

# BIENVILLE GLOBAL REVIEW

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## ARGENTINA: PART III A PATH TO RECOVERY

March 2014





## SUMMARY

Following a decade of unorthodox policies, Argentina is at the inflection point of a significant political regime change. But to alter the path of the country's current trajectory, adjustments in four primary areas are necessary. Either the adjustments will be forced by market pressures, implemented incrementally by the current administration, or comprehensively by the next administration. With reforms in place, the medium-term outlook for growth will be considerably stronger. Orphaned by the international investment community, a number of assets in Argentina today are cheap and remain convex to an improvement in both policy and the real economy.

- **Investors can earn phenomenal returns when an investment environment goes from 'very bad' to simply 'bad.'** History is replete with examples. A further transition to 'moderation' can result in additional upside
- Following a deterioration in Argentina's economic fundamentals in 2013, including a substantial loss of foreign currency reserves, an increase in inflation and a devaluation of the peso in January 2014, support for Cristina Kirchner's unorthodox policies has eroded. **The Kirchner model has unraveled, and a recession in 2014 is underway**
- **The leading presidential candidates seeking to replace Cristina in October 2015 represent a substantial moderation in policy.** Polling suggests that a reversion to more conventional policies and an improvement in the business climate is a pervasive desire among Argentines
- **A directional shift in Argentina's path requires adjustments in four primary areas.** All are relatively simple in nature, yet politically unpalatable for Cristina. The four areas include:
  1. Fiscal Reform (i.e., a reduction in subsidies)
  2. Monetary Policy
  3. Currency & Capital Controls
  4. Settlement with External Creditors
- Adjustments to tariffs and subsidies, which are necessary to resolve the fiscal imbalance, have started and will take place gradually. Recent announcements confirm Cristina's newfound willingness to initiate incremental reductions. A comprehensive package of reform, including the adoption of an inflation-targeting regime at the central bank and the removal of capital controls, is likely to be implemented early in the term of a new government. Combined with credible gestures to settle with external creditors, confidence should rise, likely attracting foreign capital
- **The legacy of Kirchernism is relative distortions within the economy**—particularly in highly regulated industries—rather than excessive debt culminating in a credit or banking crisis, which is customary in the aftermath of a populist regime. These distortions need to be unwound, a process that should benefit a number of well-positioned companies
- **Argentina is an unlevered economy.** Private sector credit relative to GDP is less than 20%. Mortgage credit is a paltry 2%. The net burden of the sovereign is also low. A more stable political and economic backdrop with lower inflation and positive real interest rates should attract bank deposits, allowing for genuine credit intermediation that would drive economic growth and create opportunities for investors

# ARGENTINA: A PATH TO RECOVERY

Kirchnerism is unraveling. After benefiting from currency devaluation, strong exports and latent capacity following the 2001 default, growth has stalled. A recession is imminent. Not surprisingly, Cristina's approval rating has halved...

## GDP (Private Estimates)



Current polling indicates that over 70% of Argentines do not believe the Kirchner administration is capable of handling today's economic challenges

## ARGENTINA: A PATH TO RECOVERY

In 2013, the central bank lost nearly \$13 billion in reserves, leading to fears of debt default. Debt repayments and tourism were the largest contributors to the decline, followed by energy imports...

### Sources of Variation of Central Bank Reserves (in USD, billions)

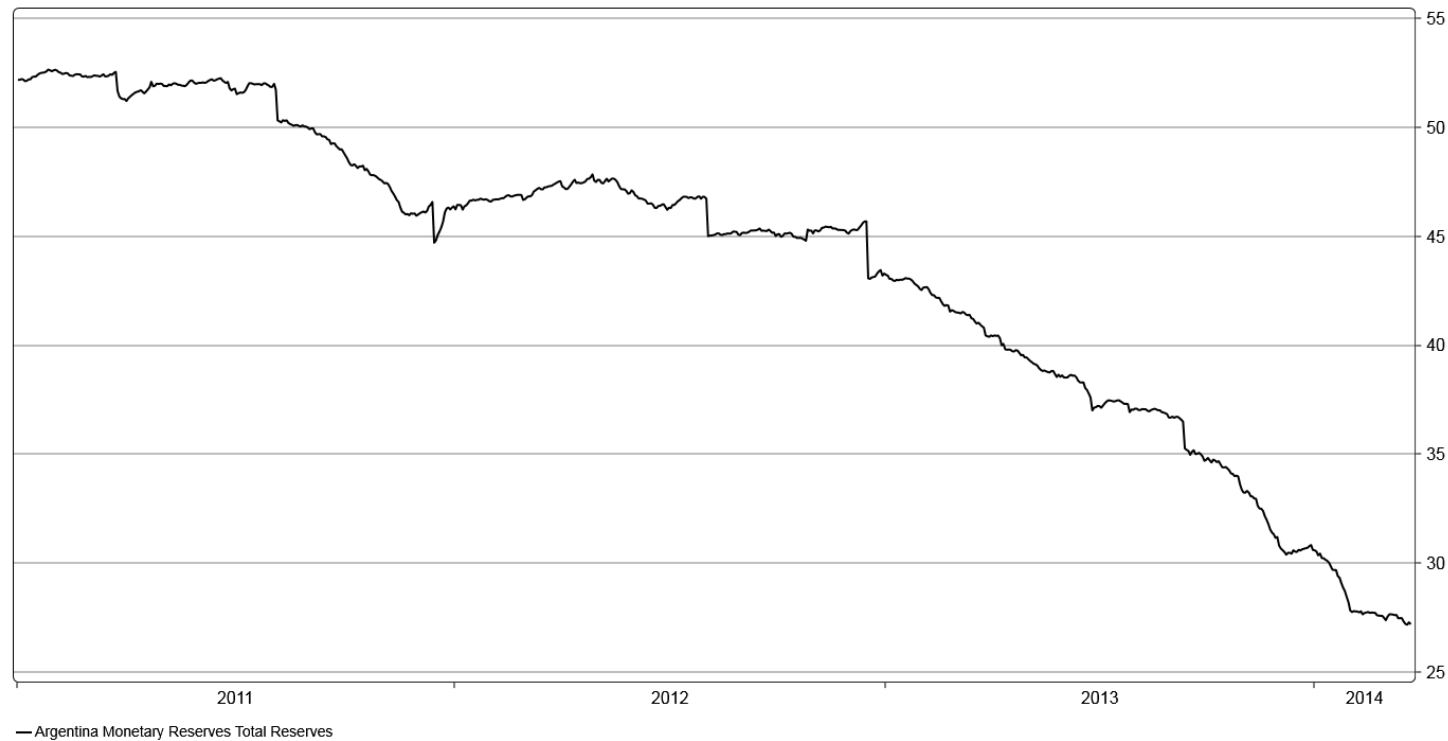
	2011	2012	2013
<b>Balance of Goods</b>	15.2	14.7	1.7
Energy	-2.2	-3.5	-6.5
<b>Balance of Services</b>	-1.1	-3.8	-9.4
Tourism	0.3	-2.9	-7.0
<b>Financial Loans, Dividends Other</b>	10.9	1.7	1.9
<b>Foreign Currency Private Purchases</b>	-21.6	-3.4	0.4
<b>Debt Payments (net)</b>	-4.4	-11.2	-7.0
<b>Fall in USD profits</b>	-4.8	-1.0	-0.4
<b>Total Variation of Reserves</b>	<b>-5.8</b>	<b>-3.0</b>	<b>-12.7</b>

Argentines traveling abroad need access to dollars. Due to the overvalued exchange rate in 2013, incentives to travel globally were high. The central bank was essentially subsidizing tourism.

