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Argentina: once again at a crossroads

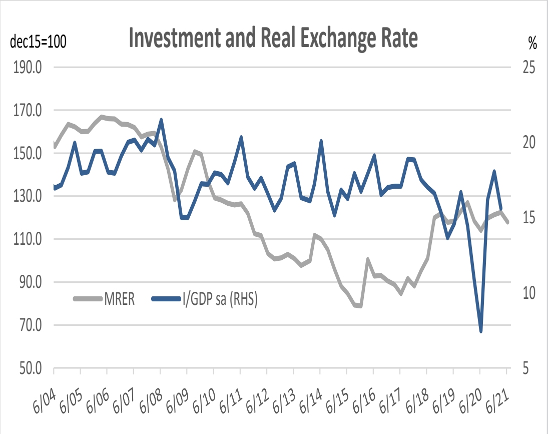
- **There is limited scope for investment and growth absent some basic policy consensuses.** Politicians and the society need to decide whether Argentina's economy will commit to market rules or continue following anachronic discretion. There will be no sustained growth as long as return on capital is being questioned and challenged. Within the current political backdrop, not even a cheap currency or low dollar wages would be promoting investment and employment.

- **An oversized and inefficient state is blocking instead of promoting development.** With almost half of the economy being publicly controlled, and taxes and expenditures being of dull quality, more fiscal expenditure does no longer generate growth, but inflation and poverty. Additional public expenses are financed with distortionary taxes, and an imploding private sector offsets any potential demand gain. A secular fall in the ratio of private employment over public is one manifestation of Argentina´s decay.

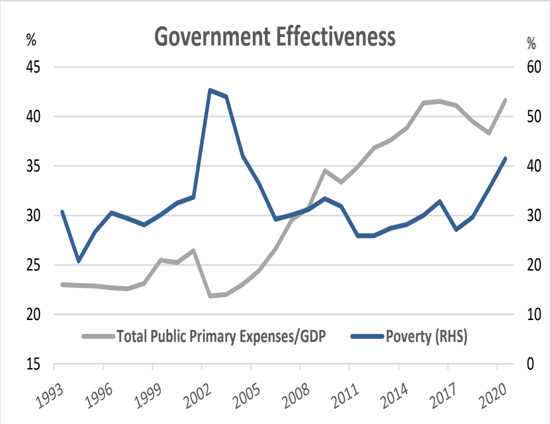
- **Cash overhang is again a serious threat to nominal stability.** Forecasting treasury financing until the end of the year anticipates the BCRA remunerated liabilities minus net international reserves to touch the equivalent of USD50bn. This would not only be the maximum ever recorded, but it would also be reached with basically null level of net international reserves to mop up such an excess. Peso financing fiscal imbalances have been the chronic problem of the Argentine economy, periodically triggering currency runs and high inflation. This time should not be different.

- **A challenging time ahead.** Argentina needs to confirm its economic regime immediately, committing to a declining fiscal deficit path, and moving forward structural reforms. If such a program is blessed by the IMF auditing, then there is a chance of avoiding more economic and social pains. Otherwise, nominal instability will simply do the usual dirty job, inflating away part of the peso debt and the BCRA liabilities. Although this and public sector default have been the usual way out in Argentina, 50% of the population below the poverty line calls for much more responsibility on policy makers than before.

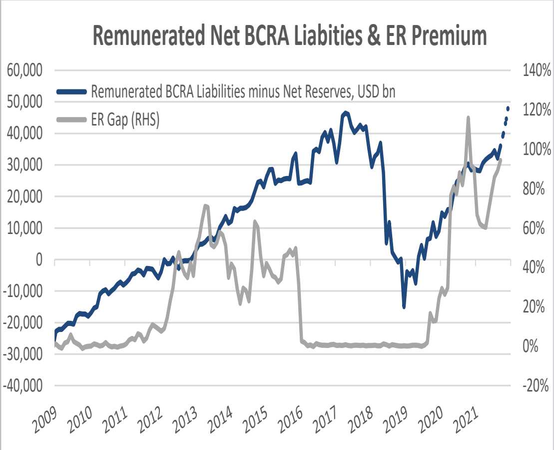
- **Investment strategy.** Assets protected from inflation/devaluation should be preferable in the present conjuncture. Likewise, private credit should be superior to public credit. Overall, Argentina's assets are relatively cheap or yet expensive, depending on the political/policy outlook ahead.



