ANDBANK RESEARCH

Global Economics & Markets

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Argentina – Yes, winds of change are blowing on the horizon but … do not put long yet!

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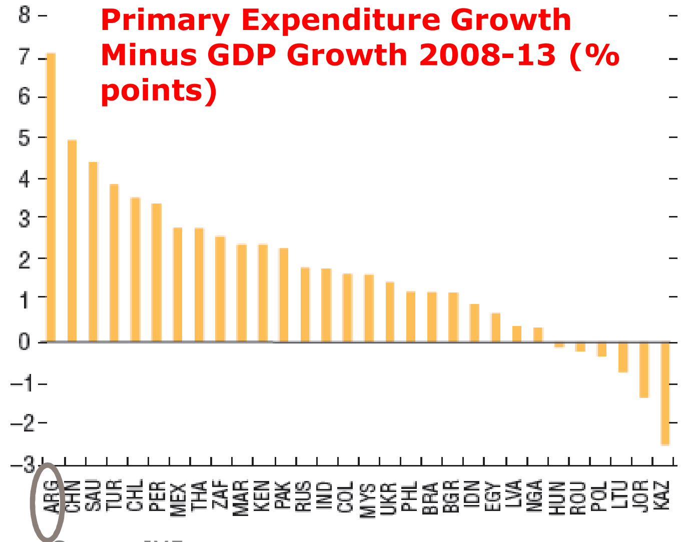
Argentina - A general assessment

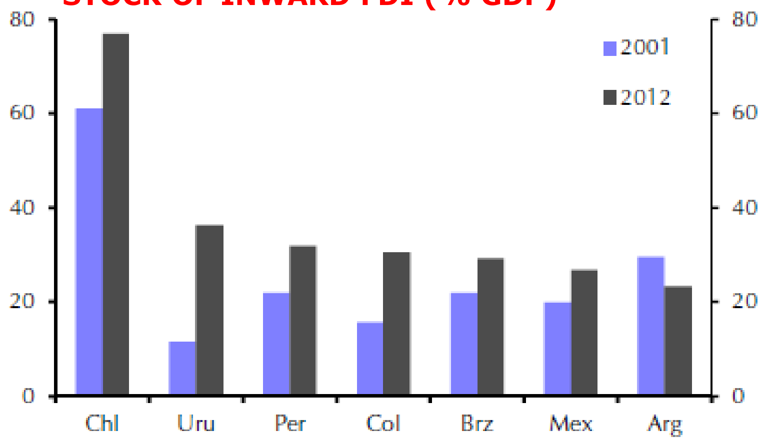
Admittedly, we have been consistently negative in our economic outlook for Argentina under the leadership of Ms. Cristina Fernandez de Kirchner. Following are just some of the reasons (that are still in force):

1. An economic model based on a heavy-handed state intervention. Government spending already represents a 45% of GDP in Argentina (40% in Brazil, 35% in Uruguay, 28% in Colombia, 27% in Mexico, 23% in Chile and 20% in Peru). And this dynamics will deteriorate further in Argentina as growth in public spending is 7 percentage points higher than GDP growth (see chart 1)
2. Official statistics that are widely discredited
3. A growth model that relies almost exclusively on positive dynamics of commodity prices (soybeans) and terms of trade
4. Fundamental distortions in Argentina's economy have not gone away (rampant inflation rate of around 25% y/y, and probably escalating above 30% in 2014) …
5. … that contribute to a drastic loss of competitiveness for producers and a constant deterioration of real disposable income for consumers…
6. … posing real hurdles to inward investment (Argentina is the only major economy in Latin America in which the stock of Foreign Direct Investment as a share of GDP has fallen over the past decade (see chart 2)
7. In fact, independently produced indicators of activity suggest that Argentina fell again into recession in 2012



Source: IMF

STOCK OF INWARD FDI (% GDP)



UNCTAD, Capital Economics

Nevertheless, the market envisions a change in the political environment (something that we consider as premature)

- **Cristina Fernandez's second successive term as a President will end in 2015. In order to run for office again she will need to amend the Constitution (something that requires the backing of two thirds of the Congress). Ms. Fernandez's FPV (Frente para la Victoria) currently holds a majority in both the Congress and the Senate, but partial legislative elections are due to take place in 27th October and could lose its majority** (at stake are 50% of seats in the Congress and one third of seats in the Senate)

- **The results of last August's primaries (where the ruling party won only in 10 of the 24 provinces) suggests Kirchner's majority could be narrowed significantly following October's vote.**

  ✓ Sergio Massa (Frente Renovador), won in the key province of Buenos Aires (home to 40% of the electorate) campaigning on the basis of a break with Kirchner-era policies, meaning that Massa stands as a presidential rival to the FPV in 2015.

