ARGENTINA: THE LAND OF MESSY

Suttle Economics Notes #222

- The Fernandez government inherited a bad situation in 2019, but has made it worse
- An FX crisis looms. Net reserves are negative, and the parallel ARS is at a 50% discount
- IMF and Chinese support might provide a bridge to a new government
- Restoring long-term investment appetite will be hard amid very fickle politics

Chart 1
Argentina: consumer prices
% Dec/Dec (2023 is Jun/Jun)

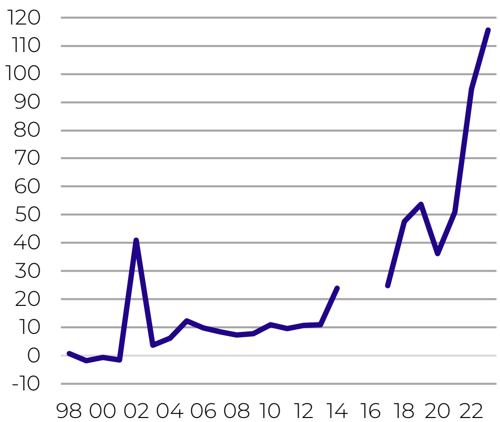
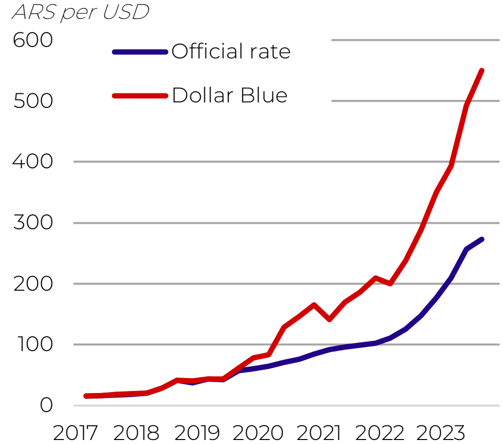


Chart 2
Argentine Peso
ARS per USD



Argentina is stumbling towards its next general election, to be held on October 22nd. Candidates will be selected in "primary" (PASO) elections to be held on August 15th. The current Finance Minister, Sergio Massa, will be the candidate for the incumbent coalition (UP). The main August uncertainty will be over who will be the candidate for the center-right coalition (JP): Patricia Bullrich or Horacio Larreta. The third relevant candidate in October is Javier Milei, from the far right. A change in government is most likely, with either Bullrich or Larreta most likely to win.

The current (UP) government inherited a very difficult situation at the end of 2019. The country had fallen into its latest debt default in the final year of the last JP-led administration, under Mauricio Macri. This had been the result of poor financial management under Macri, leaving the country vulnerable to a market-driven panic when it became clear after the August 2019 populist UP would soon return to power. This bad situation was made much worse with the negative supply-side shocks of C-19 and drought.

The current government has made a bad situation worse. It followed a more expansionary fiscal policy that could be financed only through monetization. Inflation has soared, reaching 115.6%oya in June (Chart 1). FX reserves have evaporated even with extensive foreign exchange controls. The parallel exchange rate (*dollar blue*) trades at a discount of about 50% to the official rate (Chart 2). It has struggled to meet the conditions of its latest IMF program and has moved closer to China, on the premise that more external support might be available through that channel.

A policy mess is likely to persist in coming months. A sizeable devaluation in the official exchange rate seems inevitable, with adverse inflation implications. Milei (an unlikely winner) is even in favor of dollarization. Markets have been boosted by the prospect of a shift in government. The key problem, however, is that the fixes needed to restore real investment and growth in the economy will take

