BTMU LATIN AMERICA TOPICS

Bank of Tokyo-Mitsubishi UFJ
Economic Research Group (New York)

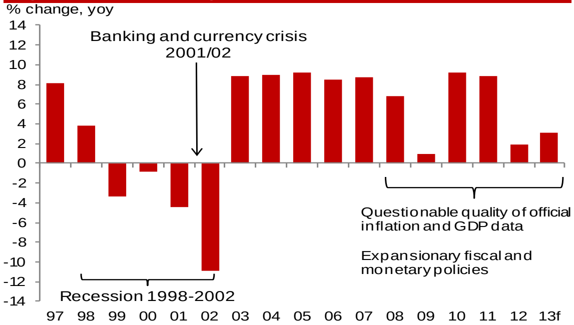
Magalí E. Solimano, Latin America Economist
msolimano@us.mufg.jp Tel: (212) 782-5708

ARGENTINA: PRESSURES ON THE ECONOMIC MODEL

February 25th 2013

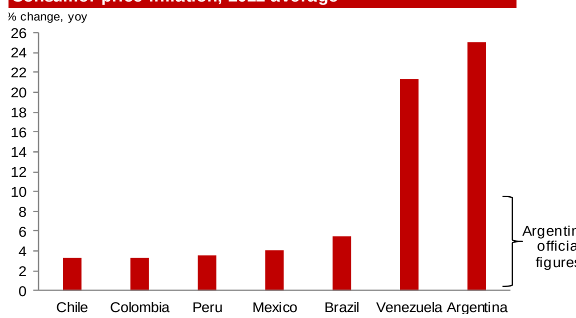
Argentina's economy is expected to grow below the regional average again in 2013, while its inflation rate will be the highest in Latin America. Despite its promise of strong growth, market distortions arising from unorthodox policies and interventions are intensifying the economy's weaknesses. Argentina also still remains far from normalizing relations with foreign investors. The economic model is increasingly difficult to sustain, and the government will struggle to buy more time without key structural policy adjustments and a weaker peso.

Argentina: Real GDP growth



Source: INDEC; Market consensus (forecast); BTMU Economic Research.

Consumer price inflation, 2012 average



Note: Private estimates place Argentina's inflation rate 2-3 times above official rate.
Source: Market consensus; BTMU Economic Research.

DETERIORATING TRADE-OFF: LOW GROWTH, HIGH INFLATION

Economic activity growth is constrained by unsustainable policies and market distortions.

- Real GDP growth decelerated sharply to 1.9% in 2012 from 8.9% in 2011, according to official figures—which are known to be unreliable—from the national statistics agency (INDEC). (Figure 1.)
- Growth should rise to around 3% in 2013, modestly higher than in 2012 upon a better crop year (for soy, corn, and wheat) and continued expansion of large government spending; but, it will again be below the regional average.
- Economic activity has slowed over the last few years—despite vastly expansionary government policies—upon weaker private consumption and investment, moderated prices for commodity exports, and drought affecting crop production. High inflation is eroding real income growth, while the uncertain business climate is deterring domestic and foreign investment.
- It remains difficult to accurately assess Argentina's economic conditions since 2007, due to the poor quality of official data for GDP and inflation. There are still large discrepancies between official figures and private estimates. Figures released by INDEC are overstated for GDP, and understated for inflation. Private estimates based on unofficial GDP figures place growth closer to zero in 2012.
- The IMF censured Argentina on February 1st 2013 over the inaccuracy of official GDP and inflation statistics, stating that the country was in breach of its obligation to the Fund to remedy the quality of its statistics. While the sanction is unlikely to directly worsen the already-strained relations between the IMF and Argentina, its implications may affect development lending to Argentina from private institutions and other multilateral agencies such as the World Bank and the Inter-American Development Bank.

Inflation remains high, despite weaker economic activity.

- Private estimates place the 12-month consumer price inflation rate higher than 25%, well above the government's reported rate of 10%. Argentina now has the region's highest inflation rate, surpassing even Venezuela. (Figure 2.)
- Expansionary government policies and supply-side constraints are pressuring inflation upwards, despite weaker economic growth.
- Argentina's Central Bank (BCRA) does not target inflation, unlike the Central Banks of Brazil, Chile, Colombia, Mexico, Peru, and Uruguay. The BCRA's independence has been lost since 2010 and, since 2012, its official mandate is to promote growth.
- The government has frozen prices on supermarket goods and domestic appliances for 60 days, from February 1st – April 1st 2013. With the wage negotiations coming up, the government seems to be signaling that it will not compromise with unions for higher wages.

