

## Economics Group

### Special Commentary

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# Argentina's Macri: A Chance to Change History

## Executive Summary

As we suggested earlier in the year, Argentina has taken the road less travelled: it has chosen Mauricio Macri, the opposition candidate from the Cambiemos coalition, as its next president.<sup>1</sup> This road less traveled will not be easy, as his administration will need to deal with a difficult internal and external environment. Furthermore, Macri has promised to keep some of the most popular policies followed by the previous administration, while fixing issues like reducing the levels of criminal activity especially related to drug trafficking and lack of security. However, some of the programs Macri has promised to keep are expensive and were created when the economy was surging and commodity prices were favoring the country.

Perhaps the biggest issue for Macri is timing, as he has come to power at a time when resources are scarce and the fiscal deficit is already higher than 6 percent of GDP. At the same time, Macri comes at a time when the lack of investment in the country's infrastructure will hinder its ability to grow faster. On the other hand, the need to reinvest in this infrastructure as well as other economic projects gives his administration an opportunity to sell the country to foreign investors. However, the biggest challenge for investors will be the control of inflation and the ability to repatriate the profits of those investments. Structural reforms made during the 1990s have largely been undone. The incoming administration will start liberalizing the economy but this will have consequences for inflation.

At the same time, the new administration will need to deal with eliminating programs that hinder productivity and this is not going to be easy, especially after so many years of government subsidies that have reduced the incentive to work. This means that Macri's future administration will be challenged from the start. Furthermore, the current administration has allowed the currency to appreciate so much in real terms that Macri will have no choice but to allow the currency to suffer a large devaluation to make the country more competitive. However, this will create all of the problems it normally creates in a country that has a history of monetary and fiscal policy mismanagement.

As it stands now, Macri will move on his promise of only one exchange rate system. Thus, we should expect a large devaluation during the first months of his administration and then some moderation if he is successful with his plans for the country. His administration needs to put its house in order, know how many liquid reserves the central bank has, fix the statistical reporting process, try to come up with a solution with the holdouts from the debt default and be ready to access the international capital markets so it can build its central bank reserves. However, the Argentine summer is the strongest season for U.S. dollar demand in the country, as individuals try to obtain U.S. dollars to go on vacations. This year's "seasonal" demand will be compounded with those that know that a large devaluation is coming and are hoping they can change U.S. dollars at the current exchange rate or by firms trying to repatriate profits as soon as possible before the devaluation is upon them. This means that the Macri administration will probably see the little reserves the central bank has quickly depleted. Thus, it has to move fast to get financing to replenish reserves.

***Macri comes to power at a time when resources are scarce and the fiscal deficit is high.***

<sup>1</sup> See "Argentina Gets Another Chance," available on our website.



**Macri will likely start a dialogue to settle the standoff with holdout creditors.**

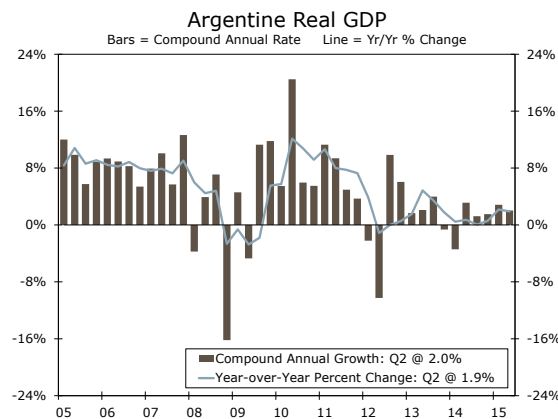
However, there is no easy way out of this conundrum. If he moves immediately, imposing a “shock” therapy, the consequences could be important, but the recovery will probably be swift. However, the devaluation will be large and inflation will increase rapidly. If he decides to wait and move during Q2 2016, once all of the aforementioned issues are taken care of, then he may become prisoner of entangled vested interests, and he may start looking for other ways that will be less market friendly.