Chart 3
Argentina: soybean production
million tonnes, crop year

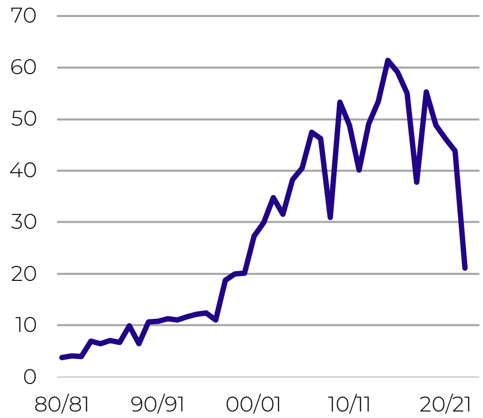
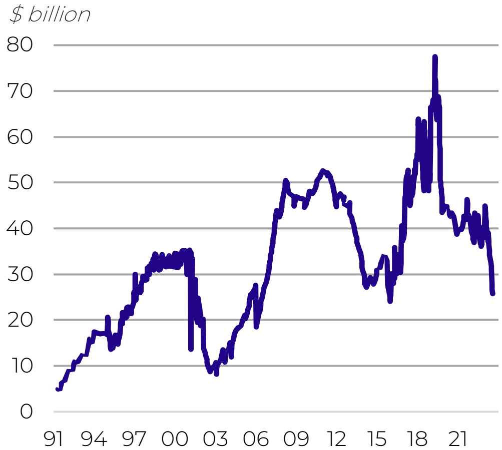


Chart 4
Argentina: merchandise trade balance
$ billion, nsa, monthly rate

Chart 5
BCRA FX reserves
$ billion



many years to complete. In the near-term, establishing macro balance will require policies of austerity, not expansion. The new government will face mid-terms in two years, making it hard to generate a durable political consensus for painful changes that can be credible to long-term investors regularly burned by default and depression. The best outcome would be generated by a strategy focused on restoring immediate financial stability alongside determined efforts to boost equity-funded investment in an economy that that has been persistently too dependent on external debt finance.

A (big) near-term problem

Argentina is facing a classic balance of payments crisis in the weeks and months ahead of the election. One near-term driver is an extended drought, which has severely reduced agricultural yields. For example, soybean production fallen by about 50% in the current crop year, to a level not seen since 1999-00, when the area planted was almost half of what was planted in 2022-23 (Chart 3). The result is that the trade balance has deteriorated sharply through 23H1, with the June 2023 deficit at $1.7bn, nsa, up from a deficit of $0.2bn in June 2022 (Chart 4). June export values were down 35.4%oya (in USD terms) while import values were down 17.2%oya. A current account deficit has re-emerged in 2023 (there was a small cumulative surplus between 2020 and 2022). The problem is that, unlike 2015-19, there is no ready supply of capital inflows to finance a deficit.

The IMF remains a key lender of the last resort for Argentina. This position reflects a mix of good intentions and self-interest. The IMF entered 2023 with loans to Argentina of $46bn. Some was paid down in 23H1. Extending new loans through Q3 will be a way for the Fund to preserve the quality of its existing exposure. China has become a new lender of the last resort during 2023, extending a CNY swap line to the equivalent of about $10bn, some of which appears to have been used to make the June payment due to the IMF. The central bank (BCRA) recently announced that Argentine banks will be allowed to offer clients accounts denominated in CNY. Even with this official support, the BCRA's official FX reserves have fallen to about $25bn, down from $46bn at the start of the year (Chart 5; net reserves, which exclude swap lines and some other liabilities are probably below zero, well below the IMF target).

Very high inflation is back

The official peso (ARS) has depreciated by about 35% so far in 2023. The parallel market peso has fallen by a similar amount (36%), to about 550 per USD (the official rate is 270). Peso weakness has been one factor behind high domestic inflation. Another has been the weakness of agricultural production, which