Source: INDEC & BCRA



Source: MECON, Ferreres & IMF



Source: CMF, BCRA & Bloomberg

I. The need for basic political consensuses

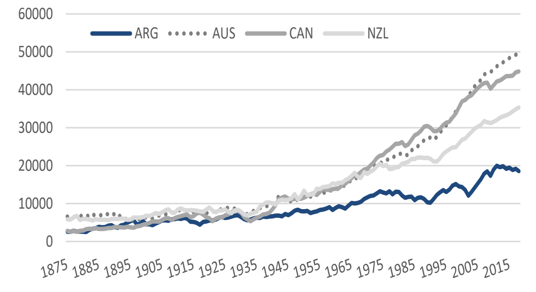
The argentine economy has been stagnant for more than a decade. But the real relative decay started more than half a century ago, or once heavy intervention in the economy began, questioning basic market rules. **Figure 1** supports that view, comparing Argentina per capita income in USD with those of Australia, New Zealand and Canada; three countries with similar factor endowments than Argentina. Quite a few studies have found a statistical break between Argentina and the world economy at around 1950 (most recently, Ertola Navajas, 2021, UdeSA, Argentina). Worth recalling, the Constitution enacted in 1949 included a new concept of "social role of capital", or limits to property rights. That Constitution was repealed in 1956 by a military government, but its spirit reached deeply into the country's social fabric. Other countries have tried that social bias as well, but have not avoided modernizing since then, while Argentina seems yet dealing with the same old ideological discussion of the past.

Interestingly, in 2007/2008, or at the beginning of the previous commodity boom, Argentina started another period of international separation, but at this point from other South American economies (**Figure 2**). At around that time, Argentina was leaving behind a period of twin surpluses, facing increasing inflation, and capital outflows. That worsening path finally led to the nationalization of the pension system, misreporting inflation, and capital controls, among other confining actions. Meanwhile, during those years, most of the other major commodities producer in SA took advantage of the global boom to start a process of disinflation that has been preserved until nowadays. Instead, inflation in Argentina this year will be close to 50%, and the prospect for next year could be even worse (**Figure 3**).

Higher inflation has not been the only distinctive characterization of Argentina´s economic failure when compared to its neighbors since early 2000. A lower level of gross investment as well as a lower and declining level of exports have been also a reflection of an economy that does not generate enough business incentive across the board. (**Figure 4 & 5**).

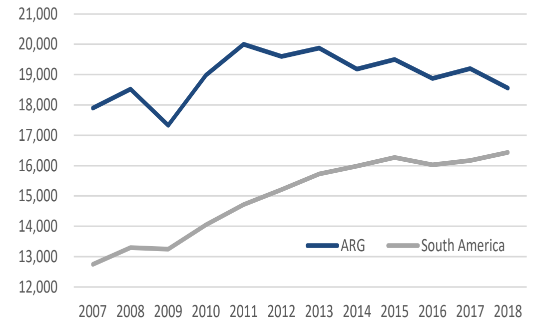
According to the World Economic Forum, Argentina is also well known to have weak institutions, a very rigid labor market, inefficient good markets, low financial market development, and, obviously, a poor macroeconomic environment, even when compared with its neighboring countries. In addition, in the last twenty years, Argentina has witnessed a significant increase in the size of the government, larger than what was experienced in any other regional country during the same period. As **Figure 6** illustrates, public expenditure in Argentina is currently 41.6% of GDP, almost reaching the size of Brazil´s government, and well above the median in the rest of South American economies. Thus, the size of the government in Argentina increased by 65% in 20 years, or by 16.4 points of GDP. Worth noting, 2020 government´s size was partly a byproduct of the Covid pandemic, but such a level had been already reached by 2015.

Figure 1. GDP Per Capita (USD mn)



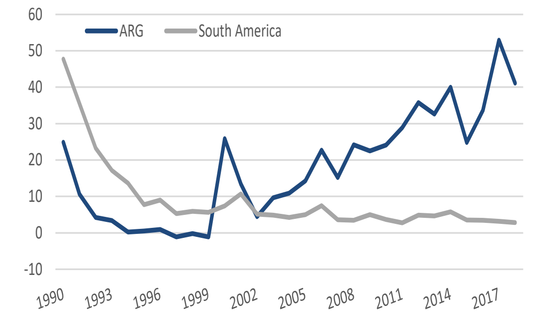
Source: Maddison Project

Figure 2. GDP Per Capita (USD mn)



