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Embassy of the Argentine Republic

Argentina's Economic Crisis: Can the Ag Sector Help?

In the past year, a number of relatively long-standing economic problems in Argentina have converged to create a full-fledged economic crisis. With Argentina's economic future remaining cloudy, the current crisis could produce important spillover effects on the agricultural sector that may diminish Argentina's competitiveness in international commodity markets.

Underlying the current economic crisis are three interrelated factors: the policy of pegging the domestic currency to the U.S. dollar at a fixed one-to-one rate throughout most of the 1990s, the failure of the Argentine government to reduce budget and trade deficits, and the ensuing default on government debt.

In 1991, Argentina pegged its *peso* to the dollar to control the hyperinflation of the late 1980s and early 1990s. Unfortunately for Argentina, fixing the *peso's* exchange rate at a one-to-one ratio with the dollar ultimately resulted in less competitive *peso*-priced commodities in international markets and artificially high domestic wages following strong appreciation of the U.S. dollar beginning in 1996.

The problems associated with an overvalued currency were compounded by Argentina's failure to lower its budget deficit and finance the trade deficit. This led to suspension of an International Monetary Fund (IMF) loan payment to the Argentine government due in December 2001 and subsequent default on sovereign (public) debt. In the wake of the default, the *peso*-dollar peg collapsed, and Argentina's recession—which had emerged in 1998—turned into a depression. Argentina's Gross Domestic Product (GDP) is projected to shrink by about 10 percent in 2002 alone, and a further contraction in 2003 is all but inevitable. A complicating factor in stabilizing the government's overall budget picture is the apparent inability to constrain provincial (state-level) spending even as provincial tax revenues have fallen.

Argentina's attempts to recover from the crisis have been hampered by multiple changes in government leadership and exchange-rate policies and controls. In early December 2001, the government of Argentina (GOA) imposed a banking freeze—know as the "corralito"—on all personal savings accounts. Initially, only minimal withdrawals were permitted. The banking freeze has greatly eroded confidence in both the government and the banking system, while severely reducing liquidity in local markets. In late December, widespread civil unrest followed the banking freeze and resulted in several deaths and significant destruction in the financial center of Buenos Aires.

In January 2002, as part of a gradual loosening of the "corralito," the GOA allowed monthly salary deposits to be withdrawn. The government also announced a dual exchange rate with a pegged rate of 1.4 *pesos* per dollar and a market-determined rate that has since exceeded 3 *pesos* per dollar. The official rate of 1.4 *pesos* per dollar was mandated to cover essential imports and all exports, whereas the market rate applies to nonessential imports, tourism, and most financial transactions. (To date, the Argentine government has not categorized agricultural inputs as either essential or nonessential.) On February 11, the GOA allowed a total "float" of the exchange rate for most goods and services, although the central bank uses a discounted rate (which acts as an implicit export tax).

These developments have led to credit policies that have disrupted Argentina's bank operations and credit markets. Dollar denominated small bank loans and mortgages are to be converted to *pesos* at a one-to-one exchange rate, despite the *peso's* drop in value. Banks in Argentina could lose over 20 billion *pesos* as a result of being saddled with devalued loan assets that would be repaid in *pesos* at the rate of one *peso* per dollar rather than at the market rate. The government has imposed export taxes on various products to compensate banks for losses caused by repayment of dollar-denominated debt in devalued *pesos*. Lenders are not the only ones to suffer. Savings deposits and other financial assets are only convertible to dollars at the less attractive prevailing market rate. Limitations on the amount of savings convertible to dollars per day have also been established.

