WORKING PAPER NO. 11

Opening Up Argentina to the World: Some Strategic Observations

Danny M. Leipziger

THE GROWTH DIALOGUE

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Opening Up Argentina to the World: Some Strategic Observations

Danny Leipziger

I. Introduction

Argentina is at a decisive point with respect to economic policy, and nowhere is this more apparent than in its external outlook. Exports have never been the main economic driver for economic growth, although, at times, due to domestic issues, they have played an incredibly important role. The Macri Administration has rightly identified trade and investment policies as crucial stepping-stones in the rebuilding of the economy and the repositioning of Argentina to be a competitive international player. Major domestic reforms in the areas of tax and pensions, as well as prudent macroeconomic policies to both gradually reduce fiscal deficits and inflation, will be prerequisites for sustained positive results. These efforts need to be complemented by microeconomic reforms to improve the productivity and efficiency of the economy.

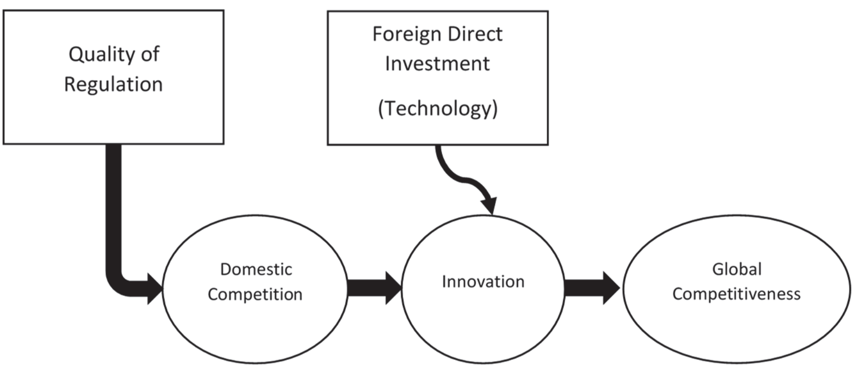
This note aims to examine how Argentina, as a late mover into the global economy and as an economy that has experienced serious prior setbacks, can now position itself in a world that requires the utmost in efficiency and innovation, and in which distance is an increasingly less important constraint to economic activity.

We take as given the fact that Argentina has been somewhat isolated from global value chains, that it has not benefited as much as it should have from regional trade agreements, and that it now faces an international economy that is both less robust in terms of commercial trade and more open to disruptive forces. In other words, Argentina faces internal as well as external obstacles in its announced desire to better integrate into the world economy.

Domestic Factors Affecting a Globalizing Strategy

A basic contention among many analysts is that without strong domestic competition and contestability in markets, economic agents see domestic rent-seeking as an easy alternative to establishing competitive activities. Argentina has for many microeconomic reasons been late to the global game, in part due to domestic price distortions and market dominance, facilitated by weak regulation and import restrictions. All of this is changing; however, economic incentives do not get reversed overnight. Many policy steps and administrative reforms will need to accompany changes in policy direction. It must also be recognized that inward investment, particularly foreign direct investment (FDI) and innovative investments, require a domestic landscape that is open and competitive, and in which new ideas and economic activities can flourish. Hence the links between micro-level reforms and macro outcomes are intrinsically interwoven. A schematic view of these relationships is shown in Figure 1.

Figure 1: Key Policy Linkages



By way of background, it is worth recalling that there is an empirically verifiable link between the degree of competition in markets and investment behavior. Research on the United States, for example, shows that “mark-ups” have risen substantially since the 1980s and that this coincided with an increase in concentration and had impacts both at the macro-level via the investment pathway and on distribution of income gains (De Loecker and Eeckhout, 2017). Moreover, declining competition in the United States can be empirically connected to under-investment relative to Tobin's Q since the early 2000s. Recall that at levels of $q > 1$, namely, where the firm valuation exceeds the replacement cost of its capital, firms should be investing in more capital. According to Gutierrez and Philippon, however, despite high asset valuations, there has been an under-investment in the United States especially since 2000; they attribute this in part to declining competition as measured by modified Herfindahl indices (Gutierrez and Philippon, 2017). Hence, the linkage between domestic levels of competition and the quality of regulation on the one hand and investment and innovation on the other is key for economies wishing to be more globally competitive.

