

International Commentary — July 29, 2022

## Argentina Falling Deeper Into Crisis? Part II

### Summary

Earlier this month, we commented on how we felt Argentina had slipped further into crisis following the appointment of Silvina Batakis as economy minister. Indeed, Batakis' time was punctuated by elevated local financial market volatility and concerns that the latest IMF program would be disregarded. In the span of a few weeks, Batakis suggested the IMF program was a priority and tried to calm markets by engaging with multi-lateral lenders and investors; however, those efforts proved futile as she has been removed from her post and replaced by Sergio Massa, president of the lower house of Congress. In our view, under Massa, Argentina is more likely to achieve IMF targets and be dedicated to a successful IMF program. The flip side of this commitment is that the IMF requires specific policy implementation to correct economic imbalances, which should still lead to a peso devaluation by the end of this year. However, under Massa we believe the probability of sovereign default is now lower and that risks are now tilted toward a shallower peso devaluation than we forecast.

Economist(s)

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## Batakis Out, Massa In

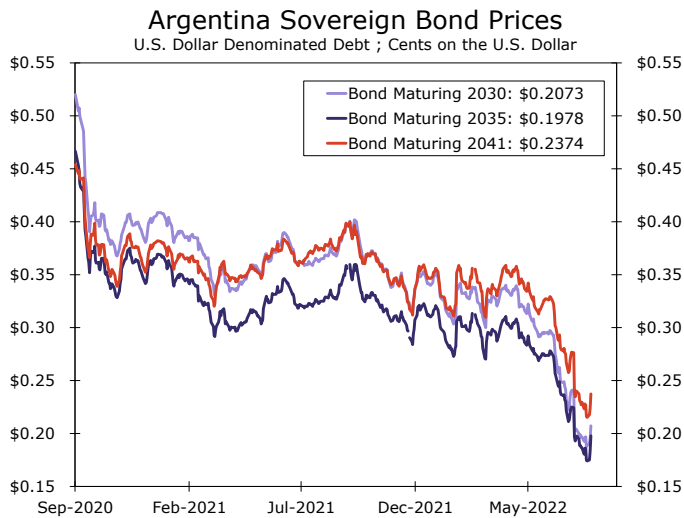
We published a report a few weeks ago touching on Argentina's economic and political crisis. In summary, following the resignation of economy minister Guzman and the appointment of the Kirchner-aligned Silvina Batakis, we believed Argentina had once again slipped deeper into crisis conditions. With the economy being led by Batakis, we felt the new IMF program would be at risk as fiscal spending would likely rise and hitting IMF targets to receive dollar disbursements would not be achieved. In fairness, since her appointment Batakis took appropriate measures to calm and appease investors as well as IMF officials. Batakis claimed to respect the IMF program and that she would set policy consistent with achieving agreed upon targets. She also acknowledged market participants concerns, and agreed with the need for tighter monetary policy and for the central bank to establish positive real interest rates in an effort to stabilize local inflation, address a depreciating currency, and ultimately improve broader economic conditions. However, a little over three weeks into her appointment, Batakis' efforts may now have been wasted as she has been removed from office and replaced by Sergio Massa, president of Argentina's lower house of Congress.

Massa has a long history within the Argentine political structure. Over the course of his career, Massa has held roles such as mayor of Tigre and executive director of ANSES (Argentina's state-owned social insurance agency). Massa also has connections to the Kirchner family. In 2005, he ran on Nestor Kirchner's ticket for a legislative seat, while also served as cabinet chief under Cristina Kirchner from 2008-2009. Despite a history of working directly with the Kirchners, Massa has been able to somewhat disassociate himself from Kirchnerism. In 2009, he resigned as cabinet chief due to disagreements with Cristina Kirchner on the direction of policy, and split from her Front for Victory coalition to make a run at the presidency in 2015 as leader of the Renewal Front party. During his presidential campaign, Massa pushed back against Kirchnerism and ran on a Peronist platform which offered an alternative to Kirchner-era policies. We say somewhat disassociate from Kirchnerism due to the fact Massa linked up with Kirchner to form the Frente de Todos coalition, a mix of Peronism and Kirchnerism supporters, to help Alberto Fernandez secure office in 2019. However, by most accounts, Massa has retained the Peronism ideology and has demonstrated little support for a full-fledged return to Kirchnerism.