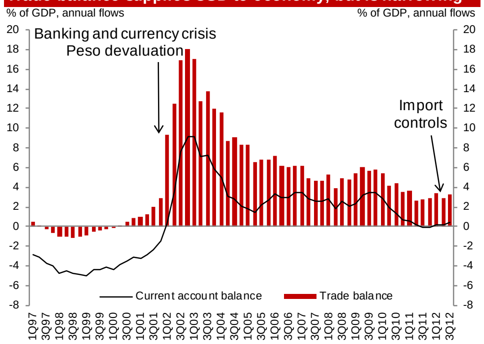
CLEAR DIFFICULTIES WITH THE CURRENT POLICY MIX, WHICH IS INTENSIFYING THE ECONOMY'S WEAKNESSES

Growth is underpinned by highly expansionary fiscal and monetary policies which, in turn, pressure inflation.

- Economic policies under the successive mandates of former President Nestor Kirchener (2003-10) and his wife Cristina Fernández (2010-present) have increasingly shifted towards populist principles. The role of the state in the economy is extensive, as seen through the large size of the public sector; generous provision of subsidies in the energy and transportation sectors; tight controls on imports, capital, FX, and prices; and, frequent number of unpredictable interventions in private sector operations.
- Loose fiscal and monetary policies are a pillar of growth. Fiscal expenditures grew by 35% in 2011 and an estimated 20% in 2012. The gap between traditional revenues and expenditures is financed with unconventional sources, including monetization (expansion of money supply) from the BCRA. Fiscal deficits are moderate, but widening from around 0.2% of GDP in 2011 to 2.4% of GDP in 2012.
- The monetary base (M0) grew by 39% in 2011 and 38% in 2012, with the strong expansion serving to pressure inflation upwards. In 2012, 56% of the expansion of the monetary base was accounted for by the public sector. The amount transferred from the BCRA to the Treasury in 2012 accounts for 20% of the end-2011 monetary base.
- The government has for several years been utilizing unorthodox sources to finance its spending growth. It nationalized the private pension funds in 2008 and has been tapping the BCRA's reserves to pay USD debts since 2010.
- Strong fiscal and monetary expansion will continue in 2013, since mid-term elections will be held in October and changes to the policy framework are not on the table for consideration.

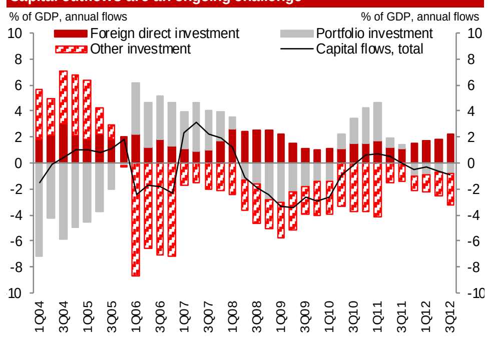
There are growing market distortions resulting from interventions. Argentina is relying on controls on imports, capital, and FX to increase the supply of USD in the economy and contain capital flight. The parallel FX rate is progressively weaker than official rate.

Trade balance supplies USD to economy, but is narrowing



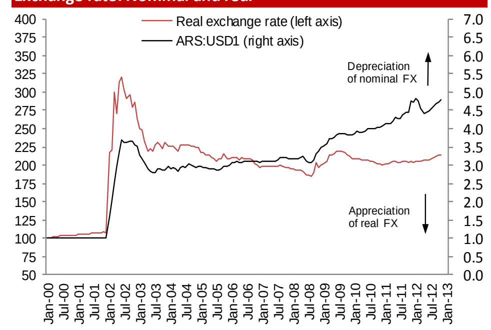
Source: MECON; BTMU Economic Research.

Capital outflows are an ongoing challenge



Source: MECON; BTMU Economic Research.

Exchange rate: Nominal and real



Note: Real FX vs. USD is based on official ARG inflation figures, which are understated.

Source: BCRA; IADB; BTMU Economic Research.

The economy is increasingly dependent on agricultural exports and the maintenance of a trade surplus to supply USD.

