

Investment in Argentina: An uncertain present A promissory future?

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Introduction

In 2001/02, Argentina suffered the worst crisis in its history. Since then, the country has undergone a strong recovery, and has even bettered its top GDP level recorded before the crash. There has been a five-year cycle of recovery and growth like never before throughout the 20th century, with a fiscal surplus matched with a lack of volatility of the kind that has constantly plagued the country in other times. From such a deeply depressed economy, there was a long road to be traveled before the nation could arrive at the limits of its productivity potential. But this point seems to have been reached in the majority of sectors, and even surpassed in others.

Now, Argentina is clearly feeling the symptoms of the restrictions imposed by its installed capacity, particularly in the energy sector.

The continuation of a sustained process of growth today depends on an increase in productive investments. Such investment has, of course, grown since the crisis, but has not been of sufficient magnitude - particularly with regard to plant and machinery- to sustain production momentum at its current levels. Official statistics include housing construction and imports of equipment, like cell phones or private vans, which are clearly durable consumer goods.

Argentina has had an average growth of 8.9%, almost equal to the 8.7% of developing Asian countries. But these countries have a level of investment of 36.9% of their GDP² levels (and some of them have rates above 40%), substantially higher than Argentina's level, indicating the country's main problem, namely sustaining the current growth level with the level of investments at equal rates.

In particular, the flow of foreign investment has dropped in recent years, which is key given the limitations of internal savings. Had Argentina maintained the percentage ratio with Brazil (36%) and Mexico (44%) in the 1970-2005 period, in the 2001-2005 period, it would have received \$8.978 billion every year in foreign direct investment (FDI), instead of the \$2.981 billion it actually received, which means that Argentina has lost \$6 billion per year.

What has been the real magnitude of investment in Argentina? What are its historical trends? What are the principal determining factors for investment, and how do they impact the investment flows of local and foreign capital? What are the external and internal problems limiting investment?

This paper intends to answer these questions, taking into account that many of the economic processes and macroeconomic policy instruments which collapsed in the 2001 crisis and how Argentina subsequently isolated itself from the international economic arena. We will try to define investment and observe its performance and its decisive elements, in order to offer a path to normalization on all fronts that may finally lead us to affirm, without hesitations, that the country is out of the crisis once and for all. Here, we propose to explore a different and somewhat unusual methodology for the field - namely, assembling a group of experts with different views, and seeking consensus among them.

2. FMI, World Economic and Financial Surveys, World Economic Outlook Database, April 2007 Edition.

The objective is to present a list of topics and proposals, particularly necessary for future authorities, to complete the emergence from the crisis and clear the way for the arrival of future investment. The results of our numerous meetings and reviews are discussed below.

1

What do we mean by investment?

The difficulty in working with aggregates is precisely that they include things that can be very different, depending on the matter to be considered. This is also the case with variable investment. Conceptually, we consider investment to be internal or external savings, or the abstention from consumption, which we transpose directly or indirectly to the production process that will eventually determine higher production and therefore higher future consumption.

This process is key for the growth of the economy and higher and better satisfaction of the needs of the individual. Although the concept may be easy to understand, it is not easy to measure. What do we include as investment? In order to measure and evaluate its behavior, we seek certain statistics but we then find that they do not measure everything that they should measure, and include certain things that should not be considered.

The definition of the Fixed Internal Gross Investment (FIGI) variable used in the preparation of the national accounts consists of the following items:

- Construction
- Machinery and durable production equipment
- Transport material
- Stock variation

However, we must take into account that the investment that sustains the growth of the economy is productive investment, or that which allows the level of production of goods and services to increase in the future. We must point out that construction includes the value of dwellings and multi-dwelling construction, which is a durable good of consumption rather than a productive investment. On the other hand, many have indicated that the import of machinery and production equipment includes items such as cellular telephones and also ultimately should include the importation of transformers and generators, which in this case do not represent investment of quality, but are rather intended to stave off losses given the current limitations of electric supply. Transport material includes 4x4 trucks.

On the other hand, the investment in education is not included in the definition because it is one of the fundamental contributions to the construction of human capital, which is increasingly important in a modern economy based on knowledge.

2

Evolution of investment in Argentina³

The problem is higher than that reflected in the FIGI statistics, because it was not only the quantity of investment that was affected, but also its quality. This is reflected in what has been called “low productivity investment”,⁴ taking into account certain periods with relatively high levels of investment and low growth rates, such as from 1970 to 1983. As can be seen in the graph below and in the table in the Annex, investment stayed high throughout the period mentioned, especially at the end of the 70s, then dropped; the growth in GDP plateaus and oscillates at similar levels in the 80s, after which it grows again, but bringing a much higher growth in GDP from 1990 to 1998, and from 2002 to 2004.



Source: Ferreres, O., “Dos siglos de economía argentina (1810-2004)” and INDEC

However, we must take into account that the recovery starting in 2002 took place thanks to the recovery of major installed capacity, which had lain idle because of the previous crisis. This is not an increase in the “production possibilities frontier”, but a recovery of much of the ground lost during the crisis.

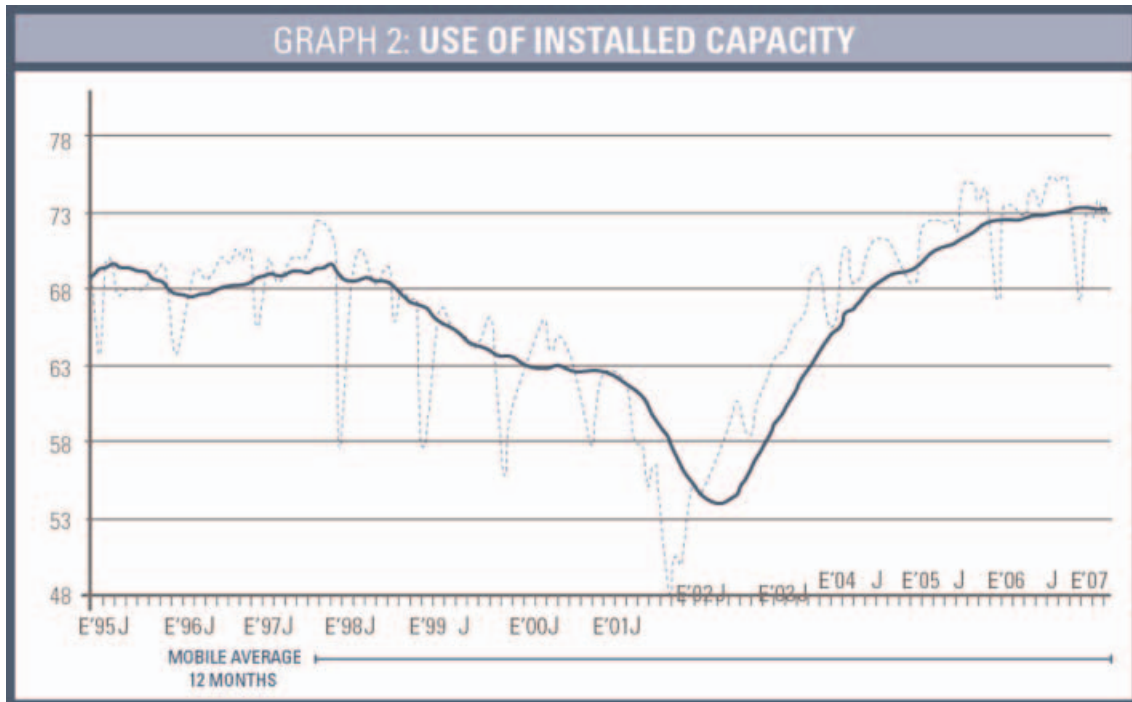
3. Surely the best presentation of the long-term evolution of Argentinean economic variables is in the work coordinated by Orlando Ferreres (2006). In the comment on the evolution of national accounts, the Argentinean history is divided into seven periods: I: 1875-1889, II: 1890-1913, III: 1914-1929, IV: 1930-1944, V: 1945-1963, VI: 1964-1992 and VII: 1993-2003.

Concerning the Fixed Internal Gross Investment (FIGI): “In the annual growth base of investment, also outstanding is stage II, which with 12.3% almost doubles the first. Afterwards there is the breakdown. There is a drop of 11 percentage points in period III. There are partial rises in the following two stages, but it drops again in stage VI and decreases -2.8% in the last. The comparison with the GDP and the Supply and Demand are a sign of the degree of attractiveness and effort of FIGI; with a very violent volatility in the beginning and in the end, FIGI grew at a lower pace, except in stages II, its peak, and in V.” Ferreres, Orlando, *Dos siglos de Economía Argentina: 1810-2004*, (Buenos Aires: UCA, 2006).

4. De la Balze, Felipe, *Remaking the Argentine Economy*, (New York: Council on Foreign Relations Press, 1995), pages 55 et seq.

On the other hand, the investment level in durable equipment is also below the peak reached in 1998. According to Sánchez and Butler, "investment in durable equipment is 8.3% of the GDP, lower than in 1998 (8.9% of the GDP). Thus, the investment in durable equipment represents today 38.1% of the total invested, versus 42% in 1998. This participation is much lower than that observed in more advanced economies, such as that of the U.S., where it reaches 56.2%."⁵

The same authors indicate that the number of cell phones imported as a portion of capital goods reached 13% in 2005 versus 5.6% in 2000. (p. 10)



According to de la Balze, this low productivity of investment might be largely explained by the isolation of the Argentine economy, the low level of competition in the local economy, excessive interventionism and profound political instability.

"In essence, the development strategy from within produced serious distortions in relative prices within the economy, which led to a poor assignment of resources and low productivity of the investment flowing in the private sector."⁶

The channel through which these factors impact on the productivity of the investment could be what Baumol⁷ and Kirzner⁸ describe as a "corporate function", but as the former argues, it may involve channels to activities that are productive, unproductive, and even destructive from a general point of view. Following Baumol, there may be periods with high investment, but this is does not necessarily channeled to productive activities for society, especially concerning the investments of companies then state-owned.

5. Sánchez, Gabriel and Butler, Inés, "Inversión en la Argentina: Evolución reciente y perspectivas" ["Investment in Argentina: Recent Evolution and Prospects"], Working Document, IERAL de Fundación Mediterránea, Year 13, Edition No. 57, May 2007, p. 7.

6. Op. Cit., p. 55.

7. Baumol, William J., "Entrepreneurship: Productive, Unproductive, and Destructive", *Journal of Political Economy*, 98(5), (1990) 893-921.

8. Kirzner, Israel, *Competition and Entrepreneurship*, (Chicago: University of Chicago Press, 1973).

Argentina has been growing at an average of 8.9%, almost equal to the 8.7% of the so-called “developing Asian countries”, which include China, India, Indonesia, the Philippines, Vietnam, among others, and far above Chile with a 2003-2006 average of 5.4%, Brazil with 2.8% and the G7 countries with 1.7%. But Argentina is not different from other countries of the region in terms of investments, showing a level of 23.5% of the GDP at current prices in 2006 compared to 24.1% of Chile, 21.2% of Mexico and 16.8% of Brazil.

