Economy

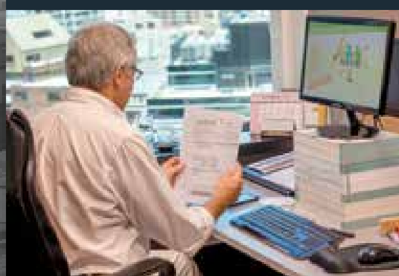
GDP expands 3.6% year-on-year in first quarter of 2018

Tax amnesty law leads to $117bn in repatriated funds

Cambiemos coalition wins October 2017 legislative race

Budget consolidation causes lower fiscal deficit in 2017

Public efforts support smaller enterprise development



Fisheries recorded the fastest growth in 2017, with a 14.3% expansion

Improving indicators

GDP, trade and credit growth on the back of an increasingly open and liberalised market

PULL STAT:

GDP grew by

3.6%

year-on-year in the first quarter of 2018

Following the inauguration of President Mauricio Macri's centre-right government in December 2015, the Argentine economy has embarked on a period of structural change propelled by increasingly liberalised policies. Under this leadership, the authorities have been rolling out various reforms to bring the country back onto the global stage, step up international competitiveness and accelerate GDP growth.

However, the nation has faced a number of obstacles, including a recession in 2016, when there was a sharp reduction in investment and production, further depreciation of the currency, and a drop in imports and exports. That year was also a tumultuous one for Brazil – Argentina's largest neighbour and primary trade partner – which further contributed to these challenges. Nevertheless, the government pushed forward with a series of reforms, which helped bring about a rebound in 2017 and positive outlook for 2018.

GDP PERFORMANCE: After the 1.8% contraction in 2016, Argentina's GDP expanded by 2.9% in 2017. Growth continued to accelerate in the first quarter of 2018 at a rate of 3.6% year-on-year (y-o-y), according to the National Institute of Statistics and Census (Instituto Nacional de Estadística y Censos, INDEC). These figures position Argentina as the third-largest economy in Latin America, worth AR2.91trn ($150bn) in constant 2004 peso terms in 2017 – behind Brazil and Mexico, but ahead of Colombia. Meanwhile, IMF figures show that the country had the eighth-highest GDP per capita in the region, at $19,015 that year. This places the country in the top third of the regional spectrum, between Uruguay ($20,377) and Mexico ($18,129).

With 20.2% of the country's gross added value, manufacturing was the largest economic contributor in 2017, followed by retail and wholesale trade (15.6%).

SECTOR BREAKDOWN: INDEC figures show that manufacturing comprised the plurality of the country's gross added value in 2017, with 20.2% of the total. This was followed by retail and wholesale trade (15.6%); real estate, business and rental activities (12.3%); transport and communication (9.8%); and agriculture and livestock (8.2%). These top contributors all posted growth in 2017, with the only contractions seen by mining and quarrying, utilities and private households with domestic service.

Fisheries and construction experienced the fastest expansion, with 14.3% and 10.3%, respectively. In the first quarter of 2018 growth was more evenly distributed, though these two remained at the top, with a 9.7% y-o-y increase in construction and 6.2% in fisheries. Construction is expected to remain a top performer throughout 2018, supported by the government's prioritisation of infrastructure projects and a continued increase in mortgage lending.

BACKGROUND: The 2001 collapse of the economy – known locally as *el corralito* – saw Argentina's GDP drop by 10.9% in one year, resulting in a crash of the financial sector and outbreaks of violence. While the economy and society were able to bounce back, citizens maintained a negative perception of liberal policies, such as those supported by right-wing President Carlos Menem, in power from 1989 to 1999. Locals blamed this *laissez faire*-style government for destabilising the country, which resulted in the election of both leftist President Néstor Carlos Kirchner in 2003 and his wife, President Cristina Elisabet Fernández de Kirchner, in 2007 and 2011.

Both of these administrations introduced interventionist measures that reached their peak during then-President Cristina de Kirchner's second term. Among these policies were strong currency controls, taxes on exports, import regulations and fixed prices on certain goods. Given the government's aggressive stance against foreign influence – especially due to its unwillingness to service its external debt – the economy retracted. The state mainly sourced funds from within its borders, and companies serviced the internal market. This resulted in a decline in Argentina's position in global markets, which hampered the competitiveness of domestic companies. Despite this, businesses were able to stay afloat due to the government's protectionist measures.

The government of President Macri is seeking to help Argentina reopen its borders and regain its global position. However, rolling back policies from the years of so-called Kirchnerism has proven more difficult than expected. Despite the victory of President Macri's coalition during the 2017 legislative elections – allowing it to pass landmark reforms and provide greater assurance to international investors – public opinion remains divided on how the country should further develop. Therefore, the success of this push towards a more liberalised economy will largely depend on whether this leadership can deliver better results than its predecessors.

HISTORICAL GROWTH: These widely varied approaches have been accompanied by similarly asymmetrical economic development, with sharp drops and quick rebounds. After hitting a peak growth rate of 10.5% in 1991, GDP progressively decelerated until 1995, when it recorded a 2.8% contraction, before expanding by 8.1% in 1997. Following this, GDP declined steadily through to the largest crash in the country's history: a 10.9% drop in 2002. The 2003-07 period saw stable growth of 8-9%, but the 2007-08 global financial crisis hit the country harder than most other emerging markets, leading to a 5.9% contraction in 2009, although this was followed by robust rises of 10.1% and 6% in 2010 and 2011, respectively. The 2012-16 period brought alternating years of moderate expansion and recession believed to be in part due to the aforementioned interventionist measures of Presidents Kirchner and de Kirchner, resulting in a relatively flat average annual contraction of 0.05%.

TRADE: Recession in 2016 led to a sharp drop in imports, which caused a $1.97bn trade surplus that year. Conversely, the subsequent economic rebound in 2017 brought about one of the largest trade deficits in Argentina's history, worth $8.52bn. This has both positive and negative implications: while it reflects the more favourable position of consumption and openness of the market to international influence, it also indicates a lack of competitiveness of Argentina's exportable goods.

The deficit continued to widen in the first five months of 2018, with imports rising by 17.9% y-o-y, outpacing export growth of 7.1%, to reach a negative balance of $4.69bn by the end of May 2018. The number of domestic companies that export goods has been persistently low, but the period since the 2007-08 global financial crisis has seen this figure dip further from a peak of 15,100 in 2006 to 9700 in 2016 (see Trade & Investment chapter).

DEFAULT: The 2001 financial crisis led to the largest sovereign debt default in history up to that point – for $102.6bn, composed of $81.8bn face value and $20.8bn of past-due interest – and caused the country to be barred from international finance for 15 years. The restructuring of the debt was undertaken

Imports rose by 17.9% year-on-year in the first five months of 2018, outpacing export growth of 7.1%

in several stages, with President Macri striking the final deal in 2016 after years of legal battles.