# ARGENTINA: A PATH TO RECOVERY

As reserves fell below the psychologically important level of \$30 billion—less than 3 months import coverage—policy priority shifted from maintaining an overvalued currency with the hope of keeping inflation lower to protecting reserves. In January, the peso devalued by nearly 20%...

**International Reserves (in USD, billions)**



Reserves have recently stabilized, primarily due to a good harvest. The majority of Argentina's agricultural exports occur between March and June. After the seasonality benefits fade, it's possible the drain continues...

Source: Macrobond

## ARGENTINA: A PATH TO RECOVERY

Recently, incremental policy changes have been announced. These modifications were done out of necessity—to ensure the survival of Cristina’s administration—rather than a change in ideology. However, a sustainable improvement in Argentina’s path requires four primary adjustments...

### The four areas of adjustment include:

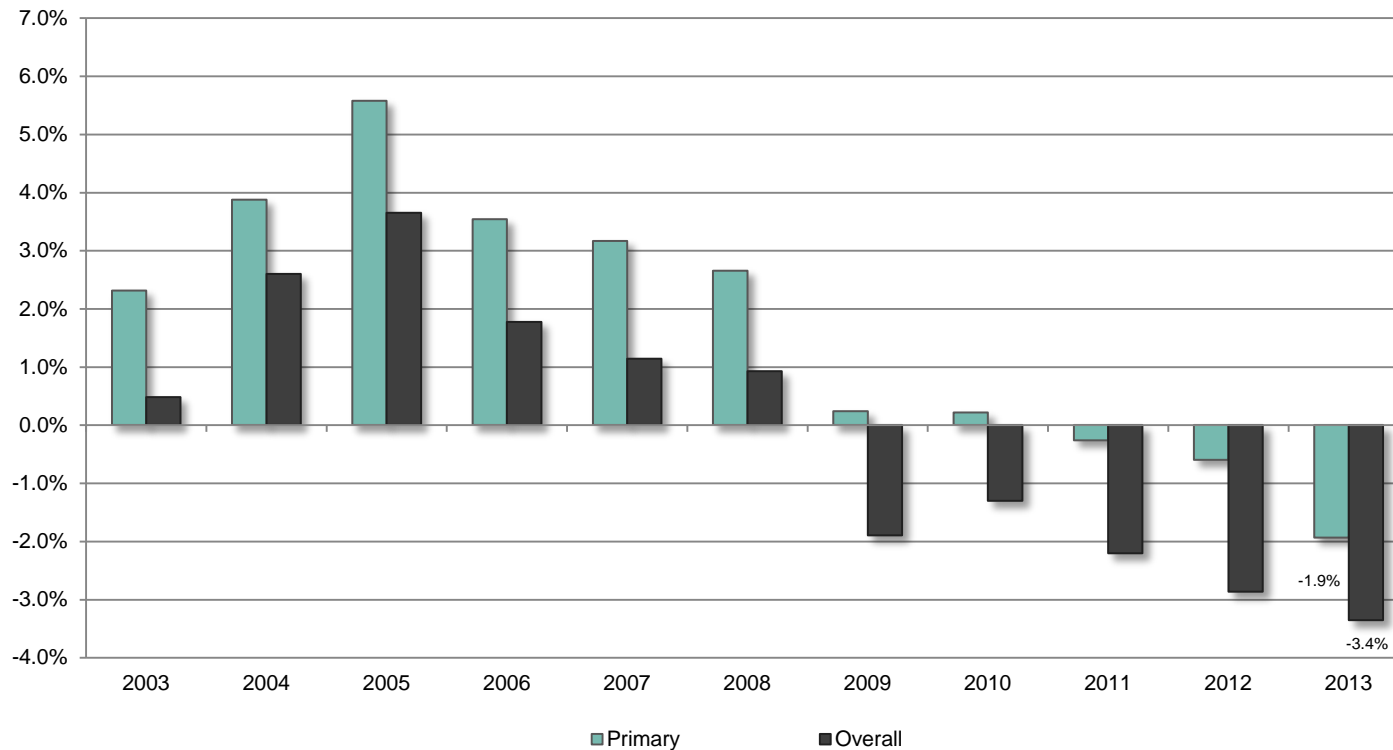
1. **Fiscal Policy** - Reduce the fiscal deficit, which requires a moderation or removal of subsidies totaling 4.5% of GDP, essentially the entire fiscal deficit. Reductions could be gradual, retaining those for the lower classes who need them
2. **Monetary Policy** – Implement a credible inflation-targeting regime, reducing inflation expectations and USD demand. Sources suggest this is inevitable
3. **Capital Controls & FX Policy** – Remove the existing capital controls, a necessary condition to attract the foreign capital required to develop Argentina’s resources, and allow the currency to freely float. Should the currency overshoot to the downside, it would likely inspire the repatriation of capital held offshore by Argentines. Sources suggest capital controls are ‘temporary’ and will be removed, and some reform could even occur in the near term
4. **External Creditors** – Settle with the Paris Club, the ‘holdouts,’ etc. Recently, the government settled with Repsol. Even credible gestures by a new government to resolve these issues will help to improve relations and instill confidence

Argentina has low levels of debt and abundant resources. Once the adjustments are made, country risk should decline, and the medium-term picture should improve markedly.

# ARGENTINA: A PATH TO RECOVERY

The Kirchners turned persistent budget surpluses into chronic deficits, largely the result of burgeoning subsidies to support their populist votes. Reversing the subsidies is a prerequisite to repairing the fiscal imbalance...

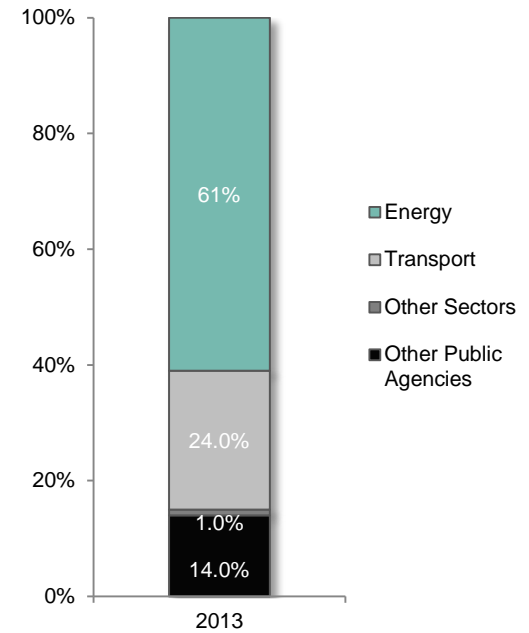
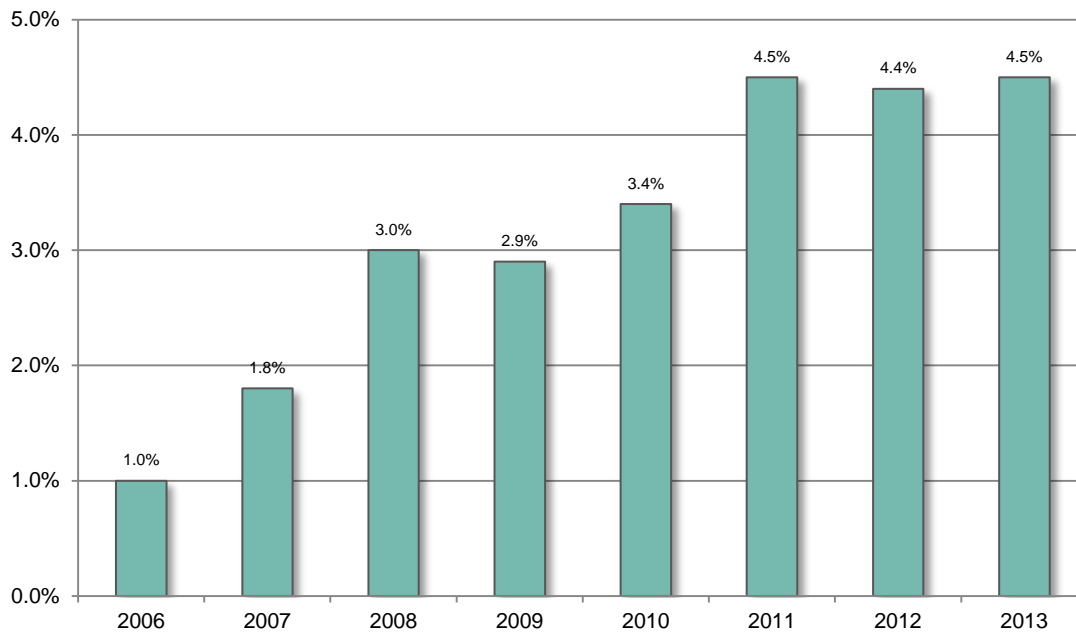
**Fiscal Balance (% of GDP)**