If these countries are growing at much lower rates, the comparison concerning investment levels should be made with the so-called “developing Asian countries”. These countries showed in the same year an investment level of 36.9% of their GDP⁹ (and some of them with rates above 40%), substantially higher than Argentine levels, which indicates one of the country's main problems, namely sustaining the present level of growth in tandem with the level of investments coming in.

2.1 The quality of investment

Countries, and people, do not get rich because they invest a lot, but because they invest well. For centuries, economists have warned about the close relationship between investment and prosperity, but only a simplification of national accounting and a childish version of macroeconomics may lead one to think that more investment is always better than less.

Sometimes economists themselves were guilty of this error and not only in recent times, but when activist pressure on economic policy has been higher than usual, as well as during less frequent periods under supposedly more liberal politicians and economists. It was the physiocrats and the classicists who paired the notion of productive and unproductive work, introducing a distinction in economic theory that is not only sterile, but also dangerous: although it is necessary to state beforehand which activities are productive, the logic of political power will soon impose the need to adopt measures in order to support those activities and discourage the others. World economic history, and obviously Argentine history as well, are strewn with examples of the costly nonsense to which this type of analysis has led.

But if a fantasy of pick up the winners is meaningless, and so is the macroeconomic optimism of establishing a certain level of savings/investment to automatically obtain a certain rate of global growth, one could conclude that the notion of investment takes us to a dead end, which cannot be diagnosed.

If the so-called productivity of investment is difficult to measure, considering that these are investments already made, then the anticipation of productive, profitable or “good” investment is not merely hard, but impossible: the required uncertainty is the key to the corporate function involved in the decision.

This uncertainty brings forth a notion that any investor is aware of and many have suffered: the possibility of error. Hence, it is possible to draw a conclusion that would serve as guide to avoid a dead end: the importance of reducing both the probability of errors and the cost of repairing them. Uncertainty in economy had, for a long time, a direct relationship to the climate: drought in the fields

9. FMI, World Economic and Financial Surveys, World Economic Outlook Database, April 2007 Edition.

or storms on the seas played a fundamental role in economic fluctuations. It has always been known that information has played a fundamental role in mitigating these cycles: the first and most famous example was when Joseph interpreted the dreams of Pharaoh as a precise meteorological forecast and correctly guided his investments.

Afterwards, the obvious difficulty of anticipating the climate was increased by two elements fundamental to making investments: credit and the political and legislative framework.

Credit is fairly relevant for investment, but also quite likely to cause distortions to the point that in fact the economic cycle was called a credit cycle. The role of politics and legislation, however, is much bigger, especially to the extent that over time the weight of public expenditure and economic regulations of all types has grown. And in fact, one can observe this through monetary policy and financial regulation.

While all this may, and does, exercise a positive influence for investments, it may also expand the probability of errors in corporate decisions through sudden and unforeseeable oscillations in price level, interest rates and exchange rates. Not to mention the budgets of the Lawful State, which have a direct impact on investment: the physical and legal security of the citizens and their assets.

The reliability, predictability, and non-arbitrary character of the authorities is critical to reduce bad investments, which should certainly guide their actions in all cases, regardless of the national origin of the funds: the institutional framework that favors correct local investments is the same that does so with foreign investments -even though in the latter case, there may be a broader or different field of violations of the laws, if investments are concentrated in activities whose profitability is at the mercy of political decisions, such as the rates of public services.

Lastly, we must not forget that regulation is important, not only to avoid ruinous investments, but also to repair them at the lowest possible cost, and this has to do with very varied regulations, from bankruptcy law to the labor market.

3

Determining factors for investment

What are the causes of investment? Usually we ask which is the independent variable, or variables, that determine investment (in which case, this variable depends on the others). Obviously, investment shares with other social factors the characteristic of being a complex phenomenon, in other words, one determined by very different variables, which may be different according to the size of the companies, their corporate structure (family companies or with dispersed shareholders), depending on the type of activity, the region where they are located, and many other circumstances.

The present economic research trend of using econometric tools, although it does make a contribution, at the same time also limits its analysis to the variables that may be measured, and assumes the rest. Our intent is to have an ample vision, classical in a certain sense, trying to incorporate elements for a multidisciplinary approach, which traditionally would be called “political economy”.

In various papers a significant number of “determining” elements of investment have been presented and empirically tested.

Each of them may have a different degree of impact on the investment decision, either by being a “direct” determinant or influencing indirectly those that are “direct”. For example, we could not dispute that the expectation of a certain return is a direct determinant factor, but this, in turn is influenced by many other factors, which we will discuss here.

3.1 Return on investment

Investment decisions are always made due to the probability of an economic or social return, which they will generate in the more or less near future. And we compare this probable return with other alternative returns, such as financial placements that also have their risk and their term. The decision to invest is then mainly economic (return and risk) and/or social (it benefits the common good), but it is also influenced by other non-economic elements, such as prestige, ambition, satisfaction, etc.

There are several elements involved in this definition.

We obviously have the return on investment, which is almost always economic if the investment is private, but can also be social if the investment is public.

There is also the probability or the certainty of obtaining the expected result, which may be quite high in very safe investments, or more uncertain if the investment is high-risk.

And finally, there is the term of the investment, which is also an element that sometimes can be uncertain, and which is fundamental to define the profitability and risk of the investment.

Now, but not always and in reality almost never, can one know for sure these calculations? even implicitly, each decision to invest assumes a certain rate of return and a certain risk that this will happen.

Usually, this is formally represented as Tobin's Q, which measures the ratio between the value of the company in the market, i.e., the future discounted cash flow and the cost of opportunity of capital. As could be expected, Sánchez and Butler (2007) find a clear positive relationship between the expected profitability that reflects this indicator and investments.

3.2. Investment by different-sized companies

The decision to invest takes various paths, depending on the organization, professionalism and size of the companies. And in any organization there also appear non-economic elements that influence the investment decisions.

For very small businesses, e.g., individuals or family concerns, investment decisions are intended to increase production capacity, for existing companies, or to create a company where the founder sees a business, production or service opportunity. In both cases, the prevailing elements will be those called animal spirits by John Keynes, which are the intuitions of the Schumpeterian businessmen, which many times are fed by a natural inclination to do. Man has a strong inclination to pour into companies his natural inclinations to dominate the surrounding nature, and this makes him rationalize his productive instincts.

This situation mainly prevails in family or small companies, but not exclusively in them. The temptation to expand is always great and when the conditions seem to exist, generally not much more analysis is done, except in more professionalized companies, or in those where it is necessary to render accounts to the shareholders who do not participate in the daily management of the company. The introduction of a new machine, a tractor, or a shed is always a reason for pride, which distinguishes him from the other businessmen in the area or of the industry. But the inauguration of a new plant in a large company usually motivates the presence of the authorities and articles in the press, which give more social power to the businessmen who invest. Consequently, we can affirm that there are non-economic underlying motivations in these investment decisions, which are added to the purely macroeconomic reasons related to the generation of profits in the near future.

Of course, these decisions gain more force when there is also a growth in demand or the need to introduce improvements in a productive company, and, if investments are not made, certain competitive weakness appears, or an opportunity is created for the competition.

It could be affirmed that the smaller a company or organization, the more importance the macroeconomic explanation has; in other words the return, but also less professional is the calculation of the expected profitability, or more precisely the rate of return weighted by the probability that such returns would occur. Consequently, we must accept that in these cases the intuition, the experience of the neighbors, the culture of the family, etc. prevail. And in the cases of growing companies, the investments arise mainly from productive needs, either due to excessive demand or the need to incorporate more advanced technology.

Obviously, we cannot omit the consideration of the costs of investment when calculating profitability, but many of those costs cannot be quantified easily for a small company. For example, the

bureaucratic formalities needed to start a productive activity may be so heavy or complicated that the investment ends up not being made. Also, there is no explicit visibility of macroeconomic premises, which obviously have great influence on the determination of returns. They appear hidden in what we would call the “business climate”, which is important for small businesses. This had to do with the expected growth of the economy and, from a different perspective, the probability of a crisis. In a country like Argentina, which has suffered numerous economic collapses in the last 40 years, among small businesses, there has appeared a “culture of volatility” contrary to productive investment and more favorable to keeping money in real estate or in foreign currency and at other times in bank deposits. This conservative attitude could be overcome if investment was very profitable or for a very short term.

This “culture of volatility” can only be diluted over time, as it happened in Chile, a country that, like Argentina until the 2002 crisis, was extremely volatile until its own great crisis of 1982. But in that Trans-Andean country, in spite of the good performance of the economy starting in 1983, it took many years for small businesses to overcome the fears of new economic and banking crises.

In large companies, the situation is somewhat different from a formal viewpoint, mainly due to their higher professionalism. The calculations of the IRR are more precise and all the costs are quantified and incorporated in the calculation. Also included are macroeconomic determinant factors, indicated by independent studies, which claim to give the calculations a “bath of independence.” Both John M. Keynes, a great scholar of investment determinant factors, used to say that the calculations of the IRR, sometimes with two decimals, were only the result of the optimism or pessimism of the businessmen. This optimism is built or destroyed through the most varied mechanisms, not exempt of ideological and psychological influences, and they are not always good advice.

An example of the latter happened in Argentina recently. If one compares the investments of 1998 to those of 2002, those of that year were much higher than those of the latter. However, the corporate gains of the large companies in the following 4 years, measured by the results published by the Commercial Stock Exchange, show that those of the second period exceed by 100% measured in dollars those of 1998. And measured in constant currency, they are 200% higher. This demonstrates that the “business climate” is not always the product of a realistic perception of the prospects of corporate evolution. In spite of the fact that these beliefs are based on objective elements and are broadly shared.

3.3. Investment in Public Utility Companies

Everything we have explained is related to private companies that are not subject to direct regulation by the State. In the case of concessionaires or public utilities borrowers, the determinant factors of their income flow are strictly related to the decisions of the Government in power. In this case, we can see another constellation of determining factors for investment, which is generally negotiated directly with the authorities. In fact, the requirement to make investments in public utilities and oil companies is one of the explicit conditions in the contracts between privatized companies or concessionaires with the State, as well as another ingredient contributing to the rates of return and the terms of these concessions, if any.

3.4. Other factors

Although economists working to develop public policies usually have objectives that are different from the businessman making an investment, it is interesting to evaluate their way of thinking. Earnings are not the only relevant factor, even though these are important. In addition, the flow of gains is compared to the risks assumed when one makes an investment in a certain business sector or location.