Chart 6
Argentina: primary budget balance
% of GDP, sum of last 12m

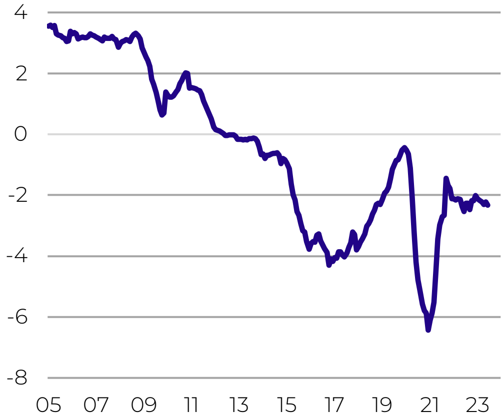


Chart 7
Argentina: base money and inflation
%oya

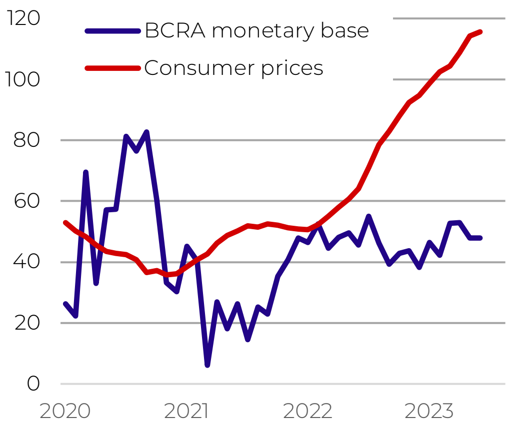
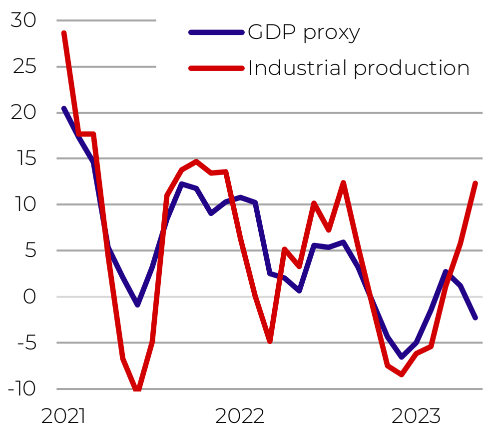


Chart 8
Argentina: activity indicators
%3m/3m saar



has had a knock-on effect on domestic food prices. The food and beverage component of the CPI was up 117%oya in June, slightly ahead of the headline rate.

Fundamentally, however, high inflation is a monetary phenomenon. Argentina's recent inflation (and FX) experience illustrates well the power of three key forces to play off each other in a vicious circle.

First, regular losses associated with public debt defaults lead investors (both domestic and foreign) to shy away from holding government debt. High nominal returns are no longer an inducement, but more a signal of adverse selection. The only way around this is for the government to run a healthy primary budget surplus as a way of regaining fiscal credibility. Instead, the primary budget deficit has averaged 3% of GDP since 2020 (Chart 6). Moreover, tax hikes on agricultural exports have had adverse effects on growth and the balance of payments.

Second, the absence of private financing flows means that the government is forced to turn to the state-controlled banking sector, including the central bank, to be a major source of finance. Monetization was heavily relied on during the C-19 crisis.

Third, money-based financing further undermines the willingness of the population to hold the ARS even at high nominal deposit rates and with extensive FX controls. The BCRA policy rate is currently 97%. The resulting contraction in the real monetary base undermines seignorage income and adds to the public finance woes (Chart 7).

The upside case: Menem and Kirchner

It is hard to have much near-term optimism about the Argentine outlook. On the more positive side, industrial production has bounced back through 2023, although the broader GDP proxy has been weak through May, partly because of problems in the agricultural sector (Chart 8). The unemployment rate—a problem in the 1990s and early 2000s—fell back to 6.9% in 23Q1, close to its low in 2015. On the negative side, the poverty rate was 39.2% in 22H2, up from 25.7% in 17H2. In coming months, the outlook is for some combination of more disorderly FX devaluation and inflation, which will likely further worsen poverty and inequality. This might well then be followed by a phase of significant fiscal austerity if the center-right wins the Presidency, as expected. The latter might well be termed the good scenario. Another UP government might well steer the country towards the economic shape of Venezuela (and to the political sphere of China).