**Rejoining the Global Economy**

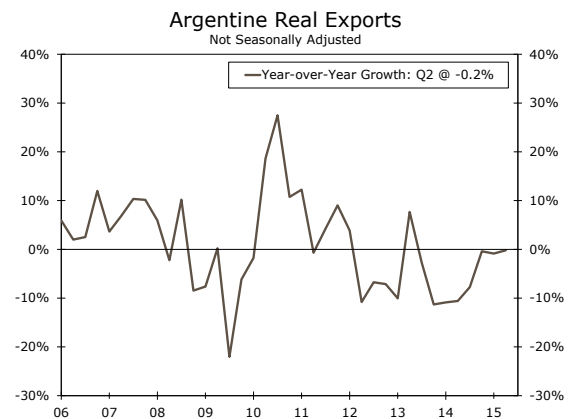
Argentina has been, in a sense, a pariah during the past decade and a half. It has defied the international financial community as well as American courts due to its unwillingness to settle its debt with what authorities in the country have called “vulture funds” that have challenged by the country’s decision to default on almost \$100 billion foreign debt in the early part of this century. You may ask, how can an open economy that depends so much on exports remain a pariah from the international markets for so long? This was possible due to the strong economic growth performance of the global economy but fundamentally by the strong performance of China and the consequent strength in commodity exports and prices. However, the new international environment has taken a turn for the worse and Argentina is having trouble growing and keeping its “isolationist” position intact. Thus, we expect the new Macri administration to start a negotiating process to solve the standoff with the holdout bondholders and rejoin the global capital markets as soon as possible. Settling this issue will be fundamental to minimizing the potential disruptive effects of the country’s transition from a highly regulated economy to a more market-oriented economy. In what follows, we will discuss some of the major issues confronting this transition.

The presidential elections on Sunday, Nov. 22, followed the first round election on Oct. 25 that shocked the country when Daniel Scioli, who was expected to win the presidency in the first round, could not manage to get a victory. Furthermore, Mauricio Macri, from Cambiemos, came in behind him to challenge Scioli to a second round of presidential elections. However, the most stunning defeat was suffered by Scioli himself and the Peronists when María Eugenia Vidal, also from Cambiemos, beat Anibal Fernández, who was chosen directly by Kirchner, the incumbent president. Maria Vidal won the governorship of the Province of Buenos Aires, which represents 35 percent of the country’s GDP and 38 percent of its population. Macri’s triumph can be understood under the new, and weaker, global economic environment, particularly as funds from the commodity price and export boom dwindled. The success of the Kirchner administration at the beginning was possible due to the strong growth in commodity prices and exports, which supplied the resources the administration needed to support an important income redistribution strategy that provided its political justification. However, as those resources started to dwindle, the administration’s ability to keep those policies and grow fast at the same time started to disappear.

**Figure 1**



**Figure 2**



Source: IHS Global Insight and Wells Fargo Securities, LLC

The election results of Nov. 22, which were not as in favor of President-elect Macri as what many polls had suggested, nevertheless help open up the country to the rest of the world after an almost 14-year hiatus. However, the problems Macri will face are important. The first six months of Marci's presidency, which starts on Dec. 10 will be trying. Among all the pressing issues he has to tackle, he also has to deal with the issues of the statistical institute, which some allege has been used by the Kirchner administration to twist the true conditions of the economy, especially the rate of inflation (see the section on the Statistical Institute below). However, this issue is probably the easiest to fix.

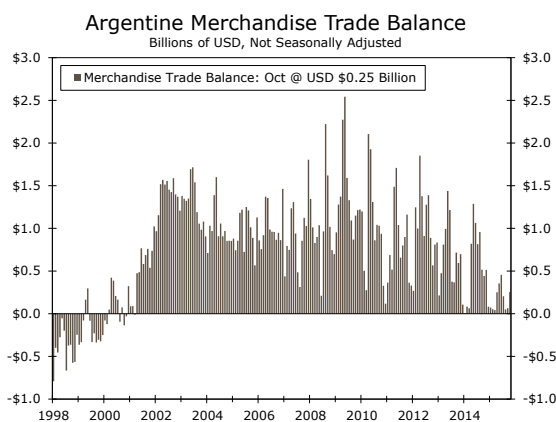
What will be much more disrupting will be to unify all the exchange rate mechanisms that exist today as well as untangle the regulatory environment of the past decade. The latter will need some time. Recent reports have suggested that the former issue is going to be taken care of on Dec. 11. However, unifying the exchange rate mechanisms will not be easy in terms of the potential consequences, especially because the central bank reserves have been used to pay down Argentina's debt and the institution's reserves have fallen close to unsustainable levels. Although the information is not free flowing today, several reports say that the country's "liquid" reserves are almost nonexistent even as October's reserves data stood at close to \$27 billion.