- The trade surplus (backed by soy, corn, and wheat exports) is a key component of Argentina's economic policy. It supplies USD to the economy since the country remains locked out of international capital markets and it also continues to try to contain capital outflows.
- Following the 2001/02 default and peso (ARS) devaluation, exports underpinned the economic recovery on the back of a more competitive ARS and boom in commodity prices. (Figure 3.) The trade surplus boosted public revenues and the international reserves stock, which the government uses to pay external debts and manage the weakening of the ARS to provide an anchor for inflation.
- The trade balance has narrowed from 2009; but, for the time being, it is maintaining a surplus upon import restrictions imposed by the government. All imports require pre-approval from the tax agency (AFIP) and Commerce Secretary since February 2012.

Capital flight is contained by tighter controls for now, but continues to pressure ARS depreciation and drainage of reserves.

- The outflow of foreign capital continues to challenge the government since it lowers the supply of USD in the economy and places stronger depreciation pressures on the ARS. Capital flight has been contained by a tightening of controls in 2012. (Figure 4.)
- Since 2011, households and corporations must obtain approval from AFIP to purchase FX, and energy and mining companies must repatriate export revenue. Moreover, the purchase of USD for savings is not allowed since 2012. Approved importers have access to FX.
- The government is drawing on its stock of international reserves to tightly manage the pace of nominal depreciation and contain inflation. Its reserves stock totals USD44bn. It has fallen 8% since end-2008, while Latam-5's reserves have risen 70% over the same period.

FX: Widening gap between official and parallel rates

- High inflation and capital outflows are placing stronger downward pressures on the ARS. (Figure 5.)
- The official rate is trading at ARS5.0:USD1, but the black market dollar rate (*dólar blue*) has widened to a weaker 7.8 since official access to USD is limited. The government will eventually have to allow a quicker nominal weakening since its FX reserves are declining and the *blue* rate is trading more than 50% weaker than the official rate. Mounting depreciation pressure is expected to continue.
- Meanwhile, with inflation persisting at a high rate, the real FX is on an appreciation trend that has contributed to narrow the trade surplus.

Price controls on energy have resulted in underinvestment in domestic energy production and a rise in energy imports.

- Controls on the prices of natural gas and electricity since the 2001/02 crisis have disincentivized investment in exploration and production. Thus, Argentina—which was formerly a net exporter of natural gas—is a net importer since 2008. Moreover, there has been limited expansion in electricity capacity since 2002, and generation increasingly relies on more expensive petroleum derivatives.

STILL FAR FROM NORMALIZING RELATIONS WITH FOREIGN CREDITORS, AND UNCERTAINTIES PERSIST

- Relations with private and official foreign creditors remain damaged since the 2001/02 default, and Argentina is still locked out of international capital markets. About 92% of its defaulted debt has been restructured as of 2010, but there are still some holdouts.
- Paris Club repayment negotiations are unresolved for about USD9bn. One of the Paris Club's implied conditions for the debt restructuring is Argentina's cooperation with the IMF. However, Argentina cut its ties to the IMF in 2006 and relations remain strained.
- The *pari passu* case of holdout hedge fund Elliott Management (NML Capital) vs. Argentina will proceed before the Second Circuit Court of Appeals on February 27th in New York. It has already been ruled that Argentina must treat bonds held by the holdouts the same as restructured debt held by other bondholders. The appeal will rule on the payment terms. (See table on Page 3 for recent developments.)
- There is little clarity on Argentina's next step. It has the capacity to pay the USD1.33bn to NML Capital with its FX reserves, but has stated that it will not concede. It may incur a technical default on payment to exchange bond holders if it chooses to avoid paying holdouts.

UNFULFILLED GROWTH POTENTIAL TO CONTINUE UNTIL GOVERNMENT FINDS BETTER POLICY BALANCE.

- The current policy mix is becoming increasingly difficult to sustain. Real GDP growth has already had a hard landing in 2011-12, inflation remains high (+25%), monetary expansion is strong (+39%), and the parallel FX rate is trading progressively weaker than the official FX rate (+50%). The trade balance has narrowed, and the government relies on tight controls to contain both import growth and capital flight.
- The government is facing financing constraints, but relies on expansionary fiscal and monetary policies that spur already-high inflation.
- Growing dependence on soy exports to supply USD has increased the economy's exposure to commodity price volatility and weather conditions affecting crop yields. Import compression policy does not address the causes of the narrowed trade surplus.
- Argentina's relations with foreign creditors continue damaged, if it does or does not incur technical default. This is prolonging its period of below-investment grade sovereign debt ratings, limited capital market access, and high credit costs.