Higher levels of risk imply not only the lower likelihood of the projects to come to fruition and therefore lower levels of investment, they also shorten the terms for their realization and the recovery of the capital. These risks may be internal:

a) Volatility of the gains: This depends on the instability of the economy over time. In less stable economies the risks are higher than in those that are stable. In addition, the composition of the income is important. Those that depend very much on subsidies or sinecures of the State are more uncertain than those that depend only on sales and management.

b) Volatility of sales: Panigo and Oliveri¹⁰ do not find that there is any relationship with net investment. However, they stress that this might exist because it is captured in the high relation with macroeconomics, which determines this volatility. Only heavy drops in sales are relevant, which may be associated with companies that have are highly sensitive to crises. This can leave them without the resources to invest, even though they had planned on it before. In small companies, sales volatility has a strong impact on net investment; this could be due to the fact that they only have their cash to invest.

c) Growth of sales: This variable does not always determine the evolution of investment. This particularly the case in the public utility companies in recovery as they do not have access to the long-term rules of the game; therefore, they don't invest.

d) Stability of rules governing investment and production: The risk of investing in certain sectors of an economy is higher whenever there is a greater possibility of arbitrary handling by the government. When the rules of the game of a sector or country are not stable over time, transparent and general, much of the success of a business depends on the will of the public officials in power; consequently, a good relationship with them becomes fundamental. The problem is that the terms of a productive investment tend to be long, and the officials tend to be vulnerable to a high rate of turnover in unstable countries. Consequently, there is no surety that one will always have the officials on one's side. Sánchez and Butler (2007, confirm the negative effect of uncertainty on investment, also in what they call "appropriability of the investment".

e) Secure legal framework: In countries without republican principles of checks and balances and division of powers, there are greater possibilities of violating the legal or constitutional restrictions imposed on politicians for the exercise of the power. This places at risk all the rights

10. Panigo, Demian and Oliveri, María Laura; "Determinantes de la inversión corporativa en empresas que cotizan en Bolsa. Evidencia empírica para Argentina 1994-2004" ["Determinants of corporate investment in companies listed on the Stock Exchange. Empirical evidence for Argentina 1994-2004"] Working Document No. 19, (Buenos Aires: Centro para la Estabilidad Financiera, June 2007).

of the citizens, including the right to property, freedom of enterprise and markets. The official in power may control prices, restrict exports, force the sale of a product in the internal market at a loss, prohibit retroactively the launch of a product that is authorized by current regulations, etc. All these interventions in the handling of the companies cause a drop in income and/or inefficiencies in operation and therefore reduce the profit margins.

f) Provision of basic infrastructure: Although it appears as a problem to be taken into account in making a decision of investment, in reality this depends on the same factors as the latter. In the final analysis, the infrastructure of a country depends on its capacity to attract resources for investment in the sector. If it is public, this concerns its management capacity, the assignment of current income or the viability of obtaining sufficient financing to start up the projects. Unfortunately, in countries like Argentina, these conditions are not met; consequently, the only source that can obtain and manage sufficient resources to offer the necessary quality and quantity of infrastructure is the private sector. The possibility of this happening is closely linked with institutional strength and secure legal frameworks. The importance of the respect for rights, especially property rights, and of a stable and clear regulatory framework is fundamental for investments like these in which the recovery terms are usually very long.

g) The existence of external financing: It is important to take into account that the nonexistence of sufficient available financing for the companies of a certain country limits the possibilities for reinvesting the profits of these companies. In Argentina, this is particularly true for small- and medium-sized companies. Because of this, given the shortage of credit, they have invested significantly since 2002, depending on their earnings and on the savings accumulated in the past. Just as the nonexistence of a capital market or a reliable financial system, they are limited as regards the possibilities for financing and they only invest with the possibilities of making safe investments. To protect the value of their savings, many sought tried and tested investments in “bricks and mortar”, i.e., construction. However, small- and medium-sized companies, given the increase in demand, have chosen to place their money in the business they know rather than in real estate operations. This was also seen in the agricultural sector, where savings and strong earnings that made the real rate of exchange high and the increases in international prices also started capitalizing production. Panigo and Oliveri (2007) show that small companies invested more than big ones in the recovery period. They wonder, and they are on the right path, whether this may also be due to the regulatory instability faced by big companies. The smaller companies have a positive correlation between short-term debt and investment. Surely, because they only obtain this type of financing for this reason, the term debt enhances the negative impact of the volatility of the sales over investment, since the latter depends on the cash, which ends up being used to face the continuous maturities of the debts. Another important point in the high relative investment of small- and medium-sized companies, which is observed by the paper mentioned, is how much of this is not redundant (over-investment due to lack of capacity to foresee the future) for a future lower real rate of exchange of a country that tends to have a certain stability. Sánchez and Butler also find there is a positive relation with current profitability, suggesting the availability of own funds to finance investment.

h) Size of the companies: In a scarce financing market, there is a positive correlation between size and investment capacity because the larger companies absorb the little credit

available in the market. According to Panigo and Oliveri, the net investment of large companies is the least affected by the crisis. It is not by chance, since they have the higher resources (management, physical and human capital, financing, external advice) to successfully wait out the crisis.

i) Holding of liquid assets: More than a concept of accounting profit, what is a determining factor in Argentine investment is the holding of liquid assets. In other words, the companies that invest are those that have the “cash”. This again has to do with the restriction of financing, which prevents making credit into a profit found in a non-realizable asset. This importance of liquidity is demonstrated again when Panigo and Oliveri discover that in economic recovery the companies with large short-term debts (taxes) invest less. It is logical, since they give priority to using the liquidity to pay these debts.

j) Composition of the debt: For the authors mentioned, there is no correlation between leverage or the composition of debt and the net investment of the companies, between 1994 and 2004. It would seem that a company that has more chances to access credit in connection with its assets is not necessarily going to invest more. However, in periods of significant prices, there is a relationship between lower net investment and higher proportion of short-term indebtedness. This must have to do with the need to use the cash (liquid available funds) to cover the maturities of the debt, since there is no access to credit.

Sánchez and Butler also did not find a positive contribution of credit on investment, but they did in the case of the companies with public offering of shares.

k) The participation of multinational companies (local or foreign): In a country whose credit market for companies was always scarce, a higher number of companies that can obtain resources abroad will easily increase the possibilities for investment. This is extremely important when we evaluate the process of “Argentinization” of public utilities and energy companies, which does not guarantee the availability of the necessary resources for the huge investment required by these sectors.

l) Real rate of exchange: The discussion on the rate of exchange could fill several libraries and we do not claim that it will be resolved in this paper. According to Sánchez and Butler, the rate of exchange has a positive but not significant impact. In our discussions, even though we the authors have different visions of what should be the level of the real rate of exchange and whether or not the government should do something about it, we agreed that it is possible to maintain the rate of exchange high only with fiscal surplus and strong political control that would allow containing the growth of the salaries, especially in the public sector.

m) Fiscal deficit: Continuing with the impact of certain macroeconomic indicators on investment, the regressions made by Sánchez and Butler find a clear positive impact of the fiscal result on the level of investment, suggesting that the existence of a surplus generates lower interest rates and lower absorption of private savings to finance public expenditure, although we must not forget the impact in this sense of an expansive monetary policy.

n) Managerial myopia: Panigo and Oliveri find differences in the variations of the values of the companies on the stock exchange and the increases of investments of the latter.

They interpret that the markets look forward and the businessmen backward. However, it is also true that investments on our stock exchange are merely speculative and short-term, so that they evolve according to risk indicators in this term (e.g., EMBI). Such being the case, the investment of the businessmen are made in terms of a long-term risk, which in a way may be conditioned by history, even though it depends on the vision of the present. In unstable markets, what allows surviving is prudence, and therefore it is not unusual that the past is averaged with the future vision. Net investment does not depend on current profits, but has a higher correlation with the average profits of the past. In an unstable country, it is not possible to consider either the profits or the losses permanent. Obviously, in the estimate of the long-term scenario determined by investment, economic history has a strong influence.

o) Past sales: Panigo and Oliveri do not find a relation between the sales and net investment of the companies listed on the stock exchange, using those of the prior period. This may mean that the investment is not taken as a percentage of income. In another paper, which considers the variation of the sales in the period¹¹, there is a correlation, even though with a risk of “endogeneity”. Given that investment is planned from one year to the next, and not on the spot, the first seems more adequate. However, it is also true that in case of a change in economic certainty, it can be expected that both the sales and investment will fall. Consequently, since both variables are determined by confidence, it is not rare to find a positive correlation taking the sales of the period.

p) Relative prices: The distortions of the relative prices discourage investment and make it more inefficient. The paper of Panigo and Oliveri mentioned discovers that in the 2003-2004 period, the recovery does not have a high correlation with the growth of net investment. This has to do with the discouragement of investment by the freezing of the rates or the lack of long-term rules of the game, for example in public utility companies. However, Sánchez and Butler measured the impact of changes in the terms of exchange, showing a positive but insignificant relation.

q) Irreversibility of investments: Sánchez and Butler consider this variable, related to the facility to reverse the decision to invest.

As mentioned earlier, we believe that the general understanding of the Argentine situation requires the consideration of certain determining factors, or taking the same factors but in different proportions, depending on whether we speak of local, small or large companies and foreign companies, be they established for a long time, others more recently arrived and likely to arrive.

In all of them, it is obvious that the impact of the rule of law is fundamental, but with a different weight. Especially for big national companies and to a good extent also for foreign companies with broad local foundation, their ability to adapt to changing conditions has been the result of a long learning process that is already part of the adaptive capacity of these companies. They have learned to exploit the opportunities presented by Argentine fluctuations and to cross the storms with the least possible damage. Both have invested and prospered thanks to or in spite of the great fluctuations in the rules of the game.

11. Elosegui, P. Sotes Paladino, J. Español and D. Panigo (2006), “*Metodologías alternativas para el análisis de las restricciones al financiamiento en la Argentina*” (“Alternative methodologies to analyze restrictions to financing in Argentina”), Working Document No. 1, *Investigaciones Económicas*, Banco Central de la República Argentina.

On the other hand, the small- and medium-sized companies have had less capacity for both things, both to take advantage of opportunities and to minimize damage, so that we observe a much higher fluctuation in their numbers.

The higher impact of the lack of regulations and instability in the rules of the game, and more difficult to measure, is the impact on potential foreign investors, which would have considered coming to the country but which did not do it due to the visible insecurity created by ups and downs. This is a nonexistent statistic, but it is no less real, as indicated by Frederic Bastiat, the French economist of the 19th century, as “this is that which is not seen”, inherent to the fact of regular instability.

4

Direct foreign investment

Flows of Direct Foreign Investment (FDI) globally have increased by a factor of 20 along with globalization, from a total of \$58.896 billion in 1970 to \$916.277 billion in 2005. FDI to developing countries increased in the same period of time from \$3.926 billion to \$334.285 billion, multiplying by 85. In the case of Argentina, the growth in the same period is 51 times. In Chile, they grew 555 times, in Spain 103, in China infinitely: since then and until 1980, UNCTAD statistics show that FDI did not exist and by 2005 it had received 72.406 billion, 62% more than the entire FDI received by South America that year.

However, higher flow tends to originate in and flow to the same developed countries.

Why are these countries the ones that received the highest amount of FDI and why does it grow much more in some countries than in others?

In other words, what are the specific determining factors for foreign investment?