The first restructuring came in 2005 after negotiations hit at an impasse. Argentina made a unilateral offer to creditors on relatively unfavourable terms, resulting in $62.3bn, or 72.2% of the face-value debt, exchanged for $35.2bn. In 2006 the government repaid its $9.5bn debt to the IMF to free itself of the fund's policy constraints, and in 2010 a second bond exchange was concluded with some $12.4bn of the $18.4bn issued. The 2005 and 2010 restructuring efforts collectively covered 91.3% of the debt.

However, ongoing litigation from holdouts pushing for full repayment prevented Argentina from participating in international credit markets, with one hedge fund going so far as to seize the country's assets. A US court ruling barred any bank operating in the US to participate in debt restructuring before holdouts were paid in full, which resulted in a so-called selective default in 2014.

After assuming office in late 2015, President Macri's government settled agreements with Italian and US holdouts in February 2016. It made final remunerations with a $475m payment in November 2016, thus settling all outstanding debt.

EXTERNAL DEBT: Argentina's rekindled openness and development plans have caused external debt growth. This has risen from $170bn in the fourth quarter of 2015 to $233bn two years later – a 37% increase. At the end of December 2017 the government accounted for 61% of this, while the Central Bank of Argentina (Banco Central de la República Argentina, BCRA) held 8%, deposit-taking corporations 3%, other financial institutions 1% and other sectors 27%. The authorities still face substantial external financing needs, so debt will likely continue to rise, albeit at a slower pace, in the coming years.

PUBLIC FINANCES: In early 2018 the government reported that it exceeded expectations in lowering

After the 2016 recession caused a trade surplus of $1.97bn, an economic rebound in 2017 brought about one of the largest deficits in the country's history, worth $8.52bn.

External debt increased by 37% in the first half of President Mauricio Macri's administration, from $170bn in the final quarter of 2015 to $233bn in the same period of 2017.

PULL STAT:

The fiscal deficit for 2017 was 0.3 percentage points lower than the forecast at

3.9%

of GDP

the fiscal deficit for 2017, reaching 3.9% of GDP instead of the initial forecast of 4.2%. This represents a notable drop from 2015 and 2016, when the deficit reached 5.4% and 4.6% of GDP, respectively.

Although the IMF projects that the primary deficit will decline by 2% of GDP by 2019, it expects the current account deficit to increase to 4.4% of GDP by then. To avoid this, the government is reducing spending on wages, pensions and social welfare – key expenditure recipients under Presidents Kirchner and de Kirchner – and encourage greater private sector participation in these. While these moves are crucial to rebalance the budget, they are likely to be met with strong opposition by the populace, especially the most vulnerable segments. The authorities are seeking to reduce the public sector's contribution to welfare.

FOREIGN EXCHANGE: Argentine policymakers have a strong history of controlling the local currency. Between 1992 and 2001 the peso was pegged to the dollar at AR1:$1. After the 2001 crash, however, it started to depreciate, reaching AR2.95:$1 in 2002 and AR9.66:$1 in November 2015. During the administrations of Presidents Kirchner and de Kirchner the BCRA kept a firm grip on the peso as part of efforts to keep a lid on inflation, which resulted in a wide variation between the blue-chip – or informal exchange – rate, the exchange rate for those travelling abroad and the one for bond purchases.

The government of President Macri liberated the exchange rate, bringing it closer to the blue-chip rate. These rates had previously deviated significantly from one another, with the official rate at AR9.19:$1 and the blue-chip rate at AR14.95:$1 in July 2015. After the government allowed it to float, the local currency officially depreciated by approximately 30% to AR12.90:$1 by the end of that year. The BCRA has since regulated this, selling dollars in the market to further depreciate the currency and thus control inflation. However, this has also put pressure on the bank's foreign reserves: by March 2018 the BCRA had intervened five times, collectively costing $4bn of foreign reserves. While this contradicts the government's plans to allow the currency to float freely, the state considers it necessary to protect against hyperinflation.

INFLATION & MONETARY POLICY: Argentina has long faced difficulties with inflation, seeing historic highs of more than 3000% in 1990 as well as periods of deflation between 1999 and 2001. A sharp increase in 2007 led to government intervention in INDEC operations. The then-executive branch tampered with the institute's inflation data, thus discrediting its findings until President Macri restructured the body in late 2015. Inflation declined from 40.3% in 2016 to 24.8% in 2017, which was considered a major achievement of the administration.

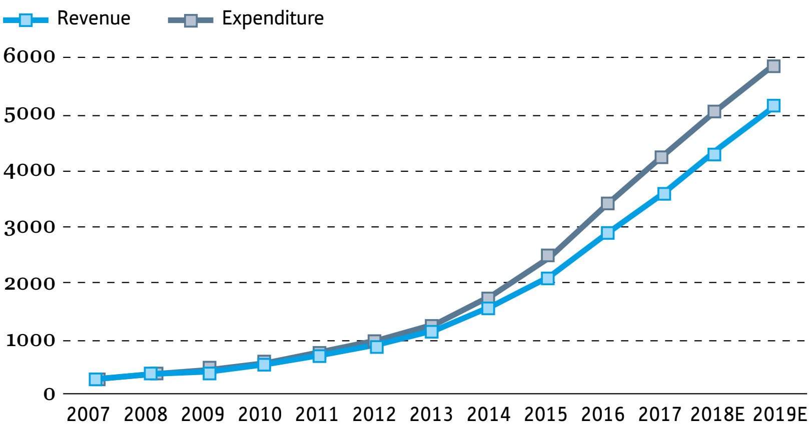
In an effort to continue moderating inflation, the BCRA increased its key interest rate from 24.75% in 2016 to 28.75% in December 2017. Over two weeks in late April and early May 2018 the bank hiked this rate by 13 points to 40%, on the back of declining investor confidence resulting from a large sell-off of pesos. With credit as percentage of GDP remaining low, the BCRA is facing the challenge of keeping inflation in check while incentivising credit growth. The first half of 2018 saw cumulative inflation of 16%, already higher than the government's 15% goal for the year. Throughout the first half of the year these higher-than-anticipated figures caused industry specialists to revise their inflation expectations for the year upward, to 27% in July 2018.

RATING: The successful implementation of various reforms and improving macroeconomic fundamentals have caused international rating agencies to improve Argentina's sovereign credit rating. In October 2017 Standard & Poor's raised this from "B" to "B+". Moody's subsequently upgraded the country from "B3" to "B2" in November 2017, and Fitch has maintained its rating of "B" since May 2016. While the outlook has improved, rating agencies point to key challenges facing the country, especially the fiscal deficit and vulnerability to exogenous pressures.