  ✓ Mr. Massa obtained 31% of votes while the ruling party just obtained 26.8% in BA, and the most recent polls suggest that Massa's lead over FPV's Insaurralde has widened since august to around 10%-pts.

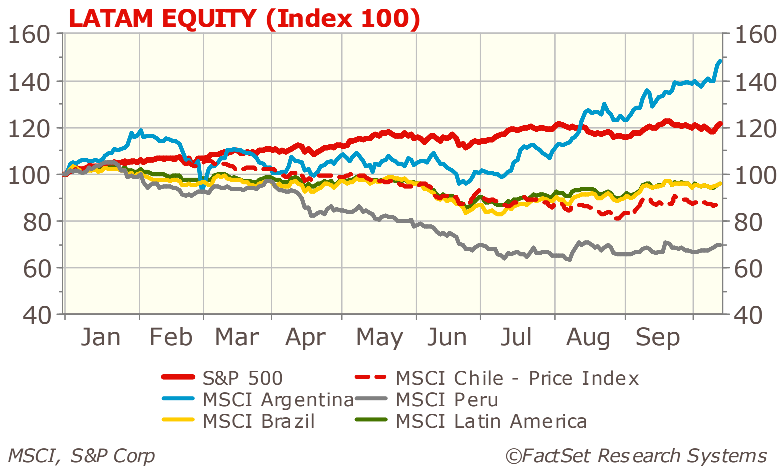
  ✓ Additionally, in the other three key provinces (Cordoba, Santa Fe and Capital Federal) representing 63% of electoral roll, the ruling party lost the elections.

- **Against this backdrop, markets reacted with enthusiasm, interpreting that the Kirchner dynasty is approaching the end of the road (MERVAL equity index has rallied a 35% since the August 11th result).**

- **However, investors should bear in mind two aspects:**

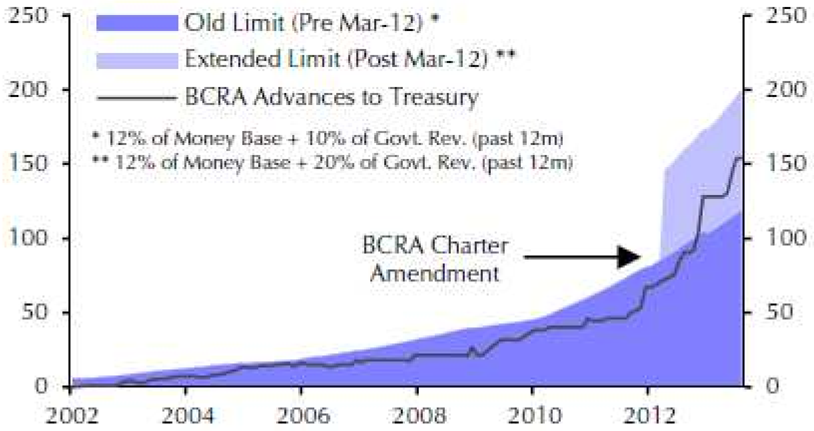
  1. Neither a victory of the ruling government would be supportive for the markets, nor a weakening of the government would have short-term positive effects on markets.

  2. Although Fernandez is unable to run for office again in 2015 elections, there is a chance that a continuity candidate fills the breach. Additionally, the FPV has a history of bouncing back from poor mid-term results.



When a ruling party is seemingly approaching the end of the road, some risks can run wild …

BCRA Temporal Advances to Treasury (AR$bn)