4.1 Determining factors for foreign investment

The potential capacity to receive foreign investments depends on many factors. UNCTAD prepared the Index of Potential Direct Foreign Investment (FDI), which calculates the following variables:

- “The GDP per capita, indicator of the complexity and amplitude of national demand (and several other factors), with the expectation that the economies with higher income will attract more FDI oriented toward innovative and differentiated products and services.
- The growth rate of the GDP in the prior ten years, which indicates the foreseen economic growth.
- The proportion of exports in the GDP, which reflects opening and competitiveness.
- As an indicator of the modernity of information and communication infrastructure, the average number of telephone lines per 1,000 inhabitants and mobile telephones per 1,000 inhabitants.
- The commercial use of energy per capita, which indicates the availability of traditional infrastructure.
- The proportion of expenditure in research and development of the GDP, which reflects national technological capacities.
- The proportion of students in higher education out of the population, which indicates the availability of high-level capacities.
- The risk of the country, a compound indicator that reflects certain macroeconomic and other factors that affect the perception of the risk by investors. The variable is measured so that higher values indicate lower risk.
- The export quota of natural resources in the world market, which indicates the availability of resources for FDI in extraction industries.

- The import quota of automotive parts and electronic products on the world market, reflecting participation in principal systems of integrated production of transnational corporations (Report on Investments in the world 2002).
- The export quota of services in the world market, which reflects the importance of FDI in the service sector, which represents approximately two-thirds of the world FDI.
- The proportion of the accumulated amount of FDI in the world market, which is an ample indicator of the attractiveness and capacity of absorption of FDI, as well as the climate concerning investments.¹²

However, these determining factors are not only, in turn, determined by other factors that we will mention further on, but show a degree of circularity. Let's take, for example, the case of the two mentioned first, the GDP per capita and the growth rate of the last ten years. How can a country have increased the former and have grown in the last ten years, other than because it received investments? Unless they were all local and suddenly opportunities were open for foreign investment, it would seem that the cause is precisely an effect of FDI. The same could be said about others, such as the number of cell phones or the commercial use of energy.

The results corresponding to the countries in the first 20 places are shown in Table 1. As can be seen, the positions do not differ substantially from the real flows of investments, which we can see in Table 2 below, which shows the average FDI received in the period from 1970-2005.

| POS. | COUNTRY | SCORE (0-1) |
|------|--------------------|-------------|
| 01 | United States | 0.637 |
| 02 | United Kingdom | 0.449 |
| 03 | Canada | 0.446 |
| 04 | Luxembourg | 0.443 |
| 05 | Singapore | 0.439 |
| 06 | Norway | 0.436 |
| 07 | Sweden | 0.432 |
| 08 | Germany | 0.421 |
| 09 | Ireland | 0.414 |
| 10 | Qatar | 0.408 |
| 11 | The Netherlands | 0.407 |
| 12 | Iceland | 0.403 |
| 13 | Finland | 0.401 |
| 14 | Belgium | 0.400 |
| 15 | Hong Kong, China | 0.398 |
| 16 | France | 0.390 |
| 17 | Korea, Republic of | 0.382 |
| 18 | Australia | 0.376 |
| 19 | Taiwan | 0.374 |
| 20 | Switzerland | 0.371 |

Argentina appears in position 66 of this index with a score of 0.187, and is qualified by UNCTAD as one of the countries with "High FDI Potential" but "Low Yield", so that it falls into the group called "Countries below their potential".¹³

12. El Índice Potencial de Atracción de IED. Metodología, <http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2470&lang=3>

13. <http://www.unctad.org/Templates/Page.asp?intItemID=2468&lang=3>

The countries that received most FDI in the 1970-2005 period are the following:
 However, as we said earlier, the indicators that measure this index are determined or at least require the existence of clear legal rules that reduce the inevitable uncertainty that any investment brings

| POS. | COUNTRY | AMOUNT (in USD billions) |
|------|--------------------------------------|-----------------------------|
| 01 | United States | 57.848 |
| 02 | United Kingdom | 24.839 |
| 03 | China | 23.463 |
| 04 | France | 14.927 |
| 05 | Belgium and Luxembourg ¹⁴ | 13.958 |
| 06 | Germany | 13.358 |
| 07 | Holland | 10.990 |
| 08 | Spain | 9.408 |
| 09 | Canada | 9.301 |
| 10 | Hong Kong | 8.146 |
| 11 | Brazil | 6.786 |
| 12 | Mexico | 6.306 |
| 13 | Sweden | 5.985 |
| 14 | Singapore | 5.322 |
| 15 | Switzerland | 4.802 |
| 16 | Russia | 4.683 |
| 17 | Australia | 4.654 |
| 18 | Italy | 4.545 |
| 19 | Czech Republic (since 1990) | 3.477 |
| 20 | Ireland | 3.364 |

with it. These conditions appear clearly in the case of the countries found in the first positions, and also in others such as China, Brazil, Mexico or Russia, both because of the size of their internal market and because of their low costs for export, which have started receiving large volumes of investments when they were able to send signals in this regard, one way or another.

4.2 Rules of the game

When we evaluated the determining factors of investment, we indicated the importance of profitability, corporate gains on the capital invested. An investment is profitable when the gains exceed the direct cost or the cost of opportunity of capital reflected in the interest rate. In turn, the latter reflects the temporary preference, in other words, the discount that exists in the future over the present.

Since the future is inherently uncertain, any factor that impacts this uncertainty also impacts the discount rate. At higher levels of uncertainty, higher discount rate, production processes become shorter, and only projects with high profitability and, therefore, high risk are achieved.

One of the factors that clearly impacts on this inevitable future uncertainty is the predictability of the rules of the game, also called "the framework of legal security". Whenever this security is missing, investments are lower than they could be, a phenomenon that particularly affects foreign investment

14. UNCTAD takes in this case the amount corresponding to Benelux (Belgium and Luxembourg.)

that, unlike local investment, is less familiar with the particular characteristics of a certain country. For countries with a shortage of savings and local capital, foreign investment is fundamental to support economic growth, also allowing the acquisition of new technology and processes whose efficiency has already been verified in other markets.¹⁵

In addition, the framework of legal security depends on what has been called “institutional quality”¹⁶, a concept that is difficult to specify strictly, but that indicates the existence of governability mechanisms that guarantee the respect of certain basic rights, including the right to property, the respect for contracts and the keeping of promises.¹⁷

“There are several reasons why the quality of the institutions may be important to attract FDI. One of them is based on the results of the literature on growth: by elevating the prospects of productivity, a good infrastructure of governability may attract external investors. A second reason is that the bad institutions may cause additional costs for FDI. This may be the case of corruption, for example (Wei, 2000). A third reason is that due to the high costs incurred, the FDI is especially vulnerable to any form of uncertainty, including that coming from low government efficiency, changes in policies, kickbacks or weak protection of property rights and of the legal system in general”.¹⁸

Although the importance of the security of legal frameworks has already been stressed by classic economists, currently it has been Harvard economics professor Robert J. Barro, who has tested this hypothesis and verified its relationship. In an amply-quoted paper¹⁹, he argues:

“The variable on the reign of the law was included in the system of regressions and shows a significant positive coefficient, 0.0293 (0.0054)”.

He goes on to conclude:

“The data currently available for an ample panel of countries for more than 30 years provides the information necessary to isolate the determining factors of economic growth. Concerning government policies, the evidence indicates that the growth rate of the real GDP per capita improves when there is higher respect to the law, less government expenditure and less inflation” (p. 70).

It should not be surprising that the countries that have more “respect for the law” are also those that receive the highest flow of direct foreign investments. According to the rule of law indicator

15. However, countries like Japan and others from Asia have succeeded at generating high levels of internal savings and, therefore, have not depended so much on external savings in the form of foreign direct investment.

16. In discussions between authors, first of all the concept of “institutional quality” was pressed, but then it was estimated that it was too broad, and preferring to consider the ratio between legal safety (rule of law) and investments. This would be more determining for investments than institutional quality as defined in: Martín Krause, “Quality of the Institutions and Institutional Competence”, (London: International Policy Network, 2007). Institutional quality would have a more direct relationship with the “quality of life”.

17. Hume, David (1739-40), A Treatise of Human Nature, Cap. 83, Sect. xi, Of the Laws of Nations, <http://etext.library.adelaide.edu.au/h/hume/david/h92t/chapter83.html>: “Where possession has no stability, there must be perpetual war. Where property is not transferred by consent, there can be no commerce. Where promises are not observed, there can be no leagues nor alliances”.

18. Bénassy-Quéré, Agnès, Maylis Coupet and Thierry Mayer, “Institutional Determinants of Foreign Direct Investment”, *The World Economy*, (Oxford, UK: Blackwell Publishing Ltd., 2007). P. 764.

19. Barro, Robert J., “Determinants of Economic Growth: A Cross-Country Empirical Study”, *NBER Working Paper 5698*, National Bureau of Economic Research, (Cambridge, Mass: 1996).

20. Kaufmann, Daniel, Aart Kraay & Máximo Mastruzzi, “Governance Matters IV: Governance Indicators for 1996-2004”, The World Bank, May 2005: http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/GovMatters_IV_main.pdf

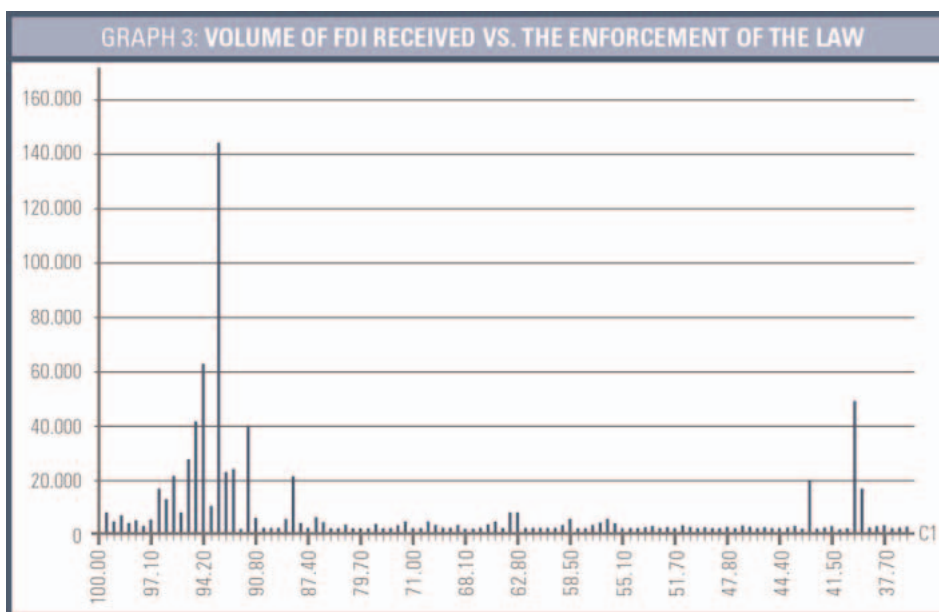
TABLE 3: "RULE OF LAW", WORLD BANK

| POS. | COUNTRY | PERCENTAGE RANKING |
|------|-----------------|--------------------|
| 01 | Iceland | 100.00 |
| 02 | Switzerland | 99.50 |
| 03 | Norway | 99.00 |
| 04 | Denmark | 98.60 |
| 05 | Luxembourg | 98.10 |
| 06 | Finland | 97.60 |
| 07 | New Zealand | 97.10 |
| 08 | Austria | 96.60 |
| 09 | Sweden | 96.10 |
| 10 | Singapore | 95.70 |
| 11 | Canada | 95.20 |
| 12 | Australia | 94.70 |
| 13 | The Netherlands | 94.20 |
| 14 | Germany | 93.70 |
| 15 | United Kingdom | 93.20 |
| 16 | Anguilla | 92.80 |
| 17 | Ireland | 92.30 |
| 18 | United States | 91.80 |
| 19 | Hong Kong | 91.30 |
| 20 | Belgium | 90.80 |

prepared by the World Bank²⁰, the first 20 positions are as follows.