Overview of Argentina's 2001/02 financial crisis

Preceding financial crises in emerging markets

1994/95	Mexican financial "Tequila" crisis: Twin banking and currency crises
1997	Asian financial crisis: Twin banking and currency crises
1998	Russian financial crisis: Currency crisis
1999	Brazilian financial crisis: Currency crisis

Argentine financial crisis: Twin banking and currency crises

1998-2002	Recession
March - Nov 2001	Large fiscal deficit and insufficient fiscal reform led to banking sector instability as the government's credibility to maintain fixed exchange rage was weakened. Upon market's expectation of devaluation and default, the interest rate differential between deposits denominated in pesos and USD widened; there was a rise in sovereign yield spreads; and, drop in international reserves.
December 2001	Escalated run on bank deposits by private sector. Banks accounts frozen by government (*corralito*).
December 2001	Sovereign default on foreign currency debts (USD81.8bn), which remains the largest default in history.
January 2002	Peso devaluation and debt redonimination Collapse of currency board that pegged peso at ARS1:USD1 since 1991. Peso weakened to average of ARS2.96:USD1 in 2003. All USD debts, contracts (for public utilities and transportation), and bank deposits were redonominated to pesos at the devalued rate (*pesification*).

To date, Argentina is still locked out of international capital markets, though now mostly voluntarily since the last debt restructuring of 2010.

Debt restructuring with private creditors has advanced, with 92% having been restructured.

There are still holdout creditors.

The Paris Club repayment negotiations are still unresolved for about USD9bn. One of the Paris Club's implied conditions for the debt restructuring is Argentina's cooperation with the International Monetary Fund. Restructuring talks have not moved forward, however, since Argentina severed ties with the IMF in 2006. Relations remain strained as of February 2013, and the IMF has not conducted an annual review of the economy since 2006.

Holdout hedge fund Elliott Management (NML Capital) has sued Argentina for the principal and accrued interest payments on the defaulted debt that it holds, on the basis of *pari passu* (equal treatment of bonds held by holders of defaulted and restructured debt). The case of NML Capital vs. Argentina is under the jurisdiction of the New York District Court because the Argentine defaulted bonds were issued in the US.

Source: BTMU Economic Research.

Recent developments in case of NML Capital, Ltd. vs. Republic of Argentina

October 26th 2012	The Second Circuit Appeals Court in New York ruled that the *pari passu* provision applies and that Argentina violated *pari passu* by discriminating between holders of defaulted debt (holdouts) and holders of restructured debt (exchange bond holders). It requested that Judge Griesa clarify how the payment would be made to the holdouts.
November 21st 2012	Judge Griesa ruled that Argentina must pay holdouts according to a "pro-ratable" formula for the full amount of principal plus accrued interest, which amounts to USD1.33bn. Full payment is due at the same time it pays exchange bond holders, and the payment should be deposited in an escrow account before that date. The Judge also ruled that third-party financial institutions involved in the payment process are subject to abide by the ruling (including the Bank of New York Mellon, which is the paying agent on the exchange bonds).
November 28th 2012	Argentina appealed the ruling. It was granted an emergency stay on payment obligations to holdouts, pending appeal. It was scheduled a hearing before the Appellate Court for February 27th 2013.
February 27th 2013	Oral arguments will be made. There is no deadline date by which the court is required to make a ruling. It may or may not take up to several months. The appeal will not rule on the vadility of *pari passu*, which has already been ruled on, but rather on the terms of payment to the holdouts.

Uncertainties persist and there are still unknown factors, but there are currently some possible outcomes:

1) Argentina appeals again and motions for the case to be reheard, possible by US Supreme Court. It will try to buy has much time as possible.

2) Argentina changes its stance and pays NML Capital the full USD1.33bn payment from its FX reserves stock of USD44bn. This is still unlikely. Other holdouts may also seek full payment through the courts.

3) Argentina incurs a technical default in payment to exchange bonholders in order to avoid making the payment to holdouts.

Source: BTMU Economic Research.

For historical data and commentary following BTMU's Economic News Releases, see our website at: https://reports.us.bk.mufg.jp/portal/site.