A surprisingly vigorous recovery, but confidence is still missing

As the southern summer begins, Argentina's economy is showing signs of life after the battering it received in 2001-02. Shops are looking forward to their best Christmas in three years and tourism is booming. Even in the less glamorous neighbourhoods of Buenos Aires, long-shuttered businesses are starting to re-open. Out in the pampas, farmers are buying new tractors and trucks, and market towns are buzzing with life.

For Roberto Lavagna, the economy minister, this is vindication. When he took the job, in April 2002, the economy was floundering, apparently at risk of hyperinflation, after a disorderly devaluation in a dollarised society, the largest debt default in history, and a deep depression. A year ago, the consensus on Wall Street was that the economy would grow a mere 2% this year while inflation would run at 20-25%. In fact, inflation is likely to end the year at 3% and GDP to expand by 7% (see chart). Next year's outlook is similar. The problems may come later.

Three things have helped the appearance of recovery along. One is simply the depth of the hole into which the economy fell. Even if growth continues at its current brisk rate, GDP will not return to its 1998 level until 2005. Unemployment is down from its peak of 21.5% last year, but is still at 15.6%. One Argentine in two now lives in poverty. Every week, militant groups of unemployed stage street protests.

Second, macroeconomic policy has been more effective than critics admit. Booming tax revenues have enabled the government to hit fiscal targets agreed with the IMF in September, though these do not allow Argentina to resume servicing most of its debts. Monetary policy has provided enough liquidity while keeping inflation at bay. Devaluation, plus the adoption of a floating exchange rate, combined with strong world demand, have stimulated exports.
Third, the government has focused on boosting domestic consumption at the expense of the demands of foreign creditors, banks, and privatised utilities. This is controversial, but has arguably made economic sense.

It has certainly made political sense for President Néstor Kirchner. Elected in April with only 22% of the vote, he has concentrated on wooing the general public. That paid off in a batch of local and congressional elections completed last month. The ruling Peronist party now holds 16 out of 24 provincial governorships, and another two are held by allies of Mr Kirchner. The party has also won a majority in both houses of Congress, though only a minority of its representatives there give the president their automatic loyalty.

When the new Congress starts work next week, the government will have less excuse for putting off some unpopular decisions. Until now, the recovery has been driven by cash and consumption (though a trickle of new investment has begun). It has relied on the "output gap" (ie, the extra amount that can be produced by bringing idle machinery and labour back into play), which probably still stands at around 10-15% of GDP. Once that is closed, growth prospects depend on new investment.

The government's critics argue that sustaining growth requires structural reforms and mending relations with international financial markets. The most urgent decisions include allowing privatised utilities to increase tariffs, frozen since January 2002, and reforming the finances of provincial governments. The trickiest issue is how much money to set aside for creditors rather than pump back into the local economy in social provision. The government insists that it can manage a primary fiscal surplus (ie, before debt interest payments) of no more than 2.4% of GDP this year, rising to 3% in 2004. That would not go far towards servicing a towering public debt of $185 billion, or 143% of GDP (see table).

With prodding from the United States and others, the IMF and other multilateral lenders have agreed to roll over Argentina's debts for up to three years. The government insists that it will honour "guaranteed loans" and newly-issued bonds (known as Bodones) which make up more than 50% of the assets of the local banks. But talks with other private creditors have barely begun. In September, the government made an offer that involved writing down 75% of the value of the defaulted debt, refusing to pay interest arrears and issuing new low-interest bonds. Since that would have amounted to an up to 40% cut in the net present value of the bonds, creditors dismissed it as derisory.

On December 3rd, the Argentine Bondholders' Committee, a New York-based group, made a counter-offer. This would accept a write-off of 35% in the nominal value of the defaulted debt, but Argentina would have to honour overdue interest. Abigail McKenna, who sits on the committee, says the government could service this by increasing its fiscal surplus to around 3.5% of GDP and raising fresh money in the international markets.

Though agreement is not impossible, it is not likely to be swift. Some Argentine economists argue that the government should anyway be looking elsewhere for new investment, rather than tapping the international markets again. Argentines are thought to hold at least $100 billion abroad, and perhaps another $20 billion at home under the mattress. To coax that money back, the government needs to set out clear rules and incentives for investment, and reform the tax system, according to Aldo Ferrer, an economist at the University of Buenos Aires.

One hopeful sign is that bank deposits are rising again. But the banks will not resume lending until they are sure that they can trust the government and its paper. To break this stalemate, the central bank has issued new rules under which banks can write off their losses from the devaluation over five years, but which also oblige them to recapitalise, or close.

"We don't have money. All we have is time," says Alfonso Prat-Gay, the central bank's governor. "It's all about the right balance between caring about the past and caring about the future." That goes for the economy as a whole. Mr Kirchner rants about the foreigners who made a fortune from Argentine debt and are now driving a hard bargain with a broken country. But to sustain the recovery, the president needs to make investors confident enough to put their money to work in Argentina. Sooner or later, that will require setting the unfinished business of the past.