

A new Argentina

By Jan Dehn

We believe that Argentina will be a different place a year from now with a new and more pragmatic government running the country. All the main contenders for president in the next government have similar economic programs that involve: a moderate adjustment of fiscal policy; replacing central bank financing with external borrowing; gradual monetary tightening; and quickly resolving the holdout issue.

As Argentina returns to capital markets to finance the settlement with holdouts, the country's index weight will rise considerably from today's very low levels. The main near-term macroeconomic risk – a balance of payments crisis of Argentina's own making – is receding due to a myriad of successful *ad hoc* capital raising exercises by the government.

All change

The 'Kirchner era' was a strange epoch that began with default and ended with default. The Kirchners – Nestor followed by his wife Cristina – oversaw the restoration of order in Argentina after the chaos that accompanied the 2001 default, but then became bogged down by unnecessary confrontations, economic mismanagement and abuse of power. In short, this was a lost opportunity for the country. This now looks set to change. The upcoming presidential election later this year will not only decisively mark the end of the Kirchner era; it also has the potential to usher in a new, more harmonious and brighter future for the country, albeit one born with serious challenges from the onset, mainly on the economic front.

A busy election schedule

2015 will be a busy year of elections in Argentina. The schedule kicks off with gubernatorial elections in the next few months followed by primaries and then the presidential election itself in October. A run-off in November will then take place unless one candidate wins by a clear margin.

Recent polls have identified three candidates that are likely to contest for the presidency: Province of Buenos Aires Governor, Daniel Scioli (a Peronist former Vice-president in the Kirchner government); former Cabinet Chief in the Kirchner government and Mayor of Tigre, Sergio Massa (also a Peronist); and City of Buenos Aires Mayor, Mauricio Macri (the sole non-Peronist candidate in the running). The final list of candidates will be confirmed by June when contestants have to register for primaries, but the odds will already shorten when the results of key local elections scheduled for Q2 become known (in Santa Fe, Mendoza, Cordoba and Buenos Aires).

2015 sees a full electoral schedule in Argentina with provincial and then presidential election activity likely to last from March until November

Fig 1: Key dates in Argentina's 2015 electoral calendar

Event	Dates
Provincial elections in Mendoza, Cordoba, Santa Fe and the Province of Buenos Aires	March to June
Registration for primary elections	June
Primary elections	August
First round of the presidential election	October
Run-off presidential election	November (unless one candidate secures 40% of the total vote plus 10% clear margin over the runner-up in the first round)

Continuity or change?

The Peronist Party has occupied a central role in the political landscape for decades, much like the Institutional Revolutionary Party (PRI) in Mexico. Of the two Peronist candidates – Scioli and Massa – Scioli seems better placed to command the majority of the Peronist vote. Scioli has money, institutional backing from the Province of Buenos Aires and support in other key provinces around the country. His trump card may be that he is more likely than Massa to attract the 25% of voters that support Cristina Kirchner.¹ A recently mooted idea is that Massa and Scioli may form a joint Peronist ticket; undoubtedly further permutations will emerge as the elections draw nearer.

¹ Argentine law requires all adults to vote, though they can vote blank or in effect nullify their vote, say, by voting multiple times or spoiling the ballot.

Mauricio Macri is a genuine 'change' candidate, a real alternative to the Peronists. But his chances are closely tied to perceptions about the economic and political situation – if locals perceive a looming crisis they may opt for Macri. Presently, Argentinians do not perceive themselves to be in the grip of a serious crisis. Besides, Macri lacks nationwide backing, though he has recently broadened his appeal considerably outside Buenos Aires by forming an alliance with the Radical Party², which holds influence in some provinces.

All three presidential candidates are likely to focus on gradual fiscal adjustment, greater external borrowing, gradual monetary tightening and seeking a rapid resolution to the holdout issue

Different candidates, same policies

At the broadest level, Scioli, Massa and Macri would all pursue the same basic, four-pronged approach to fixing Argentina's economic problems: (a) gradual fiscal adjustment; (b) replacing inflationary central bank financing of the fiscal deficit with external borrowing; (c) gradual monetary tightening; and (d) a quick resolution to the holdout issue. In their view, Argentina does not need draconian fiscal adjustment – after all, the country's external debt is so low that the government has considerable room to expand its foreign borrowing as replacement for inflationary central bank financing of the deficit without encountering debt sustainability problems.