BCRA, Capital Economics

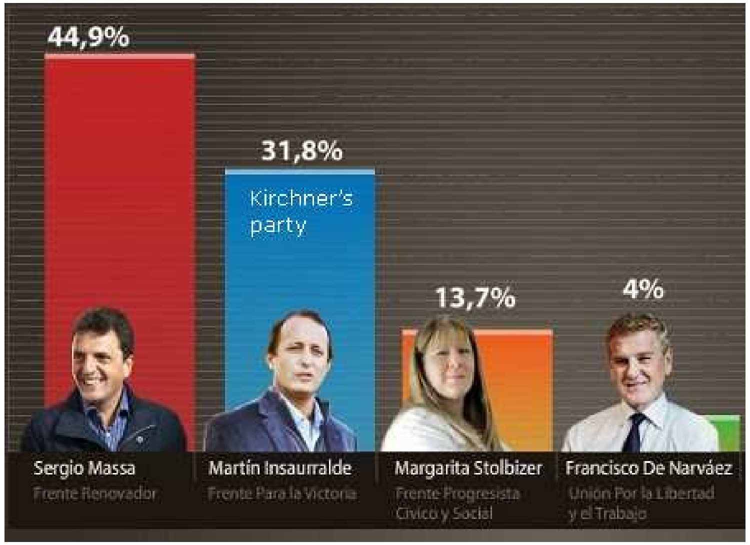
… simply because if the ruling party still receives "enough" support in the October's 27th elections there is a real threat that the "not all is lost" sentiment prevails and then, the current government will attempt to pump the economy in order to get its candidate in the Casa Rosada in 2015 by deepening the current model. This strategy could be very dangerous if we consider the following.

1. Government spending has been financed by printing pesos.
2. Since changes in BCRA charter (March 2012), the scope for the central bank to print money and lend it to the Treasury has been dramatically expanded (see the chart)
3. In reality the IOUs (non-negotiable debt instrument) issued by the Argentine Treasury in exchange of newly-printed pesos tend to be rolled over indefinitely.
4. This policy probably put further pressure on inflation and Fx in the past, but if policy is relaxed even more (in a desperate attempt to pump the economy) then, inflation could run wild above the 30% and we could witness a disastrous impact on the currency.
5. Incredibly, low quality, illiquid government securities (including non-transferable bills and temporary IOUs) now account for 60% of BCRA assets. And the pensions agency ANSeS have already been drained of a significant amount of its liquid assets. Any other movement in the same direction, could be critical.

Even if a weakened mandate for Ms Fernandez results from October's election, this could be equally dangerous as well.

- Certainly a repeat of primaries results (where the ruling party showed a poor performance) would give a slender majority to FPV in both chambers
- If true, this will effectively **leave Fernandez de Kirchner with very limited ability to push through new legislation,** and this could be also very dangerous.

Last poll in Buenos Aires Province



- The danger lies in the fact **that the current regime has relied extensively on "quick fixes" to prevent tensions in the balance of payments (BoP) and massive outflows of capital** (quick fixes that steam from import controls imposed to businesses, restriction on the ability of locals to purchase foreign currency, etc.)
- Ironically, one big risk from a poor showing of the ruling party is that the government would have little ability to legislate and impose administrative control. Speaking clearly, **there will be no effective capacity to fix problems in the short term.**
- This lower capacity could bring the BoP towards additional deterioration. With a US$10bn earmarked for debt repayment, **dollar reserves could reach critical levels with no capacity for BCRA to support the peso.**

But let us be constructive, as the winds of change blow on the horizon

- Now that it looks increasingly probable that a more orthodox administration will be in place, the key question is: **how could the economy be put on a more sustainable footing?**

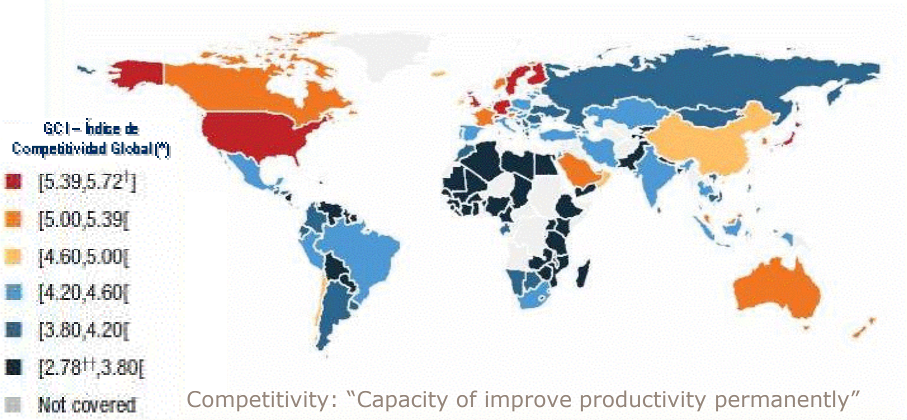
- The probability of the new government resulting from the 27th October elections (or 2015 presidential elections) to turn the economy will depend on its capacity to address three specific shortcomings