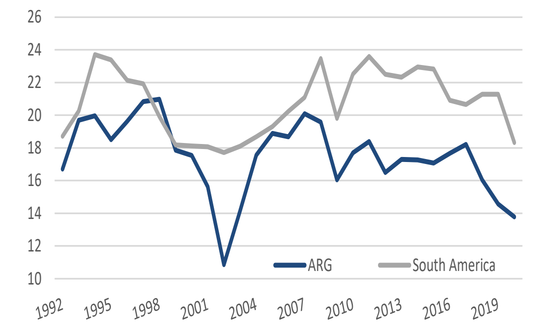
Source: Maddison Project

Figure 3. Inflation Performance (%)



Source: Indec & World Bank

Figure 4. Investment (%GDP)



Source: Indec & World Bank

II. An oversized and inefficient State

The last pre-pandemic fiscal expansion in Argentina started in 2006, when the cyclically adjusted primary balance (according to the IMF) was down to 2.9% of GDP from 5.0% the previous year. Between 2006 and 2015, the consolidated government, national and provincial, accumulated a primary spending increase of almost 15% of GDP. Such a sizeable fiscal impulse in 10 years was not exactly coincident with strong economic growth in the country. Actually, Argentina´s economic stagnation was the most notable during those years, as illustrated in **Figure 2**.

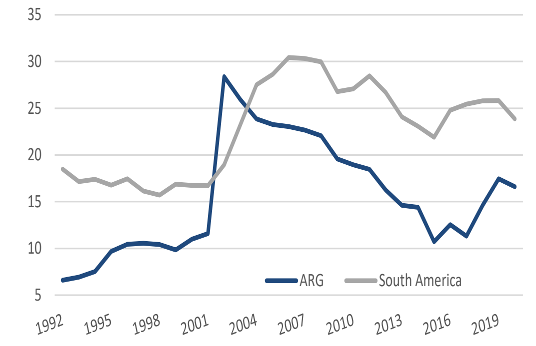
A bigger state was neither able to reduce poverty, as shown in the second chart of the front page of this report. After declining steadily from its peak in 2002, when the previous economic crisis put an end to the convertibility regime of the 90s and further resulted in government debt default, the number of individuals living below the poverty barely moved between 2006 and 2015, when it reached 30.0% from 29.2% in 2006. A mirror image of that welfare result is an average annual inflation rate of 30%, or almost three times the average recorded during the first 5 years after abandoning the convertibility regime.

Crowding out of the private sector has been probably the main reason behind the ineffectiveness of public spending in the country in recent years. Such a phenomenon is well characterized by an increasing share of public versus private employment. **Figure 7** confirms such a trend since 2012, or when detailed labor data become available. As of June 2021, there are more public wage earners tan private (55%), and total public employment represents 38% of all registered employees in the private sector.

The way public finances have been changing over time adds some color to the resulting final economic impact. For example, 61% of all increases in public spending by the national administration were concentrated in social security and economic subsidies (**Figure 8**). The social security push was explained by a number of initiatives that allowed more than 3 million people to retire without previously contributing to the system. As a result, in this year budget, social security represents 52% of total expenses. Similarly, the current size of economic subsidies symbolizes direct public intervention in public services, setting maximum prices and other restrictions that hinder private sector investment. As a corollary, a net exporter of energy in the 90s, Argentina became a net importer in few years despite a protracted economic stagnation. At the provincial level, wages and public employment were the principal instrument of fiscal expansion, accounting for 62% of total primary increases in the provinces.

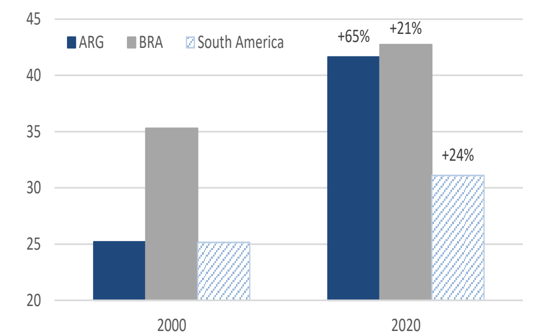
A similar anti-business picture arises from the resulting tax increases in the last twenty years. Financial transaction taxes combined with trade duties (exports and imports) and the gross income tax (a cascading sale tax) increased the most, or by 5 points

Figure 5. Exports (%GDP)