*Argentina's foreign exchange reserves have been dwindling.*

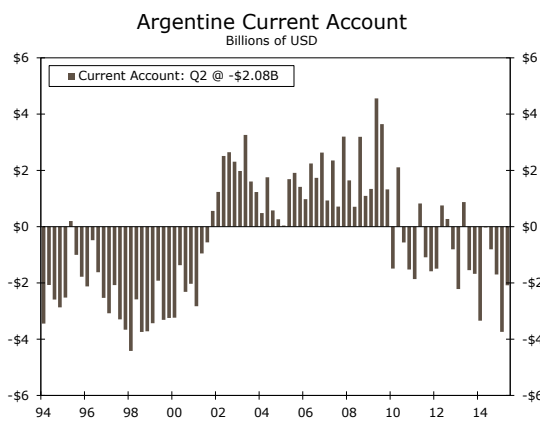
**Avoiding a Balance of Payments Crisis Will not Be Easy**

If international reserves continue to dwindle, Argentina could come close to a balance of payments crisis, which will trigger a large devaluation, or at least larger than what markets are probably expecting today. According to members of the incoming administration, the country will be able to avoid a balance of payments crisis because the untangling of the multiple exchange regimes will make agricultural producers release output that has been hoarded over the past couple of quarters. According to some estimates, liberalizing and unifying the exchange rate mechanism would bring in to the central bank between \$6 billion and \$8 billion from agricultural exports. In addition, the new administration will probably try to issue a \$2 billion bond under Argentine law to try to buy time until the country gains access to the international capital market during the next couple of months. The biggest issue with regaining access to the international financial market has to do with the prospects of an agreement with the bondholders that did not accept the renegotiation from the 2001-2002 default, also known as the holdout creditors.

**Figure 3**



**Figure 4**



**Source: IHS Global Insight and Wells Fargo Securities, LLC**

Argentina already has a court decision against it and in favor of the holdouts from American Judge Griesa. Unless the Argentine government negotiates a settlement with the holdouts, the country will not be able to participate in the international financial markets for financing. If financing is not available from international sources the country will have to find domestic financing, which will be difficult, or hope investors become bullish on the Argentine economy and bring in large flows of capital into the country. This is probably highly unlikely to have an immediate effect on reserves. However, there is a lot of talk that the incoming members of the administration have lined up a large number of commitments from foreign investors with pledges

to pour money into the country. It is also possible for the Macri administration to buy time by negotiating a deal with the IMF. However, the Kirchner administration's standing with the IMF will probably keep the Macri administration from resorting to this alternative.

At the same time, after so many years of trying to prevent capital from leaving the country there is a long line of "constituents" which could make the transition to a unique exchange rate mechanism volatile and uncertain. This includes individuals trying to exchange "worthless" pesos for U.S. dollars, i.e., currency substitution, firms trying to repatriate profits, which some estimate at close to \$8.0 billion and people just wanting to travel on vacation (recall that Argentina is entering its summer vacation season).