SHORTCOMINGS TO BE ADRESSED*

1. Lack of Competitiveness
2. Restore policy credibility
3. Clean up the business environment.

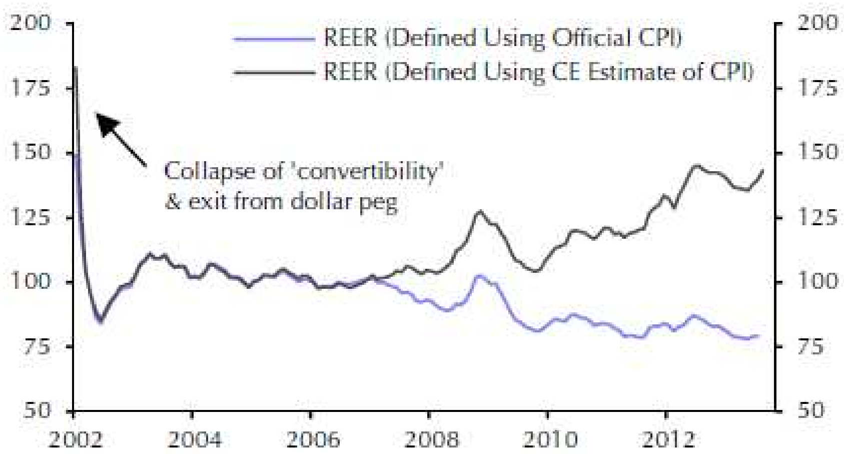
**According to N.Shearing, D.Rees and M.Henderson at Capital Economics, these are the main imbalances.*

1. How to address the problem of competitiveness?



Competitivity: "Capacity of improve productivity permanently"

ARS Real Effective Exchange Rate (2006=100)



Capital Economics

- First, in case you have any doubt, companies in Argentina are not competitive according to the "Global Competitiveness Index 2012-2013" released by Word Economic Forum (see the map)

- **Where are the problems detected?**

  1. Rampant inflation of >25% => Inputs costs faced by local producers increase at a much faster pace
  2. The Peg Regime in Forex => Means that the peso cannot naturally adjust to fully restore the external competitiveness

- **What are the steps to be taken?**

  1. **Bring inflation under control** by (1) halting the practice of deficit monetization (that has brought the M2 to grow at a 30% y/y pace).
  2. **The official peso must be devalued until reach a more "natural" level.** The official fixing in ARS has depreciated a 17% YTD vs the US$. The inflation differential with the US (using official CPI figures) would explain about 8% of depreciation, leaving the REER depreciation in the 9% area. However, using a more reliable CPI data (of about 25%), the inflation differential would justify an ARS depreciation of 23%. Since official depreciation has been of just 17% this means a REER APPRECIATION of 11% (which has brought the Real ARS to reach levels not seen since the 2001/02 crisis -see the chart-). How to allow for the necessary depreciation without spreading panic among savers?

2. How to restore Policy Credibility?

- **Argentina's government has lost credibility on several fronts:**
    1. The accuracy in key national figures such as GDP growth, CPI, etc…
    2. Independence of public institutions
    3. Additionally, ongoing legal disputes with holdout bondholders from the 2001 debt default continue to raise concerns about the ability of Argentina to honor contracts.

- **How to restore credibility? What should be the Immediate priorities?**
    1. Improve the quality of official reports by adapting the methodology to the IMF requirements (this would help to mend the relationship with the IMF and remove the threat of sanctions)
    2. A reconciliation with international creditors by removing unnecessary barriers to future negotiations such as the "lock law" of 2005 (effectively preventing the government from making any future offers to holders of defaulted bonds).
    3. The rewards in restoring Argentina's reputation with creditors are huge:
        i. If able to borrow from abroad again, this will relieve pressure on the BoP (where Current Account points south), opening space for the removal of trade controls and capital controls that have deteriorated investment and growth.
        ii. An additional benefit would be in the form of lower borrowing costs. Today's yields on Argentine sovereign debt are a multiple of those elsewhere in the region, negatively impacting corporates. Much of the competitiveness problems have its root in this issue.
        iii. With lower borrowing costs, return on investment would improve dramatically, what would encourage gross fixed capital formation, which in turn would help to overcome competitiveness problems.

