

[MUSIC PLAYING] SPEAKER 1: Hello, and welcome to the Growth Lab at Harvard University's weekly podcast.

Argentina is currently facing yet another economic crisis. Eduardo Levy Yeyati, the Dean of the School of Government at Universidad Torcuato Di Tella in Buenos Aires, believes there are deep roots in Argentina that make the economic crisis Aristotelian in nature. There are both economic and political factors that have contributed to the current fiscal situation, which make it difficult to rectify when considering the impact of shorter election cycles on economic policy strategy. For Argentina to find its way out of this crisis, Eduardo places importance on finding consensus among stakeholders to improve existing policies.

In this podcast, Growth Lab research fellow Carolina Pan and Eduardo discuss the contributing factors to this economic situation in Argentina, and the means by which the country can prevent future crises.

CAROLINA PAN: Eduardo, thank you very much for your talk at CIB titled Argentina's Aristotelian Crisis. And I thought that was a very interesting choice for the title, so maybe we can start with that. What makes this crisis Aristotelian?

EDUARDO LEVY YEYATI: Well, I would say all crises are-- you know that Aristotle used to say that men are happy in a single way and are happy in very different ways, because happiness for him was the definition of virtue and you have to fill in different aspects of happiness in order to be happy. And if you don't have any of these aspects, then the picture wasn't complete.

And when you look at the crises-- particularly emerging market crises, in particular in Argentina-- in order to have that big a crisis, in order to have a systemic change, you need to have more than one factor. And my directory point in the talk was that there is no single cause that actually can be attributed to be the origin of the crisis. The crisis has a number of preconditions. And maybe there is a trigger-- there is a shock that may be external, or a political mistake-- that causes all this fragility, latent fragility, to turn into a crisis.

And then, of course, people will attribute the crisis to this and that. And it would be a mistake-- and particularly policy mistake-- to think that changing that particular trigger would have avoided the crisis, because it was a precondition. And the crisis actually should eliminate the preconditions of the country, the inherent fragility of the country, in order for policy to start addressing the real causes-- the big causes-- rather than the triggers. The triggers are [? enigmata. ?]

CAROLINA PAN: Right. So it seems like people confuse the triggers with the causes, in the case of Argentina. But it also seems that anything can trigger a crisis in Argentina. Already, the pre-existing conditions are there all the time. Do you think this is the case? Do you think we are so unstable that anything could trigger? Or do you think now is a particular time because of particular factors?

EDUARDO LEVY YEYATI: I think Argentina has two deep handicaps. On the one hand, it exports very little, and this means that we have a structural dollar shortage. Or, in other words, if we want to grow at, say, 3%, 4%-- that would be 2% per capita GDP growth, which is the minimum to keep political stability over the long run. You would need to export, I think, twice as much. Or vice versa, with these export ratios, you can grow at 1%. That's not enough.

So what happens is that you are forced to inflate growth temporarily for political reasons, and that's typically being done by issuing debt. And at some point, that debt becomes ostensibly unsustainable, and then you have a run-- a run from investors, particularly international investors. And given that we have a second handicap-- a very weak, feeble currency that is not a reserve value for investors-- when you want to finance this inflated growth, you have to go to international capital markets. And you have to issue in dollars or in foreign currency, and you create a currency mismatch, a currency imbalance, meaning that whenever you devalue, you are automatically bankrupt.

So these two conditions combined-- the fact that you don't have enough dollars to grow at a reasonable pace, and that whenever you want to finance transitorily this artificial growth, you have to incur a currency imbalance-- opens the door to crises that might be triggered by an increase in the interest rate in the US, or by a decline in commodity prices-- we are exporters of commodities, particularly soybeans-- or because the political spectrum changes, and there is a government that's more populous and is more linked to Earth, not abiding by the law or complying with contracts.

But the trigger is [? enigmata, ?] as I said, because as long as you don't fix these two handicaps, you are in an environment that's staying inherently fragile. Any shock can actually turn this into a crisis, and shocks happen all the time. So you have to be prepared for that.