Initially, the one-*peso*-to-one-dollar conversion rate for existing debt repayment placed agricultural creditors in the position of having to accept enormous losses on loans for the current crop year (2001/02). However, Argentina's agricultural input suppliers—who furnish most of Argentina's $2.5-$3 billion in shortrun agricultural operating credit—refused to accept the conversion terms and their

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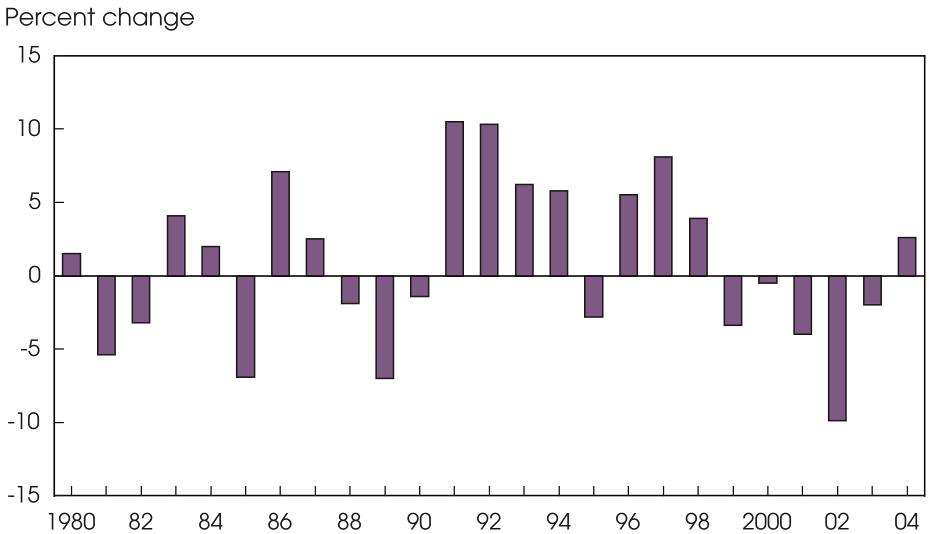
Argentina's Real GDP Is Forecast to Continue Sliding Until 2004



2002-04 forecast.
Source: DRI-WEFA

Economic Research Service, USDA

implied losses. Eventually the GOA reversed course and has offered conversion of shortrun agricultural debt at the floating exchange rate, but this episode compounded sectoral risks and will certainly raise operating costs throughout the marketing chain.

Argentina's devaluation should eventually benefit the economy in the form of increased exports and inward foreign direct investment once the country's fiscal house is in order. In the near term, however, the supply-side effects of capital controls, including the flow of capital out of the country, are devastating. Even large corporations are having trouble obtaining dollars needed to buy imports such as computer equipment and machine parts. The resulting shortages are crippling both the domestic and export economies, making prospects for near-term recovery unlikely.

Dampening the prospects for export-led recovery is the recent imposition of export taxes on some products. In February 2002, the GOA announced export taxes of 20 percent on petroleum products and crude petroleum. This was followed in March by export taxes of 10 percent on most other primary products (soybeans were to be taxed at a 13.5-percent rate), and lower differential export taxes (DETs) of 5 percent on processed products including soybean oil and meal. Then in April, export taxes were raised to 20 percent for many agricultural products, including wheat, feed grains, and vegetable oils and meal, thus eliminating most DETs.

Soybeans are still assessed a 3.5 percent surcharge, making the export tax 23.5 percent. Major exceptions to this tax structure include a 5 percent export tax on meat, and a 10 percent rate for fruits, cotton, and rice.

A further major uncertainty clouding the export picture is the GOA's failure to comply with contractual commitments made to major grain and oilseed export companies. For example, a steep 21.5-percent value-added tax (VAT) applied on all domestic sales was traditionally reimbursed to companies that subsequently exported domestically produced agricultural products (The VAT was recently lowered to 10.5 percent for all grain and oilseeds transactions, and should not be confused with the export tax mentioned above). However, in December 2001, the GOA stopped VAT reimbursements to export companies, who were left waiting for nearly $700 million in outstanding payments. After protracted discussions with the major export companies, the GOA agreed to repay the VAT reimbursements for exported goods in a series of 19 monthly payments beginning in March 2002. However, as of early April, the GOA had yet to make even the first of these monthly payments.

