ANDBANK RESEARCH

Global Economics & Markets

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Argentina's AR$ depreciation – A necessary step in the right direction … although done in the worst possible way. (But let's be constructive and consider just the first part of the sentence)

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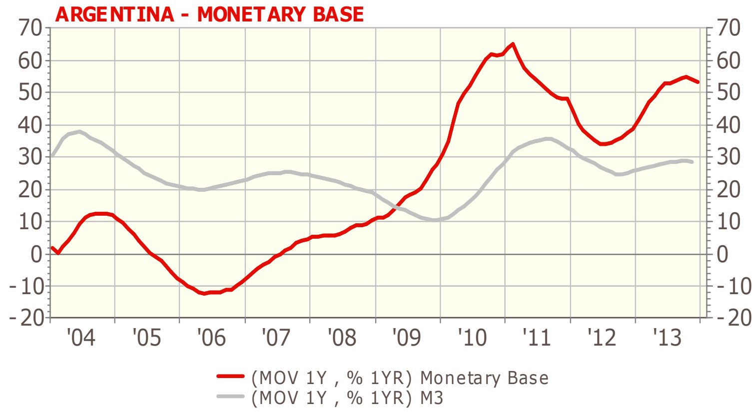
AR$ depreciation – Indeed, a necessary (good) step … although has been done in the worst possible way.

- Indeed the country's crawling peg regime did not let the peso to adjust to a **more natural level**.
- In that regard, the recent depreciation is, in my humble opinion, a necessary (good) step to restore external competitiveness. Why?
- Using a more reliable CPI rate of 25% means that the inflation differential would have justified an ARS depreciation of 23% vs the usd in 2013, however Argentina's authorities allowed a depreciation of just 17%, resulting in a Real Effective Exchange Rate appreciation (REER) of the AR$ to levels not witnessed until the 2001 crisis. Reached that point, it was inevitable and necessary to depreciate the official rate.
- Why I said it has been in the worst possible way?
    - ✓ To depreciate a domestic currency by 23%, is an exercise that must be done in a communicated and controlled way, as opposed to a sudden unannounced depreciation that could spread panic among international investors that have placed their savings in the rest of Emerging Countries (just as has happened)
    - ✓ Immediately after, all restrictions on foreign exchange transaction should be removed, allowing the peso to float. What the authorities have done by reducing the tax on purchases of foreign currencies (from 35% to 20%, but immediately to return to 35%) and only for individuals earning more than AR$7,200 per month (with a limit of $2,000 per month) is simply a kind of joke.

Here is the list of the necessary actions that Argentina's authorities should undertake so that investors (like us) decide to invest their savings in that economy.

1. **Halt the practice of deficit monetization and stop subsidizing the economy.** See how the money base has been expanding faster than money supply M3 in the last 4 years. Monetization has been implemented through BCRA's advances to treasury. These advances were drastically increased from BCRA Charter amendment in 2012, that relaxed limits on printing pesos. This amendment allows now the central bank to advance the equivalent of 20% of the Government Revenues to the Treasury. As a result, the BCRA's transfers to the Treasury have been growing steadily at an 80% y/y during 2013 and are still keeping a dangerous pace of growth (75% y/y).



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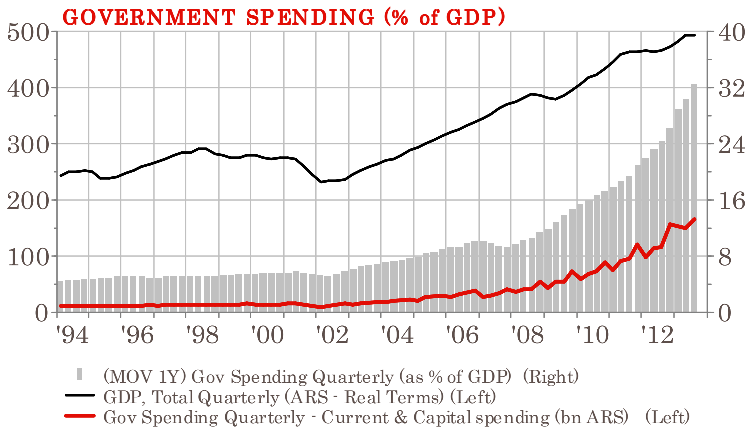
2. **Remove the restrictions on foreign exchange transactions and allow the currency to float.** I guess that at this point, allowing the currency to float should be excessively painful but the consequences of many years of poor policymaking must inevitably be painful.

