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### Special Commentary

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# Argentina Gets a New Start: Is this Time Different?

## Executive Summary

Argentina has had many “start-all-over-again” chances in its long and convoluted history as a nation-state. Many argued that the country has squandered all of those attempts considering that the country was viewed as an up-and-coming country at the beginning of the 20<sup>th</sup> Century, ahead of Australia and Canada, two countries that have surpassed Argentina in every social and economic aspect ever since.

Now, the Macri administration has a new chance of changing the direction of the country. It has decided to take it one step at a time, rather than using “shock therapy,” hoping that Argentines will understand and give his administration enough time to finish its work, as political timing normally does not coincide with economic timing. Meanwhile, international markets are also watching as the country, which has defaulted on its sovereign debt many times, continues to access international capital markets for its financing needs at a time when interest rates are scheduled to increase.

Today, the Macri administration seems to have bet the house on a highly visible infrastructure plan that it believes is going to allow Macri to be re-elected in 2019. If this is the case, it will be the first time since the birth of Peronism in the mid-1940s that a non-Peronist president finishes their term, let alone gets re-elected. This will be an achievement in-and-of-itself. High inflation, high fiscal deficits and higher global interest rates will remain the most important risks for the next several years. However, as long as the economy continues to expand, these risks will remain manageable.

## New Views Permeates; Old Ways Remain

Argentina has had many start-all-over-again political processes over the country’s tumultuous history. However, when we heard “this time is different” several times during our recent trip to the country, we remain cautious while remembering all the previous times we have heard that same argument before.<sup>1</sup> As we talked to locals, analysts and even some government officials, it was clear that the Macri administration seems to have a plan that could reverse decades of economic mishandling of the Argentine economy. The question is: How long will this process take? As it stands today, the process could take many more years, which will probably span more than one term for current President Mauricio Macri. This is not a small feat. Since the creation of Peronism, Argentina’s eternal power broker, no non-Peronist elected president has finished their first term in office. What we heard during our trip is that Macri is poised to finish his first term in office and win re-election. But what struck us more from this view is that there is no second guessing. Government officials are convinced that the path they have chosen is going to allow Macri to be re-elected. Of course, the argument is that Macri’s performance improved during the mid-term elections, which are typically not friendly for incumbents.

In any other country, a potential re-election may not be a far-fetched idea, but in Argentina, this may be wishful thinking, especially a year and a half before the elections are scheduled to occur. A

*The Macri administration seems to have a plan that could revert decades of economic mishandling.*

<sup>1</sup> Even the new CEO of General Electric, John Flannery, who lived in Argentina in the mid-1990s, has argued in a recent interview for the La Nación newspaper “there is a sensation in Argentina today that this time will be different.” (our translation from the original newspaper article: <https://www.lanacion.com.ar/2120710-john-flannery-hay-una-sensacion-en-la-argentina-de-que-esta-vez-sera-diferente>)

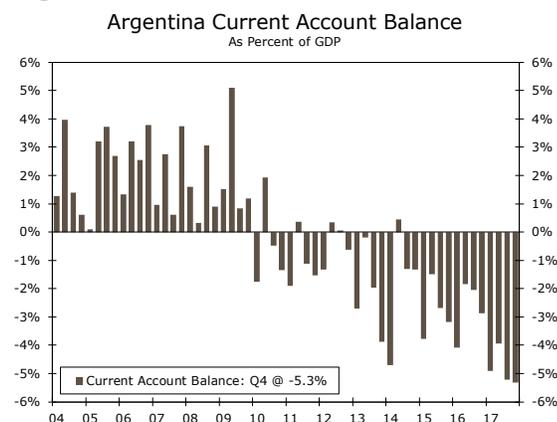


year and a half is a very long time in politics. Having said this, there are good arguments for the conviction that Macri is going to win re-election: first, the Peronist opposition is highly divided, with no clear leader to contest Macri. Second, as long as ex-President Cristina Kirchner is trying to regain the leadership with the Peronist party, they will remain divided, benefiting Macri. Third, Macri has a “not-so-secret” weapon. Her name is María Eugenia Vidal, the current governor of the largest province of the country, the Province of Buenos Aires. For all that we have heard, she is the real thing, a firebrand in her own right that is challenging the Peronist party on its own stronghold and, for now, she seems to be winning. Last, Kirchner has an approximate electoral base of about 35 percent of the votes. Argentina’s political system, however, requires that “if no candidate receives at least 45 percent of the vote, or 40 percent with a lead of 10 percentage points over the runner-up, a second round is held.”<sup>2</sup> And Kirchner is not capable of winning the majority in a second round vote today, as she also has a highly negative perception when compared to a potential opponent which would not allow her to win during a second round vote.