If we take into account the positions given in this indicator, plus the relative institutional improvements experienced by China, Brazil, Mexico and Russia, we can find an explanation for the positions they occupy concerning the real flow of foreign investment they attract.

The security of legal frameworks started to be a real issue in China with the definition of the Special Economic Zones, portions of its territory that guarantee the respect to contractual freedom and the property right in spite of the existence of the communist system in the rest of the country, reaffirmed later with the respect of legal safety existing in Hong Kong through the "one country, two systems" policy and with China joining the WTO.



The relationship between the volume of FDI received and the enforcement of the law can be observed in the following graph where the countries with better rating are close to the vertical axis and where furthermore the highest volumes of investments are concentrated.

Argentina, with an average FDI of 2,794 billion dollars for the 1970-2005 period, is well behind Brazil and Mexico and in addition, in recent years, has been shifted from third place in Latin America by Chile and Colombia, countries where, in the period mentioned, there was average FDI of 1,911 and 1,264 billion dollars, respectively, but which in the last five years show an average of 4,979 and 3,946 million dollars versus 2,981 in Argentina.

In addition, the gap with Brazil and Mexico has increased because these countries in this last period reached 19,268 million in the case of Mexico and 16,481 million in the case of Brazil. This means that, if in the 1970-2005 period, Argentina received 41% of the investment received by Brazil and 44% of that received by Mexico, in the last five years it received 18% of what the first received and 15.5% of what the second received.

| POS. | COUNTRY | AMOUNT (in USD billions) |
|------|-----------|-----------------------------|
| 01 | Mexico | 18.939 |
| 02 | Brazil | 18.782 |
| 03 | Chile | 8.053 |
| 04 | Colombia | 6.295 |
| 05 | Argentina | 4.809 |
| 06 | Peru | 3.466 |

According to more recent CEPAL data, this trend continued throughout 2006, when the data are as follows: The distance of Argentina from Mexico and Brazil, and its recent fall compared to Colombia and Chile are related to the loss of institutional quality and the lack of a secure legal framework in Argentina compared to these countries, even despite Colombia's internal security problems.

5

Pending external issues affecting investment

In addition to the problems concerning Argentina's institutional environment and macroeconomic stability that affect the nation and its capacity for attracting investment - both foreign and local - there are other key factors that especially impact the confidence of foreign investors. The most important of these are:

5.1 The Paris Club

It may come as no surprise to learn that this informal venue for discussions between creditor and debtor nations was created in 1956 in order to negotiate Argentina's foreign debt. The club currently comprises 19 permanent members, but is nevertheless a completely informal organization of creditor nations that seeks to address the debt owed to them by developing nations in a coordinated way.

In addition to the 1956 negotiations, Argentina reached agreements with the Paris Club in 1962, 1965, 1985, 1987, 1989, 1991 and 1992. Currently, it owes the club's member states a total of \$5.9 billion.

Default and failure to reach agreement with this group of nations causes two principal problems regarding investment: the first is a matter of reputation; the second is more concrete and concerns the impossibility for Argentine importers to take advantage of the financing granted by the export promotion bodies of some of the club members, as in the case of Germany, France and Italy. Default by Argentina means that these agencies cannot extend these incentives to Argentine importers, who therefore are obliged to bear a higher financing cost.

Conversations have commenced with this group of nations, but are currently stalled due to Argentina's rejection of participation by the IMF. One of the few principles established by this group states that:

“3. Conditionality: the debt treatments apply to countries that are in need of restructuring and are carrying out reforms directed at solving their payment problems. In particular, eligibility is provided by the existence of an appropriate IMF-backed program that demonstrates the need for debt relief”.

Currently, Argentina does not have a program in place with the IMF, but it has been established that the eligibility conditions would be satisfied with a letter from the Fund's director-general. This procedure was not accepted by Argentina, which would have preferred the supervision of the OECD instead.

Argentina's intransigence in this regard comes at a significant cost, which is wholly disproportionate to its political objective of independence from the IMF.

Moreover, the solution of this conflict would, in turn, overcome the aforementioned obstacle concerning the financing of imports, which originates with none other than the OECD. Effectively, the export financing agencies of many countries take guidance from what is usually called the “Knaepen Package”²¹, an agreement to ensure that additional risk premiums are added to interest charges in order to cover the risk of default on loans for exports. One of the basic elements of this “Package” is a system designed by the OECD for evaluating country credit risk, with nations being classified according to eight categories (0 to 7).

Argentina is classified under category 7, which is the lowest rating and accordingly carries the highest risk premium for the financing of imports of all kinds.²² The ratings of other nations in the Hemisphere are: Bolivia (7), Brazil (3), Canada (0), Chile (2), Colombia (4), Costa Rica (3), Cuba (7), Ecuador (7), El Salvador (4), Guatemala (5), Haiti (7), Paraguay (6), Peru (4), Uruguay (4), Venezuela (6).

5.2 International Center for Settlement of Investment Disputes (ICSID)

The ICSID was created by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention), and commenced operating in 1966. Argentina signed the Convention in 1991 and ratified its adherence under Law No. 24,353, passed in July 1994. There are currently more than 140 member nations.

The Center engages in dispute resolution under the auspices of the World Bank, and was created for the purpose of improving the legal security that is necessary for the increase of international investment.

From the 1990s onward, and with this same purpose in mind, Argentina signed a total of 59 “bilateral treaties for the promotion and reciprocal legal protection of foreign investment” with the world's most important nations. These treaties were in turn ratified by the National Congress.

The treaties contain various clauses, but there are two in particular that are common to all, and are seen as the most important:²³

- The “Most Favored Nation” clause, under which any beneficial treatment granted to a particular signatory country of one of these treaties, is automatically extended to the remaining signatory countries. This clause has a lengthy tradition amongst international commercial treaties.
- The “extension of jurisdiction and establishment” clause, under which all disputes are not just heard by the local courts, but may also be appealed before a higher international authority.

In the case of the BITs signed by Argentina, this higher authority is the ICSID, which can become

21. Agencies such as Coface in France; Ducroire/Decredere in Belgium; Export Guarantee Department in the United Kingdom; Euler Hermes in Germany; Exim in the United States; EKN in Sweden.

22. OECD, Country Risk Classification: http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_37467,00.html

23. Tondini, Bruno Mario and Martín Nicolás Roqué, “CIADI, Inversiones y el ‘Factor Confianza’ en la República Argentina” [“ICSID, Investment and the ‘Confidence Factor’ in the Argentine Republic”], Working Paper No. 38, Centro Argentino de Estudios Internacionales, 2006.

24. Perotti, Javier, “Consideraciones del caso argentino ante la jurisdicción del CIADI” [“Considerations of the Argentinean case before the jurisdiction of ICSID”], Working Paper No. 8, Centro Argentino de Estudios Internacionales, 2006.

involved in two different ways²⁴. The first possibility involves resorting initially to the local courts; if no enforceable judgment is issued within 18 months then an appeal can be lodged with the Center. The second possibility arises from the option of foreign investors to choose between local or international jurisdiction.

Since 2002, numerous claims have been brought against Argentina through the ICSID, for a global amount of approximately \$20 billion. This figure accounts for around 40% of the total for pending cases, and almost 50% of all cases opened since January 2003. Currently, there are 32 cases pending; a further 5 have resulted in agreements between the parties and 2 have been settled.

The BITs remain in force, although there is internal discussion as to whether the arbitration rulings can be reviewed by the Supreme Court of Justice in terms of their actual substance, or only in regard to the so-called “domestication” of their effects²⁵ - that is, verification that the formal orders have been complied with. There are other opinions that go so far as to question the ICSID's impartiality and jurisdiction, and even the very constitutionality of the laws that passed the BITs at issue.

It is clear that this degree of litigiousness, and the questioning of both the court and the BITs subscribed by Argentina (even though they have not been formally challenged), does not contribute to creating the investor confidence necessary to achieve a greater volume of foreign investment. Argentina must maintain the position of accepting the signed treaties and the rulings of the court. It should also ratify and renew the bilateral investment treaties.

In the last few weeks we have seen a new aspect of the problem, with the group representing the Italian holdouts putting a submission to the ICSID. It is likely that the government will respond to this demand by questioning the capacity of the Center to intervene in this dispute. Whatever the outcome, this serves as yet another example of the continued presence of claims against the Argentine nation for breach of international standards.

5.3 *The holdouts*

In late December of 2001, Argentina declared a default on its debt. In 2003, during the annual meeting of the IMF and the World Bank in Dubai, the country presented its debt-swap proposal for a total stock of \$87 billion. The debt would undergo a 75% reduction, and involve the issue of three new bonds - Par, Quasi-Par and Discount - for a maximum estimated face value of \$21.8 billion, plus a coupon linked to GDP growth. The initial proposal was increased in June 2004, with an offer to issue bonds valued at \$31.8 billion for participation under 70%, or \$41.8 billion if acceptance was greater, with the discount maintained at 75%.

In order to guarantee the fiscal consistency of the proposal, the government promised to maintain a primary fiscal surplus of 2.7% of GDP over the first five years, which would later be stabilized to around 2.3%. A projected annual growth of 3.3% would be sufficient to meet interest payments, but it was necessary to find sources to finance the renewal of the capital maturities. Various financial calculations estimated the current value of the discount at between 73 and 80%, without taking into account the interest already due and a clause repudiating the debt of those who did not take up the swap offer.

25. Perotti, *op. Cit.*

These are unusual conditions for this kind of operation.

The swap commenced on January 14, 2005, and attained a participation of 76.15%. However, with respect to the subject that concerns us here, it should be noted that the 24% of “holdouts” who rejected the offer comprises 50% of the foreign creditors.

These holdouts are not about to go quietly, and although they have not enjoyed success hitherto through legal avenues, they nevertheless contribute to further deterioration in Argentina's reputation as far as investors around the world are concerned. Moreover, there is an additional financial cost for the government because the latent threat of embargo prevents it from accessing international capital markets.

Keeping the door closed on the bondholders who did not join the swap can qualify the Argentine action not as a default but as a reputation, a qualification that very few countries have reached, and with a very negative connotation for the investment climate and for the possibility of assuming sovereign risk in the future.

Considering that the performance of the Argentine economy has far exceeded the projections contained in the proposal, and as another way of defusing one more area of conflict, Argentina should solve this conflict and make a proposal to these bondholders, which could mean the reopening of the swap without changing the conditions of those who participated at the time.