### Low Debt Is a Positive for Argentina, but This Will Change

One of the best aspects of not being able to access the international capital markets during the past 14 years is that the country's debt levels are low. The fact that the country did not have access to the international capital markets, while at the same time experiencing one of the strongest commodity cycles in recent memory, enabled it to minimize the need for external financing. Furthermore, the Kirchner administration was also successful in improving tax collection, while at the same time it proceeded to expropriate private savings (i.e., private pension funds). All these factors allowed the country to keep debt levels manageable. According to IHS Global Insight, Argentina's total external debt at present is \$231.7 billion, or 36.6 percent of GDP. However, since we are expecting a relatively large devaluation of the Argentine peso, debt as a percentage of GDP is expected to surge after the devaluation as most of this debt is denominated in U.S. dollars. For example, if the peso devalues to about 15 pesos per dollar from the current 9.6 pesos per dollar, external debt as a percentage of GDP will almost double to close to 70 percent of GDP.

Furthermore, interest and capital payments on that debt continue to be worrisome and one of the most difficult endeavors the incoming administration will need to tackle. This is why the government will need to settle the issues with the debt holdouts relatively fast. However, considering the current delicate position in terms of foreign exchange reserves and the fact that the new administration will need to devalue the currency, paying interest and principal on this debt will be one of the most difficult challenges. If the country regains access to the international capital markets, it could refinance this debt to buy some time. According to the Ministry of Economics' webpage, Argentina has to pay \$20.6 billion between capital and interest on the debt in 2016, \$13.6 billion in capital and \$7.0 billion in interest. This amount is up from \$14.3 billion in 2015.

*The eventual devaluation of the Argentine peso will make servicing external debt difficult.*

**Figure 5**



**Figure 6**



Source: IHS Global Insight and Wells Fargo Securities, LLC

What makes things more difficult is that much of this debt is dollar denominated. Although the Kirchner administration has not been able to access the international capital markets, it has had to make its debt issuance appealing to domestic investors by issuing it in U.S. dollars rather than in pesos. This puts a serious strain on the incoming administration's ability to pay if it is expecting

a large devaluation of the domestic currency.<sup>2</sup> This will be especially more challenging because the incoming president has promised to eliminate taxes on agricultural exports, which have become a lifeline for government revenues over the past decade.

After the abandonment of the Convertibility Law in 2001-2002, the government introduced high taxes on agricultural exports. In 2001, Argentina's foreign trade tax receipts (mostly composed of taxes on import) were about 5 percent of total tax revenues (see Figure 5 above). Starting in 2002, foreign trade tax revenues surged to about 15-18 percent of total tax receipts. Thanks to the drop in commodity prices and the slowdown in global economic activity, foreign trade tax revenues have come down to represent only about 8 percent of total tax revenues today.

Perhaps the most pressing issue the new administration will need to face is today's dangerously low level of international reserves. Although Argentina's foreign reserves were \$27.0 billion in October 2015 it is still not clear how much of those reserves are liquid reserves. Furthermore, the current administration has been selling U.S. dollar swaps that will come due during Q1 2016. Some of these swaps have been written according to an exchange rate of about 10.65 pesos per dollars, according to reports, a rate that is unlikely to be the actual exchange rate once the new administration assumes the reins of the government on Dec. 10 and decides to move to a unique exchange rate. This is another reason why we believe the incoming administration will need to be careful during the transition.

### **A Bounty for the External Sector and a Hit to Tax Revenues**

One of the sectors that will benefit the most from Macri's triumph will be the external sector, but especially exporters of agricultural products. Macri has promised to eliminate taxes on agricultural exports, a point of major contention against the Kirchner administration since such taxes were imposed in the early part of this century.<sup>3</sup>

This means that the agricultural sector in the country will probably be the pillar of the economic recovery next year. Furthermore, the incoming administration is expecting to get a boost in exports as soon as it liberalizes the exchange rate market as exporters have been hoarding production in the expectation that they will be able to get better terms (higher prices as well lower taxes for some agricultural exports, i.e., net export prices).

Furthermore, as we argued before, reducing or eliminating taxes on agricultural exports will produce a severe hit to the government's tax revenues. In fact, another serious issue for the incoming administration will be the current fiscal deficit, which today stands at more than 6 percent of GDP and is been partially financed by printing money. Thus, the new administration will need to come up with either new sources of tax revenues or it will need to reduce government expenditures, something that will not be easy to do, at least not in the short to medium term or until the economy starts to grow strongly.