# ARGENTINA: A PATH TO RECOVERY

Under the Kirchners, subsidies have reached 4.5% of GDP, more than the country's fiscal deficit. Over 60% of the subsidies are related to energy, with nearly a quarter dedicated to transportation. Gradually reducing them, particularly for higher income Argentines, is necessary and plausible...

## Fiscal Cost of Subsidies (% of GDP)





# ARGENTINA: A PATH TO RECOVERY

An electricity bill provides are an illustrative example of nonsensical subsidies. Prices charged are far below market rates and predominately benefit wealthier Argentine citizens located in Buenos Aires province...

## Buenos Aires Electricity Bill

<b>TOTAL A PAGAR hasta el 10/02/2014</b>	<b>\$ 161,98</b>
<b>2do. Vencimiento hasta el 24/02/2014</b>	<b>\$ 164,78</b>
La proxima factura vence el 11/04/2014	
<b>Detalle de su factura</b>	
1 - Cargo Fijo sin Subsidio	20,44
2 - Cargo Variable sin Subsidio - kWh 883	324,06
6 - Res ENRE 347/12 Monto Fijo para Inver en Infrae y Mant Subtotal por Servicio Eléctrico sin Subsidio	28,00 372,50
<b>10 - SUBSIDIO AL CONSUMO</b>	<b>-279,64</b>
Subtotal por Servicio Eléctrico con Subsidio "A"	92,86
Factor de estabilización	59,53
Subtotal "B"	152,39
A cuenta Ajuste Anual FE	32,45
Subtotal "C"	119,94

**Total Bill:** 161.98 pesos for January, or roughly \$16 USD

**Electricity Usage:** 372.50 pesos (pre subsidy)  
**Less Subsidy:** 279.64 pesos (subsidy, i.e., 75% of cost)  
**Subtotal:** 92.86 pesos  
**Total including Fees:** 161.98 pesos

Cuadro comparativo confeccionado según instrucciones del ENRE en su Res. N° 433/09 y notas complementarias. Los importes son aproximados y se indican a título meramente informativo; fueron determinados sobre la base de los valores promedio y de referencia.

Sr. usuario: Por su consumo bimestral sin subsidio usted abonaria en: (valores estimados)	EPEC (Córdoba) = \$947,85
	EPE (Santa Fé) = \$830,69
	Brasil (San Pablo) = \$884,02
	Uruguay (Montevideo) = \$1.346,63
	Chile (Santiago) = \$823,41

In order to maintain votes in the Buenos Aires province, Cristina has retained subsidies, resulting in lower costs than in other provinces, such as Cordoba and Sante Fe

In terms of regional comparison, electricity prices in Uruguay would be 8.3x higher and 5x higher in Chile, a reality disclosed on the monthly bill



## ARGENTINA: A PATH TO RECOVERY

Recently, the administration conceded that existing subsidies were not sustainable and vowed to make adjustments. An incrementalist approach, rather than comprehensive reform, is likely for now...

### Recent Headlines

“We have been working on the concept of tariff equity” for electricity, gas and water Kicillof confirmed, adding that “tariffs are subsidized because the cost of production of the service is greater than what is paid for the tariff,” Kicillof said.

- **Buenos Aires Herald, February 28, 2014**

“Proposing a complete elimination of subsidies is absolutely impossible, talking about a reduction is acceptable,” [Capitanich] said in a hearing. “Our main goal is to reach self-sufficiency in energy and to eliminate imports.”

- **Bloomberg, March 12, 2014**

President Cristina Fernandez de Kirchner said Feb. 4 that Argentines who are able to pay higher prices for public services should, while the government will maintain subsidies for the poor.

- **Bloomberg, March 18, 2014**

### Gov't unveils decreases for natural gas, water that will see bills rise from 100%-400%

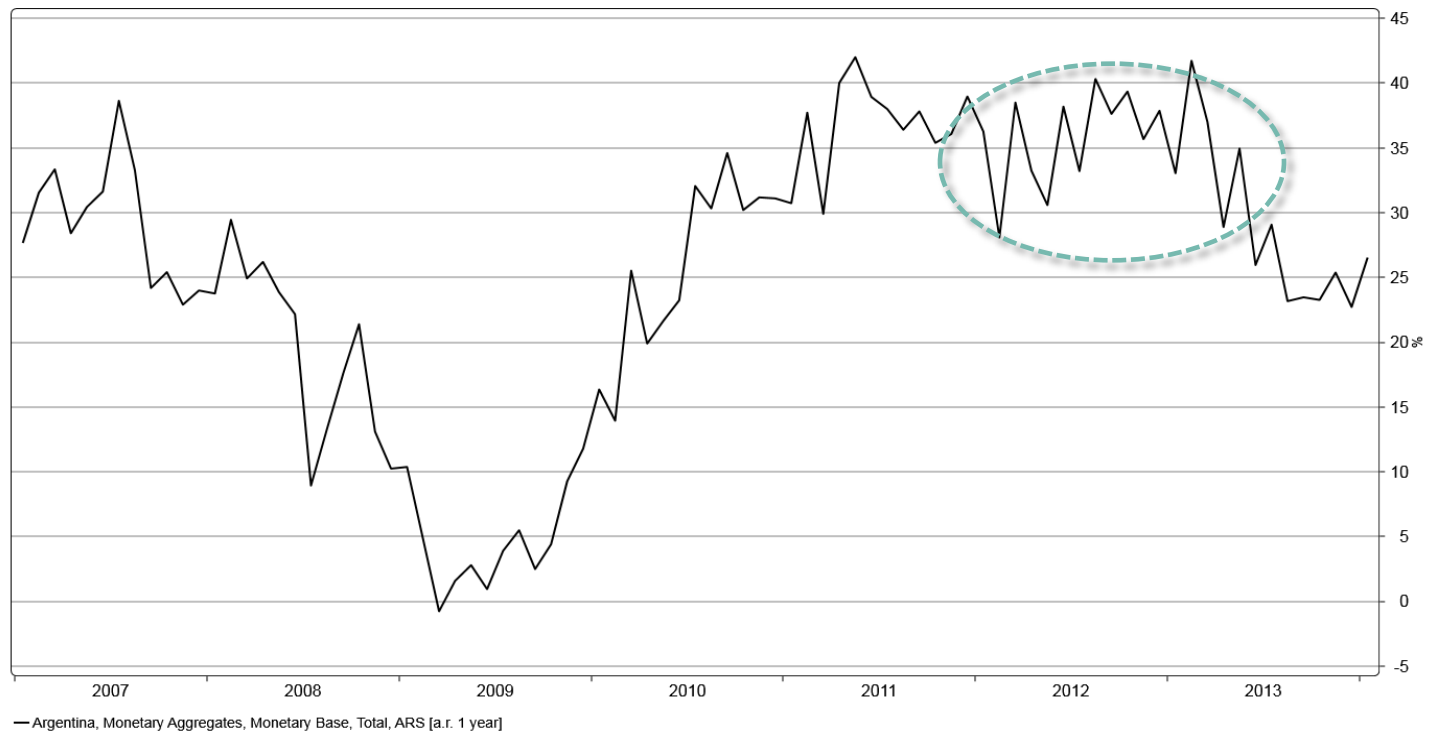
The government is moving ahead with the long-expected reduction in subsidies of public utilities, saying yesterday that the cut for natural gas and municipal water subsidies was 17 percent to 80 percent for residential and commercial users. The industrial sector will be exempt from the cuts in subsidies that will ultimately increase final water bills between 70 and 400 percent, while gas prices will rise between 100 and 284 percent.

