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# Dispatches from Argentina: Macri-economics

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## In Brief

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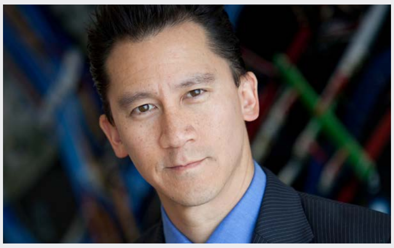


**Simon Lue-Fong,**
**Head of Emerging Market Debt**

- President Mauricio Macri's new government is implementing reforms Argentina desperately needs, but at a pace the public can handle
- The key to maintaining the reform agenda is a return to economic growth, which we expect by the final quarter of this year
- Investors have been enthusiastic about Argentina's reintegration into the global markets; there is scope for its debt to outperform

**There was a time when Argentina looked poised to become an economic powerhouse. Instead, it became a backwater. But after decades of maladministration, the country's new president, Mauricio Macri, has started to implement a reformist agenda that could yet allow Argentina live up to its potential.**

My last trip to Argentina offered up plenty of food for thought. And reasons for optimism.

I was there in June for meetings with government officials and market participants over a few days. It was my second trip of the year.

Argentina is without doubt beautiful. In the faded elegance of the capital's architecture you can see reminders of when Buenos Aires was one of the most fashionable and cultured cities in the world. On the eve of the First World War, Argentina had a higher GDP per head than a number of the great powers, including Germany and France, having grown at a faster pace than the US over the four preceding decades.

Everyone asks: What happened? The simple answer is, a lot.

You can take your pick of reasons why Argentina went from being roughly on a par with leading industrialised nations to where its people are now – less than half as well off as their developed world counterparts. Political instability, failure to modernise, overreliance on commodities, poor institutions, underdeveloped infrastructure, an undereducated labour force and anti-trade policies all played a role.

"If a guy has been hit by 700,000 bullets it's hard to work out which one of them killed him," Rafael di Tella, an economist who's written extensively on Argentina, said in an interview with the Economist a couple of years ago.[1]

My own view is that Argentina's woes are largely down to its citizens' tendency to prefer strong political personalities in an environment of weak institutions – which means there are few internal checks against poor policy.

### Governance is crucial

Good governance matters. And Argentina has had precious little of that over the past 70 years. But things could be about to change. After nearly

1 "The tragedy of Argentina, a century of decline", The Economist, 15.02.2014

three decades of Peronist populism, including 12 years of erratic Kirchner administrations, Argentinians voted for market oriented orthodox government at last December's presidential elections. Since then, Mauricio Macri's right-of-centre administration has done away with an unrealistic, government-set exchange rate by floating the currency. It also cut taxes, granted the central bank independence with a remit to control inflation and put to bed a 14-year legal battle with creditors on defaulted bonds, enabling the country to make a return to the global capital market.

Although Macri has recently sought to mitigate some of the negative effects of his economic reforms on the poorer segments of society by loosening the fiscal purse strings somewhat, monetary policy remains tight. The central bank raised interest rates to 38 per cent at one point early this year to take control of price pressures.

We'll be watching official inflation data closely, especially now that the statistics office has started to produce the first reliable CPI series in a decade – which is critical for conducting sensible policy. But we think there will be scope for interest rates to fall as inflation targeting starts to show its effects. Inflation was running at an annual rate of around 40 per cent when Macri took office. His target is to get it down to 5 per cent by the end of 2018. I don't think they're going to do it, but even if the new government achieves only 60 per cent of what it has set out to do, the result will be a much better, more investible, Argentina.

### Reform depends on growth

Growth, however, is key. For Macri to be successful and continue the reforms he's begun, he needs the economy to pick up. GDP is likely to contract around 1 per cent this year, though we expect it to resume growing in the fourth quarter and then into 2017. However, Macri's approval rating has already fallen around 18 percentage points to 46 per cent since he took over, according to a recent survey. To keep pressing ahead, he needs the continuing support of Peronists who hold the balance of power in a fractured lower house of Congress.