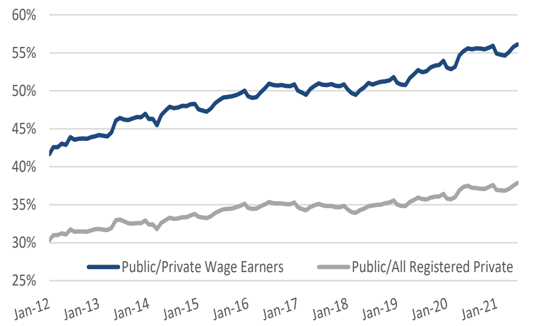
Source: Indec & World Bank

Figure 6. The Size of Government (% GDP)



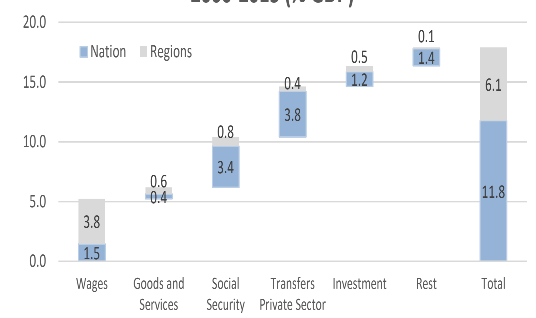
Source: Mecond & IMF

Figure 7. Public and Private Employment



Source: Argentina´s Labor Ministry

Figure 8. Primary Spending Increase 2000-2015 (% GDP)



Source: IMF & S. Galiani 2020

of GDP during these years (**Figure 9**). These are highly distortionary taxes, although relatively easy to collect. The second contributor on the revenue side were social security levies, but still representing less than a quarter of the inflated social security bill. Indeed, the social security deficit this year is projected to reach 3.3% of GDP, or 2/3 of the total primary deficit of the year.

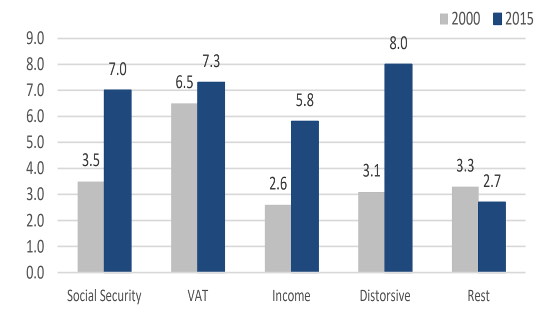
President Macri´s administration, 2016-2019, showed an increasing interest for reducing the size of the government and alleviating the burden of such state on the private sector. After an initial increase in the fiscal deficit, partly due to rulings by the Supreme Court favoring the provinces, lower taxes, and overconfidence on financing sources, total primary expenditure was reduced by 3 points of GDP, and the deficit fully erased by 2019. Unfortunately, by the time the new administration took office in late 2019, the Covid-pandemic was set to drive fiscal expenditure forward, reverting back to their 2015 size, but with an even heavier toll on the private sector due to the deep economic recession in 2020. The new government not only doubled the tax rate on the existing wealth tax, but also introduced an exceptional tax on patrimonies above USD3mn, the so-called “solidarity contribution”, that is projected to collect 0.7% of GDP in 2021.

While a larger State has been negatively affecting incentives to invest and doing business, the monetary dimension of accumulated fiscal deficits has maintained a fragile nominal equilibrium, with frequent periods of accelerating inflation and financial stress. This was the case in 2018, when the monetary legacy inherited in 2015 was combined by a still large fiscal imbalance, a negative turn around in global mood, and a severe drought afecting agriculture exports that year. At the end, a currency run destabilizing the fragile path followed, and inflation volatility once again impacted negatively on welfare and poverty levels (**Figure 10**).

III. Cash overhung is again the main risk

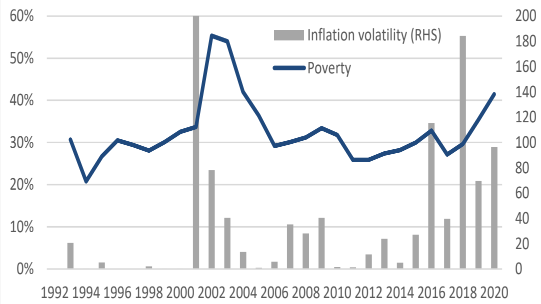
Unfortunately, once again, the argentine economy is moving forward on a brittle nominal path. Projecting monetary financing and USD flows until the end of the year anticipates an unusually high level of pesos in the system (**Figure 11**). For instance, according with our projections, all BCRA remunerated liabilities minus net international reserves would reach the equivalent of USD50bn, or 11% of GDP at the yearend. These would pass the historical maximum of April-May 2017 that to some extent anticipated what followed in early 2018. Furthermore, in 2017 net international reserves were more than USD10bn, or a quarter of these liabilities, while today the projected level of net international reserves would be close to cero. Therefore, after the mid-term elections, the BCRA will have to face a record amount of peso excesses ever with the lowest level of international reserves, the only efficient mean of mopping up those pesos. Fresh money from a potential renewed agreement with the IMF or a major