Decline in 2002 All but Certain

Major private forecast services (DRI-WEFA, Oxford Economics Forecasting, the London Economist) expect Argentina's GDP to shrink by 10 percent in 2002, with inflation of between 20 and 50 percent. Forecasters expect the Argentine exchange rate to range between 3 and 4 *pesos* per dollar by late 2002, representing a depreciation of 66 to 75 percent from the fixed one-to-one peg with the dollar. Short-term interest rates are expected to be in the range of 30 to 40 percent. With the official unemployment rate likely to be above 30 percent and with the prospect of inflation and GDP shrinkage also at double-digit rates, it is no exaggeration to say the Argentine economy is in a severe depression.

To view this in perspective, no country directly involved in the Asian financial crisis of 1997-98 experienced such a large cumulative decline in GDP as Argentina already has. Furthermore, the policy levers usually used to pull a country out of recession are not viable for Argentina. Loose monetary policy (e.g., interest rate cuts by the central bank) would drive inflation further up. Loose fiscal policy—some combination of tax cuts and/or increases in government spending—would lead to large structural budget deficits and would further drive long-term interest rates to levels high enough to offset any stimulative effects. Consequently, upside prospects for the Argentine economy in the near term are dim.

In 2002, the ability of Argentine banks to make even short-term loans continues to be very restricted. If inflation rates approach or exceed 20 percent, the risk premiums built into loans will be substantial and will likely grow, driving real interest rates even higher. The government's inability to collect tax revenue in proportion to its direct debt obligations remains a problem. As businesses and individuals routinely evade taxes, nominal rates on less avoidable taxes on business activity—such as VATs—are likely to rise, hindering new business development and consumer confidence.

Agricultural Sector: Part of the Solution?

Exports of farm products, crude oil, and manufactured goods will likely play an important role in pulling the Argentine economy out of its deep recession. The question is when. Market signals that might normally encourage greater farm exports are greatly muted as the higher *peso* prices received by farm producers are offset by export taxes, elevated input prices, rising interest rates, and tighter credit conditions.

Peso-valued commodity prices are expected to rise due to the devaluation, but the effective price paid to grain farmers is not likely to keep pace, thus dampening production incentives. The cost of most inputs—including new capital and imported inputs—could rise by as much as 100 percent. Nitrogen-based fertilizer and fuel, although domestically produced, are expected to at least double in cost, offsetting any gain in output prices.

In addition, the percentage markup for transportation and export marketing expenses will likely rise due to increased market and policy uncertainty, and increased export taxes will further lower effective earned prices for commodities. Improved access to farm credit is also very unlikely. The banking system's deteriorating balance sheets have been strongly pressured by farm debt burdens accumulated over the last decade, farming's high risk, and increased export price volatility.

One way for Argentine farmers to mitigate the input cost situation is to change cropping patterns. If this happens, farmers are likely to plant more soybeans and less corn, since corn normally relies on more intensive use of fertilizer, diesel fuel, agricultural chemicals, and high-cost hybrid seed that a farmer cannot save from the current crop to plant next year. Although Argentine corn growers tend to have lower fertilizer application rates than their U.S. counterparts, operators using fertilizer will still have strong economic incentive to switch to lower input soybeans.

Wheat cultivation normally requires more fertilizer than soybeans, but wheat production is unlikely to decline much because of the cash-flow benefits offered from wheat-soybean double cropping (although less fertilizer will likely be used). Cash generated from the wheat harvest can be used to finance production of the follow-up soybean crop, thereby sidestepping costly credit markets. However, medium and small single-crop operators may have a difficult time financing even the lower input costs associated with soybeans.

Prospects for Argentine farm exports hinge on whether the farm sector adopts innovative solutions to deal with higher business costs. During past economic crises, the farm sector has been able to cope and expand. This current economic crisis, due to its severity, will tax the innovative abilities of farm operators.

At this time, efforts by the Argentine government to negotiate a rescue package with the IMF have not been successful. Further, if the expected macroeconomic forecasts materialize and the economy goes into free fall, agricultural exports may be greatly hindered, particularly if credit continues to be generally unavailable or a significant additional tax is imposed on farm exports. Instead, farm exports could shrink. AO

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