***It is difficult to assess the true level of Argentina's reserves at present.***

***The government has been printing money to meet its obligations.***

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<sup>2</sup> Some economists, including Ricardo Hausmann, ex Chief Economist of the Inter-American Development Bank and now at the Harvard Kennedy School, call this problem the "original sin." This "original sin" has to do with the mismatch countries incur when they borrow in U.S. dollars but their tax revenues, which they use to pay for this debt, is denominated in the domestic currency. Thus, if there is a large devaluation of the domestic currency it diminishes the ability of these countries to pay the debt. Also see the paper "The Pain of Original Sin" by Barry Eichengreen, Ricardo Housmann and Ugo Panizza, August 2003.

<sup>3</sup> It seems that Macri will eliminate taxes on agricultural exports with the exception of taxes on soybean exports. At the beginning they are promising a reduction on soybean taxes from the current 35 percent to 30 percent. However, he has promised to eliminate these taxes once the economy returns to growth and tax revenues stabilize.

### Campaign Promises that May Be Difficult to Fulfill

Another big problem for Macri will be how to fulfill the promises he made during the presidential campaign. Argentina's fiscal deficit surged to more than 6 percent of GDP and fulfilling the promises made will probably keep the deficit high, especially if the new administration also delivers on the promise of eliminating taxes on agricultural exports.

Figure 7

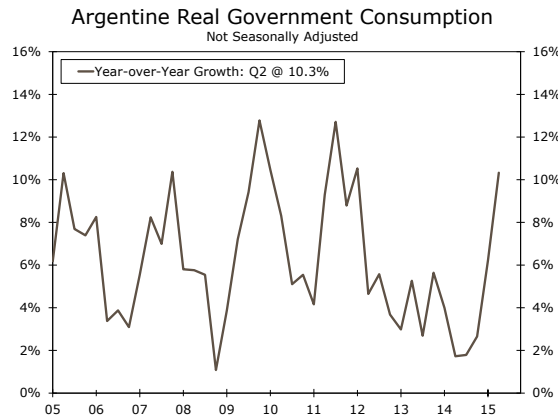
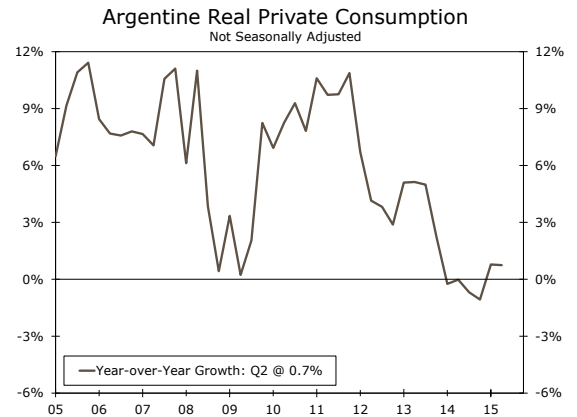


Figure 8



Source: IHS Global Insight and Wells Fargo Securities, LLC

Furthermore, to win the presidential elections, President-elect Macri promised to keep the most important subsidy programs, i.e., income redistribution programs, created by the Kirchner administration. These are the programs that have contributed to the surge in the country's fiscal deficit and continue to feed the rate of inflation. Putting an end to the financing of the fiscal deficit through the printing of money will serve the purpose of slowing down the rate of inflation and the potential depreciation of the currency. However, to keep these programs intact as Macri promised, it will need to find real resources that could help finance those programs.

