Brazil and Argentina: different economic challenges

The Brazilian and the Argentine economies have for the past several decades followed paths that undoubtedly have shown many similarities. It is not difficult to establish a parallel between the common experiences of these two countries characterized by populist economic policies, hyperinflation, foreign debt default, fixed or semi-fixed exchange rate regimes, etc. The similarities often give rise to comparisons on both sides, and to an attempt to draw lessons from the achievements or failures of the neighboring country.

Despite the resemblance, however, recent decades have also shown fundamental differences in the economic histories of Brazil and Argentina. The currency board regime adopted by our southern neighbor, for instance, was a much more severe and inflexible fixed exchange rate option than the Brazilian experience, which was based on a semi-fixed exchange rate following the Real Plan. This difference in approaches to fighting hyperinflation since the end of the 1990s has brought about differences in economic performance.

Still more relevant for the current debate on the world economy are the almost totally opposite ways in which Brazil and Argentina came out of the foreign debt crisis at the beginning of this decade. Both economies have managed to build a path of impressive primary surpluses (cash surplus less interest); yet Brazil managed to consolidate its macroeconomic framework of floating exchange rate and inflation targets by working with high real interest rates. Argentina, on the other hand, has abandoned its targets and has chosen to retain the control of the nominal exchange rate within determined intervals and to slash real interest rates.

As is well-known, Argentina, with all its economic heterodoxy, has not fulfilled the gloomy growth predictions many economists have been making at least since 2002. After a 20% fall in GDP between 1999 and 2002, the country went through a period of high growth exceeding 8% a year. In contrast, inflation soared past 15%, perhaps even 20%, leading the government to ineffective price controls and the indecent practice of manipulating the price indices. In the area of regulating investment, particularly in infrastructure, the Argentineans created an institutional framework whose main feature is disregard for what has been contracted for.

This will certainly have serious effects in the future.

Domestic savings

The weaknesses of the "Argentine model" are obvious to most Brazilians. The violent global financial and economic crisis that exploded after the Lehman Brothers bankruptcy in September 2008 has only increased the risks to the future of the country. Even so, setting aside the most extravagant excesses of economic populism demonstrated by our neighbor, certain aspects of the Argentine performance are noteworthy. Take, for example, the recovery of domestic savings, whose high levels provoke envy in Brazil. At the peak of the crisis at the beginning of the decade, Argentine savings dropped to 14% of GDP but recovered to 27% by 2007 — an increase of more than 10 percentage points. On a more stable measure, savings went from an average of 15% of GDP from 1997 to 2001 to 24.3% between 2004 and 2007, an increase of 10 percentage points. In contrast, Brazilian domestic savings have been crawling along at between 16% and 18% of GDP since at least 2003.

This facts has led some economists to conclude that our neighbor made a better choice than us in adopting the regime of a controlled exchange rate and low interest rates as a way out of the crisis in 2001 and 2002. The Argentine example, once stripped of its populist excesses, may still contain some elements we can learn from.

To determine what can be learned from the Argentine experience, it is essential that we revisit our neighbor's economic history. Breaking away from the fixed exchange rate regime (currency board) at the end of 2001 with a significant devaluation of the exchange rate, followed by the default on foreign debt, represented a way out of the trap of the preceding years. After a fall in growth of more than 20%, which inevitably led to an underutilization of production factors, the economy recovered its breath in a more consistent way than foreseen by most critics (though it was true that the populist excesses that accompanied this process harbored the seed of new crises).

There are indications that the Keynesian investment phenomenon, determining its own savings, occurred in the Argentine recovery starting in 2002. However, this is only part of the story. It is important to note that the investment rate in the country jumped from an average of 15.4% of GDP between 2002 and 2004 to 22.1% between 2004 and 2007, followed by a 10 percentage point increase in savings as a proportion of GDP.

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Reforms

But there are other aspects of recent Argentine economic history that must be taken into account. The structural reforms (privatization, deregulation, Social Security reform) carried out by Domingo Cavallo, Minister of Finance, were profound. But the inconsistent macroeconomic regime (currency board and overvalued exchange rate) prematurely aborted the positive effects of the reforms. The departure from the Keynesian trap in 2002, in turn, brought about the possibility that those institutional reforms would bear fruit once more. In combination with the start of a period of high commodity prices in 2004, which benefited Argentina even more than Brazil, the good part of the Cavallo legacy lent extra oxygen to growth.

Furthermore, privatizations and reform of the individual accounts of the Social Security system, whose dismantling has just recently been decided, have also contributed to an increase of private savings, just as the default on foreign debt did. In this case, because the majority of the bond holders were Argentine citizens holding funds abroad, the default led to a natural restructuring of portfolios.