PRIVATE DEBT: Credit was once seen in a much less favourable light. In the lead-up to 2015 very little was done to incentivise banks to participate in the economy, and the 2001 financial crisis – which saw the freezing of most accounts – severely eroded trust in financial institutions. These factors contributed to a credit-to-GDP ratio of 11.8% in 2016, one of the lowest in Latin America and down from 25% in the 1990s. However, accelerating economic growth and liberal policies have contributed to a rise in credit, spearheaded by mortgages, a previously non-existent segment (see Banking chapter).

AMNESTY: The relative success of a tax amnesty law – which brought in $117bn of offshore funds in March 2018 – is seen as a sign of rising investor confidence. The law offers attractive terms to help repatriate the estimated $400bn of assets held by Argentines outside the country. The move brought in AR148.6bn in taxes and fees to help bridge the fiscal deficit for the year. "While increased confidence is

General gov't revenue & expenditure, 2007-19 (AR bn)



Source: IMF World Economic Outlook April 2018

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a factor behind the relative success of the amnesty law, we must not overlook the global change in consciousness with regards to international capital flows – some countries have become less lenient with matters such as tax evasion and sources of funds," Diego Finchelstein, professor of economics at the Universidad de San Andrés, told OBG "I believe both factors are important to consider."

DEVELOPMENT PLAN: In further support of economic targets, in 2016 the government launched the National Productive Plan (Plan Nacional Productivo, PNP) to increase production, attract investment and boost employment across key sectors. The initiative comprises eight pillars, aiming to lower the cost of capital; enhance human capital and labour productivity by strengthening vocational training, promoting employment, formalising labour, and reducing absenteeism and labour litigations; develop infrastructure to bring down logistics and energy costs; expand investment in research and development to be equivalent to 1.5% of GDP; support fiscal sustainability through a policy that aims to facilitate growth, decrease informality and increase investment in production; defend free competition and market transparency by favouring new entrants, lowering input costs and protecting consumers; reintegrate the country into global supply chains and boost exports; and facilitate and de-bureaucratise administrative procedures.

Smaller reforms have been passed in support of the broader goals of the PNP, including infrastructure initiatives in various stages of development. For example, the Biotechnology Law was passed in January 2018 to incentivise investment and innovation in biotech, but others are still being discussed.

HUMAN CAPITAL: The human development and labour productivity pillar of the PNP addresses an important gap – the World Economic Forum (WEF) ranked Argentina 52nd out of 130 countries with regards to human capital development in its "Global Human Capital Report 2017". While this only places it in the upper half of global economies, it was the top performer in Latin America, ahead of Chile (53rd), Peru (66th), Colombia (68th), Brazil (69th) and Mexico (77th). This top regional position was due to Argentina's relatively large, young and skilled population, with 40.6% of its 44.5m residents below the age of 25 in 2018. However, the WEF reports that ascending the global ranking would require stepping up the quality of the education system, as well as reducing unemployment and underemployment, which are all priorities of the PNP.

SOCIAL PRESSURES: Although President Macri's *Cambiemos* (Let's Change) coalition has implemented landmark reforms across a variety of sectors – including sensitive issues such as pensions – it faced resistance from certain segments of the population and opposition lawmakers (see analysis). There have been several general strikes across the country since 2015, both before and after President Macri assumed office. The transport unions – among the largest and most powerful in the country – went on strike twice in 2015 before the general election, resulting in an estimated $100m in daily losses.

The General Labour Confederation, teachers, bankers, health care workers and other unions have also taken to the streets on various occasions, typically demanding salary increases due to the sharp depreciation of the peso and high inflationary pressures. The 2017 pension reform similarly resulted in widespread protests and a general strike. Domestic labour unions are well organised and play a pivotal role in policy-making. Therefore, the government, aiming to liberalise the economy and reduce the role of the public sector, will inevitably face an uphill battle in implementing its planned reforms.

OUTLOOK: Increasingly liberal policies since 2015 are generally considered to have resulted in growth in investor confidence and improving macroeconomic indicators. However, challenges remain: to simultaneously lower inflation, improve competitiveness and maintain purchasing power, the government will need to continuously adapt its policies to address changing market trends.

Although many of President Macri's policies have been met with opposition, the majority of the population supports these efforts, as evidenced by the Cambiemos coalition's win during the October 2017 legislative elections. With now-unified executive and legislative branches, the government will need to undertake fiscal consolidation without negatively affecting the most vulnerable populations.

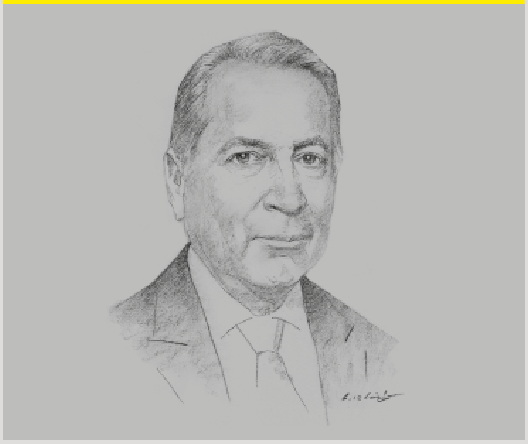
The IMF anticipates a gradual reduction in the primary account deficit in the coming years, with inflation subsiding and GDP growth. This should be supported by private consumption, which is expected to increase following the 2016 decline.

In 2016 the government launched the National Productive Plan to increase production, attract investment and boost employment across key sectors. The initiative comprises eight pillars.

Economic indicators, 2017-20

	2017	2018	2019	2020
GDP, current prices (AR bn)	10558.50	13012.01	15483.81	17942.77
GDP per capita, current prices (AR)	239518.55	291947.99	343607.73	393820.83
Total investment (% GDP)	19.07	17.40	17.41	17.77
Inflation, avg. consumer prices (% change)	25.68	22.68	15.41	12.32
Vol. of imports of goods & services (% change)	14.16	10.61	7.13	5.70
Vol. of exports of goods & services (% change)	-0.45	5.22	6.41	5.65
Population (m)	44.08	44.57	45.06	45.56
General gov't revenue (AR bn)	3596.77	4424.69	5188.82	5950.42
General gov't revenue (% GDP)	34.07	34.01	33.51	33.16
Total gov't expenditure (AR bn)	4278.53	5140.40	5944.32	6666.86
Total gov't expenditure (% GDP)	40.52	39.51	38.39	37.16
Gov't net lending/borrowing (AR bn)	-681.76	-715.71	-755.51	-716.44
Gov't net lending/borrowing (% GDP)	-6.46	-5.50	-4.88	-3.99
Gov't gross debt (AR bn)	5555.33	7039.71	8167.24	9365.16
Gov't gross debt (% GDP)	52.62	54.10	52.75	52.20

Source: IMF World Economic Outlook April 2018



Daniel Funes de Rioja

Catalyst for change

Daniel Funes de Rioja, B20 Chair, on building investor trust through the G20 presidency and adapting the labour market

How might the G20 and B20 presidency help build trust in Argentina's long-term growth stability?