3. **Take meaningful steps to tackle high inflation.** This will be all the more challenging after a 23% depreciation that will put upward pressure on input costs, but it is of the utmost importance to start seeing action in this area. Rampant inflation (>25%) means that input costs faced by local producers are much higher than for their competitors. <u>Importers rush to buy everything they can (over-invoicing), while exporters try to delay sales (sub-invoicing). The result is a deteriorated current account balance. The current mortal sin in financial markets.</u>



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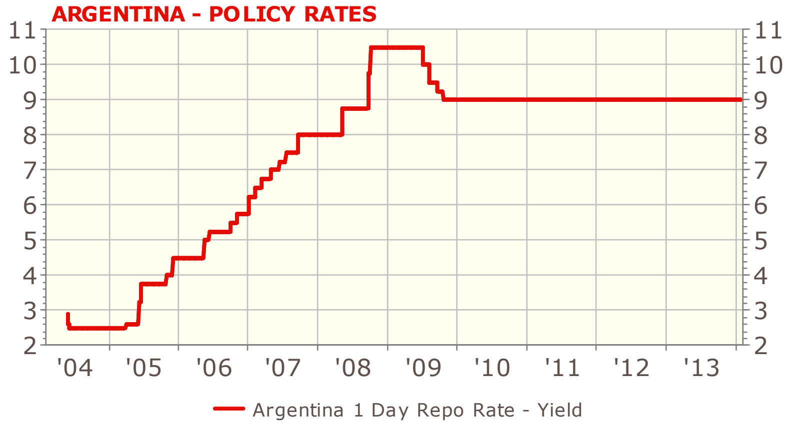

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4. **Monetary policy must be tightened aggressively.** Admittedly this will also weight on growth (at least in the short term), but by tightening immediately, the administration would at least be laying the foundations for a stronger and sustainable recovery. Additionally this step (combined with all the aforementioned), should help to compensate the outflow of domestic capital.
5. **Improve the accuracy and quality of official reports** by fully adapting the methodology to the IMF requirements. This would help to mend the relationship with the IMF and remove the threat of sanctions.
6. **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). 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 the Current Account points south), opening space for the **removal of trade 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.

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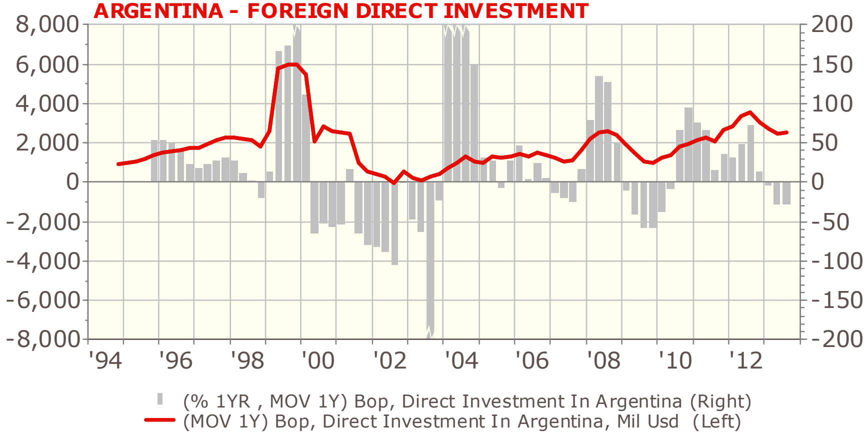
7. Improve the business environment by smoothing regulation (Long Term process).
One example of the State interference could be the maintenance of artificially low tariffs in the utilities sectors. The effects are (1) a subdued profitability dampening the likelihood of local players to invest, and (2) 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. Foreign investments were poor in 2012 (barely amounted 2% of GDP) and were even lower in 2013 (with negative growth dynamics). 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.



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8. 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.

9. And finally, eliminate the risk (or perception) about expropriation.

With the government failing to take meaningful efforts in these areas we suspect that the peso will face further falls. Perhaps weakening to 10/$

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