

International Commentary — July 5, 2022

Argentina Falling Deeper Into Crisis?

Summary

The resignation of economy minister Martin Guzman has the potential to upend Argentina's long-term economic recovery. Guzman, an investor friendly reformist, was committed to fulfilling Argentina's commitments under the new IMF plan and bringing longer-term stability to Argentina's economy. His successor, Silvina Batakis, a former economy minister aligned with Cristina Kirchner, is more of an unknown to the investor community; however, her alignment with Kirchner makes us nervous that she could boost fiscal spending and disregard the IMF program. With limited policy levers and insufficient foreign exchange reserve buffers, as well as sentiment toward Argentina worsening, another large peso devaluation could be looming. Going forward, we will be mindful of the policy priorities set by Batakis and how progress toward the IMF's objectives is evolving. Any deviations from achieving fiscal balance and other reform items could see pressure build on the peso to the point where a 10%-15% devaluation is needed to avoid another full-blown crisis.

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Guzman's Resignation Clouds Argentina's Recovery

There is an old saying in economist circles. It goes something like this: "Throughout history there have been only four types of countries. The developed, the underdeveloped, Japan and Argentina." Credit former economist and winner of the Nobel prize in economics Simon Kuznets for these words of wisdom. According to Kuznets, his quote relates to the diverging economic histories between Japan and Argentina. Said another way, Kuznets was referring to the long-term economic successes of Japan and economic failures in Argentina. As a quick history lesson, in the early 1900's, Japan's economy was underdeveloped and wealth levels across the nation were relatively low. Over the last century, Japan has industrialized, invested, and increased productivity enough to become the third largest economy in the world. On the other hand, at the turn of the 20th century, Argentina was one of the wealthiest and fastest growing nations in the world. However, since the mid-1900's, those fortunes have reversed course amid a broad shift to interventionist, protectionist and nationalist policies. Rather than a leading economy the country once was, Argentina has become labeled a serial sovereign debt defaulter and is plagued by one of the highest rates of inflation in the world. In many ways, Japan is the "rags to riches" story, while Argentina is the "fall from grace" cautionary tale.

Kuznets made this comment decades ago but, in part, his quote lives on today. While Japan's economy has stagnated in recent years, Argentina's has continued to find new depths. In 2020, the government defaulted on its debt for a historic ninth time. Just recently, in an effort to avoid a tenth sovereign default, the Alberto Fernandez administration took on a US\$44B bailout program from the International Monetary Fund (IMF). And finally, the political concerns that frequently plunges Argentina's economy into recession persists today. In fact, political risk has flared up again over the last few days. To that point, economy minister Martin Guzman, who negotiated a debt restructure with bondholders after the government's latest default and worked with the IMF to secure a new program, resigned over this past weekend. Guzman's resignation letter cites persistent infighting within the current administration and a lack of political backing as his primary reasons for leaving. According to Guzman, his lack of centralized control of macroeconomic policy instruments left him somewhat powerless to turn Argentina's economy around. Markets viewed Guzman positively for being a reformist dedicated to placing Argentina on a more sustainable path to recovery. While inflation topped 60% year-over-year under Guzman and the economy is likely headed toward recession again, market participants still felt he was a credible policymaker operating with a long-term vision of fiscal balance and lower inflation.

Another Peso Devaluation Could be Imminent

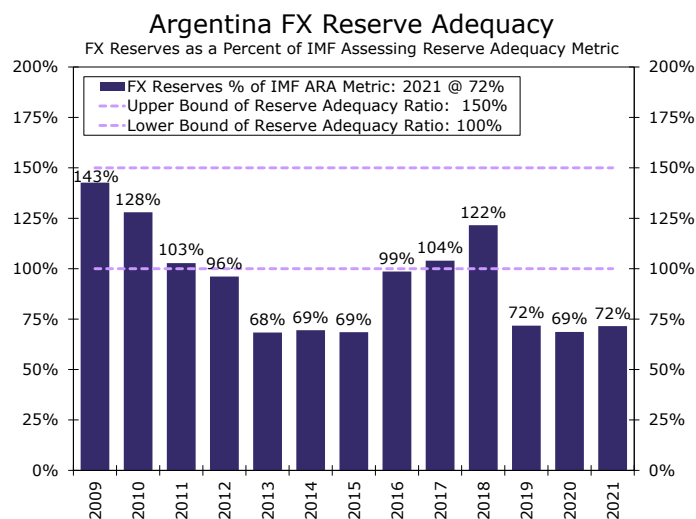
The infighting Guzman is referring to is between President Fernandez and Vice President Cristina Kirchner. Despite being running mates in the 2019 election, a lack of economic momentum created tensions between the two leftist politicians. These tensions boiled over last year when their Frente de Todos coalition performed poorly in legislative elections and lost its congressional majority to the main conservative opposition. Since the legislative elections, Fernandez and Kirchner have not seen eye-to-eye on the path ahead for Argentina. Many political appointees have aligned themselves with either Fernandez or Kirchner, creating a stalemate within the coalition and dynamics associated with policy paralysis. Against this backdrop, Silvina Batakis has been tapped to replace Guzman. Batakis is the former economy minister of Buenos Aires Province, and by most accounts, aligned with Kirchner. Being aligned with Kirchner has market participants and Argentina watchers nervous, as Kirchner has made a political career off pushing for interventionist policies and boosting fiscal spending to support the local economy. While Batakis has already commented she will continue with her predecessors plan for the economy and will seek to achieve fiscal balance, financial markets are not convinced. Local equity markets sold-off sharply on the news of Guzman's resignation and Batakis' appointment, while sovereign bond yields spiked and the unofficial exchange rate in Argentina plummeted around 10%-15% based on certain exchanges.