Figure 9. Tax Burden (% GDP)



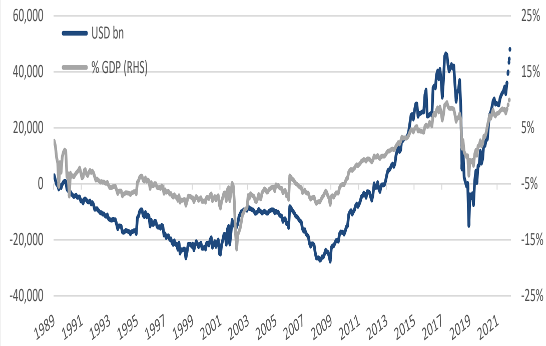
Source: S. Galiani 2020

Figure 10. Inflation and Poverty



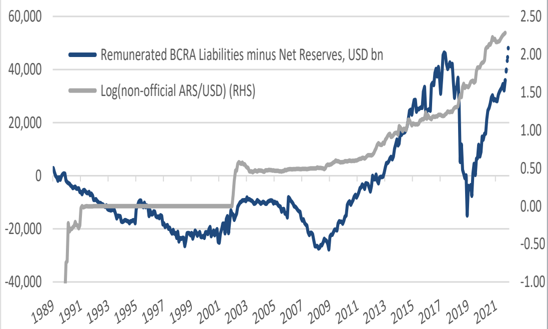
Source: Indec

Figure 11. Remunerated BCRA Liabities minus Net Reserves



Fuente: BCRA & Bloomberg

Figure 12. Remunerated BCRA Peso Liabilities & the ER



Fuente: BCRA & Bloomberg

turn around in the consolidated fiscal accounts could do part of the trick, but both are unlike in our view.

These BCRA remunerated liabilities are the mirror image of pesos that the monetary authority takes out of circulation to control peso supply, usually aiming at price stability. In Argentina, however, that historically high amount of BCRA liabilities are not preventing high inflation, which means that this metric is most likely already underestimating the real amount of cash overhung. On a more positive note, stringent controls on capital mobility are certainly helping to moderate the potential spillover effects from those extra pesos as the usual scape circuit, the USD, is restricted. Nevertheless, while running away, excess pesos could always buy goods.

The size of peso excesses already in the system should not be understated. To put things into historical perspective, this metric of peso surpluses was on average cero between 1991 and late 2012. It only reached the equivalent of USD33.5bn or 6% of GDP by November 2015, or after an expansionary push by the Kirchner administration prior to that year national election. Back then, however, the prospect of a new government with a clear pro-business approach did work as a buffer to mitigate its impact on inflation and financial markets. Nonetheless, this did not prevent the BCRA from heavily intervening in the exchange rate market, selling up to USD15bn in the forward markets in the run up to the 2015 elections.

These pesos accumulated in the system up to 2015 plus the monetization of the FX forward contracts came later to hunt the new administration´s effort to nominal stability. The opening of the capital account did not facilitate things for the entering government, although it was a fundamental part of the new economic paradigm proposed by the Macri´s administration. The latter reveals a major challenge for any administration that will try to fix Argentina´s macroeconomic disequilibria: to create enough genuine peso demand while opening Argentina to the world economy, avoiding a currency run and a major instability in the transition (**Figure 12**). Or to fix the flow problem without being trapped by destabilizing stocks.

IV. A challenging time ahead

The mid-term election in November is providing a meaningful short- term anchor to nominal stability. The short period of time until then, and the expectation that the government will do everything in its power to avoid any financial distraction does help to create that transitional stability. The BCRA does not hold a lot of ammunitions for a sustained confrontation with markets, but enough to resist until November. The question is what could happen after the election, almost independently of the election outcome (**Figure 13**).