CAROLINA PAN: So I think that some of these conditions are region specific. So Latin America has a deep problem with exporting and the macroeconomic volatility. But still, some countries manage to grow, even in that context. Do you think that Argentina has something more?

EDUARDO LEVY YEYATI: Well, no country is identical to another one. I think that-- having said that, in Latin America, in general, the middle sized countries, the large countries in Latin America-- Mexico, Brazil, more recently Colombia-- have growth problems. And Chile will have-- is starting to have, to experience those growth problems, because originally, these countries were catching up from very low levels of per capita income. But now that they have reached the middle income, group they are facing what's typically called the middle income trap. They cannot actually go to the next step. So I think that the problems--

CAROLINA PAN: So you're not very hopeful for what's going to happen in the region.

EDUARDO LEVY YEYATI: What I'm saying is, they struggle to actually

make the next step, and it's going to take more than just continuing to do the same thing they were doing before. It probably will take a different type of reforms and a more focused development strategy.

But going back to Argentina, I think maybe Argentina is a particular case because of the lack of currency, of reserve currency. So whenever you want to actually finance those cycles, you become extremely dependent on international capitalists, typically reciprocally. They lend you when you don't need the money, and they never lend you when you need the money. So whenever you are approaching a recession, you are facing, typically, a problem of market access. Nobody wants to refinance your debt, and that adds to the fragility. So we have a real problem, in terms of exports and our capacity to growth, that is augmented by this dependence on external capital.

CAROLINA PAN: Right. And I also tend to think that external capital is also very moody in some ways. For instance, in the case of Argentina, I think that there's a very strong incidence of politics in economic performance. And then I believe this is also due to the fact that Argentina is a very expectations-driven economy, and then whenever expectations change, that affects what happens with investors and, in general, behavior of the economy. Do you think this is actually a case? Do you think that politics actually dictates what happens in the economy? And do you think there could ever be economic stability when you have political instability?

EDUARDO LEVY YEYATI: I think the two levels of instability are intertwined, because first of all, we're in a democracy. So if you have changing views in the population, you will have, almost by definition, changing views in the government, because the government has to, to some extent, represent what the population is actually voting, is actually choosing.

One thing is important to bear in mind is that when you talk about investment, investors. We need to invest more. Same in Latin America, and particularly now we need to invest more. There are two types of investment. In the real investments, one that is missing in Argentina. Investment that actually increases your growth capacity. And then you have a financial investment. A financial investment particularly in the mid 90s is characterized by her behavior. Because after the introduction of the Brady plan and the creation of emerging markets, particularly bond markets, you have an investor base. That people actually lend to a country. International investors lent Argentina for instance, that are extremely atomized, and follow her behavior. Which is mostly uninformed.

So it's true that they are driven by expectations. Sometimes are misled by expectations, and that makes them even more procyclical than they were before when it was banks rather than bondholders. The ones they're the creditors, the ones that were financing the country. So in the case of Argentina, this dependence has been compounding with the emergence of this new type of investor. Small investors essentially following the lead of large investors by behaving like in a herd. Our expectations are much more successful in attracting financial investors than real investors. Because the real investor is actually a more savvy, more informed investor. And takes a long run view, rather than the short run view that this illusion of liquidity. Say, yeah,

you can actually sell them on whenever things get-- starts worsening, which is an illusion.

Because if everybody sells, then you're going to lose in terms of the price that you're selling at. But this liquidity illusion actually makes these financial investors much more moody, as you say. Much more procyclical the real investors, on the contrary, they need to see more credible signals. A thing will be better. Not tomorrow, not today, but in two years, three years, four years' time when he is starting to reap whatever investments put in right now. That contrast I think is one of the characteristics that explains what happened Argentina in 2016. Because you saw a lot of positive expectations that were reflected. I would say an increase, a significant increase in capital inflows. But you never saw the corresponding demise in the real investor side. So we had a lot of finance. We could actually issue a lot of that, but we didn't grow. That's one of the reasons why we're facing now a financial crisis.

CAROLINA PAN: So a lot of speculation too. With what happens with the currency in Argentina. And so people actually want to make money out of it. So take advantage of the rates.