We are not convinced either. Kirchner has a poor track record with the IMF stemming from multiple failed programs that often left Argentina facing crisis conditions and default. Should Batakis look to implement economic policies consistent with Kirchner's ideologies, fiscal spending is likely to rise and budget-related targets set by the IMF could be at risk of not being achieved. Should the IMF plan go off-track, Argentina could lose a key source of dollar funding as well as lose market confidence that another sovereign debt default can be avoided. Without an IMF program and subsequent dollar disbursements, Argentina has few policy levers it can pull to avoid slipping into another crisis and experiencing a tenth sovereign default. Interest rates have been lifted; however, tighter monetary policy has done little to combat rising inflation or stem capital outflows. Capital controls have kept

the official peso exchange rate steady, but currency restrictions might not be tenable. Also, the central bank has added another layer of protection to the peso by aggressively intervening in FX markets to keep the currency stable. However, the central bank is running out of foreign exchange reserves and current levels are insufficient to act as a sustainable buffer over the long-term. To that point, the IMF suggests that FX reserves as a percent of its assessing reserve adequacy (ARA) metric are dangerously low. At the end of 2021, the FX reserves-to-ARA ratio was 72% (Figure 1). According to IMF officials, central banks should maintain a ratio of at least 100% for a minimum level of sufficient reserve coverage.

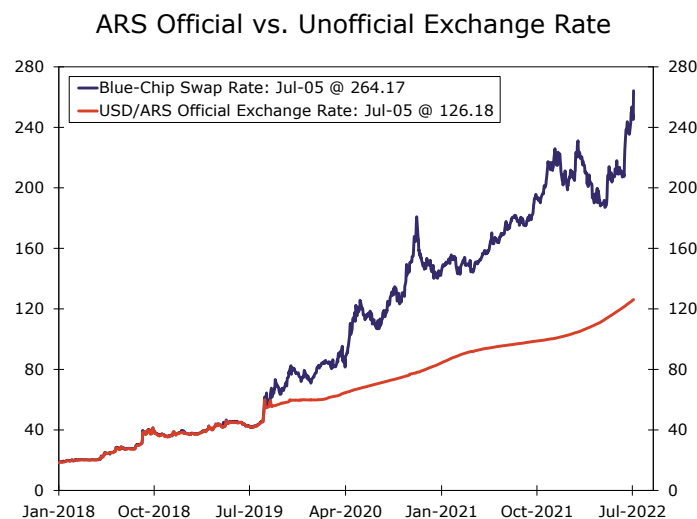
We believe the combination of insufficient FX reserves, policy uncertainty, the risk of another failed IMF program, and rising sovereign default risk could result in another large peso devaluation in the coming quarters. Batakis' policy priorities will be crucial to the path of the official peso exchange rate going forward. If Batakis is committed to fiscal responsibility and hitting IMF targets, sentiment should improve and markets should feel more comfortable with her guiding economic policy. However, spending her way out of the current economic crisis will likely create additional volatility and weakness in Argentine financial markets and pressure on the peso could mount to the point where current levels cannot be defended. Should this "spending scenario" unfold, a devaluation of 10%-15% could materialize in Q4 of this year. A sizable depreciation will bring the official exchange more in-line with the "blue chip" exchange rate; however, a wide gap would still remain due to the stringency of capital controls (Figure 2). We believe capital controls will stay in place, and only until controls are completely lifted will unofficial markets disappear and the Argentine peso depreciate up toward the ARS260 level. For the time being, we forecast the official USD/ARS exchange rate to hit ARS140 by the end of this year, although risks around that forecast are tilted toward more depreciation than we forecast.

Figure 1



Source: IMF and Wells Fargo Economics

Figure 2



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

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