## Peso Devaluation Still Our Base Case

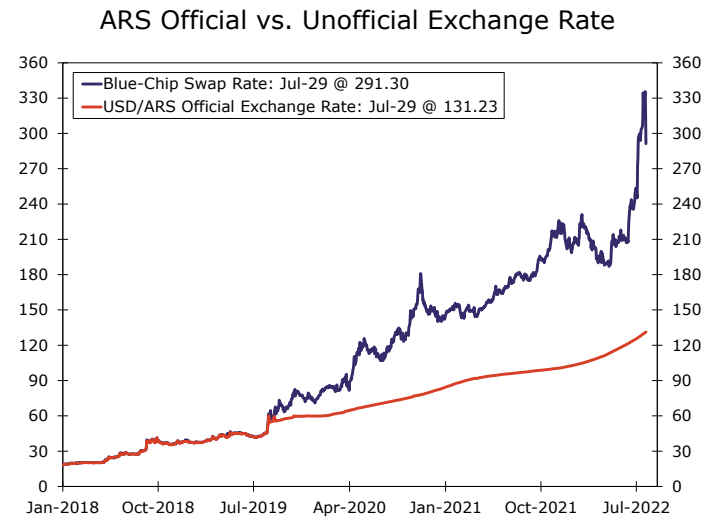
Massa's appointment as economy minister comes down to political infighting between Fernandez and Kirchner. With Argentina's economy struggling to gather any type of positive momentum, Kirchner has spoken out against Fernandez's policy mix and cabinet members, and has questioned the role of the IMF as a pillar of economic support for Argentina. Kirchner has disrupted the implementation of policy she does not agree with, and facilitated former economy minister Batakis' appointment a few weeks ago in an effort to exert more influence over the direction of policy. Likely in an effort to diminish Kirchner's authority and influence, and have an economy minister more aligned with his views, Fernandez tapped Massa to take on the role of "super minister" and have an expanded range of influence over all economic-related decisions. So far, the initial market reaction to Massa has been positive. Sovereign bond prices across maturities have risen ([Figure 1](#)), while the unofficial exchange rate strengthened sharply and reversed a portion of the depreciation experienced over the last few weeks ([Figure 2](#)). In our view, Massa's appointment is a positive development for Argentina. We feel more comfortable that a Massa led economy can make progress toward IMF targets and that he will be dedicated to facilitating a successful IMF program. This should provide markets with some sense of relief that the worst case scenario can be avoided and reduce the probability of sovereign default in the near future.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

With that said, a successful IMF program, as defined by the terms of the plan, includes building foreign exchange reserves, lifting capital controls and allowing the peso to be more driven by market sentiment. In our view, should Massa indeed be committed to the program, he will need to ease capital controls and lift other peso supportive measures in an effort to build FX reserves to an adequate level. In that sense, **while Massa's appointment is a step in a positive direction for Argentina, we maintain our view for peso depreciation to pick up pace in Q3 and for an outright devaluation to take place in Q4-2022.** As far as the magnitude of peso depreciation, we believe the official USD/ARS exchange rate can hit ARS140.00 by the end of Q3, and for the explicit devaluation to push the currency to the ARS155.00 level by the end of 2022. While we expected a devaluation under Batakis, we feel the circumstances around the large depreciation have improved. Under Batakis, we felt IMF targets would likely not be achieved given her alignment with Kirchner. We felt large economic imbalances would worsen and the combination of capital flight and insufficient external buffers would culminate in a forced peso devaluation. Under Massa, we believe a devaluation will occur in the context of an IMF program, which we view as a positive development. Granted, the direction of the peso is the same; however, a devaluation paired with IMF support and much needed dollar disbursements tilts the balance of risk toward a shallower and more contained peso depreciation over time. A peso move to ARS155.00 represents a 15% depreciation from current levels. Should Massa exercise fiscal prudence and have the full backing of IMF officials, sentiment toward Argentina could improve and capital outflows could slow. In this scenario, the need for a large a peso devaluation could be mitigated and the official exchange rate may not slide as much as we expect.

We should also note that by no means do we expect Massa to immediately pull Argentina out of its current crisis just because he is in charge of the economy. **Hitting IMF targets and a peso devaluation will likely lead to more economic pain in the short-term as inflation could spike higher and general economic activity slow as fiscal prudence is exercised.** Household finances could be impacted severely and, typically, harsh economic conditions often leads to social unrest and the potential for elevated political risk. Argentina will hold general elections in 2023, and given the state of the economy now and possibly more pain in the near future, a return to Kirchnerism-type policies could be near. We will refrain from offering a view on the outcome of the 2023 election; however, if the recent regional trend of electing a left-leaning populist-style candidate is any indicator, Argentina could be on the brink of shifting local policies even further to the left and further away from an administration that is supportive of free markets and less interventionist policies.

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