EDUARDO LEVY YEYATI: No. I think that there is a dimension that you were mentioning before. Politics and the message that the politicians sent to the markets. And markets react to that. Our problem is that the economy, the real investors don't react to that. We need probably to change the message, or at least to make it more credible in order for actual real investors to come to the country. Without real investment the only thing we have is a transitory inflation of growth financed by debt that ends up typically in a financial crisis. And an unwinding of these positions, partially bailed out by IMF money. So we need to probably change the message.

I think in Argentina in many countries, the governments tend to mistake the happiness in financial markets. The support of financial markets with the support of investors. The real investors are always trickier. And you need to be much more convincing to attract them.

CAROLINA PAN: And what would be the ideal scenario? What would a real investor need to come to Argentina happily, and stay?

EDUARDO LEVY YEYATI: Well, investors need to make money. That's why they come. So you need to have profitability. And you need to have sustainable profitability. Like in Argentina we have several sectors that were artificially profitable because of subsidies. You need to have sectors that could be profitable, even in the absence of subsidies. Those subsidies can work in the very short run. Stimulus but at the end of the day, a country with a fiscal problem cannot subsidize everything that investors are investing in.

CAROLINA PAN: I also think there's a role that the rules play in the sense that-- It seems like in Argentina rules are changing all the time. So you know what's the scenario today. You don't know what it's going to be in two months, or even in a year. So it's hard to plan.

EDUARDO LEVY YEYATI: But that's tied to the sustainability concept. If you are engaging in a stimulus, or a development plan that is based on

unsustainable subsidies-- Sooner or later, those subsidies will be cut down, or something else will appear. Because you cannot simply sustain this over time. So the message should be credible in the specific sense of being sustainable over the long run. That's one thing and then, of course profitability is associated not only with their productivity in [INAUDIBLE] within the firm, within the company. But also say the company. And that's where the rationalization, and I would say reduction that this optimization of fiscal spending comes into play. Because you would like to see the tax burden come down a little bit. But you cannot do that without reducing expenditure.

And you cannot reduce expenditure at the expense of, say, social spending. So you see there is sense of a catch-22 there. In order for a promise to reduce tax burden to be sustainable, and have an effect on investors. Then you should show the way in which you will achieve that lower tax burden without facing a fiscal crisis. Which is exactly what happened right now in 2016. Reduce export taxes, reduce-- You cut some taxes. And promises further cuts in tax burden, but at the same time, you didn't fix the fiscal deficit. And now you're actually reintroducing the taxes that you cut in 2016. So the conviction of this promise is entirely related to the sustainability of your plans. If your plan is not sustainable investors simply will not react.

CAROLINA PAN: So in this context of Argentina today, do you think there's any hope?

EDUARDO LEVY YEYATI: Yeah. There's always hope. If there weren't any hope then we wouldn't be talking about this, and we would be doing something else. I think the hope-- they only hope-- the only upside of a very unnecessary and socially costly crisis is that it makes you face the urgency for some reforms, some changes. And out of that urgency you can get the courage, or the altruism, political altruism to actually prioritize what's best for the country. So there is hope in that this crisis open up that possibility. A new consensus. And I'm hoping that this will get a more constructive view next year at the minimum cost. Because a crisis actually can always deteriorate to a full blown crisis like 2001. So I'm hoping that that's not necessary. That's not the case.

But there is always hope we know what we need to do. The problem is how do you do that. How do you coordinate the different interest groups, how you negotiate the distribution of costs. Because with every reform has winners and losers. And we need to find a way to put everybody, all the actors, all the participants, the shareholders on the table. And to negotiate who pays what, who gives what. This is something that's very difficult Argentina. This is my view of a consensus. A distribution of cost, not the distribution of gains. And that's something that crises can actually trigger.

CAROLINA PAN: Right. Very interesting. So do you think that we agree on what our main economic problems are. And we just disagree on what policies we need to implement? Even taking the political aspect aside. Do you think every party agrees what our main issues are?