**Figure 1**



**Figure 2**



Source: IHS Markit and Wells Fargo Securities

However, what probably struck us the most during our trip was that members of his administration not only seem to believe that Macri will be re-elected to a second term, but that after that, it will be María Eugenia Vidal’s turn to win the presidency. This will give them at least 10 years to implement the changes they believe are necessary to alter the destiny of the country. Thus, if a year and a half is a very long time in politics, 10 years is an eternity.

Perhaps the most important change we saw during our trip, and the most important aspect of this political climate in the country, is that the changes that are being made through the legislative process are probably going to be long lasting. The reason for this is that President Macri does not have majority in Congress, so any legislative change has to be negotiated with the rest of the parties and, in many cases, they are being successful.

Furthermore, why would they need 10 years in power? The answer is that they have chosen a very slow implementation strategy because they do not want to “shock” the economy with measures that could be very costly in terms of political capital. They think that the slow speed of adjustment with reforms was one of the reasons that they were able to perform better in the mid-term elections than what everybody was expecting. Of course, this strategy has political costs, because inflation will remain higher for a longer period and people could become impatient with such a high rate of inflation, ultimately voting them out of power. However, for now, the strategy has worked.

At the same time, the slow pace of adjustment continues to put pressure on the country’s fiscal accounts. This has pushed the Macri administration to look for international financing of the deficit. Although this is not a serious issue today, it could become an undoing if world interest rates continue to increase, as we are expecting, and capital markets start to worry about the country’s

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<sup>2</sup> Edmund A. Walsh School of Foreign Service: Center of Latin American Studies. Republic of Argentina. <http://pdba.georgetown.edu/ElecSys/Argentina/argentina.html>

ability to pay back its debt. At the same time, tax pressures on individuals are extremely onerous in Argentina today, as the size of the underground economy makes it difficult for the government to expand the tax base and only those that are “legal” feel the brunt of the tax pressures.

Although Argentina managed to record a primary deficit of 3.8 percent of GDP in 2017, down from a primary deficit of 4.2 percent of GDP in 2016, the overall deficit in 2017 was 6.0 percent of GDP compared to an overall deficit of 5.8 percent of GDP for 2016. The overall deficit increased 32 percent as interest payments on the debt increased 71 percent compared to 2016, both measured in local currency. However, the government is targeting a continuous improvement in the primary fiscal deficit over the next several years. The government expects a primary deficit of 3.2 percent for 2018, 2.2 percent for 2019 and 1.2 percent for 2020.

Argentina’s gross public debt increased to \$305.7 billion in the third quarter of 2017 from \$275.5 billion in 2016, an increase of \$30.2 billion. In 2016, gross public debt had increased by \$34.8 billion, to \$275.5 billion from \$240.7 billion. Having said this, debt as a percentage of GDP has remained relatively stable since 2015, growing to 53.4 percent from 52.6 percent. However, this growth in debt will continue to put upward pressure on the overall fiscal deficit, as the cost of this financing increases as interest rates continue to rise higher.

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**Betting the House on Infrastructure Spending**

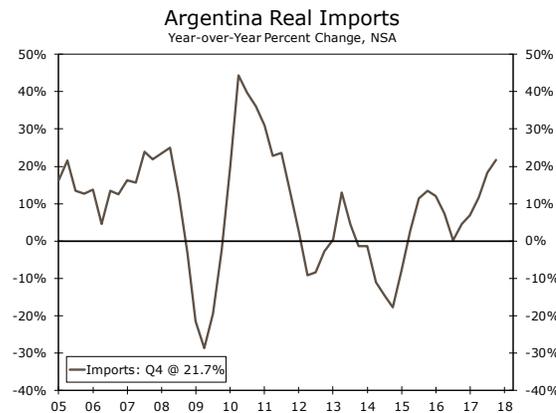
One of the biggest differences today, compared to the past, according to many observers is that the changes are self-evident, at least in the nation’s capital, Ciudad Autónoma de Buenos Aires as well as in the Province of Buenos Aires. That is, the argument that this time is different has an important component of infrastructure investment by the administration of both of these regions, which houses almost 46 percent of the population of the country. Both of these regions’ leaders are members of Macri’s Cambiemos coalition. The governor of the Province of Buenos Aires, whose population represents about 39 percent of the country, is María Eugenia Vidal, who everybody sees as the successor of Macri after he “finishes his second term in office.”

However, the infrastructure plan is not limited to these two large regions of the country and includes water, sanitation, housing, energy & mining, transportation, communications & technology, education, health and the administration of justice, etc. The government estimates an investment need of about \$26 billion in capital expenditures between 2018 and 2023. By walking the streets of Buenos Aires and visiting limited places in the Province of Buenos Aires, it is clear that the changes are highly visible compared to other periods in the past where very little changed in terms of infrastructure. The Macri administration believes that these changes will keep them in power and help his re-election in 2019.