5.4. El costo de los incumplimientos

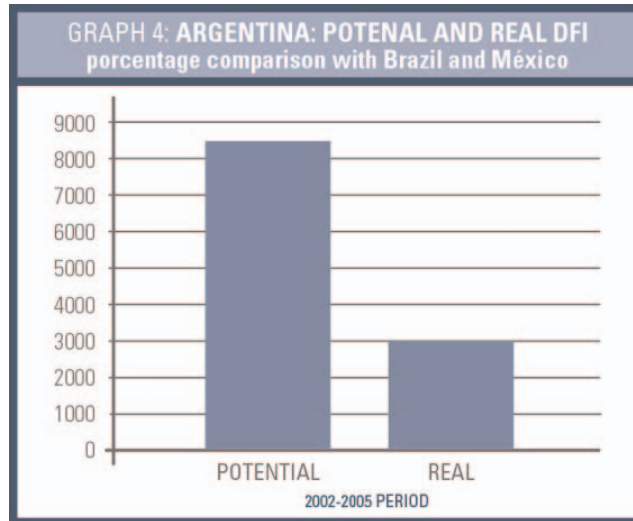
It is very difficult to calculate with any certainty just what amount of investment Argentina would have received if these problems had not existed, or if solutions to them had been found. However, by way of example, we can engage in the hypothetical exercise of estimating the amount of investment Argentina would be receiving now if it had managed to maintain its traditional position in the region.

Clearly, the inflow of foreign investment does not depend exclusively on the destination country itself, but also on the degree of liquidity in global capital markets. This affects the region as a whole,

| COUNTRY | AVERAGE 2002-2005 | AVERAGE 1970-2005 | DIFFERENCE | CHANGE % |
|-------------|-------------------|-------------------|------------|----------|
| Argentina | 2.980.06 | 7.270.85 | -4.290.25 | -59.01 |
| Bolivia | 273.72 | 542.28 | -268.56 | -49.52 |
| Brazil | 16480.65 | 20.240.12 | -3.759.46 | -18.57 |
| Chile | 4.979.03 | 5.323.14 | -343.83 | -6.46 |
| Colombia | 3.946.24 | 3.513.66 | 432.58 | 12.31 |
| Ecuador | 1.446.67 | 1.069.54 | 377.13 | 35.26 |
| Paraguay | 74.42 | 129.78 | -55.36 | -42.66 |
| Perú | 1.762.57 | 1.881.69 | -119.12 | -6.33 |
| Uruguay | 367.93 | 277.57 | 90.36 | 32.55 |
| Venezuela | 2.319.08 | 3.256.00 | -936.02 | -28.75 |
| Costa Rica | 593.05 | 543.89 | 49.16 | 9.04 |
| El Salvador | 356.94 | 333.19 | 23.76 | 7.13 |
| Guatemala | 211.96 | 227.81 | -15.85 | -6.96 |
| Honduras | 242.46 | 204.83 | 37.64 | 18.38 |
| México | 19.267.07 | 16.198.12 | 3.069.59 | 18.95 |
| Nicaragua | 209.03 | 207.68 | 1.62 | 0.78 |
| Panamá | 605.02 | 731.31 | -126.11 | -17.24 |

Source: UNCTAD

and therefore by considering Argentina's relative position we can get an idea in this regard. Not only is Argentina the country where FDI inflows have gone down the most, but if for the 2001-2005 period Argentina had maintained the percentage relationship it held with respect to Brazil (36%) and Mexico (44%) during 1970-2005, then it would have received \$8.477 billion annually in FDI, instead of \$2.981 billion. So, the country has suffered a loss of \$6 billion each year.



6

Internal issues affecting investment

6.1 Retentions at export

Again, this is a topic for serious discussion, which starts with the definition of whether these are taxes or differential rates of exchange; our work was not exempt from this discussion, although we do not claim to resolve the topic at this level.

We discussed whether it is possible to take into account the amount that the affected sector loses for this reason, or whether it would be necessary to take into account all the modifications of the variables that affect its profitability.

We recognized its inevitable introduction in the 2001/2002 crisis and also the convenience, looking to the future of reducing the dispersion of the rates of exchange and progress towards its elimination.

Furthermore, we indicated that even the form in which the retentions were introduced has not respected the necessary legislative processes, contributing to the institutional weakening indicated earlier.

Although the Economic Emergency Law reestablishes the retentions only for oil exports, the Executive Branch assumed that the possibility was broad and decided to apply it to many more products. Such being the case, even though any tax must be decided by Law of the Congress according to the National Constitution, as a result of a decree law of the last military dictatorship, known as the Customs Code, it was “delegated” to the Executive and the latter in turn delegated it to the Ministry of Economy to impose import and export duties. This custom, whose constitutionality is questionable, continued after the return to democracy. All this indicates the fragility of the local legal safety faced by somebody who thinks of investing in the production of exportable goods.

Congress sanctioned Law 26,124 of “Superpowers” in which, in article 1, it granted the government basically three powers: a) to unify in a single account for expenditure purposes what is currently divided into five different accounts; b) to erase the difference usually established between current expenditure and capital expenditure; and c) to eliminate the distinction between “above the line” expenses and “below the line” financial applications. Eliminating the application by the Executive of these three broad divisions of authorization of public expenditure means broadening its powers, including excessively, delegating to Congress one of the main functions given to it by the National Constitution, namely having the last word on the form in which the tax funds of the citizens will be used.

However, the advance of the NEB on the legislative did not stay within these new extended limits. Resolution No. 10/07 increased by 4 percentage points the already high retentions on soy and Resolution No. 9/07, with the same date, establishes the mechanism of subsidies to industrialists and operators who sell in the internal market products derived from wheat, corn, sunflower and soy, which was extended a few days afterwards to the entire dairy chain (Resolution No. 40/07). Thus, through a mere Resolution of the Ministry of Economy, the income of the new retentions

was assigned to a new expenditure. This exceeds the powers granted in the “Superpowers” Law. Thus, this mechanism indicates, in addition to granting monetary subsidies calculated in an amount of \$1,500 million, the fixation by the same regulatory channel or “supply prices”. The latter are illegal because price fixing is contemplated in paragraph a), article 2 of Supply Law 20,680. The possibility for its application has been suspended since 1991.

6.2 Price controls

Given the Argentine experience, it is superfluous to indicate that price control policies do not work and end by generating more problems than they try to resolve. These controls have destabilized the rules that support the productive growth of the economy.

In addition, the existence of an instrument such as the Supply Law, which threatens businessmen with prison, damages considerably the necessary climate of confidence in order to make investments.

Although certain constitutionalists discuss whether this rule is in force or has been suspended, the 1974 Supply Law was severely curtailed by Decree No. 2284 of 1991, which liberalized vast sectors of the economy and which was ratified in 1993 by Law 24.307. In fact, in 2002, given the enactment of the decree of the then-president Duhalde, the Prosecutor's Office of the Treasury decided that the regulation was no longer in force. The only thing the decree maintained active was paragraph c) in article 2, which allows the Executive Power to issue rules governing the marketing, brokerage, distribution and/or production of goods or services. Consequently, in order to dispose of the excessive powers that appear in the rest of the Supply Law, the Executive Branch must have the prior authorization of the National Congress concerning the “state of emergency of supply”. Otherwise, it cannot dispose of these powers.

Certain officials tried to justify its use in the Economic Emergency Law sanctioned in early 2002. However, nowhere in the text of this regulation is there a mention of a supply emergency or of the return of the powers suspended by the Supply Law.

In spite of this, the Ministry of Economy issued resolutions that: i) prohibited retroactively the sale of a new type of gas oil whose marketing was confirmed in the regulations valid until then; ii) set maximum prices for the marketing of meat and operating farms (art. 2, para. a), Supply Law); iii) for the oil companies to sell fuels at a loss (art. 2, para. d), *Idem*); and, in addition, iv) for the latter, fines were introduced for violations of the resolutions mentioned earlier (art. 4, 5 and 6). All these acts were justified by the ambiguity and broadness of paragraph c), article 2 of the Supply Law, which allows the Executive Branch to issue rules governing the marketing, brokerage, distribution and/or production of goods or services. However, the powers to take these measures were explicit in the other articles and paragraphs of the Law. Consequently, if the 1991 government and the legislators who, in 1993, gave status of law to the suspension of the supply regulations, wanted to maintain the possibility of applying these articles, why did they then suspend them? It is obvious, therefore, that the spirit of the suspension intended for all the measures mentioned could not be taken by the NEB without prior express approval of Congress.

6.3 Subsidies to companies

Faced with devaluation, the certainly logical answer was the freezing of the rates of public transportation, gas and electricity -especially residential rates- until such time when contracts could be renegotiated and rates could therefore be adjusted. However, even after five years, long-term rules have still not been established for these sectors, nor is there any knowledge about how the rates will be adjusted in the future. In this framework, the investments in the sector dropped to a minimum, and in certain cases it inevitably led to a reduction in the quality of the services.

A recent report from the company TBA is certainly illustrative. It indicates in its cost structure a salary increase of 252% from 2000 to date, a 221% increase in the value of materials and 105% in expenditure for electricity, fuels and lubricants, while the ticket (its income structure) only experienced an increase of 17% in the same period. Consequently, if we look at the consumer and wholesale price data prepared by INDEC, we can see that the general retail index increased 95.5% since December 2001 and the wholesale one about 189%, when the itemized values of the public services (which are included in the CPI calculation) showed almost no variation at all.

Subsidies to public transportation services for this year, 2007, will total \$3,810 million, with an increase in their amount by no less than 435% over a period of four years. In spite of this, the prospects are not for coverage of the deficit in investments in the sector, nor their consequent transfer of benefits to the user, but they will be used to increase salaries and other operating costs. The same can be said about the rest of the services that receive this type of transfer.

To have an idea of the dimension of the use of state subsidies in the structure of the income of the companies, it seems appropriate to carry out the following exercise. In 2006, with an average price for a bus ticket of \$0.80 for a route of 12 kilometers, with an amount transferred as subsidy close to \$1,840 million and given the number of passengers, we can conclude that the bus companies receive on average \$2.00 per person who travels 12 kilometers. Of the total, \$0.80 is paid directly by the user and \$1.20 is paid by the government, in other words, all of us. Only by incorporating the subsidies was it possible to make an international comparison of the costs of our transportation. The ticket in Argentina costs \$2.00, so that its value in dollars becomes comparable to what an individual pays in Rio de Janeiro (US\$0.59), San Pablo (US\$0.67) or in Santiago, Chile (US\$0.50).

It is a known fact that this tool has difficulty achieving the improvements necessary in the service by providing an incentive for investment. This is not a regular income or one that can be fairly foreseen, but clearly it is perceived by the recipient as an extraordinary income (and most of the time arbitrary) that can be discontinued, since in the terms handled today in society, there is no perception of their cost.