The long-run economic performance of Argentina has combined brief phases of solid performance with extended phases of disorderly, weak growth (Chart 9). There were two extended problem phases (1980-85

Chart 9
Argentina: real GDP
1980 = 100

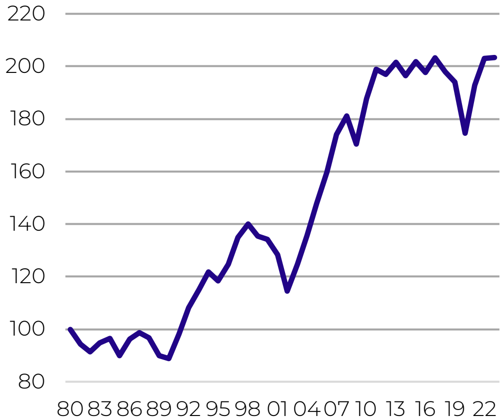


Chart 10
Argentina: IIP
% of GDP; foreign assets less foreign liabilities

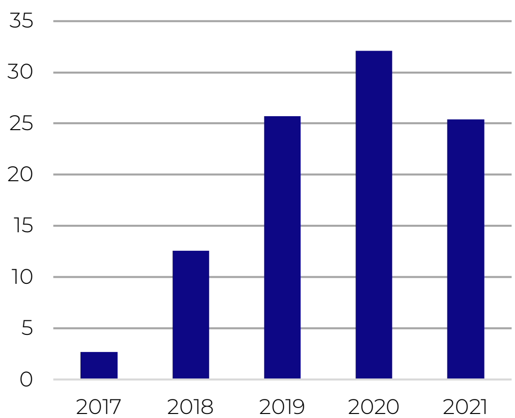
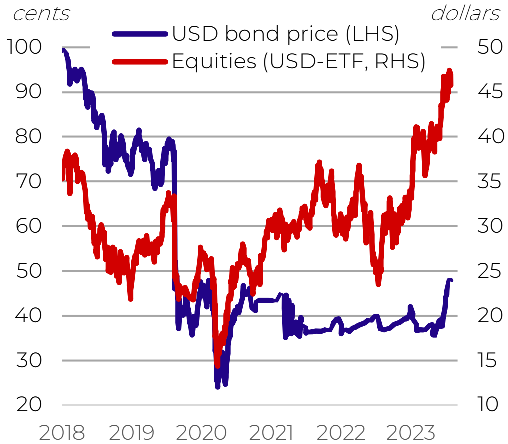


Chart 11
Argentina: asset price developments
cents *dollars*



and 1997-2002) coinciding with adverse global developments and external debt defaults. The most recent phase of stagnation, which began in 2011, has been the most protracted and serves as a reminder that the drag from poor performance cumulates. Reversing it cannot be done overnight. The experience of the Macri Administration, when early optimism (in 2016-17) turned to default (in 2019) is a sober reminder of what might follow a post-election asset price bounce. Whoever wins the election will inherit a public debt/GDP ratio of about 85% of GDP.

However, there have been two episodes of economic success in the past 50 years, both spurred by the election of populist politicians who turned out to be surprisingly orthodox in policy implementation (Carlos Menem in 1989 and Nestor Kirchner in 2003). Aside from the confidence benefits that might follow from more determined efforts to re-impose fiscal discipline and lower inflation, there are three developments that could help the new team.

First, they will take over at the likely peak of a DM monetary policy cycle. Second, Argentina's overall net international investment position (IIP) is strong (Chart 10). One way or another, domestic entities have accumulated large stocks of international assets. This *could* be a source of supportive capital inflows back into the country if domestic savers could regain confidence in the governance of the country (a very big "if"). Finally, there remain important upside opportunities in commodities sectors, most notably in natural gas, where the *Vaca Muerta* formation is in the early stages of being developed.

After years of (justified) relative pessimism, financial markets have moved to price in more optimism about Argentina as the elections have moved closer. A USD-denominated bond due in 2028 has risen by 34% in price since mid-May (Chart 11). The run-up in equity prices has been more extended, helped by the boost to the demand for real assets provided by inflation. These are vulnerable to an FX crisis in Q3 but could resume in 24H1 under a new government.

Philip Suttle
phil@suttleeconomics.com
202-378-6793

Important Information