Argentina Returns to Capital Controls

By Kavaljit Singh
Global Research, September 12, 2019
Region: Latin America & Caribbean
Theme: Global Economy

*On September 1, the Argentine government led by **President Mauricio Macri** imposed capital controls in a bid to stem the fall in the foreign exchange reserves and the peso currency. This unexpected move was initiated soon after the authorities spent nearly $3 billion of forex reserves to repay short-term debt and to protect the value of the peso.*

The announcement followed the Macri government's unilateral decision taken on August 28 to delay repayment of short-term debt instruments (denominated in both US dollar and peso) to maintain liquidity in the financial system and to protect dwindling forex reserves. The government also unraveled its plans to seek a "voluntary reprofiling" of $50 billion of longer-term debt held by foreigners besides requesting the International Monetary Fund to restructure its debt repayment of $44 billion received under the Fund-supported bailout program.

The Policy U-turn

Hardly anyone anticipated that the Macri government would make a U-turn and embrace capital controls. Such was his commitment to market-friendly and pro-investor policies that Mr. Macri dismantled all capital controls introduced by the previous government in one go within hours of his inauguration in December 2015.

Just a few weeks back, he ruled out the imposition of capital controls when the opposition parties called for these measures to halt a slump in the forex reserves and the peso. Leave aside critics; even his supporters were not expecting a sudden policy reversal from President Macri – a firm believer of free markets and a vocal critic of capital controls and other interventionist policies of his predecessor, Cristina Fernández de Kirchner.

Now the Macri government has undertaken a course correction, but will the gambit pay off? It is too early to make any reasonable assessment of the efficacy of capital controls introduced in Argentina just two days ago, but initial reports[1] suggest that these measures did help in arresting the free fall of the peso.

The Political Shock

Since April 2018, Argentina has been facing severe macroeconomic instability, but the recent slump in the peso and financial markets started with the August 11 primary elections when Mr. Macri suffered a resounding defeat by the left-leaning opposition candidate **Alberto Fernández,** thereby further dimming the chances of his re-election. The presidential election will take place on October 27, 2019.

The primary election results were viewed by many as a referendum on the Macri government's deeply unpopular austerity policies. The election results sent a shockwave in the domestic financial markets as investors feared a break with the market-friendly policies pursued by the Macri government. That led to a massive sell-off in the financial markets and triggered a fresh wave of capital flight out of the country. On August 17, Argentina's finance minister, **Nicolás Dujovne**, resigned while admitting that "undoubtedly we have made mistakes"[2] in his resignation letter to President Macri.

Amid financial fragility and political uncertainty, the peso plunged to record new lows against the US dollar as investors dumped Argentina's sovereign bonds and stocks en masse. The country's 100-year bond that was four times oversubscribed just over two years lost more than 50 percent of its value after the August 11 primary vote. The chaos in the currency markets got further exacerbated when nervous Argentine depositors withdrew their savings from the dollar-denominated saving accounts.

In August alone, the peso dropped by more than 30 percent against the US dollar. The Macri government was left with no option but to impose capital controls to stem the peso's slide and to protect forex reserves. According to data compiled by Capital Economics, Argentina's foreign exchange reserves are currently at $58 bn, down by 25 percent from a peak of $77 bn in mid-April 2019.[3]

What is even more worrying is the low net forex reserves (now estimated at $19 bn) that cover only 25 percent of the country's total external financing need. Such low net reserves not only increase external vulnerabilities but also preempt the possibility of undertaking large intervention in the forex markets to stabilize the peso.

The Controls

What are capital controls? In simple terms, capital controls are regulations that restrict or prohibit the movement of capital into or out of a country.

The controls imposed by the Macri government are only aimed at restricting capital outflows. No controls have been introduced to restrict capital inflows. The authorities have enforced controls for a short duration (120 days) and will remain in effect until December 31, 2019. Some of these measures are summarized below:

- Residents are restricted to buy foreign exchange of no more than $10,000 a month. While no restrictions are imposed on residents to withdraw foreign exchange in cash from their bank accounts.
- Non-residents can only buy foreign exchange of $1000 a month, and they are not allowed to make bank transfers abroad.
- New deadlines have been imposed for exporters to repatriate foreign currency earned from sales abroad. Exporters will have to repatriate foreign exchange within five working days of payment or 180 days after the loading permit.
- Companies, banks, and financial institutions will need prior authorization from the central bank to purchase foreign exchange or to distribute dividends abroad.

Putting the Cart Before the Horse

From a broader policy perspective, it was a wrong move by President Macri to remove all capital controls in one go when he took office in December 2015. To a greater degree, capital controls would have provided his government breathing space to reduce inflation and address longer-term structural problems facing the economy. The removal of capital controls made the Argentine economy extremely vulnerable to sudden stops in capital flows.