- **Buenos Aires Herald, March 28, 2014**

# ARGENTINA: A PATH TO RECOVERY

Currently, Argentina does not have access to international credit markets. Therefore, the central bank is forced to monetize the fiscal deficits arising from existing subsidies, causing the monetary base to rise at rapid rates...

**Argentina Monetary Base Growth, y/y**

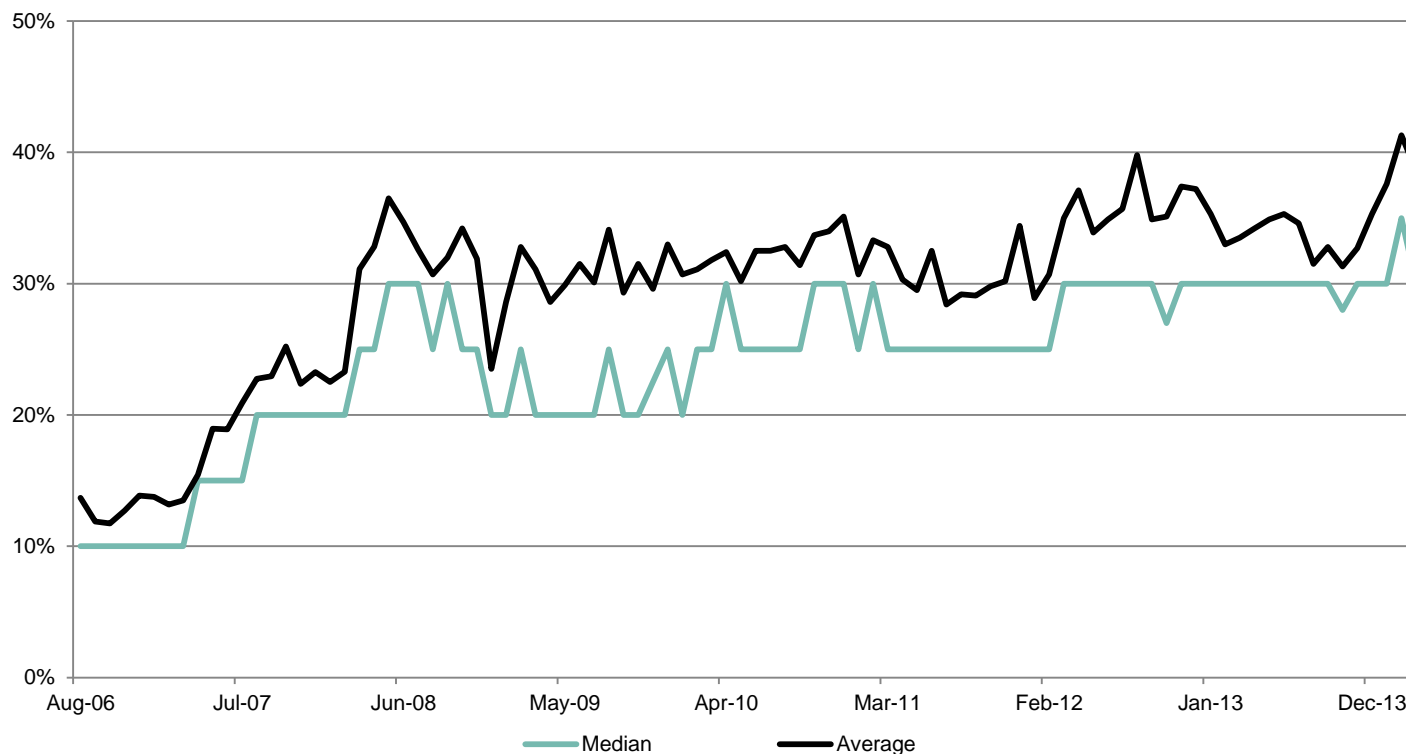




## ARGENTINA: A PATH TO RECOVERY

Without a 'nominal anchor,' a rapidly rising monetary base has fueled both inflation expectations and actual inflation. The implementation of a credible inflation-targeting regime by an independent central bank, combined with a reduction in fiscal subsidies, would help to crush inflation expectations...

