Argentina

Up against the wall

The Macri government faces an emergency situation in the run up to October's general elections. Confronted with the erosion of foreign reserves and its failure to roll over short-term bonds, the government was forced to 1) delay payment of Treasury bonds held by local institutional investors, 2) announce debt "re-profiling" and 3) tighten capital controls. After this summer's primary election, the opposition is largely expected to take power. The future government will have to manage numerous priorities and will probably roll back certain economic liberalisation measures. Yet, it has very little manoeuvring room since it cannot risk breaking off relations with the IMF, which is now its main creditor.

With the approach of the first round of presidential and legislative elections on 27 October[1], Argentina's economy continues to sink into recession. Faced with the erosion of BCRA's foreign reserves and the failure to roll over short-term bonds, the government was forced to 1) delay payment of treasury bills held by local institutional investors through the end of the year, 2) announce bond restructuring and 3) tighten capital controls (see box). The IMF supported these emergency measures and is exploring rescheduling proposals. Mauricio Macri's chances of getting re-elected are very low, and his main challenger, Alberto Fernandez, will have to manage an emergency situation with IMF support.

Pre-election financial crisis

In the primary elections, known as PASO, Alberto Fernandez and his vice-presidential running mate Cristina Kirchner reported a big lead over Mauricio Macri, triggering a wave of distrust between foreign and resident investors alike. The official exchange rate plunged to a low of ARG 60 to the dollar before stabilising in early September once new capital controls were introduced. Stabilisation of the currency is obviously very fragile, since the peso has already depreciated by 35% against the dollar since the beginning of the year. The *blue chip swap,* which had disappeared with the elimination of currency controls in 2016, widened again to 15%. To limit capital flight, BCRA had to raise its key benchmark rate (LELIQ) from 60% to 86% before the implementation of capital controls, but it has since eased to 73% (with a floor set at 68% for the end of October). The BCRA had to temporarily postpone its target of a stable monetary base. Lastly, while awaiting the details of the government's bond re-profiling proposal, the risk premium on USD-denominated international debt has culminated at more than 2000 basis points (bp).

Monetary tightening and capital controls slowed the haemorrhaging of foreign reserves, which were down by USD 20 bn compared to the mid-July level, but they continued to erode by USD 120 million a day through early October, to USD 48 bn. After deducting the USD-denominated deposits of commercial banks, IMF loans to BCRA, and the currency swap agreement with China, net reserves had dwindled to only USD 13 bn in mid-September. According to the BCRA's monthly balance of payments statistics, net purchases of external assets (the vast majority of which are net dollar purchases)

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	2.7	-2.5	-3.0	-1.5
Inflation (official, annual average, %)	25.2	34.3	56.3	50.0
Fiscal balance/ GDP (%)	-6.0	-5.0	-4.0	-4.0
Public debt/ GDP (%)	52.5	86.0	95.0	84.0
Current account balance / GDP (%)	-4.9	-5.4	-2.5	-1.5
External debt / GDP (%)	36.9	54.2	60.4	61.8
Forex reserves (USD bn)	53	64	45	50
Forex reserves, in months of imports	7.2	8.9	7.0	8.2
Exchange rate USDARS (year end)	18.6	38.3	65.0	80.0

e: BNP Paribas Group Economic Research estimates and forecasts

were buoyant through August (averaging USD 2.8 bn between March and August, with a peak of USD 5.1 bn in August) and will probably continue going strong. Indeed, USD deposits, which had tripled to USD 32 bn between year-end 2015 and end-July 2019, declined by a third until early October, even after the tightening of capital controls (although for households, the ceiling on withdrawals is rather high). All in all, delayed payment of USD-denominated Treasury bills (LETES) - to preserve the banks' USD liquidity - combined with capital controls, failed to reassure deposit holders, although it did prevent a run on deposits. If USD liquidity reserves were to dry up, the banks would still have access to BCRA swap lines.

An alarming economic and social situation

Financial pressures since August can only make an already deteriorated macroeconomic situation worse. In Q2 2019, GDP continued to contract for the fifth consecutive quarter (down 1.3% year-on-year). The cumulative decline since Q2 2018 is 7%, with domestic demand making a negative contribution of 14 percentage points. All of the components of domestic demand are in decline, including public consumption at a time of budget austerity. Despite the recession, the federal government's primary surplus was trimmed to only 1% of GDP in August 2019. Unsurprisingly, foreign trade made a very strong positive contribution (a cumulative total of 7 pp since Q2 2018), but this was due to a sharp contraction in imports, and not to the dynamic momentum of exports. The international cyclical environment has not helped either. Soybean prices have picked up after bottoming out in early May, but wheat and corn prices are still depressed.