**Figure 3**



**Figure 4**



**Source: IHS Markit and Wells Fargo Securities**

Of course, not all of the changes the Macri administration is making are considered good for some people, especially for those that used to pay close-to-nothing for some services like public utilities.

The government has continued to repair the distortions implemented by the previous administration in public utilities' prices. According to the country's Minister of Energy, Juan José Aranguren, when Macri became president in December 2015, natural gas customers in the country paid about 19 percent of the costs of natural gas with the rest, 81 percent, paid by government subsidies. This policy became unsustainable in the medium-to-long-term but helped keep the Kirchners in power for 12 consecutive years, while many who saved due to the subsidies saw their savings confiscated by the Kirchner administrations to help pay for those subsidies.

**Inflation Remains a Threat to Both Politics and the Economy**

Dealing with Argentina's entrenched inflationary expectations is never easy, but dealing with these expectations after 12 years of massive price distortions is an even more daunting project. Nobody has a more clear view of this issue than the country's central bank president, Federico Sturzenegger. However, his views on the topic of how to bring down inflation probably continue to collide with the Macri administration's chosen path to transition the Argentine economy to a more open, market-friendly economy.

On the one hand, the need to lower the rate of inflation has never had such a strong appeal for citizens, as well as for policymakers, as high inflation affects the poor disproportionately and President Macri's number one objective is "zero poverty." On the other hand, as we said above, transitioning the economy into a more open and market-oriented economy is not easy after 12 years in which individuals did not pay, or paid minimally, for public utilities services. That is, the government has had to move slowly to revert public utility subsidies, but every time it adjusts the prices of these services, to reflect the cost of producing and distributing these services, consumer prices surge on the back of higher utilities' prices as well as higher inflationary expectations.

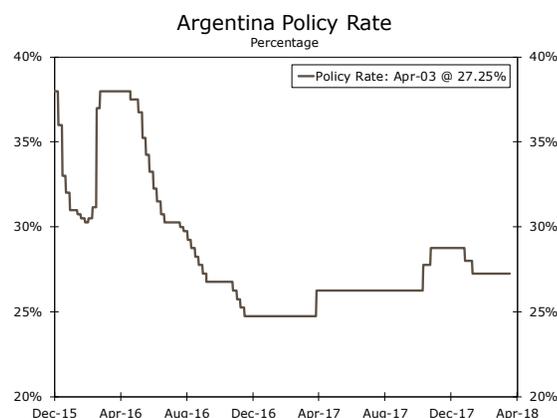
Today, the central bank has few options to anchor inflationary expectations. Right now, the central bank is trying to anchor inflationary expectations by keeping interest rates very high, but this is also affecting economic activity. At the same time, if the central bank is not credible with its interest rate policy, then the Argentine peso becomes a target of these higher inflationary expectations and pushes expectations on inflation even higher in a country whose population continues to use the U.S. dollar as a store of value and, in some instances, as a medium of exchange.

**Today, the central bank has little options to anchor inflationary expectations.**

**Figure 5**



**Figure 6**



**Source: Bloomberg LP, IHS Markit and Wells Fargo Securities**

Markets criticized last year's rise in the inflation target made by the Argentine government arguing that the change severely undermined the independence of the central bank. However, the central bank responded that the inflation target was a political target and being a political target, it was the executive branch government, not the central bank, who was the party responsible to modify it. Perhaps once the government gets rid of regulated prices the discussion could begin on what are the degrees of independence of the Argentine central bank, but for now, the executive branch of the government is the one setting the target. That is, the central bank has to adjust monetary policy to

hit the target. Argentina originally had a 12 to 17 percent inflation target for 2017. The actual rate of inflation for 2017 was 25.0 percent. For 2018, the original central bank target was 8 to 12 percent. They have recently changed the 2018 inflation target to 15 percent.

We think that the issues markets had regarding the change in the inflation target were out of focus for the following reasons. First, as we said before, the target in this case is political. As long as you have a particular policy that is affecting the target, i.e., the normalization and de-regulation of regulated prices, the executive branch of the government is who determines the target. Second, Argentina's inflation rate is not stable, and the country is trying to disinflate. Inflation targets are normally set when inflation is relatively low and stable. Having an unmovable inflation target when you are trying to disinflate makes very little sense. In fact, the inflation target for Argentina was not a typical inflation target. The target was changed each year since the Marci administration came to power, so changing inflation targets is not your traditional definition of an inflation targeting mechanism used by central banks. Third, once inflation stabilizes at a low level, inflation targets should be seldom changed, even if the central bank has had difficulty hitting the target, as it has been the case in the past for many central banks across the world that work with inflation targets for keeping inflation expectations anchored. A target is just a guarantee that the central bank will take all the necessary measures to achieve that target by using all the tools it has at its disposal.