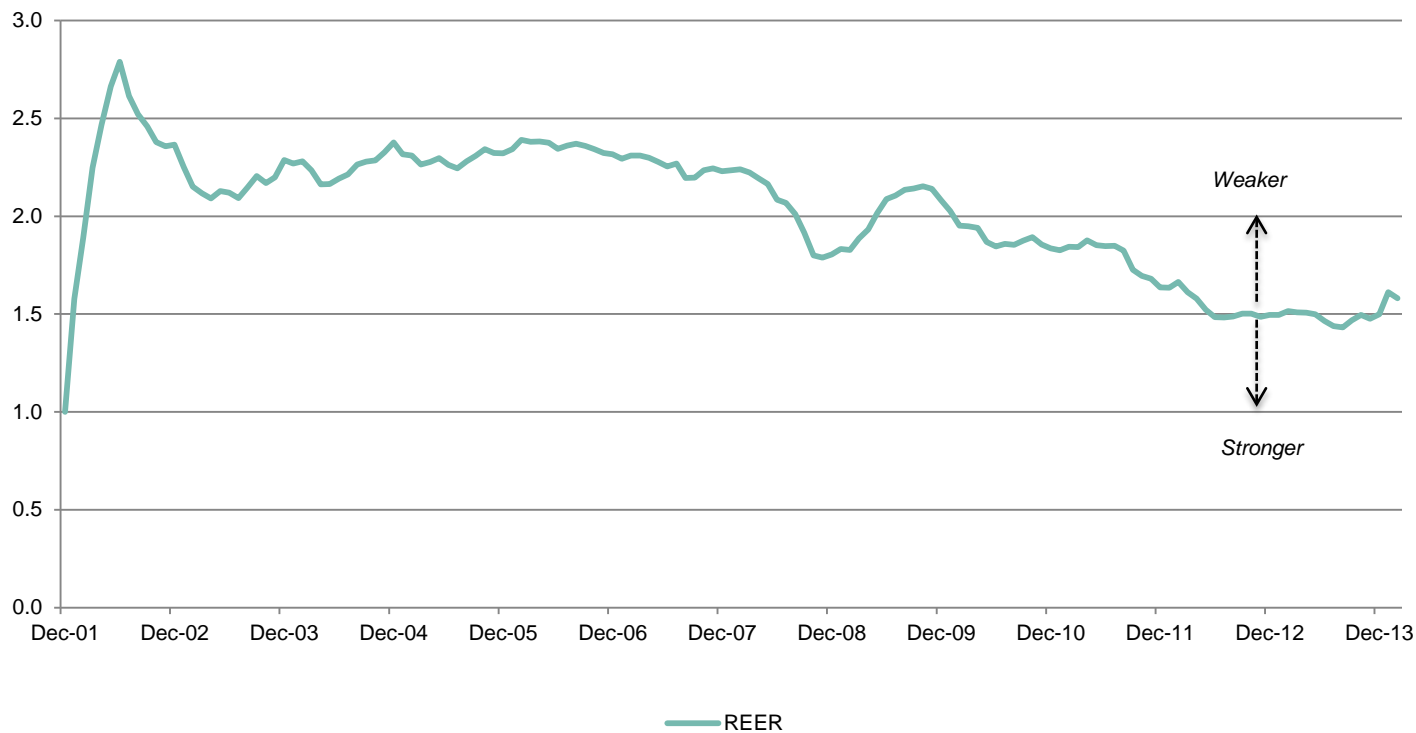
### Inflation Expectations (Annual)



# ARGENTINA: A PATH TO RECOVERY

High levels of inflation while defending an overvalued nominal exchange rate has caused the real effective exchange rate to rise, resulting in a loss of competitiveness. Argentina's current account has fallen from strongly positive to negative. Despite January's devaluation, more currency depreciation is necessary...

**Real Effective Exchange Rate (Dec. 2001 = 1.0)**



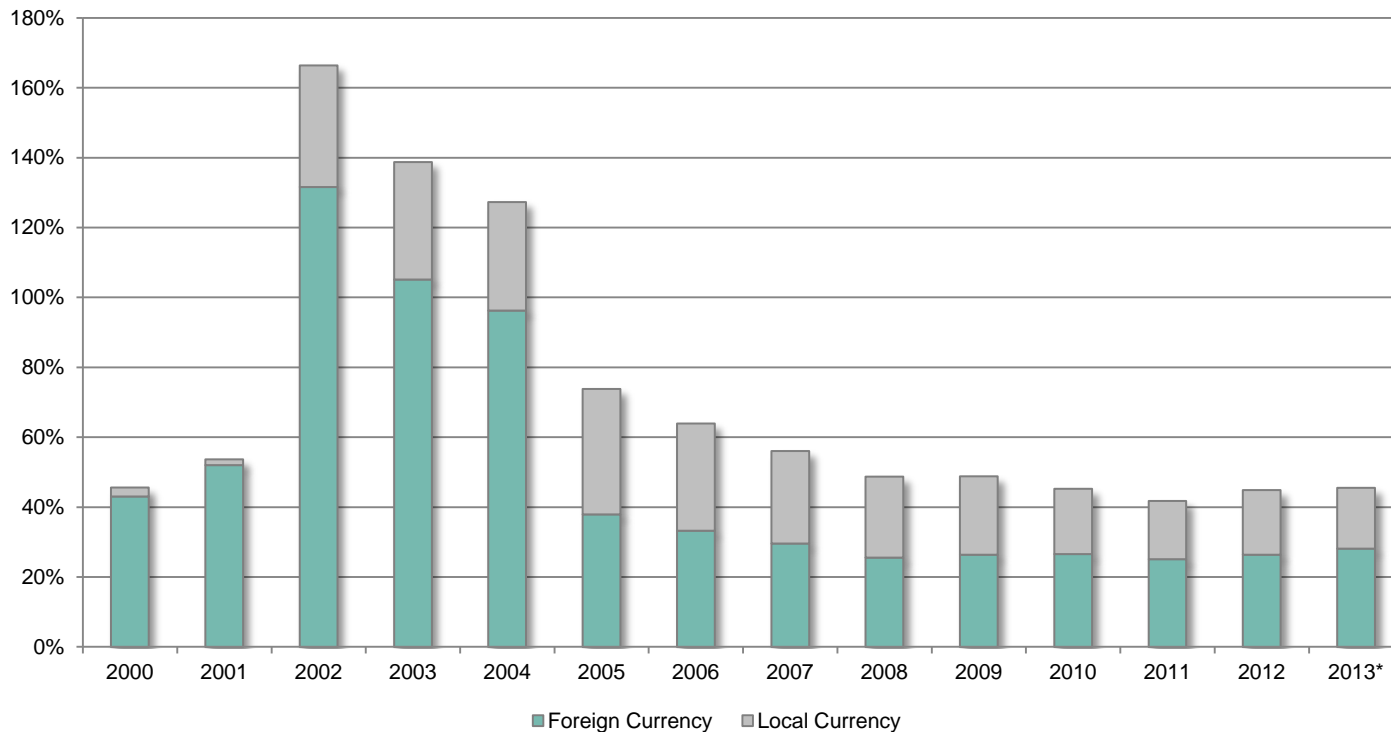
Removing the existing capital controls and allowing the currency to freely float is a necessary condition to attract the foreign capital needed to develop Argentina's vast resources...



# ARGENTINA: A PATH TO RECOVERY

Argentina has very low public debt levels, much of which is denominated in pesos. This contrasts to 2002 when over 90% was foreign denominated...