FUNES DE RIOJA: The G20 and the B20 are going to be extremely important in both the domestic and international communities. In the end, Argentina will be reliable when stable long-term policies are in place and our society perceives globalisation and being an important part of the world as necessary. Due to our history, with highly variable movements on economic, political and social fronts, the G20 process could be a great catalyst for a new spirit, philosophy and commitment to be instilled from Argentina towards the world, and vice versa.

We are convinced that there is a serious and responsible government in place, with space for debate and dialogue with all political actors. This is the only way to generate a necessary strategic plan for Argentina's reinsertion into the world, similar to what Chile, Peru and Colombia have done in the past. Our society is ripe for this, and it is our responsibility as organisers to ensure that the both the G20 and the B20 have a direct, real and positive impact on our society and business community, especially small and medium-sized enterprises, as we need them to be an active part of this undertaking.

How is Argentina developing its human capital according to future labour needs?

FUNES DE RIOJA: Education, business and employment must be inextricably linked. There is a significant challenge, not only in research and development, but also in terms of technical training. These areas must be updated, because we will need to focus on technical training to meet the demands of both the modern and the future world. We want and need a level of commitment that encompasses entrepreneurship and workers alike. We are starting to see more technological production models in the automotive industry, for example, with more sophisticated automated processes. The same situation applies to the food processing industry.

Industry 4.0 has already begun, and it will keep expanding as foreign direct investment levels continue to increase. We have to prepare for a future in which there might be less need for workers in production processes. The government, companies, unions and academia should design a strategic technical training plan for the future of the country.

What are the priorities to lower labour costs, and how might Brazil's reforms affect this?

FUNES DE RIOJA: Argentina has a formal labour market of around 11m workers. About 65% of this is private, 32% public – which is double the rate of any other country – and the rest goes to miscellaneous categories, mainly self-employment. This means that there is an alarming 35% of the labour market taking part in informal activities. Therefore, from a general point of view, reforms will not bring greater instability to the market because it is already unstable. Our labour regulations are old, obsolete and Fordist, in that they are highly regulated in the individual aspect and strongly concentrated on the collective.

We have challenges to address in productivity, absenteeism, high rates of litigation and elevated labour taxes. These are particularly pronounced in the labour-intensive industries that are concentrated in the northern and eastern regions. The Brazilian reform generates a productivity challenge in integrated spaces such as Mercosur. Then we have to actively respond to domestic challenges with a long-term policy that integrates all members of society.

We need more flexible labour regulations with an agile recruitment and dismissal regime, and adequate funding systems. In essence, we must adapt to a new reality in the 21st century. Unions will more than likely play an important role in this transition, but we need to find common ground to move forward.

Efforts to restructure financial services have been under way since 2015

Policy revision

October 2017 win of *Cambiemos* coalition set to facilitate President Mauricio Macri's liberalisation agenda

Since taking office in December 2015 President Mauricio Macri has implemented sweeping reforms to improve the Argentine economy, incentivise private sector development and increase investor confidence. However, after 15 years of interventionist policies some lawmakers and segments of the population have protested these efforts. The landmark win of President Macri's *Cambiemos* (Let's Change) coalition in the October 2017 elections has turned the majority of the legislature – previously dominated by the opposition party – to liberal lawmakers, thus augmenting the executive branch's ability to achieve its policy goals and change the regulatory framework.

QUICK WINS: One of the administration's first moves after taking office was to lift currency controls that kept the exchange rate artificially high. Mandatory one-year deposits in foreign currency applied to *encaje* (capital inflows) into local financial institutions were eliminated, enabling natural and legal persons to purchase up to $2m of foreign currency, which could be held in a foreign or local account. This permitted the free circulation of capital, which had previously been tightly controlled, and resulted in much lower capital outflows than expected. The 35% tax on the purchase of products abroad through the use of credit or debit cards was also lifted.

The liberalisation of the exchange rate and capital movements – coupled with the removal of export tariffs and import controls – were well received by private operators, particularly those who rely on exports and imports (see Trade & Investment chapter). Farmers sold their stockpiles, and local manufacturers began importing much-needed goods for local production. Meanwhile, several foreign companies took this opportunity to repatriate part of their capital on more favourable terms. In this context, and given the economic downturn during 2016, foreign direct investment dropped by more than 50% that year. Companies previously shielded from imports also came under pressure, as years of protectionism prevented them from becoming globally competitive.

FINANCIAL FRAMEWORK: Further contributing to its efforts to augment global trade, the government rolled back several interventionist policies in the financial sector. Banks saw the elimination of interest rate caps, thresholds on banking fees and requisites to lend a portion of their portfolios at lower-than-market rates (see Banking chapter).

Furthermore, the conclusion of negotiations on the repayment of the country's outstanding debt with holdout creditors in November 2016 resulted in regained access to international capital markets. This re-entrance saw a record $16.5bn bond issued in April 2016, the first after 15 years of isolation. The country then issued a smaller, yet perhaps more ambitious, $2.75bn, 100-year bond in June 2017. Having attracted $9.75bn in orders from investors, this could point to greater stability in a country that once defaulted on $100bn worth of bonds.

Since 2015 efforts have been under way to restructure financial services, with reforms to the central bank, stock exchange and capital markets regulator. The goal of these measures has been to reintegrate the financial sector into the economy while boosting its growth potential.

SUBSIDIES: According to the IMF, energy subsidies – which were introduced following the 2001 financial crisis – represented 3.25% of GDP in 2015, or $17.5bn. Meanwhile, transport received subsidies equivalent to 1.4% of GDP, with public transport accounting for 70% of this. A rising fiscal deficit, worth 5.4% of GDP in 2015, and a lack of investment in new production capacity resulted in state efforts to normalise prices at the beginning of President Macri's leadership.

The first price hike was introduced in 2016, when the government aimed to cut electricity subsidies by $4bn, but it was nullified for the residential segment, as the government did not hold public hearings.

PULL STAT:

In June 2017 the government issued a 100-year bond worth

$2.75bn

Measures to normalise prices and reduce the fiscal deficit began in April 2016, when the government aimed to cut down subsidies by $4bn.