Ironically, policy is likely to have been complicated by foreign investors, like us, rediscovering Argentina. Earlier this year I bought LEBACs, peso-denominated short-dated Argentinian central bank debt. Demand was so strong it started to push the currency up, boosting our returns even further. A stronger peso helped the central bank in its fight against inflation and has also enabled the government to rebuild its paltry foreign reserves. But it also acts as a drag on growth. So the central bank has been trimming interest rates – they'd dropped to 30.25 per cent by early July – and put up restrictions to foreign ownership of these locally denominated sovereign bills.

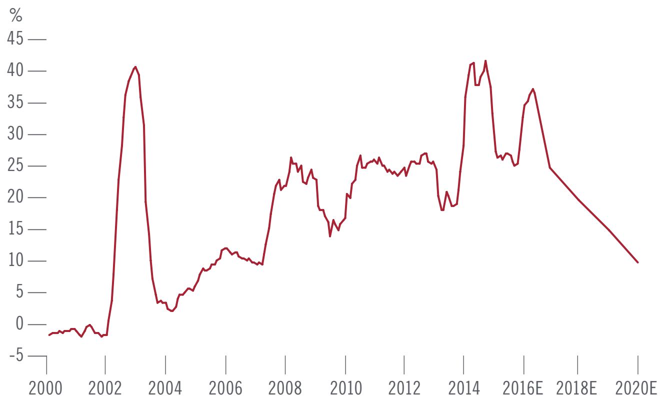
Even so, I think the mix of a loose fiscal regime and tight monetary policy suggests the currency will remain strong. Although LEBACs have since been closed to foreign investors, we think other local debt instruments remain interesting. For now, Argentina's story is compelling. The government is facing many challenges, but it's pushing in the right direction.

It looks like Argentina might be set to undergo International Monetary Fund Article IV consultations – annual meetings designed to ensure countries are complying with IMF policy recommendations – which could pave the way to Argentina's full re-integration into the global financial system. Ultimately this would open Argentina's access to emergency funding sources like the IMF's Flexible Credit Line, an important crisis-mitigation tool. The market would take a very positive view of these developments as an endorsement of Macri's policies and a backstop against future economic volatility.

### Investors like what they see

You can see how positive the story is in Argentina's bonds. Having not so long ago said that they wouldn't go to the market until next year, the government recently took advantage of investor demand to issue another USD2.7 billion of dollar denominated bonds in two tranches. Argentina started the year in default, and yet yields on its 12-year debt are 6.3 per cent, a spread of 470 basis points over Treasuries. As Macri's reforms take hold, there's every reason to believe those spreads will head towards Brazil's, currently at around 290 basis points.

FIG 1. - ARGENTINA'S INFLATION (PER CENT CHANGE ON YEAR)




Sources: Billion Prices Project @MIT; IMF year end forecasts from end-2016 (as at 04.2016)

When I was in Buenos Aires, a woman who worked at the hotel I was staying in expressed astonishment that I could determine a case for investing in a country with such a messy economic history after spending only a few days there. But I've been travelling to Argentina and analysing the country's prospects since the mid-1990s. I only get on the plane after I've already done a lot of legwork. Even flying visits offer insights that I can't necessarily get in the office back in London. Like the enthusiasm I saw for Macri's policies.

On balance, the moves to normalise Argentina are going ahead. There's no shock and awe – this is methodical policymaking. It is still early in the process, which could yet unravel. But I'm hopeful and the signs are positive. All of which is why I think we should have a bias towards being overweight in Argentinian sovereign, provincial and corporate debt where the pricing makes sense.

**Simon Lue-Fong, Head of Emerging Market Debt**

Simon Lue-Fong joined Pictet Asset Management in 2005 as a Senior Investment Manager and Head of Emerging Debt with responsibility for investment management, product development and client relations.

He has been an investment manager since 1991. His first role was managing global bonds and currencies. In 1996 he set up an emerging markets debt business in external debt and local currency at Fischer Francis Trees & Watts. Before joining Pictet he worked for Standard Asset Management and INVESCO in their respective Emerging Markets Debt teams.

Simon graduated from Bournemouth University with a BA (Hons) degree in Finance.

**Contact details**

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