### Argentina Public Debt to GDP, %

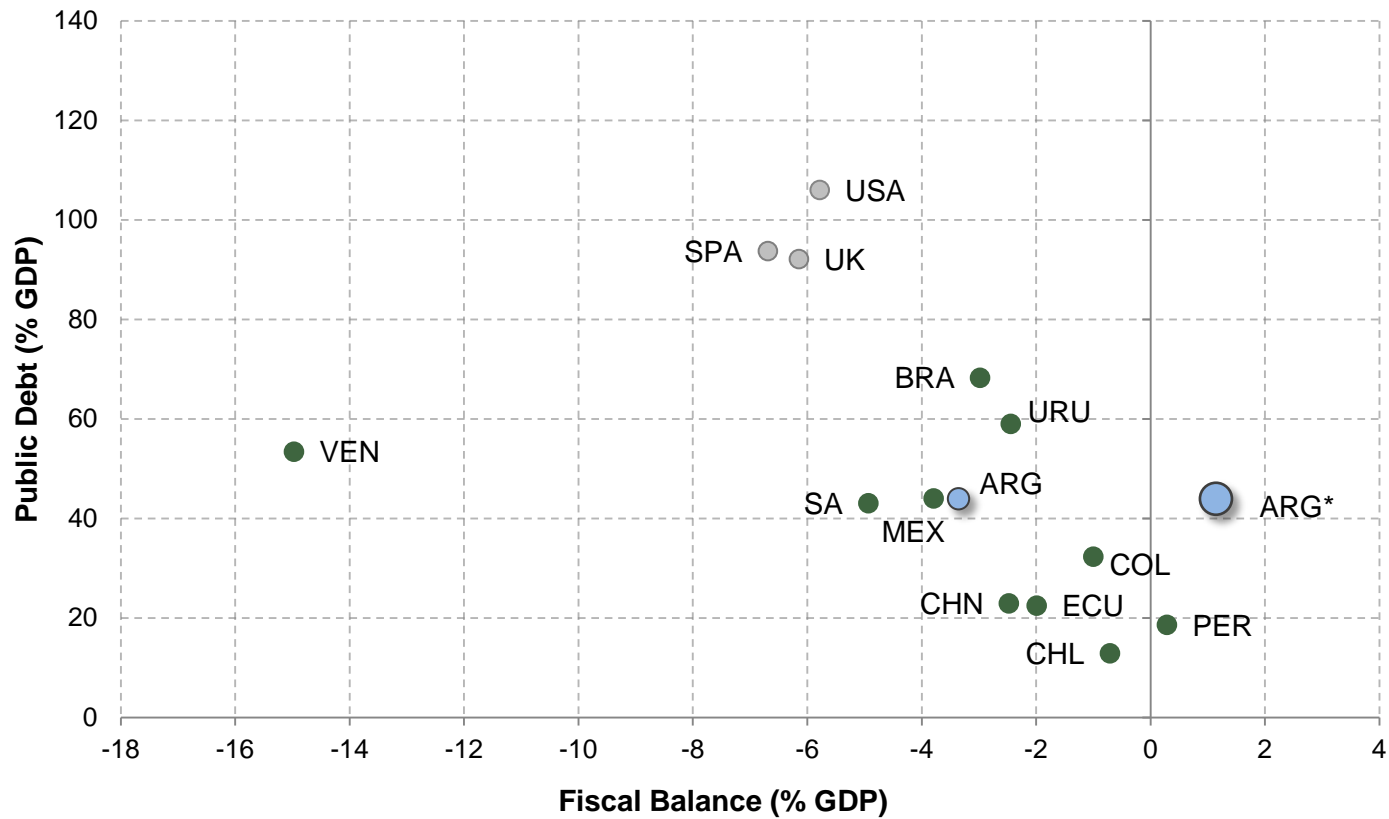


Today, only 59% of Argentina's debt is foreign denominated. This compares to 94% in 2002

# ARGENTINA: A PATH TO RECOVERY

Argentina also has a superior fiscal, gross and net debt position relative to a number of countries...

**Fiscal Balance vs. Gross Debt**

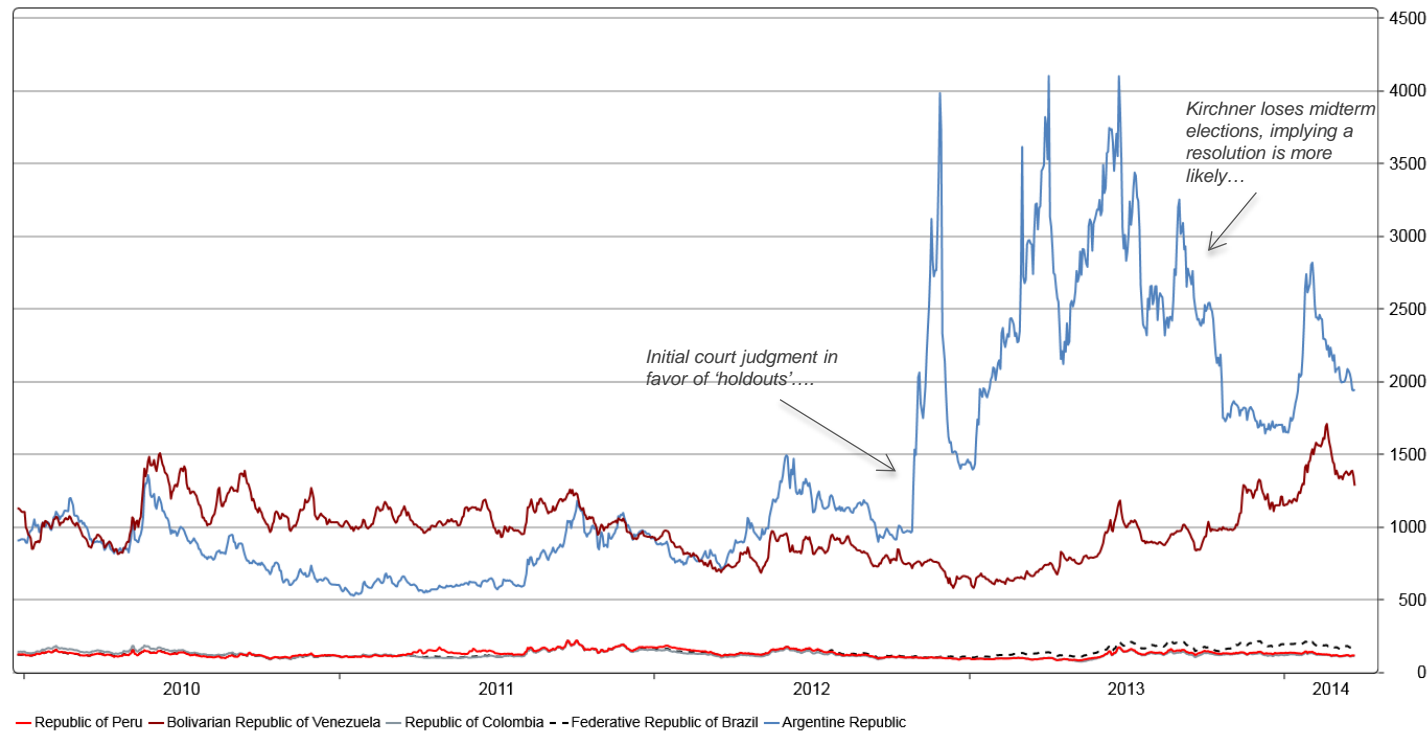


\*ARG = fiscal balance post hypothetical subsidy and tariff reform

# ARGENTINA: A PATH TO RECOVERY

Despite these positive fundamentals, the public battles with ‘the holdouts’ led by Elliott Management, and negotiations with the Paris Club have weighed on Argentina’s borrowing costs. The country risk is far too high. Reducing borrowing costs will be a priority for a new administration. In the meantime, modest efforts to repair relations with international creditors are underway...

## Latin America Borrowing Costs



Argentina currently trades with interest rates nearly 2000bps over U.S. Treasury rates compared to the failed state of Venezuela, which borrows at 1200bps and is able to issue debt.

Restoring relations with the holdouts and Paris Club should see borrowing costs eventually fall into the 300-500bps range.