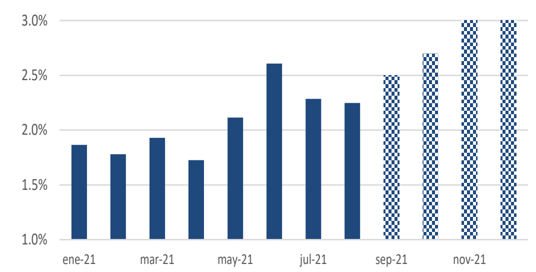
Not exactly helping on the after-election task, the government has recently embarked in a rather expansionary policy at the time when

Figure 13. Market Expectations

	oct-21	nov-21	dic-21	Q I 22	Q II 22
Inflation, MoM, %	2.70	2.80	3.10	3.22	3.22
ARS/USD, MoM, %	1.55	1.70	4.08	3.70	3.30
Badlar, MoM, %	2.87	2.88	2.92	2.93	2.93

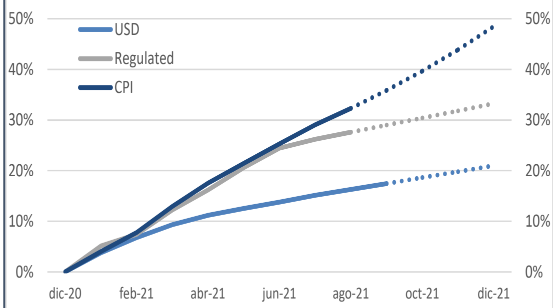
Source: BCRA's REM

Figure 14. Projected Total Fiscal Spending (% GDP)



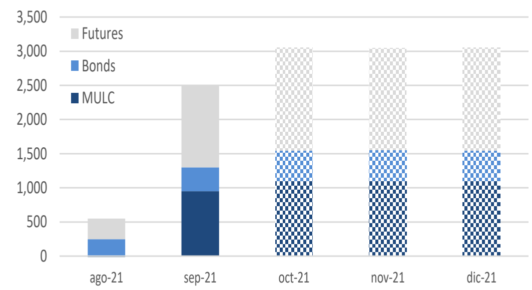
Source: Mecon & CMF

Figure 15. Accumulated Relative Price Distortions



Source: Indec & BCRA

Figure 16. Expected FX Intervention(USD mn)



Source: BCRA & CMF

money printing seems the only financing source left in the margin. **Figure 14** pictures the spending path that is consistent with the government own forecast of the final fiscal results for the year. However, that is not the only intervention tool the government is planning to use. A much lower adjustment in utility prices and the official exchange rate than inflation, as already observed during the early part of the year, is also likely to be continued. The expected accumulated deviation in these relative prices for this year only is likely to reach 27% and 15%, for the exchange rate and the utility prices, respectively (**Figure 15**).

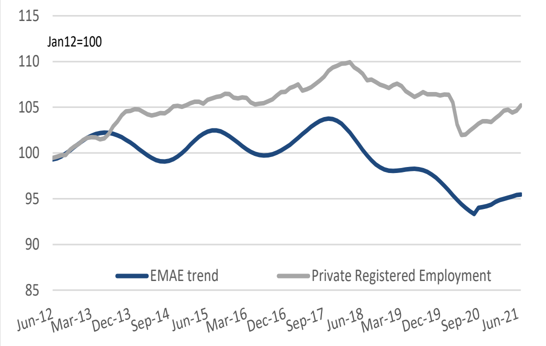
Such an economic and financial picture for the end of the year is already increasing concerns about the future, explaining the recent waking up of the non-official exchange rate market once again. After a relatively calm August, during the month of September the Central Bank had to sell USD950mn of reserves in the whole sale FX market, an estimated USD350-400mn in the bond market, and more than USD1000mn equivalent in the future market. A simply extrapolation of this trend together with debt commitments with multilateral organizations anticipates that the BCRA will use most of its net international reserves by the end of the year (**Figure 16**).

Despite this electoral fiscal and income push, economic activity and employment are unlikely to react, consistently with the causes of Argentina’s long-term economic decay already discussed (**Figure 17 to 20**). As noted, any sustained recovery will demand a credible commitment to follow market rules, away from the anachronic policy discretion that has once again characterized economic policy in the last couple of decades. Strict regulation is always an efficient protection to consumers and those more vulnerable, and far more preferable that business threats without rules or predetermined criteria.

Critical reforms should also include at the minimum a ceiling on public spending, on a consolidated level with provinces, as well as a major tax and administrative reform. A long-term solution to the pension deficit is also warranted, as well as greater flexibility in the labor market, even if this were to apply on the margin, or only on new employees.