Having said this, we believe that not decreasing inflation relatively fast will continue to hurt the economy in 2018 and could start to hurt the prospect of the Macri administration as the re-election process picks up steam in 2019.

### The Economy Rebounded in 2017

After declining by 1.8 percent in 2016, the Argentine economy rebounded in 2017 by 2.9 percent. During our trip, many analysts mentioned that the Macri administration would be happy with avoiding a negative number in 2018 in order to avoid the pattern the economy has followed since 2011, which is, growing one year and falling into recession the next. Real personal consumption expenditures (PCE) recovered handsomely in 2017 compared to its performance in 2016. PCE increased 3.6 percent in real terms in 2017, after declining 1.0 percent in 2016. Still, growth in PCE was still improving at the end of 2017, which should be good news for the economy this year. However, real gross capital formation drove higher economic growth in 2017 as it posted a rate of growth of 11.3 percent during the year, with a very strong fourth quarter year-over-year performance when it grew 20.7 percent. Real gross capital formation had declined 4.9 percent in 2016. Real exports of goods and services were up only 0.4 percent in the year, while real imports of goods and services surged 14.7 percent, also driven higher by the strong performance of real gross capital formation. In 2016, real exports of goods and services and real imports of goods and services were up 5.3 percent and 5.7 percent, respectively.

*The Argentine economy rebounded in 2017 by 2.9 percent.*

Figure 7

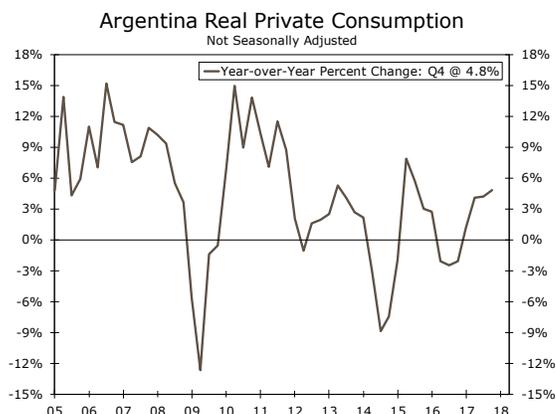


Figure 8



Source: IHS Markit and Wells Fargo Securities

On the supply side the strongest growth was recorded in fisheries output, a very small sector of the economy, growing 14.3 percent during the whole of 2017. Second came the larger construction sector, surging 10.4 percent after declining 11.2 percent in 2016. The important manufacturing sector improved 2.8 percent during the year, after declining 5.2 percent in 2016. However, there were clear signs that the manufacturing sector was slowing down at the end of 2017. The agriculture and cattle sector increased 3.9 percent in 2017, after declining 4.7 percent the year before. This sector poses a large risk to economic growth and to exports this year because of the drought that has been affecting the largest growing regions of the country.

Commerce, on the other hand, improved 2.6 percent in 2017, after falling 2.4 percent the previous year and was still improving as 2017 ended, while output in the financial sector improved 5.1 percent in real terms, after declining 3.2 percent the previous year. Thus, the recovery in economic activity was broad based with only the mining sector, public utilities output, and services to private homes posting negative numbers of 3.4 percent, 1.1 percent and 0.6 percent, respectively.

Furthermore, with the release of the monthly Economic Activity Index for January, it is clear that the economy remained strong at the start of 2018. According to this index, which is a proxy for GDP growth, the economy grew 4.1 percent over a year earlier, and by 0.6 percent on a seasonally adjusted basis and compared to December 2017. This means that the economy ended 2017 on a strong footing and has started the year the same way.

### **Conclusion: Change Is Happening**

Perhaps the biggest difference we saw during our trip, was that there were many signs that things were different this time. Of course, we do not want to be overly optimistic with the current situation, as we have been burned before. However, the fact that the government is betting the house on a strong infrastructure plan that is so visible will probably give the Macri administration an edge in next year's presidential elections. As we previously mentioned, this is no small feat for a country that has not been able to keep a non-Peronist in power for a full presidential term since Peronism reared its head into Argentine politics back in the 1940s.

Still, caution should be front and center as political timing is very different from economic timing. However, as long as the Macri administration is able to keep the economy going, and the Argentine central bank continues to work on bringing down inflation, the odds for a successful re-election campaign for Macri will improve.

Perhaps the biggest risk is keeping a tab on the fiscal deficit, and the costs of access to the capital market, as global interest rates continue to head north. The inexistence of a developed domestic capital market will keep the country vulnerable to the whims of the global economy and of global capital flows.

*There were many signs that things were different this time, but caution should still be front and center.*

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