We believe all three candidates would aim to dissolve the so-called 'lock law' within the first 100 days of the next government to enable a quick deal with holdout investors. Since this would require passage in Parliament the odds of success would probably be greater if Scioli won than if Macri won. All candidates would then proceed with rapid external debt issuance, in our view. The amount of money required to settle with holdouts could easily reach USD 12-20bn (depending on the outcome of a deal with holdouts). The effect would be to increase Argentina's JPM EMBI index weight materially in 2016, with more coming in subsequent years.

All three candidates are likely to tighten monetary policy gradually – eventually targeting 2%-3% real interest rates. Scioli would eliminate deficit financing by the central bank more gradually than Macri's more drastic adjustment. Macri is betting on stronger inflows from abroad in response to a strong adjustment, but the policy risks triggering a social backlash. Macri's administration would also go further on the fiscal front by targeting a balanced budget within a year or two by cutting subsidies to zero. By contrast, Scioli's economic program would aim only to halve the 5% of GDP fiscal deficit within the first year through subsidy reductions limited to the higher income segments of the population and thus only target fiscal balance over a multi-year period. Massa would similarly be more gradualist than Macri.

A Macri administration would also place greater weight on reversing the country's most distortionary policies, such as price controls, directed credit and capital controls in particular. Macri's program counts on a strong supply-side response aided by significant capital inflows. For that reason, he sees the currency stabilising and even appreciating, which should help to break

Argentina's entrenched inflation problem. Scioli and Massa would remove capital controls and free up the exchange rate, but would be happy to see the currency weaken, particularly in relation to the Brazilian Real.

Look through the election

Argentinian politics are volatile. Predicting anything more than a few months in advance is difficult. The level of political noise could rise significantly leading up to the election. Cristina Kirchner will aim to sell her support in exchange for guarantees of immunity after leaving office, placing strong incentives on the part of the candidates to polarise public opinion about Kirchner, including her alleged role in the recent death of a prosecutor Alberto Nisman and an alleged cover-up of a terrorist attack in 1994.

Investors should discount the election-related noise for several reasons, in our view. First, there is little time or political room for Kirchner to inflict a lot of additional damage on the country even if she 'radicalises' towards the end of her term to deflect political attacks. Second, if Scioli and Massa get tainted by scandal through their association with Kirchner this will only enhance Macri's chances of becoming president, which would be good news from a market perspective.

Kirchner could only leave office before her term ends if she resigns or is impeached. Impeachment is difficult given her majority in parliament and a resignation in the few remaining months seems unlikely given that any court case to establish her guilt would take years to reach a verdict.

Predicting outcomes in Argentina's volatile politics is difficult, but we believe investors will look through most of the election related 'noise' and focus on the next administration

The economy – to the brink and back again

The early Kirchner administration inherited an economy in ruins – worse than the Great Depression. There was one silver-lining – most of the country's debts had been wiped out.

The government immediately engaged in hyper-stimulus to pull the economy out of the slump. Initially the economy responded well to stimulus, but the Kirchners never understood that stimulus had to give way to supply-side reforms to ensure a sustainable expansion.

As demand overtook supply and Argentina began to overheat, the Kirchners attacked the symptoms of overheating. Inflation spiralled out of control (a problem that has continued to this day – inflation is currently close to a historical high at nearly 40%). When pension funds became reluctant to buy government bonds because of inflation the government manipulated inflation statistics and eventually nationalised the pension funds. This marked the beginning of the end of the national savings base. As savers started to take their money off-shore the government imposed severe controls to keep the funds at home, including restrictions on both capital and current account transactions. The result was inevitable: the real economy began to hurt and soon the public finances began to reflect the underlying economic weakness. The government then turned to money printing to replace forgone taxes, which only weakened the currency further.

² Radical is in name only. The Radical Party is largely regarded as more market friendly than the Peronist Party.

Argentina has faced a constant battle to achieve a healthy balance of payments (BOP) and today appears to be uncomfortably close to a BOP crisis.

Microeconomic interventions also became more wide-spread as the economy weakened. The government nationalised companies, introduced price controls and limited access to foreign capital. On the demand-side, it made extensive use of subsidies, particularly for energy, while pension benefits and wages were boosted in a bid to increase growth and the government's own popularity.

The many distortions soon resulted in a vibrant parallel economy. Incentives to engage in corrupt practices rose sharply, particularly for those in or close to the government. Unions and other organised groups with strong lobbying powers became particularly effective in furthering their own narrow objectives at the expense of the well-being of the wider population – to the point that these groups now pose a serious challenge to anyone seeking to reverse the current distortionary policies.