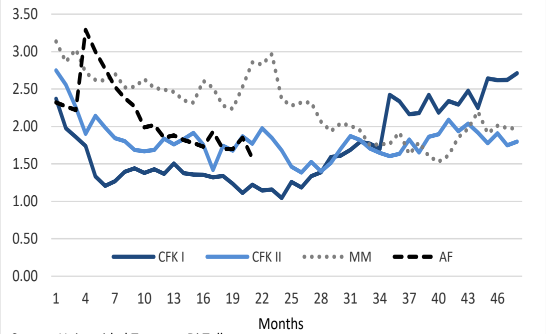
Advancing on these fundamental reforms within a new program with the IMF would add credibility to such a major policy effort. More importantly, the IMF credentials could help address the challenging monetary legacy that would inevitably remain. Any alternative policy route, even if that includes a soft program with the IMF, would face extraordinary risks of resulting in another major currency event, and nominal instability, sooner than later. Peso excesses would have to fade away, in one way or another. Capital controls could continue to moderate those risks, but the non-official exchange rate valve would eventually process the scape pressure demanded by a society that has seen these crises repeatedly over the last few decades.

Figure 17. Activity and Private Employment



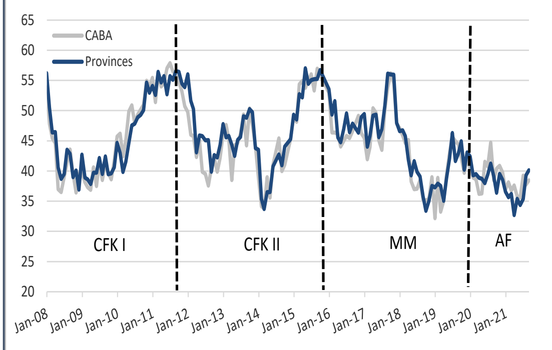
Source: Indec & Argentina´s Labor Ministry

Figure 18: Confidence on the Government



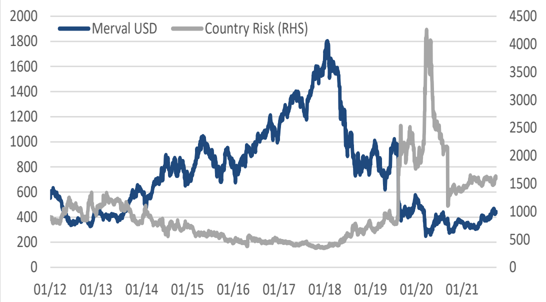
Source: Universidad Torcuato Di Tella

Figure 19. Consumer Confidence



Source: Universidad Torcuato Di Tella

Figure 20. Merval & Riesgo País



Source: CMF & Bloomberg

V. Investment strategy

The prior discussion suggests that inflation and exchange rate hedge are very valid options in the current circumstances. Therefore, assets indexed to inflation (CER), or the USD are the most attractive. However, it is worth analyzing the implied scenarios in those assets to identify the most appropriate investment. Secondary market prices of bonds due by January/February 2022 indicate that the associated implied inflation is 35.2% annualized. The latter looks low compared to average projection by analysts, telling that CER protection looks still cheap (Lecer Feb22) (**Figure 21**).

Likewise, the bond market indicates that implied real exchange rate depreciation between now and April 2022 is 11.7% (**Figure 22**). This indirect expectation seems consistent with the belief that the government will accelerate the daily pace of exchange rate depreciation after the mid-term elections, but avoiding a big discrete jump in the level. If this were the case, CER would look better even than USD linkers. This notwithstanding, USD linkers could still offer value amid a less predictable path, or where the market starts questioning the BCRA ability to control the market while losing the few international reserves left (**Figure 23**).

The Badlar instruments (AA22) carry the same implied inflation than the CER assets, but they could still be a valid investment strategy in case the new policy approach were to use a higher real rate to gain stability. Although this has not been the preferable policy preference of the monetary authority so far, such a role for interest rates would be a natural ingredient of an IMF program. Without such a program, and facing a probably flimsy stability, these instruments lose their relative advantage.

The sovereign USD curve also offers an alternative protection mean. Buying AL30 against pesos would allow buying a low USD parity bond at a peso price that is positively correlated with the exchange rate gap. Different from other peso options, the AL30 does not have a good carry, given the associated low coupon. Actually, any improvement in the USD parity would probably demand improving expectations about economic policy. On its favor, the AL30 has a relatively low parity (**Figure 24**).