Ideally, the government should have introduced capital controls in April 2018 when sudden capital flight out of peso-denominated assets began following the rise in U.S. interest rates and a surge in the US dollar. At that time, the rapid depreciation of the peso increased Argentina's external vulnerabilities due to its heavy reliance on borrowings in foreign currency. That forced the Macri government to seek financial support from the IMF.

The Social and Economic Costs

Since early 2018, the rapid depreciation of the peso and rising public debt (nearly 75 percent is denominated in foreign currencies) have added to the country's financial vulnerabilities. The market confidence and domestic demand are on the decline. At 60 percent (the highest in the world), benchmark interest rates have crippled domestic investment.

The Argentine economy is now suffering from a deep recession that is worsening social conditions. The recession has negatively impacted tax revenues, which implies that adhering to the program's ambitious fiscal targets would necessitate more spending cuts. The inflation rate is currently at more than 50 percent and has drastically reduced private consumption, especially of poor households. Unemployment and poverty rates have risen considerably since mid-2018. According to a report by the Catholic University of Argentina's Social Debt Observatory, almost a third of Argentines were living below the poverty line at the end of 2018.[4] Facing an imminent electoral defeat in October, Mr. Macri announced ad hoc relief measures including a three-month freeze on fuel prices and income tax cuts on August 14.

Is a Quick Recovery Possible?

Given the precarious state of the Argentine economy, it will be far-fetched to expect a quick economic recovery ahead of the presidential election in late October with the help of capital controls.

Sorry, Mr. Macri, capital controls are not a magic wand to turnaround a messed up economy in less than 60 days.

There is no denying that capital controls are useful policy tools, but these measures alone cannot restore financial stability. To be more effective, capital controls need to be complemented by other policy and regulatory measures such as counter-cyclical fiscal and monetary policies, tightening of financial regulations, and keeping public debt under control. Many of these measures may not be compatible with the policy recommendations of the ongoing IMF-supported program in Argentina.

Also, one needs to keep in mind that capital controls will be enforced in Argentina only for a limited period of 120 days which may not be sufficient for restoring macroeconomic stability.

What about the IMF?

At the time of writing, there is no official word from the IMF on the capital controls introduced by the government. No one can dispute that the IMF enthusiastically supported the Macri government's pro-market reforms – including the dismantling of capital controls and a floating exchange rate regime. When the country faced financial fragility last year, the

IMF quickly approved a loan package of $57 bn – the biggest loan package in the IMF's history – with the strong backing of the United States.

The IMF's engagement with Argentina raises a critical question about the rationale of significantly frontloading disbursements under the program. Out of total $57 bn, $44 bn has been already disbursed to Argentina, and the next tranche of $5.4 bn is due in late September. As per the agreement, close to 90 percent of the total financial support is to be disbursed to Argentina before the 2019 presidential election. Isn't a case of IMF supporting Macri's re-election?

At present, the Argentine economy is in a much deeper recession than it was before the implementation of the IMF-supported program. It not only indicates that frontloading disbursements was a severe mistake but also suggests that the support program designed to restore market confidence and sustained economic expansion is not delivering positive results. It begs the question: What is the accountability of the IMF Executive Board, Managing Director, and senior staff members who designed and approved the support program?

Rather than acknowledging the likelihood of policy failure, Mr. David Lipton, the IMF's Acting Managing Director and Chair, strongly backed the IMF-supported program just a few weeks back. On July 12, he stated:

> "These policy efforts are starting to bear fruit. Financial markets have stabilized, the fiscal and external positions are improving, and the economy is beginning a gradual recovery from last year's recession."[5]

One can only hope that the new Managing Director of the IMF will undertake a complete review of its lending programs as well as its broader policy framework. In particular, the IMF should revisit its 2012 Institutional View[6] that endorses capital controls as a last resort, imposed selectively on capital inflows, and on a temporary basis. As several other emerging market economies are also experiencing sudden reversals in capital flows, the IMF should adopt a more flexible approach towards capital controls and support member-countries with all the policy options needed to safeguard financial stability.

It is yet unclear what kind of renegotiations with the IMF would take place if Mr. Fernández becomes Argentina's next president. Most Argentines blame the IMF policies for exacerbating the financial crisis of 2001, which deepened the recession and triggered social unrest and political instability.

The Importance of Capital Controls

There are valuable lessons to be learned from the current financial crisis in Argentina. First, the policymaking in a complex, uncertain, and the financially integrated world should not be driven by financial orthodoxy endorsed by the IMF, G7, financial markets, and credit rating agencies. Instead, the policymakers should adopt a pragmatic and flexible approach towards managing cross-border capital flows and, therefore, they should not hesitate to use capital controls (along with macroprudential measures) for maintaining financial and macroeconomic stability. Needless to say, financial stability is a public good that every modern economy needs.