Gutierrez and Philippon go further and argue that much of the impetus to innovate comes from external competition these days, namely, in the case of the U.S. market, the role of Chinese imports. This argument goes beyond the one posted in Aghion et al. (2005) and makes the case that import competition can serve the same purpose as strong domestic competition, a finding that Argentine policymakers can draw upon in a proactive way. Gutierrez and Philippon also find that increased concentration measures associated with a lesser degree of competition may in fact be bolstered by regulations that favor incumbents. Again, this is a finding that carries relevance for Argentina, where most measures of domestic concentration are high, although exact mark-up analysis may not have been carried out.

How does this relate to Argentina today? At present, the "country brand" is not as strong as it needs to be, whether measured by indices of doing business, governance and regulatory quality, ICT preparedness, or logistics.[1] These factors not only hinder export-oriented activities, but also inward investment, where companies have a wide choice of locations and partners. There are numerous strengths in the economy, including in the agricultural sector, in biotechnology, and in higher-end human capital, enhanced by strong universities. To this can be added possible diaspora investors and returnees. These are advantages to be harnessed and built upon.

[1] See World Bank (2018a, 2018b) and Worldwide Governance Indicators in World Economic Forum (2018).

Recent data on start-ups tell us that Argentina is not on the forefront and actually may lag for an economy of its sophistication and size.[2] Of course, start-ups are important if we follow the literature on where productivity gains are highest and how "gazelles" can help propel innovation and growth.[3] To this must be added the possibility of expanding too quickly to scale in order to capture new markets and be globally, or at least regionally, significant. Work on domestic sources of innovation clearly points to the need for strong linkages between university research, new firms, and access to venture capital as indispensable elements in operationalizing research and development efforts (Adler et al., 2017).

There are also areas of challenge, such as the existence of many small firms that lack the size to be competitive, while others are large but lack the incentives to be global. For the former, the path is through achieving scale quickly for the best firms (with domestic and possibly foreign infusions of capital), while for the latter, the solution is to create new and more competitive arms of existing companies. Public policy can indirectly help; however, past experiences in Brazil and elsewhere are not encouraging. Most public policy interventions are at the margin and can only be considered once a range of domestic microeconomic distortions have been removed.

The major microeconomic distortions that are limiting the productivity and efficiency of the Argentine economy include the following: a trade regime that has been sufficiently restrictive so as to reduce the openness of the economy from trade volumes equal to 42 percent of GDP in 2006 to 26 percent of GDP a decade later; product market regulation as measured by the PMR index of the OECD that is 30 percent more restrictive than the average of 19 Latin American economies; and food prices that are excessively high according to the World Bank despite Argentina's agricultural strength (Martinez et al., 2017).

[2] See OECD (2016) on start-ups in Latin America.
[3] See Adler et al. (2017) on productivity patterns.

Policy Considerations

What to do and, by implication, what not to do based on experiences elsewhere leads to the following basic conclusions. First, reforms that are deep and lasting need also to be comprehensive; that is to say, opening up depends on many factors, including, the tariff and non-tariff regime, the competitiveness of the exchange rate, logistics costs, the quality of rules-based trade, adherence to global technical standards, and issues of productivity and local costs, among others. A selective approach to reforms will yield weak results compared to comprehensive policy actions.

Second, innovation tends to thrive in competitive markets. Innovation systems are just that, namely, systems of mutually consistent incentives that reinforce one another and foster movement to what Aghion has called the technological frontier (Aghion and Cette, 2014). As we have seen in the case of Brazil and the spending of its national development bank, BNDES, competitive global champions cannot be created when incentives favor the domestic market (Musacchio and Lazzarini, 2014).