At the government level — similar to what occurred in Brazil at the end of the crises in 1999 and 2002 — an economic policy decision was made to increase public sector savings. Argentine domestic savings of 26.6% of GDP in 2007 was made up 25.1% of private savings and 1.6% of public savings. In 2004 and 2006 public savings peaked at 2.5% of GDP. In contrast, as the crisis culminated in 2001, the Argentine public sector showed negative savings of 6% of GDP. The recovery of the levels of public savings was also importantly related to the debt default, which reduced substantially interest payments on public debt. Although the default generated short-term benefits, it generated also long-term costs, such as the near shutdown of global capital markets to Argentina and the resulting increase in the spread of the country's bonds.

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A last, positive element identified in the Argentine public sector in recent years is an increase in the export tax on agricultural commodities (*retenciones*), which has substantially increased tax revenues, helping explain improved public savings. Like the debt default, this formula carries long-term costs, such as discouraging investment in those sectors affected by the tax and raising the possibility of fiscal gaps if recurrent expenditures must be reduced when revenues vary in line with raw material prices. Needless to say, the recent fall in commodity prices has already had its effects on Argentina public accounts.

Argentina's Keynesian way out

In short, the post-2002 Argentine experience suggests that it is possible to come out of a period with underutilization of production factors the Keynesian way. For Argentina, currency devaluation and later a loose monetary policy were the levers that pulled the economy out of the mud. This led to a cycle of optimism that triggered a simultaneous rise in investments and savings, which in turn increased potential GDP growth. Part of the increase in private savings must be credited to abandonment of a bad Keynesian equilibrium; the rest is due to changes in the Social Security system, the debt default, and devaluation of the exchange rate. It must be said, too, that half the total increase in domestic savings must be credited simply to the increase in public savings, which in turn was powered by risky policies, such as the debt default and the *retenciones*.

To be sure, Argentina worsened its chances of success for the medium- and long-term by resorting to systematic populist diversions from the logic of its own model. The comeback of dangerous levels of inflation jeopardizes the macroeconomic balance and reveals the absence of adjustments: either public savings

had to be increased to higher levels than what was actually achieved, to contain domestic demand; or the exchange rate and interest rate policy should have been different — less undervaluation in the first case, and higher real rates in the latter.

Today, doubts about the sustainability of the Kirchner economic policy continue to grow. Inflation has been reducing the real devaluation, and the Argentine exchange rate today is far less competitive, with the aggravating circumstance that the country has been virtually closed out of international financial markets as a consequence of the debt default. There is a risk, definitely not negligible, of a short-term shortage of foreign currency, which raises the specter of a new debt default. The roll back of the Social Security reform of the 1990s may reduce private savings. Lastly, the fall in commodity prices reduces *retenciones* revenue and will have a substantially negative impact on public savings.

Brazil

Even assuming that the Argentineans had flawlessly managed their post-2002 economic policy, the Keynesian impulse experienced in that country would not apply to Brazil. To justify this assertion, it is necessary to understand the conditions surrounding the Brazilian economic recovery after the difficult years from 2001 to 2003. High commodity prices and the maintenance of the macroeconomic model during the presidential transition of 2003 helped consolidate optimism about the economy and pushed up the return on investments, particularly after 2005. The "animal spirits" of the Brazilian business community were revived, and private investment increased.

Nevertheless, private savings declined from 18.3% of GDP in 2003 to 14.2% in 2008. The rates of domestic savings and investment leveled off, on a relatively mediocre level for an emerging economy, only because public savings increased. The public sector cannot be blamed for the fall in domestic savings because public savings went from a negative 2% of GDP to a positive 3% between 2005 and 2008.

In other words, and in contrast to what we saw in Argentina, Brazil had not fallen into the trap of underutilization of production factors before the recovery in 2005, although there was some idle capacity, particularly in 2001–02. The path to recovery was more classical than Keynesian. The increase in autonomous spending, notably the hike in private investment, put pressure on scarce resources, which led to exchange rate appreciation — which in turn matched excess demand with external supply. This was possible because of the growth in exports during that boom period.

Some claim that the appreciation in the exchange rate at that time was a consequence of high interest rates. However, in fact there was a fall in real interest rates: between mid-2005 and the beginning of 2008 the real interest rate fell by almost half, from about 13% to just over 7% a year. The Central Bank increased Brazil's international reserves and maintained the nominal valuation of the real. Finally, the international crisis, and the resulting collapse of credit and investor and consumer confidence, dried up demand, helping the Central Bank to contain inflation. But a price was paid in terms of lower economic activity, employment, and welfare.

The post-2005 Brazilian experience makes it clear that growth is constrained by a limited supply of production factors rather than by structurally deficient aggregate demand. The Argentine example thus provides nothing with which to address the Brazilian challenge. To accelerate potential long-term growth, our task will continue to be to build up savings and introduce reforms to render our economy more efficient.