As I discussed elsewhere[7], capital controls should be viewed as a legitimate tool of macroeconomic policy to manage the risks associated with volatile capital flows. In recent years, several countries have deployed controls on outflows as part of crisis management tools with positive outcomes. This long list of countries includes Malaysia in 1998, Iceland in 2008, Cyprus in 2013, and China in 2016.

It is high time that the stigma attached to capital controls is removed. Apart from academia and civil society groups, the IMF, World Bank, OECD, UN, and other international organizations should play an important role in removing the stigma. In a more interconnected and integrated global financial system, national measures alone may not be sufficient to address the systemic risks posed by cross-border volatile capital flows to financial stability. Hence, there is a need for regional and international cooperation for maintaining global financial stability.

Lessons for India Too

Argentina's current crisis has highlighted the issue of currency risks associated with a large share of foreign currency-denominated public debt. As nearly 75 percent of Argentina's public debt is denominated in foreign currency, it has risen over 30 percentage points due to depreciation of the peso over the past year.

The Argentine crisis offers important lessons for New Delhi as the Ministry of Finance is planning to raise as much as $10 billion this fiscal year via sovereign bonds denominated in foreign currencies. In her budget speech on July 5, finance minister, Nirmala Sitharaman, stated: "India's sovereign external debt to GDP is among the lowest globally at less than 5%. The government would start raising a part of its gross borrowing programme in external markets in external currencies. This will also have a beneficial impact on demand situation for the government securities in the domestic market."[8]

Till now, India has never issued a foreign currency-denominated sovereign bond due to the inherent risks posed by currency volatility. In the international markets, India has issued sovereign bonds (such as masala bonds) but only in Indian rupees so that the bond investors bear the exchange rate risks.

The finance minister is sticking to the issuance of sovereign bonds in foreign currency despite the widespread criticism of this proposed move and serious apprehensions expressed by some former RBI governors about the potential risks involved in issuing such bonds.

Of course, India's external debt situation is vastly different from Argentina but as pointed out recently by Duvvuri Subbarao, former RBI governor, "Governments start off believing that they will remain prudent, open their doors wider, and soon become so addicted to foreign money they wouldn't stop until a crisis hits them. To believe that markets can discipline governments is a stretch. The stories of Argentina and Turkey are telling examples."[9]

One of the main reasons why India has so far avoided financial crises like those experienced by other emerging markets in Asia and Latin America is because of not borrowing funds from international markets in foreign currencies. Much of India's external debt is in the form of long-term borrowings from official sources (multilateral and bilateral) and that too on concessional terms.

If nominal currency depreciation and hedging costs are taken into account, foreign currency-denominated sovereign bonds may not turn out to be a cheaper option. Nor is a compelling need to raise funds from international markets in foreign currencies at this moment.

Let's hope better sense prevails in New Delhi too.

*

This article was first published on Madhyan

Note to readers: please click the share buttons above or below. Forward this article to your email lists. Crosspost on your blog site, internet forums. etc.

Notes

[1] Benedict Mander, "Argentine Peso Strengthens after Capital Control Measures," *Financial Times*, September 3, 2019; Reuters, "Argentine Peso, Bonds Whiplashed After Capital Controls Imposed," September 2, 2019.

[2] The text of the resignation letter in Spanish is available at https://www.lanacion.com.ar/politica/sin-dudas-hemos-cometido-errores-escribio-nicolas-nid2278599.

[3] Edward Glossop, A Closer Look at Argentina's FX Reserves, Capital Economics, August 28, 2019.

[4] 31.3% of population living below poverty line, says UCA report, *Buenos Aires Times*, March 25, 2019.

[5] Quoted in "IMF Executive Board Completes Fourth Review Under Argentina's Stand-By Arrangement, Approves US$5.4 Billion Disbursement," Press Release No. 19/268, IMF, July 12, 2019.

[6] IMF, The Liberalization and Management of Capital Flows – An Institutional View, November 14, 2012.

[7] Kavaljit Singh, What Are Capital Controls?, *Policy Brief # 1*, Madhyam, January 2, 2019; Kavaljit Singh, Recent Experiences with Capital Controls, *Policy Brief # 4*, Madhyam, May 2, 2019.

[8] The full text of the budget speech is available at https://www.indiabudget.gov.in/doc/Budget_Speech.pdf.

[9] Duvvuri Subbarao, "The name is Dollar Bond," *Indian Express*, August 3, 2019.

Featured image is from 123rf.com

Articles by: **Kavaljit Singh**