The Public-Private Partnership Law was passed in 2016, with incentives to support 52 proposed projects

PULL STAT:

In December 2017 the corporate income tax rate was decreased by 10 points to

25%

Contrary to public goals, this caused subsidies to increase to 3.6% of GDP in 2016. Towards the end of 2016 the authorities enacted a pricing scheme that would phase out energy subsidies over the period leading up to 2022 (see Energy chapter). However, anticipated widespread popular opposition prevented the government from putting transport subsidies on the chopping block by mid-2018.

FISCAL REFORM: A landmark tax reform was passed in December 2017, reducing the corporate income tax rate from 35% to 25% and establishing a dividend withholding tax rate to promote the reinvestment of profits. Further alterations were made to personal income, excise, fuel and value-added taxes, as well as social security contributions, to be gradually implemented in the lead-up to 2022. Luciano Laspina, president of the legislature's Budget and Finance Committee, announced that these reforms should reduce citizens' tax contribution by 1.5% of GDP, thus serving to stimulate investment and job creation. The government is implementing tax reform to boost revenue and hit ambitious targets to reduce the fiscal deficit from 3.9% of GDP in 2017 to 2.7% in 2018 and 2.2% in 2019.

The government has also been working to expand the tax base, tackle cases of non-compliance and open communication channels with taxpayers. The Federal Administration of Public Revenues (Administración Federal de Ingresos Públicos, AFIP) is being restructured, with an overhaul of its staff, new instruments and technology to collect information. As part of this, the AFIP began requiring tax returns to be filed online.

SOCIAL SECURITY: The legislature also passed a new social security framework in December 2017. While this will have fewer repercussions on the business environment than other reforms, it was met with much more popular resistance. It altered the calculation of pensions, now growing 70% in step with inflation and 30% with formal salary rises (see Insurance chapter). This resulted in a 6% increase in benefits in March 2018 – much lower than the 15% anticipated under the previous calculation system.

The 2018 draft budget reported that 10 public-private partnership projects are set to be finalised by 2020, with another 10 reaching at least two-thirds completion by that year.

Meanwhile, planned labour reforms were postponed due to growing opposition. The proposed bill aimed to lower costs for employers across various metrics and provide a clear path to the formalisation of unregistered workers. However, in a country where labour unions hold significant sway over the economy, passing this will be no easy feat.

NEW STRUCTURE: Structural reforms are under way to improve the efficiency and transparency of administrative bodies. The first step towards this was the creation of the Ministry of Modernisation in late 2015. This body serves to improve public sector functions by revising processes, identifying administrative hurdles, integrating technologies across departments and coordinating with the provinces to ensure that policies are properly implemented at the federal level.

President Macri's government also moved to re-establish the credibility of the National Institute of Statistics and Census (Instituto Nacional de Estadística y Censos, INDEC). Trust in the body had been lost both locally and internationally, as the former administration was believed to have tampered with any data that did not conform to the government's targets, including inflation, GDP growth and poverty. While the IMF deemed INDEC credible once again in November 2016, deliberations are ongoing on how to further this and change its legal structure.

Public tender processes also saw an overhaul, with projects now required to be posted online, as is the case for company submissions. These changes will increase accountability and transparency in public procurement contracts, as well as mitigate the risk of cartels or oligopolies forming. Law No. 27.275, passed in September 2016 and effective as of September 2017, represents another step towards transparency and accountability of public bodies through the establishment of the Access to Information Agency and an online portal. It also establishes an independent monitoring entity for each power of the state.

PRIVATE PLAYERS: In a bid to fulfil its infrastructure programme and boost private sector participation, the government passed the Public-Private Partnership (PPP) Law in November 2016, effectively repealing the 2005 regulation (see Trade & Investment chapter). The law has brought mechanisms for conflict resolution between public and private stakeholders through expert panels and arbitration. It also offers incentives for PPPs, such as temporary tariff-free imports, tax exemptions and the ability to use a PPP contract as a guarantee for loan applications. The Ministry of Finance highlighted 52 projects it aims to develop through PPPs, collectively worth an estimated $21bn.

The 2018 draft budget reported that 10 projects should be delivered by 2020, with another 10 to be at least two-thirds completed by that year. Among the largest PPPs are plans to construct 2800 km of highways and 4000 km of roads, improve freight railway lines, build and renovate prisons and hospitals, develop the energy network and construct housing units.

Mariano Mayer

Small firms, big plans

Mariano Mayer, Secretary of Entrepreneurship and Small and Medium Enterprises, on bolstering competitiveness

What steps have been taken to make small and medium-sized enterprises (SMEs) competitive?

MAYER: Argentina has competitiveness and productivity issues, and in response to that we propose not to be cheaper, but to be better. Beyond weak infrastructure and unstable macroeconomic conditions, SMEs are most concerned about taxes, financing, labour costs and bureaucracy. In that context, the newly issued SME Law lowered taxes for these companies for the first time in years, complemented by new lines of credit and the Productive Financing Law. The Occupational Risk Insurers Law was also modified in order to reduce labour costs.

In regards to bureaucracy, it is estimated that we can save up to 1% of GDP with the bureaucratic simplification process already initiated by the national government. We are applying the concept of "think small first", taking steps on a smaller scale before implementing them at a general level. There are a number of other examples, such as the creation of the Secretariat of Productive Simplification, whose mission is to dismantle the layers of bureaucracy added in previous decades.

What are the reasons for low adherence to the SME Law, and how can this be improved?

MAYER: Today, SMEs that are taking advantage of all the benefits of the SME Law represent only a small percentage of the total. Many do not know about the law, and many believe it does not apply. There are also SMEs that simply do not want to join due to fear or scepticism. This is understandable, as many SMEs have been mistreated in the past.

Looking ahead, we aim to reach 1m SMEs in the next few years, up from the 6000 that had signed on as of July 2018, so we are targeting provinces where participation is especially low. Beyond this, we want more people to feel the possibility of opening a business in Argentina. Argentines have a great entrepreneurial spirit, but there are certain things that must be changed in order to exploit it.

What is being done to leverage the contribution of knowledge-based services (KBS)?

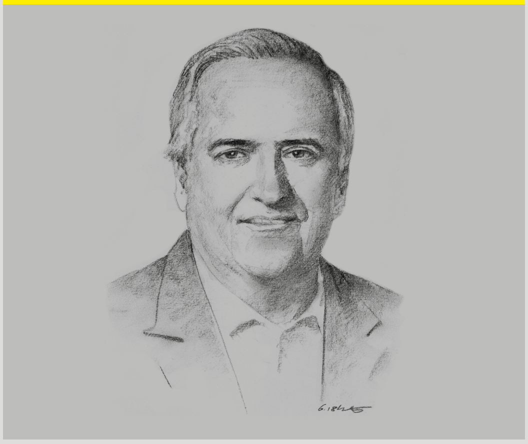
MAYER: KBS is an extremely important sector of the economy, and today it represents the second-largest export industry in Argentina, with the potential to create as many as 500,000 high-quality jobs, according to figures from the Argentina Software Industry Chamber. Technology clusters are therefore being developed throughout the country to boost its impact on the national economy and encourage better communication channels.