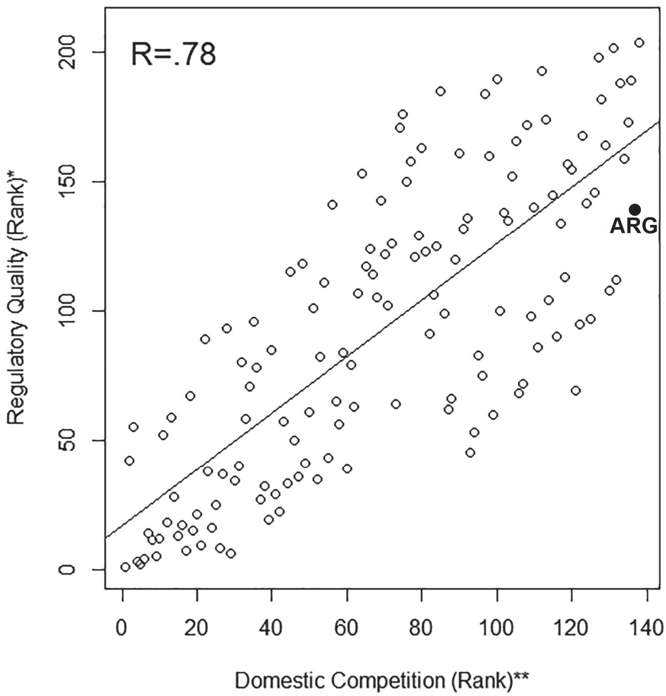
A third major observation is that the link between basic research in universities and applied research in the private sector is a key determinant of innovation success. These linkages are seen in a practical way in the German system, or the purely capitalist system in the United States, or the managed system in China. Governments can play a useful connecting role between basic research and applied technological advances. However, stakeholders' receptivity to collaboration is driven by the competitive pursuit of better, smarter, and cheaper production. This leads to views on what should be avoided.

A major "Made in Argentina" push would be premature without significant prerequisite reforms to render the economy more competitive, more efficient, and more productive. Infrastructure investments, regulatory actions, and enhanced competition are at the core of those reform measures, and their enactment can be a strong catalyst to attract new firms, both national and international. On the backs of these firms, new global opportunities will arise, and Argentina, not having ridden the previous GVC train, can quickly move to new and more innovative delivery of things and services. It is in our view a major mistake to leap into industrial policy style interventions without prerequisite micro-level reforms preceding those efforts. Doing so is simply a waste of public monies.

A Deeper Dive

A quick look at some basic interrelationships can be useful to tease out which reforms can best assist the process of opening up Argentina to the world. As seen in Figure 2, there is a positive and significant correlation across countries in 2016 between the quality of regulation (as measured by the Worldwide Governance Indicators ranking) and the degree of domestic competition (as measured by the WEF's Competition rankings

Figure 2: Argentina: Regulation and Competition (2016)

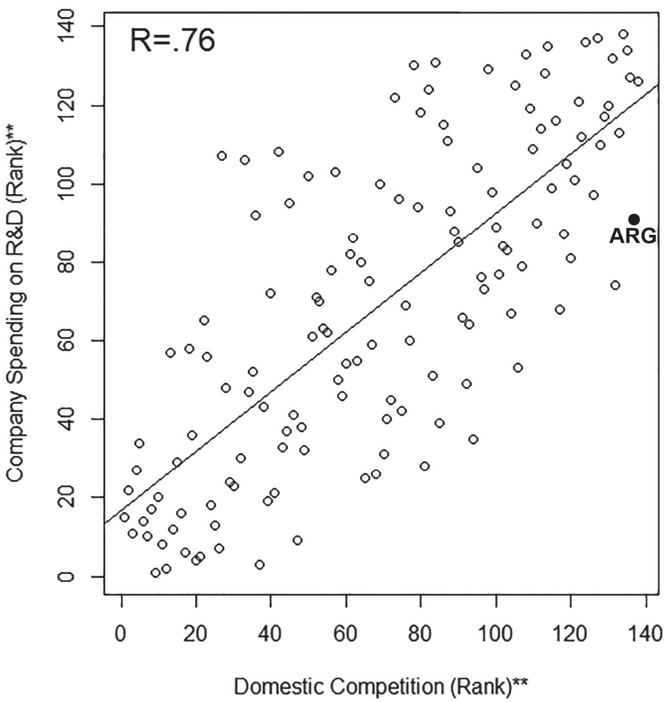


Sources: *World Bank Worldwide Governance Indicators
**WEF Global Competitiveness Index