[1] The elections cover half of the 257 seats of the Chamber of Deputies and a third of the 72 Senate seats. Gubernatorial elections for five provinces, including Buenos Aires and Grand Buenos Aires, will also be held on 27 October.

The social situation is alarming. Inflation dropped back to a monthly rate of 2% in July, but accelerated again to 4% in August, and should hold within a range of 4-6% through the end of the year. This would boost year-on-year price inflation to close to 60% in December. Since early 2018, the cumulative loss of real wages had already hit 15% at the end of July. Over the same period, social welfare benefits were slashed by 12% in real terms as well. The official unemployment rate rose to 10.6% in Q2 2019, from an average of 8.5% in 2017. A large portion of the middle class was impoverished over the course of the past year.

Even if debt restructuring is carried out smoothly and the IMF shows some flexibility in the face of the gravity of the economic and social crisis, Argentina's economy seems to be headed for a second consecutive year of recession.

Managing priorities

The state's debt load has become excessive despite a restrictive fiscal policy. Major fiscal efforts were taken in recent years to address the situation (the primary deficit was still at 4.2% of GDP at year-end 2016), but they failed to stabilise the federal government's debt ratio, which should reach about 95% at end-2019, up from 52.6% at end-2015. Granted, net interest charges have doubled from 1.3% of GDP at end-2015 to 2.7% at end-2018, but the sin is an excessive foreign currency debt (80% of federal government debt is in foreign currency). Until now, the authorities have tried to avoid asking for a debt haircut, which would open the door to litigation with potential holdouts. Thus, although debt restructuring should provide some respite, it will not solve the problem of stabilising the debt.

In the short term, the most urgent need is to ease the debt burden in USD and to stabilise inflation. Yet this creates conflicting monetary policy targets. Legally, the government has the option to repay its USD debt under Argentine law in pesos, and, for that, it could be tempted (or forced) to resort to monetary financing. Even if the IMF were to agree to ease its quantitative control of the monetary base, it is unlikely to accept such a potentially inflationary solution.

Moreover, the social crisis will probably force Alberto Fernandez to roll back a number of liberalisation measures introduced by the Macri government. At the least, this would entail freezing energy and transport prices, and possibly even the reintroduction of subsidies for low-income households. At the same time, to contain the inflationary effects of currency depreciation and to preserve USD liquidity, we can expect to see higher export taxes, import restrictions and even some price control measures.

The more immediate risk is that the future government might decide to distance itself from the IMF, as E. Duhalde and N. Kirchner did in 2002-2007. This seems very unlikely, especially since Argentina owes the IMF USD 44 bn. Moreover, the current situation is very different and much less favourable than the one in 2002-2007.

The emergency measures introduced on August, the 28th and September, the 1st

Mandatory delay/extension of the maturity of Treasury bills

The payment of Treasury bills (mainly LETES in pesos and LECAP in dollars) held by local institutional investors has been delayed for 6 months for those reaching maturity before the end of 2019, and for 3 months for those maturing in 2020. Interests will continue to be paid.

Bond debt re-profiling

The government will ask parliament to approve a project to reschedule the 2020-2023 calendar of principal repayments of the bond debt issued under the Argentina law and held by local institutional investors. As to the international bonds hold by private creditors (USD 66 bn), the government will propose to reschedule repayments as well. In both cases, there would be no haircut. The government has also asked the IMF to reprofile the repayment of credit lines already disbursed.

Capital controls

The BCRA has imposed time limits on the repatriation of export revenues. Companies will need an agreement of the BRSA for i) the payment of imports of more than USD 2 mn ii) payment of services to foreign companies (except those linked to tourism), and iii) dividend payments.

Companies are not allowed to purchase dollars for savings purposes. Resident individuals are allowed to buy up to USD 10,000 per month and 9/10ths would have to be held in an account with a local bank.

Limitations to new USD obligations are introduced; bonds issued in international bond markets would have to be transferred and converted into pesos. Residents are not allowed to access the official FX market to honour new debt obligations in foreign currency if that debt is between residents.

Lastly, forex arbitrage operations between the official and informal markets would be limited as well.

Source: Global Source Partners, BNP Paribas

The government currently has very little fiscal space. At a little more than 20% of GDP, primary spending is double the 2003 figure, and the pension shortfall amounts to 4% of GDP, compared to 2.5% in 2003. It will be hard to reduce structural inflation due to the legal obligation to index social welfare and pension benefits to past inflation. Lastly, the external environment is much less buoyant: the upward phase of the commodity price cycle in 2003-2007 will not be repeated.

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