Regarding hard currency investments, USD sovereign assets are only recommendable for those investors with adequate risk tolerance and a relatively long investment horizon. For this universe, the GD41 seems the first option, given its more generous indenture and high yield. A second option would be the GD35, due to its low parity, offering higher upside potential in the longer term. Otherwise, the AL30 would be the ideal vehicle for those more optimistic, betting for a relative rapid curve normalization (**Figure 25**).

Figure 21. Macro Implied in Bonds

S31E2 40.14%
X28F2 3.65%
Inflation: 35.21%

FX: 98.87
FX Implied: 122.5

X18A2 2.93%
TV22 -7.87%
Real Deva: 11.72%

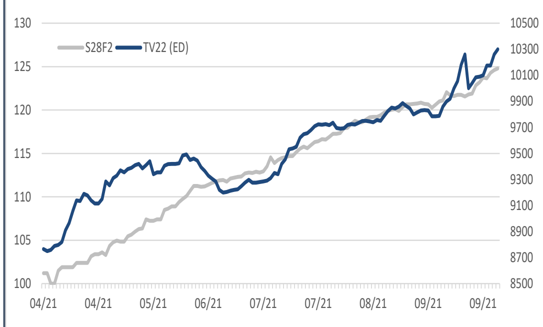
* With inflation above 35.2% (Oct.-21 to Feb.-22 annualized), Lecer Feb22 wins.
* With real devaluation above 11.7% (Oct.-21 to Abril.-22 annualized), TV22 wins.
* Bond prices implied a jump in the official FX of 27.7% for early 2022.

Figure 22. Macro Implied in Bonds

AA22 38.56%
X18A2 2.93%
Inflation: 34.62%

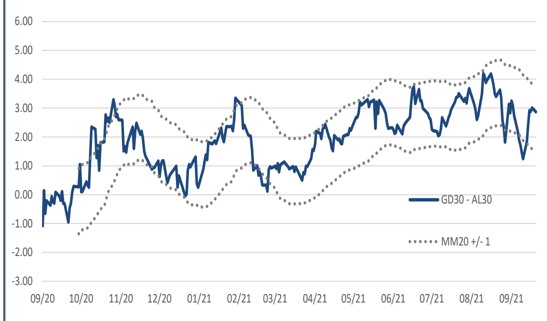
* With inflation above 34.6% (Oct.-21 to Feb.-22 annualized), Lecer Feb22 wins.
* AA22 could take advantage of positive real rates.

Figure 23. CERs vs USD Linkers



Source: Bloomberg

Figure 24. Price Differential GD30-AL30 (USD)

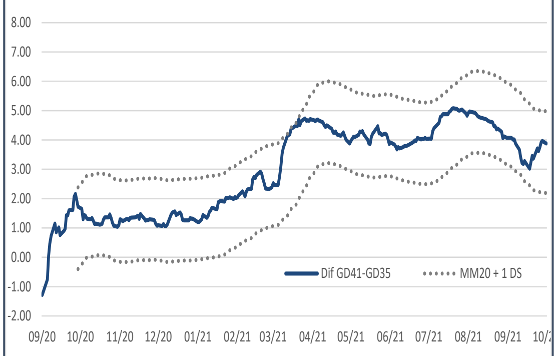


Source: CMF & BRava

It is also very important to pursue an adequate credit diversification, in particular because the corporate debt looks safer than the public debt, both in pesos and USD. There is some relatively cost to face in terms of liquidity, but private names involved in any exportable sector seem the most robust credit around nowadays The same would apply for equity names at this conjuncture.

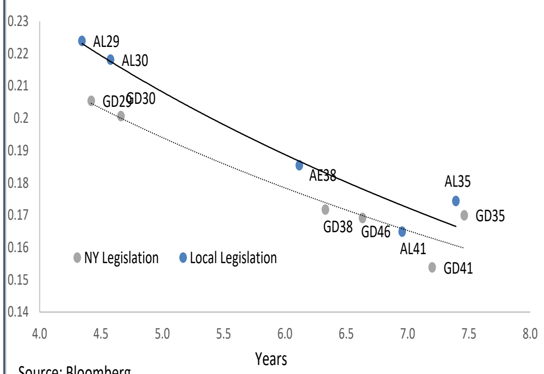
GCanonero
RGeretto
JCandia

Figure 25. Price Differential GD41-GD35 (USD)



Source: CMF & Bloomberg

Figure 26. Argentina Sovereign USD



Source: Bloomberg