EDUARDO LEVY YEYATI: No. There is no full agreement. There are some partial agreements. For instance, we know that we need to do something with the Social Security reform, Social Security scheme in order to

prevent the deficit from widening. And offsetting-- I would say more than offsetting whatever fiscal consolidation we are getting this year. I mean, it's very costly to do this fiscal consolidation to the fiscal adjustment. And we are going to lose within five years if we don't do anything with the Social Security system. Now, what social security scheme we want, that we don't know. In fact, I prefer one that's more distribution is New Zealand. And I'm pretty sure what most people in Argentina prefer is more of a contributed scheme, as the one that we have now.

The problem is not that we differ on the scheme. At the end of it they we'll have different preference. The point is that you need to sit everybody on the table and agree with one scheme. And at least get 51% of a vote. We need to have a minimum consensus to pass a reform. A reform that will incorporate this diversity of views, but at the end of the day we'll favor one view over the other. The problem is when you are in standstill, and no view actually can be pushed forward. Because you don't have any consensus. And then there is no reform. I would be happy to have a social security reform that is sustainable, even if it's not as distribution as I would like to.

I'm unhappy in economic terms if we ignore reform, and we face another problem with the fiscal deficit in 3 years. So it's not common view that we are asking for. It's just a place where we can trade views and negotiate something that can be actually implement.

CAROLINA PAN: Right. So it's getting something done. Having policies that favor the economy rather than the elections. Being more radical in how we implement our policies, and even if we're all not in full agreement, knowing that we should take some direction somewhere.

EDUARDO LEVY YEYATI: Yes. I think the standstill that we are in right now is worse than choosing any of the options that are on the table-- have been on the table for a while. And I think we tend to agree on the priorities. They would oppose prioritizing in budgetary terms-- education, particularly public education. Given that you have this degree of poverty. And this very low social mobility. The question that we have to negotiate is where the money's coming from. So as I said, it's not negotiating who gets what. It's actually who doesn't. In a sense, economic is like that. It's the allocation of scarce resources. So we have to decide who's not going to get something that now he's getting, or where to get the resources.

That negotiation is a positive sum game. So at the end of the day you will probably grow more in. We'll have more to distribute. Whether the first time, at the beginning you have to be aware that some point you will have to take something from someone. And if you don't state the negotiation this form, then you are fooling the voter, or fooling the stakeholders. So you need to be very clear about that. Who pays for what. What every one of these actors is actually giving, and putting on the table. That's never been done in Argentina. That's probably-- in my view, is probably the deeper political pending assignment, so to speak.

CAROLINA PAN: And finally, and to wrap up. Going back to the beginning. Going back to the title, you were talking about these deep roots that make the crisis actually Aristotelian. And I think those

roots are very embedded in our institutions and in our culture. Do you think those could be changed, or that we just have to deal with that? That's what we are. And then we have to make all necessary adjustments to just be normal again?

EDUARDO LEVY YEYATI: Let me put it this way. The most likely scenario is that we are not going to change. But that's also the case in many other countries because it's very difficult to impose cultural change. There's no way they can do that from the top. Now, faced with this scenario in which we are going to essentially repeat ourselves. [INAUDIBLE] in which we have crises. We are already little. We are always complaining. We're always missing a mythical time in which we were reach like Australia, which never happened. But nonetheless, it's something that's always in our minds. I think that looking that scenario in the face can actually trigger a reaction. And the reaction would be to do somethings differently.

To understand that some of our beliefs, we have myth, we have illusions. And to start from scratch. I think there is a choice and there is a hope, but it's not going to happen naturally. There should be a disruption. A political disruption leads to a change in the way people think some of these topics. And for that you need a leader. A leading party, but particularly a strong leader that is willing to lose an election. Is willing to lose some support in order to impose what he thinks is the direction of the next step. We're still missing that, but everybody can change also countries.

CAROLINA PAN: Thank you very much, Eduardo. This was a very interesting talk.

EDUARDO LEVY YEYATI: Thank you.

SPEAKER 3: If you want to learn more about the Growth Lab's latest research and events, please visit growthlab.cid.harvard.edu. See you next week.