reported in the Global Competitiveness Report). This relationship exists for Argentina as well, although it should be noted that the country ranks approximately 130th in both measures. This observation matters because without effective regulatory environments, competitive forces will be stifled and new entrepreneurship will be stymied. Low barriers to entry is a primary prerequisite to encourage new firm development, necessary for the efficient working of the domestic economy, and related to the economy's ability to compete abroad.

The fundamental story that we wish to convey is seen in the results of Figure 3, where we plot the 2016 relationship between the degree of domestic competition and the degree to which firms engage in innovative activities (as measured by firm-level R&D expenditure ranking according the WEF's data of the Global Competitiveness Report). The strong and

Figure 3: Argentina: Competition and Innovation (2016)

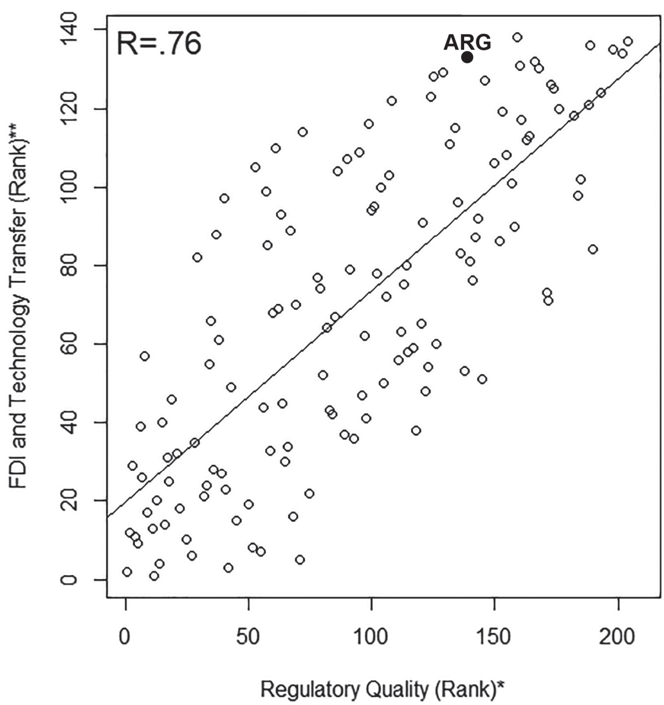


Source: **WEF Global Competitiveness Index.

statistically significant correlation coefficient supports the finding that greater levels of competition are associated with more robust innovation efforts. This reinforces our view that an external strategy that doesn't at the same time address domestic market concentration may in the end fail due to normal and understandable rent-seeking incentive behavior.

A third relationship that is useful for economies seeking to gain global competitive advantage is the link between the quality of domestic regulation and the country's attractiveness for FDI. This picture emerges clearly in Figure 4, where we see a strong correlation between the aforementioned Quality of Regulation ranking and the country rankings, again for 2016, of FDI and technology transfer (using WEF Global

Figure 4: Argentina: Regulation and FDI (2016)



Sources: *World Bank Worldwide Governance Indicators
**WEF Global Competitiveness Index

Competitiveness Indicator).[4] Put differently, innovation can be domestically produced or it can be facilitated by the technologies embedded in FDI. Many successful globalizers, including Malaysia and Singapore, among others, have utilized this latter springboard for innovation.[5]