Politics of confrontation

From Day One, the Kirchner administration pursued a highly confrontational approach to problem solving. This meant that seeking favour (and avoiding confrontation) with the government became a more effective way to achieve prosperity than conventional business. Argentina's institutions – the central bank, the judiciary, statistics agencies, etc. – gradually became more politicised. Today, even the press is heavily coerced – resulting in a loss of important checks and balances and fuelling a growing sense of impunity, although Argentina's media retains a far greater degree of institutional independence than, say, the press in Venezuela. The government's abysmal economic management has been extremely bad for investment, especially in attracting foreign direct investment which has rarely exceeded 1% of GDP in recent years.

The failure to resolve the holdout issue is another symptom of the confrontational attitude of the Kirchner administrations. This ultimately led to a renewed default, which has pushed sovereign spreads to some of the widest levels in the world. The only silver-lining of Argentina's financial isolation is that Argentina has not been able to borrow much abroad, so the country's external debt levels are very low and have in fact been falling throughout most of the Kirchner era.

Fig 2: Selected macroeconomic indicators – 2014

Indicator	End-2014 (estimate)
Real GDP growth (%)	-2.5%
Inflation (% annual)	39.0%
Primary fiscal deficit (% of GDP)	-1.0%
Gross general govt debt (% of GDP)	43.0%
Net general govt debt (% of GDP)	26.0%
External public sector debt (% of GDP)	15.0%
FDI (as % of GDP)	1.0%
2014 scheduled debt amortisations (USDbn)	5.3
2015 scheduled debt amortisations (USDbn)	8.7

Source: Ashmore, JP Morgan

Argentina's external balances, while weak, have performed less badly than expected. The BOP is likely to remain under pressure but we believe the new government should have sufficient reserves to address the macro economic challenges it will face

The BOP – today's main risk

President Kirchner is unlikely to make major changes to the broad direction of economic policy during the remainder of her term in office. The BOP will therefore continue to be under pressure. Even so, the BOP problem is mainly one of liquidity rather than solvency.

Argentina's external balances, while weak, have performed less badly than expected. An acute BOP crisis now looks unlikely in the remainder of Kirchner's term. The reason is that Argentina has been able to secure financing from a number of unexpected sources, including:

- A commitment of up to USD 11bn in swap lines from China (of which USD 3.1bn has been disbursed)
- A USD 500m bilateral loan from France
- Issuance to the tune of USD 750m by the nation's largest energy firm, YPF
- Another USD 750m in FDI from the auction of 4G licenses
- Project loans, including a USD 300m loan from China.

The government also has the option to issue more USD bonds under local law, though it has proven difficult to reach foreign investors.

Taking these latest developments into account we expect that Argentina's FX reserves will decline to around USD 24-25bn in 2015. While this is not comfortable, it should suffice to enable the next government enough to fix the holdout issue. The key to easing the BOP situation is reducing the external borrowing constraint – this requires macro adjustment and resolving the holdout issue, both of which look set to be addressed by the next administration.

Fig 3: Table: Balance of payments (USD bn)

Indicator	2015 (estimated)	2014
Current account	-7.0	-5.7
Goods balance	6.0	8.8
Balance on services, income and transfers	-13.0	-14.5
Capital account	2.0	8.7
Financial entities, including foreign central banks	8.5	3.6
Non-financial public sector	-6.0	6.6
Non-financial private sector	-0.5	-1.5
Errors and omissions	-2.0	-2.2
Change in reserves	-7.0	0.8
Reserves (year end)	24.4	31.4

Source: Ashmore, JP Morgan

Shifting local sentiment

Local businesses in Argentina have begun to respond to the improvement in Argentina's external balances and particularly, the prospect of a change in government. Locals believe that regardless of who wins the election the next president will be far better than the Kirchner administration – more pragmatic, adjustment-minded and focused on the key macroeconomic issues without seeking to implement radical change. The default issue is therefore being heavily discounted. This improvement in domestic confidence has lately manifested itself in a phenomenon not seen in Argentina for some time, namely the willingness of some locals to place money in Argentine term deposits rather than immediately taking funds out of the country.

Conclusion

We think investors will increasingly discount the holdout issue and look through the election-related noise to the next administration. Despite these positives, the economic legacy of the Kirchner era poses a major challenge for the next government. Also, Argentina's record of past defaults means that greater reliance on external debt going forward requires close monitoring. Still, debt sustainability and the government's amortisation profile are benign after the country's long exclusion from global capital markets. As locals are becoming more optimistic about the future, foreign investors are also likely to slowly begin to believe in a new Argentina.

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