### Construction, Real Estate and Investment Will Help Drive Growth

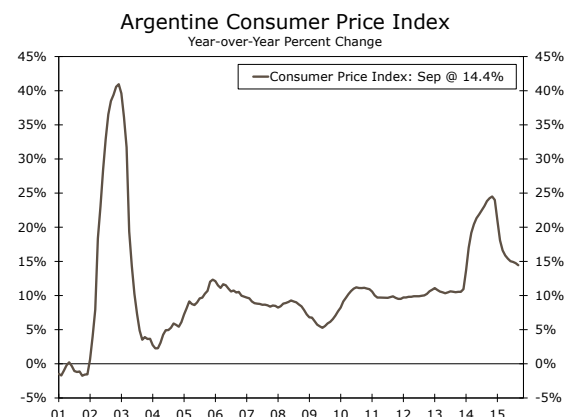
Although the construction sector and the real estate sector have been recovering during the past several quarters, we are expecting these two sectors to strengthen further during the incoming administration. These two sectors were negatively affected in 2012, as the Kirchner administration targeted the real estate sector to bring it out of the underground economy (i.e., pushing this sector to pay appropriate taxes).

*The real estate sector was targeted several years ago for not paying appropriate taxes.*

Figure 9



Figure 10



Source: IHS Global Insight and Wells Fargo Securities, LLC

However, this effort has put considerable downward pressure on the real estate sector as well as on the construction sector, which have suffered considerably. For decades, the Argentine housing

market has been one of the preferred investment alternatives for the high echelons of society as a way to accumulate and preserve wealth. In the meantime, those groups would buy and sell homes and many times avoid the corresponding taxes. The Kirchner administration's regulations have been effective in containing tax evasion from real estate transactions but this has had a negative effect on the sector's economic activity. The improvement in the construction sector means that from the demand side of the economy, gross fixed investment in construction will probably continue to improve and help the economy strengthen in the near future.

### **Fix the Statistical House: Statistical Institute (INDEC)**

Perhaps one of the first steps in improving the confidence of foreign and domestic investors in Argentina has to do with fixing the INDEC (the country's statistical institute), which has been manipulating economic indicators since the Kirchner administration decided several years ago to produce numbers that supported its own economic vision rather than reality. In fact, Argentina has been the only country in history to have been censured by the IMF for tampering with its economic statistics.

Although this may be a cumbersome and time-consuming task for the incoming administration, the country needs to come out clean with its economic statistics reporting to regain international standing as well as confidence from markets, domestic as well as international.

This means that the INDEC will need to be reformed to limit political intervention. Perhaps the institute can bring back those career individuals that have been dismissed during the past decade or so from the institute for opposing the manipulative policies of the current administration. What is encouraging is that there are capable economists in Argentina that can fix these issues relatively fast.

### **Conclusion**

The triumph of Mauricio Macri during the second round elections on Nov. 22 is a momentous development in Argentina's political and economic history. Macri's win is reminiscent of what the late former President, Raúl Alfonsín, did in 1983 when he and his Radical Party beat Peronism in what returned the country to democratic life after suffering one of the longest and most traumatic military dictatorships in the country's history.

Although many Argentines are upbeat with the current election of Macri, his presidency will be difficult because the economy is experiencing relatively serious issues that could limit its ability to change course. One of those issues is that the PRO, Macri's party, has only four senators from a total of 72 senators and 41 representatives of a total of 257 seats in the lower house. The alliance that took him to power, Cambiemos, includes the Radical Party of the late former President Raúl Alfonsín, which means that he will have to negotiate everything that he would like to pass through the Argentine Congress.

Furthermore, during Kirchner's eight years in office, she almost always had absolute majorities in both chambers of Congress. However, she seldom used the congress to legislate, as her emergency powers were broad. Furthermore, whenever she could not use her emergency powers, she used decrees of "necessity and urgency," a political instrument that was also used, very often, by Kirchner's predecessors. Thus, expect Macri to also use decrees of "necessity and urgency," especially at the beginning of his mandate.

Thus, on top of all the economic problems Macri is going to face to immerse Argentina back into the global economy and rekindle economic growth, he will also face some political problems. That is, his powers will be limited by his ability to reach a consensus with other, larger political forces within his Cambiemos coalition as well as with the rest of the opposition. The Peronist Party has a simple majority in the nation's Senate and could form a majority in the lower house if it is able to coopt Peronists that do not respond to Macri.

Macri has a unique opportunity to finish its term in office, probably get re-elected for a second term, and start a new chapter in the political and economic history of this country. The world will be watching!

***Transparency is essential for Argentina's economic statistics.***

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