The major point of these correlations is to show that interventions to improve institutions and to put microeconomic reforms in place can have significant positive effects. Better regulations promote more vigorous competition, which, in turn, fosters innovation as well as attracting FDI with embedded technological advances. Hence interventions aimed at ultimately enhancing the ability of Argentine firms to compete successfully overseas may in fact be outside the direct purview of the trade officials who are trying to integrate Argentina in the global economy. One of the lessons of East Asia as seen in the Growth Commission Report and other accounts is that coordinated, consistent, and sustained policies are necessary conditions for successful interventions.[6]

Global Trends and Factor Affecting the Strategy

Argentina correctly sees that it needs to integrate its economy more closely with the global system; however, it needs to be noted that the global economy itself has changed significantly, and that it is poised to change even further. The appeals of openness and inter-connectivity in trade and finance, while still present, have taken on different characteristics. In this sense, being a late mover is both a negative and possibly a positive element facing Argentina. What exactly are these new trends, possibly dubbed mega-trends because they are both hugely important and likely to persist for the next decade? And how will this affect Argentina?

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[4] The WEF indicator chosen is 9.03 (FDI and Technology Transfer Ranking) taken from the Global Competitiveness Report.

[5] See case studies by Soon and Tan on Singapore and by Salleh and Meyananthan on Malaysia in Leipziger (1997).

[6] Policies to attack infrastructure bottlenecks, distorted economic incentives, and financial sector impediments cannot be separated from trade and investment inducements towards globalization. See, for example, Leipziger (1997) and Commission on Growth and Development (2008).

The first mega-trend is the appearance of potentially permanent "de-globalization phenomenon," as seen in the form of a marked slowdown in trade growth as compared to GDP growth, a plateauing of import-dependence in some countries, and some retrenchment on the part of MNCs in their operations (Constantinescu et al., 2015). Whether GVCs have peaked, as some argue, remains to be seen. However, we do know that the major gains in logistical efficiency (especially in global transport) have already been achieved and that inequality and nationalist sentiment are rising, to the detriment of further global integration (Leipziger, 2017).[7]

The second trend revolves around disruptive technologies and the increasing ability of firms to replace key pieces in the production chain with more easily movable capital of new kinds (e.g., 3D printing) and to use artificial intelligence (AI) to replace services that were previously off-shored to take advantage of lower labor costs. The "Internet of things" adds another dimension to what promises to be a major shift in the way and the location of production and related service industries. This has implications for emerging markets, although the first order effects will be seen in the advanced economies, like the United States. A quick review of the issues surrounding disruptive technologies and knock-on effects can be gleaned from Dahlman (2017).

A third mega-trend is the evolution of the Chinese economy in a significantly different direction from its spectacular leap based on export-led growth. Numerous forces are at play, including simple convergence and new demands of the emerging and enormous middle-class, policy actions aimed at reducing intermediate external input dependence (such as on Korean imports), and policy directives aimed at establishing new competitive industries in China (see Conrad et al., 2016) utilizing even more forceful "industrial policies" as part and parcel of state capitalism.

In this new environment, some previous opportunities will disappear, but new opportunities will arise. The key is to be able to capitalize on new areas and to be well positioned for new technological developments. Some countries, such as Singapore and Chile, have already begun adjusting their sights to seize new ground. Singapore already has a corporatist state and uses all levers to promote new economic activities and to benefit from the R&D efforts of others. Chile is attempting to forge

[7] For more on the de-globalization phenomena, see Leipziger, Dahlman, and Yusuf (2017).

new links between universities and business and to seek new productive activities based on advanced technologies. The implicit motto underlying strategies in both countries is that standing still is tantamount to losing competitive ground.

The key to both economic resilience and adaptability lies in the flexibility of capital and labor markets; new approaches to education, skills and life-long learning; the fostering of innovation in a general if not a specific sense; and the ability to cushion the inevitable dislocations that change will produce in the coming decade. Important elements in effective policy include a strong and productive relationship between public policy and business; new understanding between the state and the individual; and a strong fiscal effort to empower government to act on the issues noted (Guriev, Leipziger, and Ostry, 2017; 2018).