Although KBS is viewed as a vertical sector, we see potential not only in the vertical chain, but also in the horizontal line, improving the productivity of the rest of the Argentine economy, and to some extent following the case of Israel.

One of the most important segments in Argentina is agro-technology. In this area, we do not only want to be technology users, but also producers and generators of technological solutions.

How have companies in the SME sector changed their views on energy efficiency?

MAYER: The recent turbulence in the Argentine economy brought to light the need for working capital to be offered at lower rates for SMEs. For a long time, energy was not part of the cost structure for SMEs; in many cases, it did not reach 1% of their overall costs, so efficiency was neither sought nor encouraged. However, the gradual increase in energy tariffs spurred a change in companies' approaches. Those that invested little resources in efficiency suddenly found themselves in desperate need of doing so. This is why we implemented specific programmes to help SMEs following the macroeconomic turbulence we saw in June 2018.



Luis Pagani

A stable foundation

Luis Pagani, CEO, Arcor, on supporting small and medium-sized enterprises (SMEs) and boosting competitiveness

In what ways could Argentina's SMEs achieve higher levels of internationalisation and integration into global value chains?

PAGANI: Argentine SMEs have developed their businesses in a macroeconomic environment that is not always propitious, without the possibility of accessing financing and facing a tax burden that in recent years has risen by 10 percentage points of GDP. One of Argentina's main challenges is putting an end to the cycle of macroeconomic instability, which has hindered international integration and continues to affect the continuity of a business model for SMEs. It is therefore necessary to continue on the road towards delineating the place and role that Argentina should occupy. The resulting definition will impact the internationalisation of SMEs and their integration with global markets.

That said, large companies can also contribute to the development of SMEs by incorporating them systematically and organically into their supply chains. For several years, Arcor has advanced the implementation of a sustainable procurement strategy, whose objective is to contribute towards traceability in the supply process and promote sustainable management based on three main axes: awareness and training; incorporation of sustainability criteria with suppliers; and the implementation of projects.

To what extent will macroeconomic stabilisation bring confidence to the financial sector?

PAGANI: The current process of establishing macroeconomic order and recovering confidence in the value of the Argentine currency is gradual and will not happen overnight. As the process progresses, it is estimated that the level of financing in Argentine pesos will grow, which is precisely what SMEs need: financing at affordable and long-term rates to boost their investments. The fact that these companies have to resort to the reinvestment of profits for financing greatly limits their projection of growth. However, I am convinced that the main factors that distinguish the Argentine business people and producers are their capabilities, commitment and resilience. This involves our entrepreneurial talent and culture, as well as the values of our society.

How important are consumption and investment variables in Argentina's current growth model?

PAGANI: The central pillar of development for this administration should be reaching greater levels of investment, both foreign and domestic. The percentage of investment over GDP today is low and it must increase to make growth viable and inclusive. If we analyse public spending over the past two years, we see a reduction in subsidies, which affects consumption, whereas investment in public works has increased considerably. It is important to focus on investments as they demand sustainability and projection over time, allowing entrepreneurs and business owners to evaluate with a long-term view instead of only focusing on daily operations. Argentina cannot neglect consumption either, as it is a fundamental component of our economy.

What measures could reduce structural inflation, which impacts Argentine's competitiveness?

PAGANI: Argentina has great economic challenges to overcome, including the high logistics, port and fiscal costs. Properly addressing each of these issues will require fundamental reforms, as well as a general consensus among different actors of society. This will allow Argentina to become a key player in the region and to re-enter world markets.

We remain confident that the current measures promoted by the authorities such as tax reform, new public infrastructure works and the simplification of bureaucratic procedures – will lead to an overall improvement of Argentina's competitiveness.

Smaller businesses generate 4.1m jobs – the majority of employment

Dynamic development

Smaller enterprises adapt to the government's increasing focus on liberalisation and fiscal consolidation

According to the Ministry of Production, 99.8% of Argentina's companies are micro-, small and medium-sized enterprises (MSMEs) – those with fewer than 200 employees – in 2017. With a 4.1m-strong workforce, they also provided the majority of jobs. A skilled local labour force and pervasive entrepreneurial spirit have also fostered a dense and diverse MSME ecosystem, covering nearly all sectors.

The previous administration's prioritisation of local production and employment fostered a relatively robust MSME segment through to 2015. However, after the election of President Mauricio Macri in November that year, the country has repealed years of protectionist safeguards and reopened its borders. This led to the arrival of cheaper imports, which weighed on MSMEs. Nevertheless, President Macri has emphasised that his administration will seek to support the development of MSMEs and enable the segment to capitalise on a more open market.

MSME STRUCTURE: As of 2016 – the most recent year for which figures were available – nearly 606,000 of the 856,000 domestically registered businesses were job providers. Of these so-called active companies, 83% were considered micro-sized, 16.8% small or medium-sized and 0.2% large. In terms of sector, the largest cohort (37%) of enterprises operated in a services-oriented industry, followed by 30% in wholesale and retail trade, 10% in farming and livestock, and 10% in manufacturing.

Companies were heavily concentrated by region in early 2017: 69.9% were located in four of a total 24 regions – comprising 23 provinces and the Federal Capital District – with the Federal Capital District and greater Buenos Aires home to more than 50% of all enterprises. While 80.6% of the 5990 exporting companies were MSMEs at that time, they only accounted for 17.8% of total exports.

Between 2007 and 2011 the number of active companies climbed by 8%. However, these numbers began to stagnate over 2011-14, before decreasing between 2015 and 2016. This downward trend has since continued, with number of companies opening in the first quarter of 2018 decreasing by 4.5% year-on-year. These trends are due to challenges in acquiring financing, as well as changes in aggregated market demand and the regulatory framework.

PERFORMANCE: July 2017 marked the first month of industrial MSME production growth after 21 months of decline, according to a survey by the Argentine Confederation of Medium-sized Enterprises (Confederación Argentina de la Mediana Empresa, CAME) across 250 MSMEs. By the end of that year only marginal growth of 0.3% was recorded on 2016, which was one of the worst years on record, with a 5% drop in production from 2015. In the first half of 2018 industrial MSME production grew by an average of 1.1% year-on-year, with stronger growth in the first quarter of the year. Fabian Tarrio, president of CAME, noted that high fixed costs, lacklustre sales, increasing cost of financing and payment delays were negatively affecting the profitability of MSMEs.