On the other hand, the government has tried to compensate by public investment in energy the investment not made by the companies of the sector. For this purpose, it has created trusts that are within its area of influence and whose objective is to advance in some of the necessary works. However, the lack of own resources forced the electric companies to fund them with the debts that CAMMESA (clearance entity of the State) had to them, for the subsidies intended to cover the differences between the real cost of energy and the cost they are allowed to charge the user. Another way was the creation by Law of the system of specific charges (Law 26,095). It allows the Executive Branch to collect in a discriminatory manner an additional cost to the rates of the public services assigned to these trusts. In reality, the concept of specific charge is a creation that allowed con-

gress to delegate to the Executive Branch the power to determine the amount of a tax and to decide who will pay it, both things prohibited by the National Constitution.

6.4 INDEC intervention

In early 2007, given the perception of a possible acceleration of inflation, given the decision of the managers of the agency that prepares the consumer price index to maintain the methodology, which implied a jump of the prices in January, the government decided to remove them. It hired in their charges personnel who followed the instructions of the Ministry of Economy and who changed the way price data and the preparation methodology were taken. Given the obvious objective of showing lower inflation data and the subsequent establishment of such data, to the extent that they were different from what people perceived as the reality, the agency lost credibility. This has been a fundamental deviation from a crucially important rule, on whose consistency the investors depend in order to make their decisions.

The importance of having an institution like the INDEC, which is reliable, goes far beyond the preparation of data on inflation. In a democracy, one of the duties of the government is to give the citizens and their representatives (the legislators) reliable information that allows them to control its management. For this purpose, it is important for the public agencies that prepare such data to have the maximum independence possible from those who exercise public power.

This is the really damning aspect of the intervention that took place in the area that prepares the CPI at INDEC; because it ends up distorting the figures that show the loss or gain in the purchasing power of the Argentines, which generate current economic policies. On the other hand, the Central Bank loses an important "compass" required to determine its economic policy, which should be trying to contain losses in the value of the national currency that, in reality, right now it does not know. In addition, it leaves the consumers and investors plunged into enormous uncertainty; because it is impossible to evaluate the real levels of inflation required to negotiate salaries, rents or yields for savings or credits in pesos. All this leads to an inefficiency that generates lower investments, activities and welfare for Argentines.

Lastly, this measure has also affected negatively the credit of the country. A good part of the public debt is expressed in pesos and is adjusted by a CER indicator that is prepared based on the CPI. To the extent that the latter is prepared downwards, the CER will also reflect this, which means a loss for the holders of those state debts and, therefore, fraud.

6.5 Reconstitution of capital markets

In 2001, the growing loss of credibility of the government of Dr. De la Rúa seemed to be taking the country towards the stoppage of payments. In this framework, people remember that in the past and on similar occasions, other governments appropriated the savings deposited in the banks. The last time it was at the end of 1989, with the Bonex Plan, when the Supreme Court actually sanctioned this measure. What could stop this from happening again?

This led to the preparation of various draft laws to guarantee the intangibility of the deposits. In this sense, we must say that in the discussions with legislators (mostly graduates of law) we see a

redundancy of their sanction because the property right of the deposits was guaranteed by the Civil Code (art. 1.197 and 1.198) and the National Constitution (art. 17). However, history had demonstrated that this was not quite clear. Consequently, it would be possible to enact a law for intangibility of the deposits (Law 25,466) as a regulation, an explanation of the rights of bank savings customers. Finally, the drafts were unified and approved by a sweeping majority in both chambers.

Given the heavy loss of deposits by December 2001, the government decided to apply the "Corralito", which restricted cash withdrawals from banks to \$300 and transfers abroad. However, by not affecting the use of the funds or the currency in which they were, in January 2002, there was a huge complication in the situation of the debtors in dollars and the government at the time obtained approval in the Congress of an Economic Emergency Law, which suspended the Law for Intangibility of Deposits. The Supreme Court, almost five years later, decided to give its opinion on the matter. It chose to modify the form of calculation of the pesification which means that today it ends up giving an approximate value to the current dollar and thus declares that it is not necessary to give a ruling on the matter of substance; because the depositor will recover what he deposited, even though he does so in pesos.

If we add to this lack of trust in the safety of the financial system, the restrictions imposed by the legislators on the execution of the guarantees of defaulting debtors, we can understand why the credit is so scarce. This leads to a big limitation in the possibilities of giving credit.

6.6 Lack of adjustment of the balance sheets of the companies to calculate income tax

In spite of the significant increase in inflation since the devaluation in early 2002, the Federal Tax Administration determined that the companies could not adjust their balance sheets because of the increase in prices. This implied that the inflation increase of the assets of a company was taken as profit, when in reality it was not. In the extreme, this may imply that the companies that had losses would not pay income tax based on this mechanism.

Thus, inflation became a way to increase the tax pressure on the companies without having to raise by law the Income Tax Rate. This taxation uncertainty is also a conditioning factor for investments.

6.7 Regulatory barriers

Among other regulatory problems that worry possible investors, a study carried out by El Cronista mentions:

1. The previously-indicated security of legal frameworks and the tools that protect investors against economic and political instability.
2. The specific regulatory framework commensurate with the industry in which they will invest.
3. The resolutions of the Central Bank concerning the system of foreign currency inflow required to make an investment and the restrictions on sending foreign currency abroad, whether they are produced by profit or by disinvestments.
4. The tax regulations, including matters related to provincial taxes and municipal contributions.

5. The existing legal vehicles to channel investments.
6. The systems of compliance with the resolutions of tax authorities and the regulations of commercial company law.
7. The labor legal framework.
8. The system of price controls and manipulation of indexes that reflect the performance of the economy.
9. Regulations on consumer rights.
10. The current immigrations system for expatriates.²⁶

In more general terms, the “Doing Business” indicator, which is part of a program initiated by the World Bank to generate a database with objective regulator measures on economic activities and its application to a total of 155 countries places Argentina in position 101.²⁷

The index takes into account the necessary formalities, the time they take and their cost for the following processes:

- Starting a business or economic activity
 - All procedures necessary to register a company
 - The average time required by each procedure
 - The official cost of each procedure
 - The minimum capital required as a percentage of income per capita
- Obtaining licenses (permits)
 - All procedures to build a warehouse
 - Average time per procedure
 - Official cost of each
- Hiring workers
 - Difficulty of hiring a new employee
 - Difficulties of expanding or reducing the number of work hours
 - Difficulty and expense necessary to fire a redundant employee
 - Cost of a redundant employee expressed in weeks of salary
- Registering a property
 - Number of legal procedures required to register a property
 - Time required
 - Costs such as duties, taxes, stamps and others paid to the register of property, notaries, lawyers and government offices. The cost is expressed as a percentage of the value of the property.
- Obtaining credit
 - An index of legal rights that measures the degree to which the sureties and the bankruptcy laws allow access to credit
 - An index of credit information that measures the rules that affect the environment, the quality of credit information
 - Coverage of a public registration of credit
 - Coverage of a private registration of credit
- Investor Protection

26. Neuman, Ariel Alberto, “Los problemas legales que más preocupan a los inversores” [“The legal problems that worry investors most”], El Cronista, Buenos Aires, 5/21/07.

27. World Bank & International Finance Corporation, *Doing Business in 2006: Creating Jobs*, (Washington D.C.).

- Transparency of transactions
- Responsibility for one's business in a company
- Capacity of the shareholders to sue the executives and directors for mishandling
- Strength of investor protection
- Payment of taxes
 - Total number of taxes paid
 - Time taken to prepare, file and pay them
 - Amount of taxes payable by a business, except for labor
- Foreign trade
 - Quantity of documents required for import/export
 - Number of signatures required for import/export
 - Time necessary to carry out all procedures
- Performance of the contracts
 - Number of procedures from the time the plaintiff files his complaint with the courts until he obtains payment
 - Time in days necessary to resolve the dispute
 - Cost in the courts, professional fees, administrative costs for recovery proceedings as a percentage of the amount of the debt
- Closing of a business
 - Average time to complete the procedure
 - Cost of the bankruptcy process
 - Recovery rate that calculates the percentage obtained by the plaintiffs (creditors, tax authorities, employees).

All the indicators mentioned are added up in a general index named "Facility for businesses (or economic activity)", in which the first places correspond, in this order, to: Singapore, New Zealand, United States, Canada, Hong Kong, United Kingdom, Denmark, Australia, Norway and Ireland.

As an example, we observe that the first place in "Starting a business" goes to Canada, where 2 procedures are required taking 3 days at a cost of 1% of the average income, and no minimum capital required. In Argentina, 15 procedures are required, taking 32 business days at a cost of 12.1% of the income per capita.

Concerning the payment of taxes in Argentina, 34 payments are required, totaling 615 hours and taking 116.8% of the profit, compared to 15.3 payments in developed countries of OECD, which require 430.5 hours to prepare and file and take away 47.8%.

7

Recommendations

1. Healing the wounds and avoiding new ones

- Argentina has not only lost great opportunities in recent decades, but it suffered deep wounds of all types, many of them of an economic nature.
- For this reason, perhaps, it is more important here than in other countries to avoid new downfalls. The Argentine economy has many scars, some very recent, and it should not receive new wounds.

2. Sustaining economic growth

- It is a priority to sustain the current period of economic growth at the highest level possible to be able to put the country on the way to development. Even though it is true that this is not the only determinant of the quality of life, it is certainly very important because it means opening opportunities for progress, employment and business, training and education, satisfaction of a larger number of needs.
- In this sense, the Argentine society has demonstrated that it has great capacity to recover, and a great vocation for progress, in addition to the burden of the phenomenal crisis and it has started again to produce and generate wealth. It does not need an engine to pull it since it has it in itself, only provided its projects are not impaired with economic upheavals that destroyed hopes and forced people to start everything again.

3. The key will be the investment

- The continuity of economic growth depends on investment and investment is present savings intended for higher production of goods and services in the future. What matters is the so-called productive investment because it is precisely the one that broadens the frontier of production possibilities, the capacity to produce in the future.
- Argentina requires a higher degree of normalization and consistency in the determination of investment, even in the margin of the economic model it decides to follow.
- It is necessary to clarify this because investment statistics include components that do not belong there, such as housing, construction or the purchase of cell phones. In both cases these mean more or less durable consumption, but not investment.
- Certainly consumption has nothing bad; moreover, it is the destiny of any production, but the engine that will support growth is the investment in productive capacity.

- This is currently insufficient to sustain a growth rate that would allow Argentina to recover part of the terrain lost during the last decades.

4. Investment must be of high quality

- At the same time, for long periods of time when there were even interesting levels of investment, their destiny was conditioned and distorted by the numerous interferences in the operation of the markets, which in the end diverted this investment to applications that are not the most productive for society.
- In addition, investment is fragile because it is influenced by many factors that impact in a different manner the various investors. Certainly, the return on investment is a fundamental determining factor, but the investment decision takes various paths depending on the organization, professionalism and size of the companies. It is not the same in single-person or family companies as in large international companies.

5. The rules of the game must be stable

- In both cases, however, the stability of the rules of the game is a central factor. In Argentina, a culture of volatility has developed, contrary to productive investment and busy to protect the value of the savings. It is a key factor for this culture to become diluted, which will happen only as the result of a long evolutive process.
- But this long evolutive process must be sustained and supported by the stability of the rules of the game or, more precisely, the rules of the game that protect investment, especially those that allow making long-term decisions foreseeable. It is necessary to extend the horizon for decision-making.
- For this purpose, clear rules of the game are needed, which protect central elements of investment such as property right, performance of the contract, stability of the macroeconomic variables. More than big revolutions, Argentina needs to sustain at this time this small group of central elements.