The Way Forward for Argentina

The World Bank in its recent report on Argentina's plans to integrate into the world economy makes a number of important policy suggestions. These include a view that we share, namely that "to achieve the full potential of Argentina's reintegration into the global economy, institutions will need to effectively coordinate so that reform initiatives are concurrent, coherent, and integrated in design and implementation" (Martinez et al., 2017: 15). There are clearly some lessons about what has not worked with respect to policy formulation that haven't changed, as noted in the section on "Bad Ideas" in the Spence Commission Growth Report (Commission on Growth and Development, 2008). There are, however, some new elements to consider.

The limitations previously imposed by size and distance may no longer be the binding constraints for Argentina. Niche markets can be created based on agrobusiness and biotech if companies can quickly come to scale. Market opening may be short-lived and slow movement will imply quick obsolescence of ideas. Getting to scale is potentially easier with ICT advantages; however, small creative firms need to be nurtured and then protected from absorption.[8] Regional markets can provide opportunities for scaling up, but only if Mercosur is reformed and competitiveness is encouraged inside and outside of Argentina's borders. With the United States a less reliable partner and with China undergoing major internal transformation, regional markets are a key piece of the puzzle, provided these markets are efficient and open (Inter-American Development Bank, 2017).

The reform agenda in Argentina needs to quickly move from a catch-up phase of dealing with legacy issues into a proactive, future-oriented phase of preparing the economy and its economic agents for the world of the 2020s. This means that the current reform agenda needs to be rapidly completed and the political capital spent on reversing past issues of state capture must be quickly complemented with new policy ideas. Domestic capital markets need to be bolstered to create more sources of venture capital funding. Repatriation of savings and return of precious human capital are part of the solution. Incentives for their return need further consideration. Labor market reform needs to stress productivity factors and it needs to be forward-looking to support individual effort and learning since formal employment will no longer be the main source of skills acquisition.

Policy reforms cannot be partial, half-hearted, or slow. Leipziger and Thomas (1993) show how quickly public policy can move, but more importantly, that policy packages of coordinated reforms are most likely to succeed. Therefore, macroeconomic policy reform is necessary but not sufficient to succeed.[9] Microeconomic reforms of the kinds mentioned in competition policy, regulatory policy, tax policy, and labor policy are needed to reposition Argentina for the global game of competitiveness.

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[8] The case of Korea is one where start-ups are easily snuffed out or bought out by the dominant conglomerate sector. See Leipziger, Dahlman, and Yusuf (2017).

[9] There is a major debate going at present at to whether the Central Bank of Argentina should be trying to maintain the exchange rate in light of inflationary pressures by raising interest rates (which of course retards aggregate demand) or whether to allow the peso to depreciate (raising the carrying cost of external debt) but perhaps stimulating exports and economic growth. For a non-government view, see S&P Global Ratings (2018) on Argentina. Regardless of which side of the debate one is on, the decision to ask for additional support from the IMF makes sense to calm fears of exchange controls being re-imposed and to stop the outflow of reserves. Ultimately taming the fiscal deficit, halting wage increases far in excess of productivity gains, and getting FDI rather than issuing bonds should be the goal.

Moreover, vested economic interests focused on domestic markets cannot dominate the economic landscape since this approach is at odds with a successful globalization strategy, Data on firm entry and exit can be instructive in this sense because a static economic structure is a dying one in light of the speed of technological advances. Major investments in ICT are required to effectively connect Argentina to the global market. Some experimentation at home may lead to global competitiveness; hence the link between competition and competitiveness cannot be mentioned too often.

Thinking of where Argentina wants to be in 2025 is instructive, not in a prescriptive sense, nor in the sense that public monies will make it happen. A strategic vision, however imprecise, can help motivate and guide economic actors. This can be supported by relatively neutral but effective incentives to promote mobility in the movement of capital and labor and to facilitate the linkages of technology with new and creative economic activities. The economy can build positive momentum from concrete examples of start-up success, of clear cases where new entrants capture existing markets, and where foreign capital can be crowded in to new ventures. This can lead to a "New Argentina."

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