ACCESS TO FINANCE: According to local consulting firm First Capital Group, while the potential credit demand from MSMEs amounted to $100bn in 2017, their actual credit portfolio was equivalent to 3% of GDP, translating to a $72bn shortage. According to a 2010 survey by the World Bank, a comparatively small portion of funding for small enterprises and medium-sized businesses took the form of bank loans, with 11% and 14.5%, respectively. Meanwhile, in Brazil and Chile bank loans represented 32.2% and 50.6% of investments in these segments, respectively.

Moreover, 43.5% of companies identify access or cost of credit in Argentina as restrictive – significantly higher than the Latin American average of less than 30%. A separate study by Fundación Observatorio PyME in June 2017 concluded that industrial MSMEs needed $1.4bn of investment, with those

PULL STAT:

99.8%

of domestic companies were micro-, small or medium-sized in 2017

While the potential credit demand from smaller enterprises amounted to $100bn in 2017, their actual credit portfolio equated to 3% of GDP, translating to a $72bn shortage.

A law was passed in 2016 to support small enterprises, providing incentives including easier access to financing

Since 2016 banks have launched lines of credit with lower interest rates and longer maturities to facilitate funding in the industrial sector, with a focus on micro-, small and medium-sized enterprises.

most in need operating in food and beverages (26%). Bank participation in investment for MSMEs dropped from 35% in 2015 to 22% in 2016, while the share of MSMEs financing their own development projects increased from 54% to 68% over this period. Capital markets are similarly underutilised, comprising less than 1% of total investment in MSMEs.

UNDERUTILISED CREDIT: Fundación Observatorio PyME also found that the proportion of companies requesting credit from the financial sector never exceeded 40% over the 2006-16 period. In 2016, 37% of companies that applied for a loan did so for short-term funds, or working capital, while 12% sought leases and 33% some other type of credit. Out of $1.3bn worth of demanded loans, the financial sector has supplied $1.15bn, with over 50% of this coming from national banks. Of firms that did not apply for credit, 37% did not consider this financial assistance necessary, 27% said that interest rates were prohibitive and 12% reported that they were not able to meet banks' criteria for selection.

In 2012 the government introduced the Financing Line for Production and Financial Inclusion, which required that banks to lend part of their portfolio at lower-than-market rates to MSMEs. Since the implementation of this policy, loans to MSMEs have substantially increased, reaching 45% of total credit to the private sector in local currency. Since early 2018 the central bank has made efforts to gradually lift this requirement, which is likely to cause higher financing costs for smaller businesses.

However, public and private sector banks, including Banco Nación, Banco Provincia and Banco Galicia, have launched new lines of credit at lower interests and with longer maturities to facilitate financing across the industrial sector since 2016, with a particular focus on the MSME segment. The Bank for Investment and Foreign Trade also launched a $1.5bn subsidised loan programme for MSMEs, allowing it to issue credit at 16% interest with maturities of up to seven years and a two-year grace period.

MSMEs primarily use their own resources to meet their funding needs, followed by bank loans, and to a much lesser extent other methods, such as factoring through capital markets, trading in deferred-payment cheques or negotiable debt securities.

REFORMS: In response to this underutilisation of funding sources, the government of President Macri has been implementing policies that aim to better understand and support MSME development. It established updated parameters through which a company may be characterised as an MSME depending on the sector and annual sales figures. The passage of the MSME Law in July 2016 also provided smaller firms with exemptions from the minimum presumed income tax, an extension of the deadline for value-added tax payments, fewer bureaucratic procedures and easier access to financing.

Other draft legislation is being discussed, including a bill to extend the advantages benefitting local companies in public-tender processes. Furthermore, a national plan is under consideration to differentiate tariffs for MSMEs and cooperatives. If passed, the segment would benefit from discounts on tariffs for basic services such as utilities.

Passed in early 2017, the Entrepreneurship Law also serves to facilitate the registration, promotion and development of enterprises through the establishment of joint-stock companies, enabling the digital creation of new businesses in less than 24 hours. Moreover, the law established the Registry of Institution for Entrepreneurship Capital (Instituciones de Capital Emprendedor, ICE) – which provides incentives to companies investing in entrepreneurship programmes – and the Fiduciary Fund for the Development of Entrepreneurship Capital to finance entrepreneurs and third-party institutions qualifying for benefits from the ICE.

Reforms for capital markets – such as the introduction of *obligaciones negociables simples garantizadas* (simple negotiable debt securities) – have already begun to affect the ability of MSMEs to acquire financing through the stock exchange, and ongoing reforms are anticipated to continue the trend (see Capital Markets chapter).

The challenges facing MSMEs have played an important role in the public agenda since the election of President Macri, with reforms including specialised treatment for smaller firms. The authorities have sought to reduce the role of the public sector in the economy and provide the means for the private sector to take over many of these responsibilities. The success of such efforts will require the development of a strong, dynamic MSME segment. In this context, the MSME Law marked a first step towards strengthening the competitiveness of local enterprises; however, the formalisation of the large informal sector will require substantial efforts in building trust and providing an adequate environment for MSMEs to grow without pressure from authorities.

Global Perspective

Tax liabilities

Impacts of the trend towards lower corporate tax rates on developed and developing economies

Recent decades have seen a downward convergence in corporate tax regimes as advanced, emerging and developing economies moved to grab a bigger slice of the global investment pie. Headline corporate tax rates have fallen by 20 percentage points since the early 1980s. Alongside lower average rates, special tax incentives aimed at capturing investment have emerged, further reducing the effective rates paid by transnational corporations.

In the aftermath of the 2007-08 global financial crisis, many countries were compelled to slash spending and raise revenue in order to rein in precipitous budget deficits. Even as tax revenues as a share of GDP in many economies have reached their highest levels in decades, the trend towards lower corporate tax rates has remained largely intact.

In the face of post-crisis austerity, however, public tolerance of corporate tax avoidance has dissipated, giving rise to political momentum behind increasing transparency and limiting the scope for businesses to minimise their tax bills. The OECD has led the charge in this respect, in close cooperation with the G20 as well as partner countries and emerging markets, through the coordination of efforts to reduce base erosion and profit shifting (BEPS). Parallel efforts have been undertaken by the EU, which also continues to work towards a common consolidated corporate tax base that would have profound implications for corporate tax regimes in the region, if implemented.

DEVELOPED MARKETS: Average corporate income tax rates in advanced economies fell to 22% in 2015, down almost half from the rate in the early 1980s. In the OECD's latest comprehensive take of changes in tax policies among its 35 members with mainly advanced economies, "Tax Policy Reforms in 2017", the organisation pointed to a recent intensification of competition on corporate tax rates, coming after a period of relative stabilisation in the years immediately after the crisis. For example, 12 countries introduced or announced reductions in headline corporate tax rates during the 2016-17 period, with only Chile and Slovenia hiking rates. While many countries phased in these tax changes gradually, the single most dramatic change during this period was the reduction in Hungary's corporate tax rate from 19% to 9%, effective January 2017. The OECD also highlighted rising global tax competition through new or enhanced tax incentives, with an emphasis on research and development (R&D), and intellectual property-related activities.