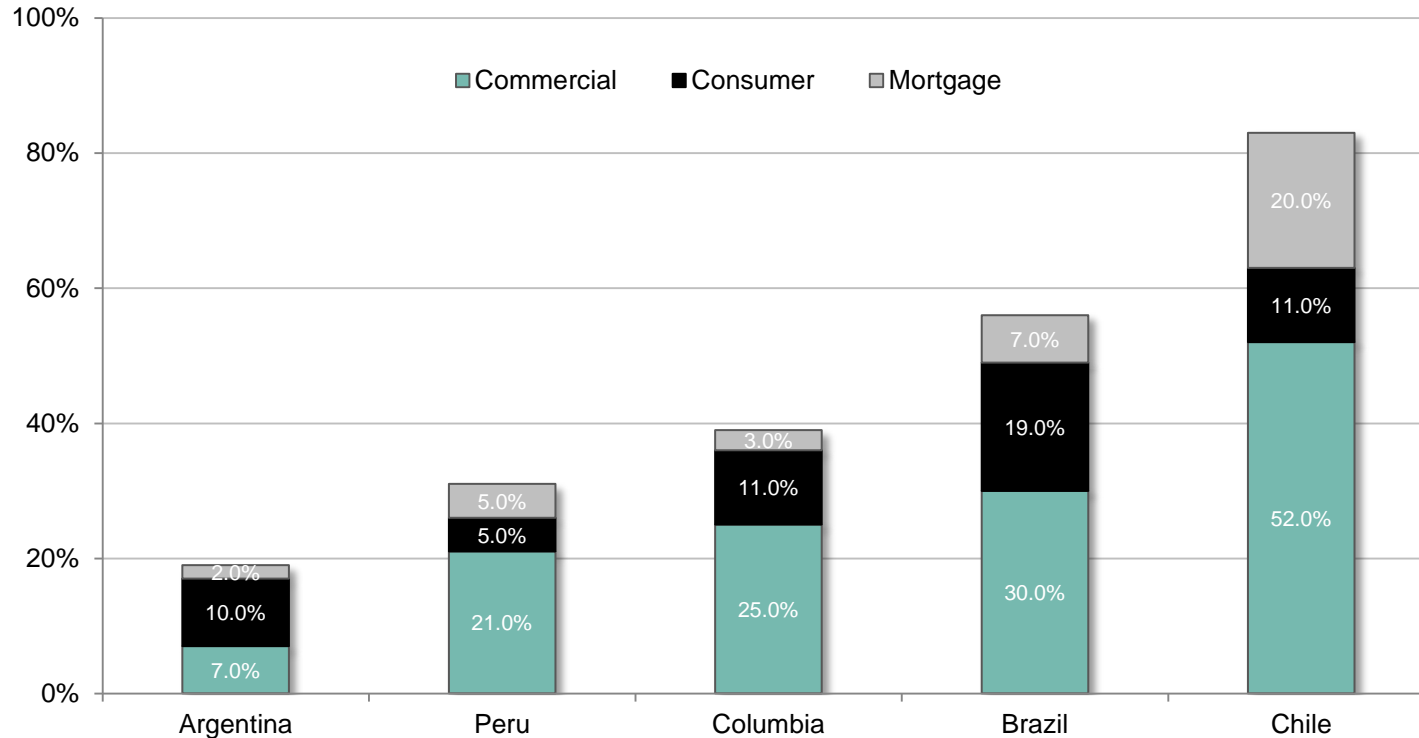
Source: Macrobond



# ARGENTINA: A PATH TO RECOVERY

Argentina is mostly a de-banked economy. Banks deposits relative to GDP are only 18%. Credit penetration is also abnormally low, even relative to Latin American peers with lower per capita GDP, such as Peru. Sound fiscal and monetary policy that reduces inflation would allow for banking intermediation and credit to rise, fueling growth...

## Argentina Domestic Credit to GDP (versus peers in South America)

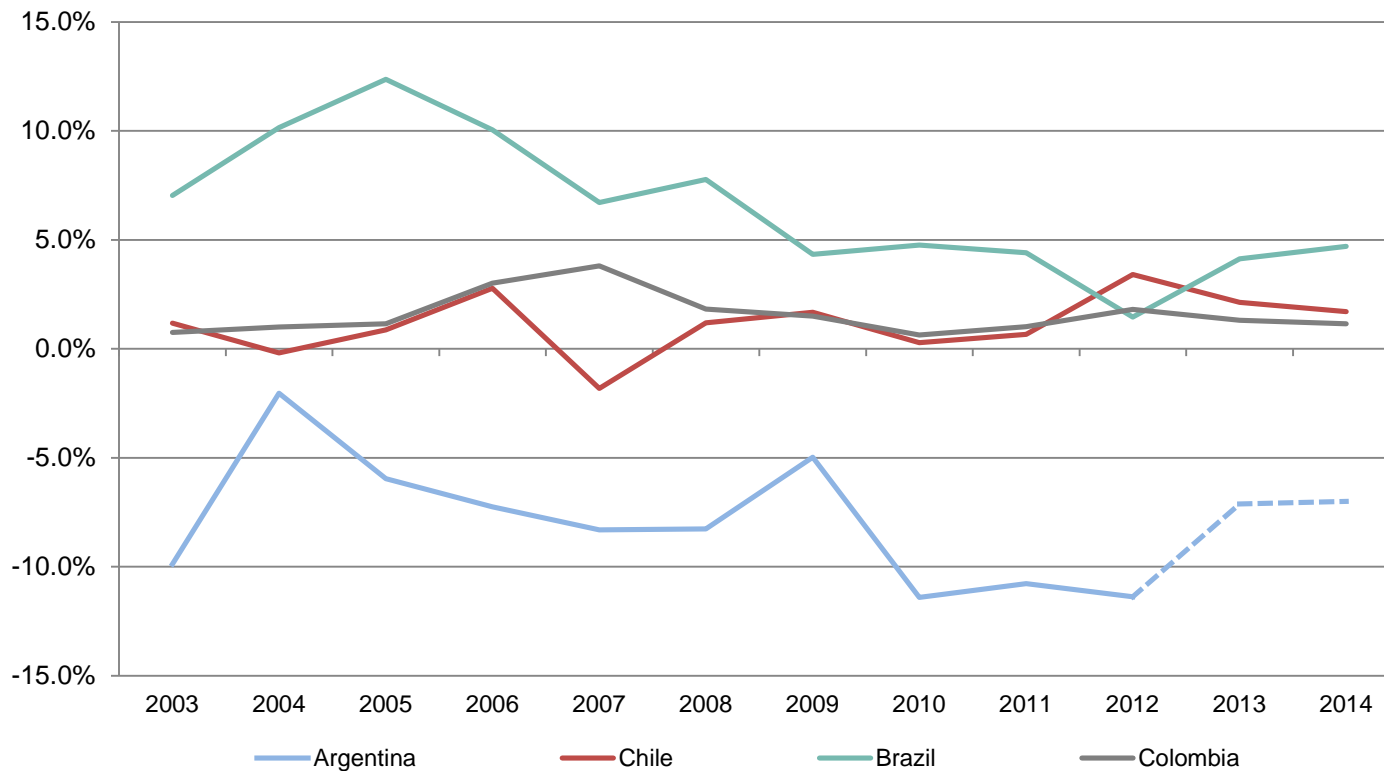


Reaching Chilean levels of leverage would take at least a decade. However, a credit cycle taking leverage even to the levels of Peru would be enormously positive for growth.

# ARGENTINA: A PATH TO RECOVERY

Retaining the deposits needed for credit creation will require positive real rates. This is a difficult adjustment, but a necessary one in order to engineer an investment cycle...