6. Fiscal solidity and macroeconomic consistency are indispensable

- For long periods of time, Argentina has implemented incoherent economic policies, which led to the periodic crisis that reached true “implosions”. Fixed or dirty rates of exchange with high fiscal deficit, financed with money printing or indebtedness have been a constant.
- There is a strong relationship between the volume, quality and profitability of investments and the country's macroeconomic conditions. Its instability prevents and distorts the process of formation of capital that mainly takes place at the level of the companies, which affects both its magnitude and the sustainability of economic growth.
- Because the volume and pace of the growth of the GDP depend on changes in the accumulation of capital, incorporation of technology and knowledge and corporate

abilities that in turn support new investments. This process of dynamic refunding is what Argentina needs to stabilize.

- But its strength depends on the macroeconomic conditions of the country, which in turn determines the degree of risk and the levels of uncertainty that the investors must face. Instability affects the capacity of the businessmen to plan their future investments and therefore affects the volume, destination, continuity and quality.
- By macroeconomic stability, we understand an environment of economic policy in which the rates of inflation, the rate of interest and the rate of exchange are stable and foreseeable.
- In this regard, maintaining fiscal solidity must be a permanent priority and all efforts necessary to maintain it must be made, taking into account obviously that fiscal pressure and the efficiency of public expenditure should not deteriorate the competitiveness of the economy.

7. It is necessary to reach all our potential to receive foreign investment

- These rules of the game are also determining factors for FDI. Argentina has lost its place as receiver of FDI in the region and the shortage of internal money makes it necessary to increase the arrival of foreign capital, the same as the return of the original local savings that fled to seek protection outside the country.
- In reality, it is very difficult for an underdeveloped country to make the leap to become a first-world economy without DFT because it will imply an enormous sacrifice for its population. The investment necessary to reduce the gap is huge and it would mean requiring a great effort of internal savings from a relatively poor society.
- Argentina is a country with “high potential to receive FDI” but “low yield”; in other words, it does not meet its potential. The FDI that is already installed in the country for decades has become accustomed to the ups and downs of the local economy. However, some of the more recently arriving foreign investors have decided to withdraw and most importantly, a large volume of potential FDI stays away given the enormous uncertainty generated by Argentine instability.
- The “rules of the game” and/or the “legal stability” impact this future uncertainty. In addition, it depends on what has been called “institutional quality”, a concept that is difficult to specify strictly but that indicates the existence of governability mechanisms that guarantee the respect of certain basic rights, including those mentioned above.

8. We must normalize international economic relations

- In addition to what we indicated, the pending problems that affected the arrival of new foreign investors and that need to be resolved or started to be tackled include, in short, the relations with the Paris Club, the petitions to the International Center for Settlement of

Investment Disputes (ICSID), and the situation of the holdouts.

- Argentina must normalize its foreign relations in these fields. Until it succeeds, it would not get out of the 2001/2002 crisis, nor will it escape its continuous costs.

- In this regard we propose:

- **Paris Club:** reach an agreement immediately to establish a plan for the payment of the existing debts to this group of countries, putting aside the ideological and/or political considerations that slow down the negotiations for the required participation of the IMF.

- **ICSID:** Argentina must maintain the position of accepting the decisions of this court, complying with the agreements signed and accepting the rulings. Ratification and renewal of the Bilateral Investment Treaties (BITs).

- **Argentina must resolve the problem of the holdouts.** For this purpose it should make a proposal to normalize the situation, which could be the reopening of the swap without altering the conditions of those who participated at the time. Due to the relative improvement in market conditions since the swap, declaring their reopening in the terms of 2005 would allow offering the best solution to these bondholders without generating a disadvantage for those who adhered earlier, respecting the risk they assumed at the time. Additionally, with a reopening under the same conditions, the country would not generate an international precedent for future swap operations in other countries. Furthermore, such a reopening could change the dynamics of the pending lawsuits in the courts of New York, where the conditions have worsened in recent months. This would have a cost for Argentina, but in last analysis such cost would be lower than sustaining the repudiation of this debt over time.

- The solution of these problems would help Argentina resume its traditional participation as a receiver of FDI in the region. This would mean receiving on the average a volume of six billion investment dollars annually, which would more than double the current volume of FDI.

9. And resolving the internal problems that affect investments

- As to the pending internal topics that directly affect the investment, we find as the most important, the following:

- Retentions to exports. Although inevitable in the context of the crisis, looking to the future, it is necessary to reduce the dispersion of the rates of exchange and advance towards their reduction.

- Price controls: They are useless and generate more problems than they allegedly resolve. They must be eliminated. The persistence in applying the Supply Law generates a high degree of legal insecurity, especially since its validity itself is highly doubtful. In addition, there are the extraordinary powers granted by the Economic Emergency Laws, which survived even though it is already difficult to continue speaking of "emergency".

– The freezing of the rates of the public services, which determined in turn the freezing of their investments. This becomes obvious in the energy restrictions faced by the country and that damage the current production and future investments due to the great uncertainty as to their availability. The highest incentive to private investment would allow leaving the path of nationalization of the provision of the infrastructure necessary in the sector. The State has historically demonstrated that it is inefficient in its management and capacity to obtain the huge resources necessary to provide the quality and quantity of services required by the Argentine people. The next government must consider a gradual adjustment of these rates, guarantee the autonomy of the regulatory agencies and establish competitive regulatory frameworks.

– Reduce until their elimination the sectorial subsidies by which an attempt is made to remedy this situation. Given their discretionality and inefficacy, they can only be a temporary palliative for extreme situations; they do not favor investments given the unforeseeability of their maintenance over time.

– Seeking to increase as much as possible the capacity of the officials to limit the right to free trade, to sell goods and services at market prices, to export products, to appropriate part of the proceeds of the sales, without a law that authorizes it, to force selling at a loss. All this not only reduces the incentives to invest, but gives the wrong signals to the businessmen, which make the little that is actually done not to go to the most productive sectors most needed by consumers.

– The intervention of INDEC must end, guaranteeing its independence and autonomy. The current manipulation leads to a distortion of the figures that show the loss or gain of purchasing power of the Argentines that generate current economic policies. In addition, it makes the Central Bank lose an important “compass” to determine its monetary policy. In this framework, the consumers and investors are plunged in a huge uncertainty because it is impossible to assess the real inflation with which they negotiate salaries, rents or the yields for savings or credit in pesos. All this leads to an inefficiency that generates lower investments, activity and welfare for Argentines. INDEC should be an autonomous institution not depending on the Executive Branch, with an independent board of directors that guarantees the truthfulness of the information issued by the agency. Right now the present government or a future one should appoint as its director a person with unquestionable solvency and honesty.

– The weakening of the financial sector in order to play its role of intermediary between savings and investment, as a result of the huge hit suffered by depositor confidence in connection with the pesification of deposits in 2002. The context of this paper does not allow presenting a specific proposal on this topic, but this does not reduce its importance.

– The persistence of inflation generates a lack of adjustment of the balance sheets of the companies to determine the income tax, which ends up by acting as an increase in tax without an increase in its rate. The final and definitive solution is obviously to eliminate inflation itself, but as long as this objective is not reached, allowing the adjustment would be a pro-investment measure.

– Regulatory barriers to investment that end up placing Argentina in the 101st position among 155 countries in connection with the facility of doing business. Here, the recommendation is simple, all the companies do it and they call it “benchmarking”. This would require studying what are the countries in first positioning in each of the categories in matters of business regulations, and copying their procedures. According to the “Doing business” indicator mentioned above of the World Bank, these countries are:

- Opening a business: Canada
- Obtaining licenses: St. Vincent and the Grenadines
- Hiring workers: United States
- Registration of property: New Zealand
- Obtaining credit: United Kingdom
- Investment protection: New Zealand
- Tax payment: Maldives
- Foreign trade: Hong Kong
- Performance of the contracts: Denmark
- Closing a business: Japan
- Facility to do business: Singapore

10. Everything boils down to a solid and reliable institutional framework, and macroeconomic consistency that eliminates the volatility of the rules of the game

- All these problems require serious solutions that allow consolidating a solid and reliable institutional framework, which would guarantee the continuity of the rules of the game and would allow for a horizon of stability as the country has not had for decades. Argentina must put an end to volatility, which would be the basis to multiply investments, in order to guarantee a continuous growth process.
- This institutional framework is the one that must also guarantee macroeconomic stability, to give foreseeability to the fundamental economic variables that affect investment. These, of course, must not only be stable but consistent among themselves, to avoid the recurrent crises suffered by the country.
- This is not a small task, especially for the authorities that will be elected in October, but the conditions are suitable. It is always simpler to accommodate and implement these conditions in a process of sustained growth and international conditions that are still favorable than in the midst of a recession or crisis.

Argentina has an opportunity, it is in the hands of the voters, and it is up to those who will be elected not to lose this opportunity.

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Annex

| ANNEX: INVESTMENT PRODUCTIVITY IN ARGENTINA (in USD millions 1993) | | |
|---|----------------------|--------|
| YEAR | GDP AT MARKET PRICES | GFDI |
| 1970 | 160,861 | 36,931 |
| 1971 | 166,913 | 39,915 |
| 1972 | 170,379 | 40,370 |
| 1973 | 176,761 | 37,451 |
| 1974 | 186,316 | 38,957 |
| 1975 | 185,211 | 39,024 |
| 1976 | 185,189 | 43,098 |
| 1977 | 197,015 | 52,102 |
| 1978 | 190,666 | 45,433 |
| 1979 | 203,892 | 48,515 |
| 1980 | 207,011 | 51,106 |
| 1981 | 195,787 | 43,453 |
| 1982 | 189,602 | 34,787 |
| 1983 | 197,401 | 34,926 |
| 1984 | 201,349 | 33,482 |
| 1985 | 187,352 | 28,759 |
| 1986 | 200,726 | 31,935 |
| 1987 | 205,926 | 36,066 |
| 1988 | 202,022 | 34,796 |
| 1989 | 188,011 | 27,280 |
| 1990 | 184,569 | 22,683 |
| 1991 | 204,094 | 29,475 |
| 1992 | 223,701 | 39,096 |
| 1993 | 236,505 | 45,069 |
| 1994 | 250,308 | 51,231 |
| 1995 | 243,186 | 44,528 |
| 1996 | 256,626 | 48,484 |
| 1997 | 277,441 | 57,047 |
| 1998 | 288,123 | 60,781 |
| 1999 | 278,369 | 53,116 |
| 2000 | 276,172 | 49,502 |
| 2001 | 263,996 | 41,750 |
| 2002 | 235,235 | 26,533 |
| 2003 | 256,022 | 36,660 |
| 2004 | 279,020 | 49,307 |

Source: Ferreres, O., "Dos siglos de economía argentina (1810-2004)" and Index