Despite periodic discussion around tax reform in the US, it had resisted jumping on the corporate tax-cutting bandwagon until late 2017. With a headline marginal corporate tax rate as high as 39.1% – one of the highest in the world, and more than 10 percentage points higher than the average in advanced economies – the US would appear to have been something of an outlier. When campaigning for office, US President Donald Trump called for corporate tax rates to be slashed to as low as 15%. In December 2017 the US Congress enacted a sweeping tax reform package, with the reduction in the corporate tax rate to 21% the standout feature. Additionally, a lower 15.5% amnesty rate is to be applied to historical profits, in a measure aimed at encouraging the repatriation of such funds to the US. Another key change for the US was the move towards a territorial-based corporate tax regime, which aligned the country with most other corporate tax regimes around the world. This means that US taxes will no longer be levied on the global profits of a US multinational, but only on that portion generated in the US itself. However, this move could end up encouraging offshoring.

EMERGING MARKETS: The downward convergence in corporate tax rates, and reduction in corporate tax bases, is far from being confined to the most advanced economies. In addition to Hungary, the OECD also highlighted corporate tax rate reductions recently implemented or announced in other emerging markets in Europe and MENA, notably Slovakia and Israel. The

Headline corporate tax rates have fallen by

20 percentage points

since the early 1980s

In late December 2017 the US Congress enacted a sweeping tax reform package, of which the reduction in the corporation tax rate to 21% was the standout feature.

Annual tax revenue lost by developing countries as a result of tax incentives offered to large businesses amounts to between $100bn and $138bn, according to recent estimates.

Czech Republic and Slovenia have also cut rates since 2008. Turkey, with the introduction of its so-called super tax incentive model, alongside specific incentives for R&D investment, was one of the main EMEA movers in 2016, while Hungary, Poland – and, outside the region, Mexico – signalled intentions to improve their tax incentive offerings in 2017 or subsequent years.

The knock-on impact of corporate tax reform in developed countries on emerging economies is exemplified by the pressure likely to be brought to bear on Mexico to enhance its tax offering to multinationals in light of the recent reforms in the US. Elsewhere in the region, President Mauricio Macri's government in Argentina introduced a tax reform that would bring the corporate tax down from 35% to 25% in October 2017. According to Dante Sica, CEO of ABECEB, a regional economic consultancy, the move is in the country's interest. "The reform is geared more towards redistributing the burden of tax than drastically reducing it, in order to prop up investment and job creation," he told OBG.

This is not a new phenomenon. IMF research has identified evidence of a "partial race to the bottom" in corporate tax regimes in 50 emerging and developing economies in the decade running up to the global financial crisis, as countries have been under pressure to reduce tax rates in order to attract investment. While the IMF found that headline tax rate reductions in emerging and developing economies were on a par with those seen in advanced countries over the same period, tax competition served to reduce the tax base even where the headline corporate tax rate was unchanged. Evidence of a race to the bottom in such special regimes, whereby parallel tax systems are essentially established, was found to be particularly strong in African countries, where effective corporate tax rates had essentially fallen to zero in many instances. Large declines in effective corporate tax rates were also found to have taken place in Egypt, Ghana, Kenya and Morocco in the decade before the global financial crisis. As part of the same research, the IMF's quantitative analysis demonstrated that higher tax rates adversely affect both domestic and foreign investment.

TRICKLE DOWN: Long-term trends towards lighter taxation of corporate profits in advanced and emerging economies have had a knock-on impact on developing and least developed countries. In some cases profits on activities carried out in developing countries are diverted to friendlier corporate tax regimes in advanced economies. According to Oxfam, for example, corporate tax avoidance schemes give rise to $100bn in lost tax revenues for developing countries. There are also situations where developing countries may lose out on even greater revenues by following suit and introducing their own corporate tax avoidance schemes or incentive regimes. Action Aid, a South Africa-based NGO has estimated that annual tax revenue lost by developing countries as a result of tax incentives offered to large businesses amounts to $138bn.

IMPLICATIONS: One of the most important implications of downward corporate tax convergence is the reinforcement of inequality, both within and between countries. When investment is diverted from emerging and developing markets, where returns should be higher, to advanced economies purely for tax reasons, the result is likely to be relatively slower cross-country convergence in living standards.

In advanced, emerging and developing economies alike, reduced taxation on corporate profits means, on the one hand, that wealth remains more concentrated in the hands of shareholders; while on the other hand, a combination of increases in other taxes or reduced spending is necessary to maintain healthy public finances. In sub-Saharan Africa, for example, countries rely on indirect taxes for around two-thirds of their tax revenues compared to less than one-third in advanced economies. At the same time, overall tax revenues in less developed economies are generally much lower than in advanced economies, meaning that there are less resources available for either public investment or social spending – both of which tend to benefit those on the lowest incomes and improve an economy's productive capacity for the future.

As the IMF concluded in July 2017, "The trouble is that by competing with one another and eroding each other's revenues, countries end up having to rely on other — typically more distortive — sources of financing or reduce much-needed public spending, or both. This has serious implications for developing countries because they are especially reliant on the corporate income tax for revenues." The IMF also notes that while efforts such as the OECD-G20 BEPS initiative may reduce tax avoidance, such measures could lead to more intense tax competition in other realms.

Even the economic rationale for reduced corporate taxation rings hollow. In theory, relatively lower taxes on corporate profits across the board should encourage productive investment. However, in the decade since the global financial crisis there has seen a slowdown in investment. Rather than reinvesting earnings to further expand their businesses, large corporates the world over have, in aggregate, been either hoarding cash or returning it to shareholders in the form of dividends or share buy-backs at historically high rates.

The big potential game-changer in global corporate tax regimes early 2018 remains the tax reform under way in the US. While downward convergence in corporate tax rates had slowed in the aftermath of the global financial crisis, such a significant reduction in the world's largest economy would seem to confirm recent trends. A large number of countries have already announced, or begun, phased multi-year rate reductions, with those moving in the opposite direction now very much the outliers. The medium-term outlook for corporate tax rates is therefore clear: globally coordinated efforts to improve transparency and curb the aggressiveness of legal tax avoidance schemes are changing the tax landscape somewhat, but do not appear to have slowed the emergence of new or redesigned incentives in advanced, emerging or developing economies. Going forward, this appears to be the more intense arena for tax competition among countries, albeit, perhaps, now with clearer rules of the game.

In sub-Saharan Africa, countries rely on indirect taxes for around two-thirds of their tax revenue compared to less than one-third in advanced economies.