunity to promote a broad discussion between the central government and the provincial authorities regarding a common policy agenda. Protecting the most vulnerable during the transition will have to be at the heart of this process, as it will be central to achieve inclusive growth.

The road towards investment grade is indeed long, demanding at least 6 partial credit upgrades, but offers a major compensation: the distance between Argentina´s spread and the closer Latin American BBB sovereign is still 180bps, at least at current prices.

OTHER REPORTS

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