3. The third pillar. How to restore the business environment?

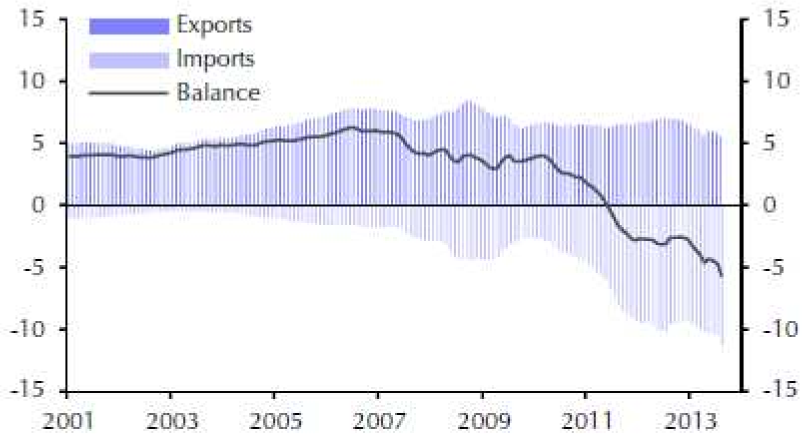
- **There are significant restrictions in the business environment**

  1. ***Heavy regulation.*** One example could be the maintenance of artificially low tariffs in the utilities sectors. The effects are (1) a subdued profitability, dampening the likelihood of local players to invest, and (2) this situation significantly reduces the entrance of new competitors. In summary, low investment plus low competition that results in a bad service. A very expensive one for the government (which is to say that is expensive for the entire population). Crystal clear, an uncompetitive environment.
  2. ***High Taxes,*** that raises the required rate of return to be considered by new entrants
  3. ***The threat of expropriation***, etc…

- **How to improve the business environment?**

  1. ***Smooth regulation*** (Long Term process). We reckon that this entail first a change in the own model of growth. From the current model where there is a heavy state presence, to a one less dependent on Government spending. One thing is clear. The higher the government presence in the economic growth, the higher the taxes and regulation.
  2. **Attract foreign operators in the energy space** (Short Term strategy). This might eventually restore Argentina to energy self-sufficiency. Consider that the Vaca Muerta formation is estimated to contain the third-largest reserves of shale oil and gas. Because of the lack of technical capacity among domestic operators (due to the structural shortcomings mentioned), these resources remain untapped.

ARGENTINA – Energy Balance (US$bn, 12m roll)



Capital Economics, Thomson Datastream

Conclusions

- **Many of the reasons justifying our negative stance in the economy are still in place** (heavy-handed state intervention, official statistics widely discredited, high leverage on commodity prices, fundamental distortions in key factors such as inflation, drastic loss of competitiveness, deterioration of real disposable income, real hurdles to inward investment, etc.)
- **Nevertheless, the market envisions a change in the political environment (something premature in our view).** The results of August's primaries (where the ruling party won only in 10 of the 24 provinces) suggests her majority could be narrowed significantly following October's vote. If true, Ms Fernández will not receive backing of the two thirds in Congress required to amend the Constitution in order to run for office again.
- **Despite the fact that winds of change blow on the horizon, risks during the following two years are arguably as great as at any time in recent history.**
  - ✓ if the ruling party still receives enough support in October's elections and keeps power to push through new legislation, there is a real threat that the "not all is lost" sentiment prevails and then, the ruling government will attempt to pump the economy by deepening the current model
  - ✓ However, a repeat of primaries results would leave the ruling party (FPV) with a slender majority in both chambers, effectively leaving Fernandez de Kirchner with very limited ability to push through new legislation. The danger lies in the fact that the new government could not any longer enjoy on "quick fixes" to prevent tensions in the balance of payments (BoP) and massive outflows of capital.
- **However, we are constructive in the long term by assuming that a more pragmatic and orthodox government takes office in late 2015.** By removing radical bills the new administration will be able to lay the foundations for a more sustainable recovery although, admittedly, this will weight on growth in the short term. the new authorities take the steps to address the structural shortcomings in the areas of competitiveness, the Restoration of policy credibility and the clean up of the business environment**.**
- **When will we change our "negative" stance toward a more positive one?** When we have evidence that steps have been taken to address the structural shortcomings. Specifically when we see advances in (1) bringing inflation under control, (2) halting the practice of deficit monetization, (3) a firm devaluation of the official peso toward a more "natural" level, (4) improve the quality of official reports by adapting the methodology to the IMF requirements, (5) steps to smooth the acrimony with international creditors by removing the "lock law", (5) reduce the excessive regulation in the business environment, (6) reduce the perceived threat of expropriation, and (7) attract foreign operators (ideally in the energy space).
- **For now, we recommend to take profits and stay short in Argentinian equities, bonds and Forex.**

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