## Real Interest Rates – Latin America



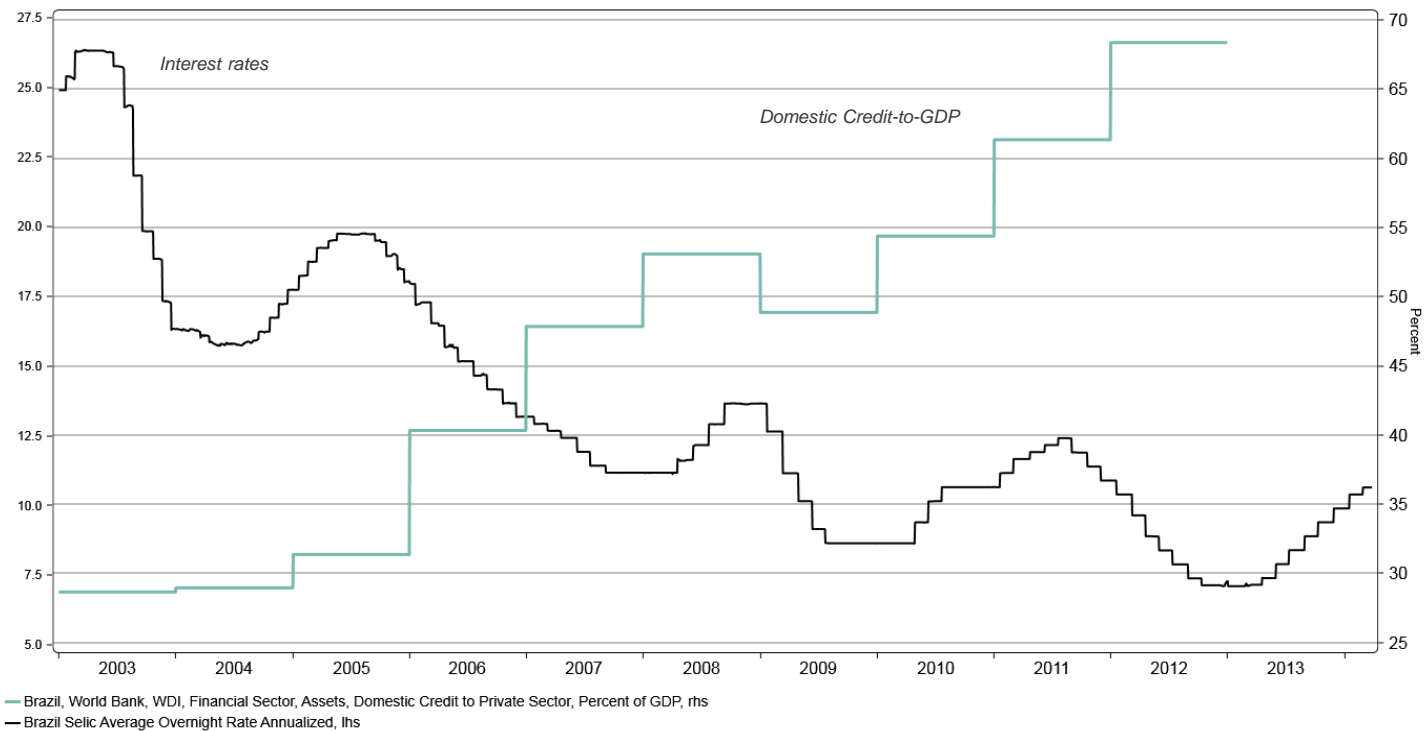
Restoring positive real interest rates will be vital in rebuilding the confidence in the government and the monetary system in Argentina.



# ARGENTINA: A PATH TO RECOVERY

Brazil provides an interesting analog. As inflation and nominal interest rates declined over the past decade, private sector credit exploded, helping to drive years of strong growth in Brazil. A similar scenario would be enormously positive for Argentina...

## Brazil – Interest Rates & Domestic Credit



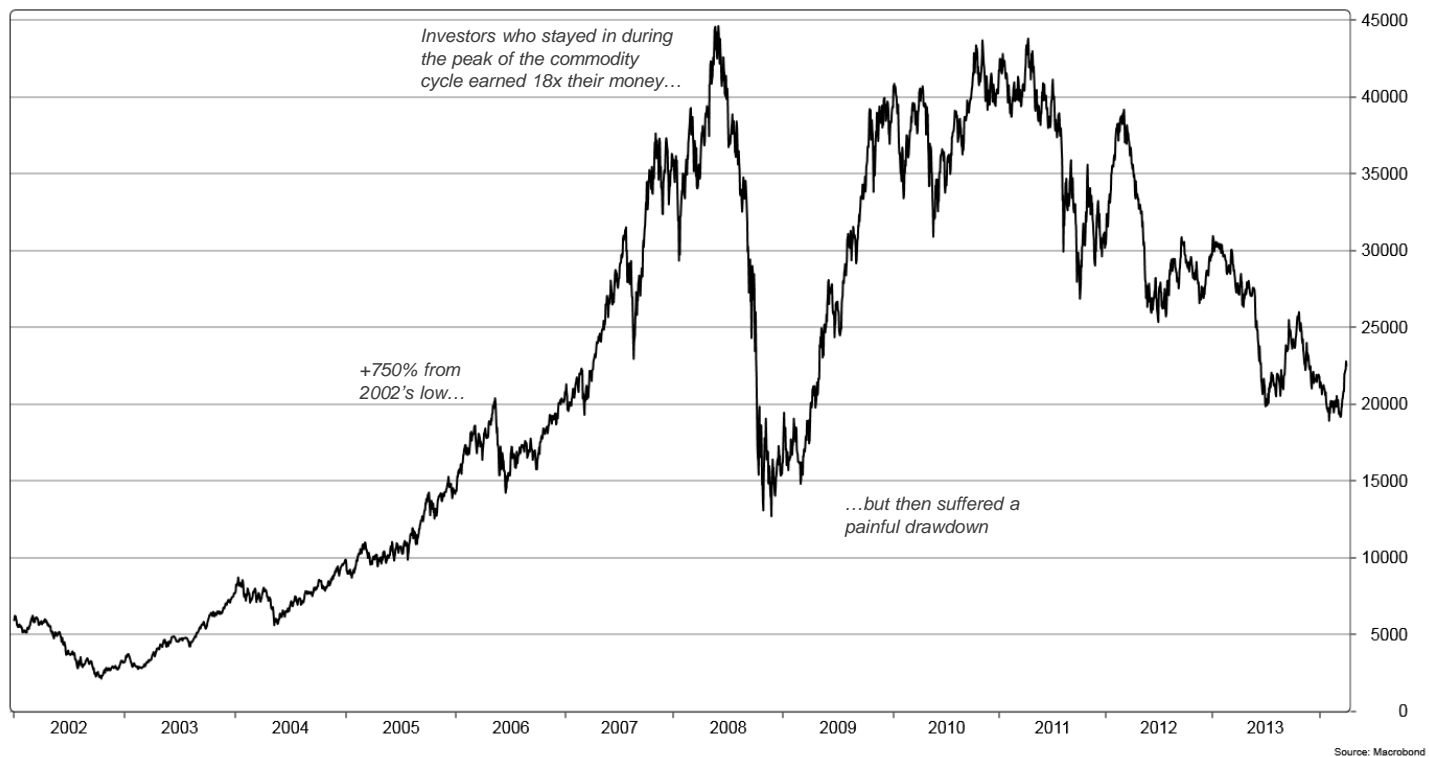
Source: Macrobond



# ARGENTINA: A PATH TO RECOVERY

Although Brazil also benefited from the commodity super cycle in the middle of the decade, as inflation fell to single digits, equities rallied aggressively, earning investors several times their money....

## Brazilian Equities (Bovespa Index)



Over the entire period, in dollar terms, equities returned 900%.



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