August 22, 2024

Argentine Macroeconomic Framework and Bond Prices

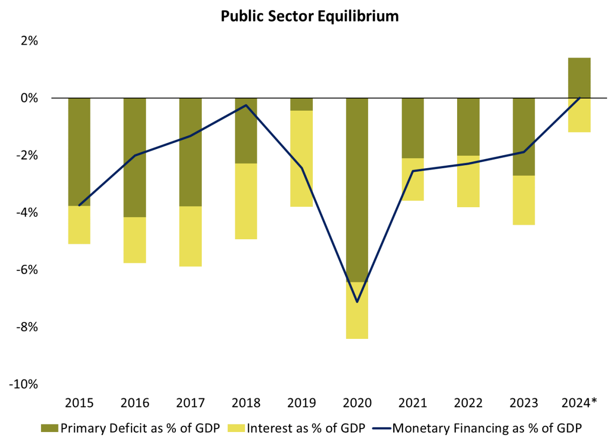
The Argentine economy is clearly undergoing a transition. This process involves institutional, regulatory, and bureaucratic changes, the outcomes of which are visible in the medium or long term. Since the new government took office, several modifications stand out, such as those introduced by the Bases Law, the DNU, and the ongoing efforts of the new Ministry of Deregulation and State Transformation. All of this aims to improve productivity over time. Additionally, we must highlight the excellent work being done by the Secretary of Commerce, led by Pablo Lavigne, in simplifying international trade.

Argentina is characterized by an absurd abundance of regulations and an excessive bureaucratic burden in virtually all sectors of the economy. Therefore, any public policies aimed at simplifying the economy or making life easier for the private sector are more than welcome.

However, the short term is challenging, and in the short term, macroeconomics takes priority. The desirable changes mentioned will fall short if the country does not achieve the much-needed macroeconomic stability. Although it may seem reachable, as evidenced by argentine regional neighbors, this stability will not be easy to attain. In macroeconomic terms, the government has made remarkable progress in fiscal matters in just nine months. However, these changes are not enough to graduate as a stable economy. The exorbitant country risk is the clearest reflection of the outstanding issues. In our view, the major unresolved issue, which is never easy to address, is the exchange rate regime.

Fiscal Policy

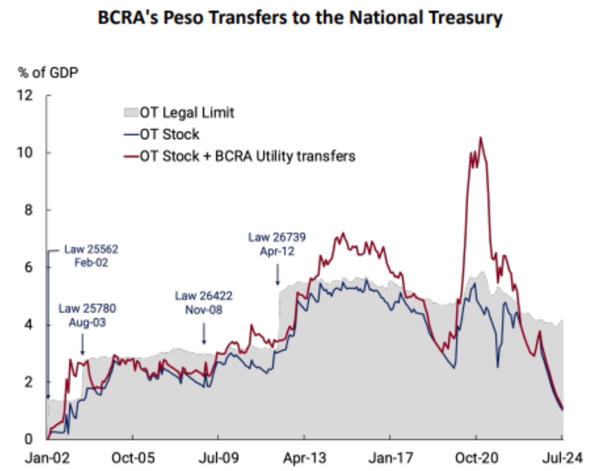
Let's start discussing fiscal policy. Last Friday, the fiscal result for July was released, showing another primary surplus, this time amounting to $908 billion. The financial result was negative due to interest payments on the debt; it is important to note that bond payments (ARGENT/ARGBON) are due in July and January. In the first seven months of the year, the Treasury accumulated a primary surplus of 1.4% of GDP and a financial surplus of 0.4%. It is worth noting that approximately half of the primary surplus was explained by the PAIS tax. Even considering a reduction of the PAIS tax to its previous level (from 17.5% to 7.5%), the government will be able to show a primary surplus in its first year in office.



Source: Sekoia Research based on Ministry of Economy.

To better understand the fiscal trajectory, let's highlight some key data. The Government has managed to balance expenses and revenues (before interest payments) for the first time in 14 years. Considering the cumulative total of the first seven months of the year, the adjustment focused on subsidies for public service tariffs, discretionary transfers to provinces, capital expenditures, and other state operations. Meanwhile, the adjustment in pensions has eased in recent months due to increases above inflation and compensation through the alignment with the new formula. Notably, the Universal Child Allowance has increased in real terms since the new government took office.

In brief, the most significant achievement is that the new economic policy has ended a highly damaging fiscal dominance that made any stabilization efforts impossible. The graph below highlights the transfer of pesos from the Central Bank to the Treasury as a percentage of GDP over the last two decades. The massive monetization of the fiscal deficit from 2010/2011 onwards severely damaged the national currency. The fiscal path has taken a 180-degree turn, a necessary condition for achieving stabilization.



Source: BCRA presentation, Vladimir Werning, Deputy Governor BCRA.

Let's take a moment to look at other comparable emerging countries, considering the cases of Angola, Pakistan, and Egypt. Although each economy has its nuances and idiosyncrasies, we will use some macroeconomic data as a reference. We will take the simple average of these three economies to have a benchmark with Argentina. Looking at the fiscal numbers, these economies, on average, have a primary surplus larger than Argentina, but this difference does not seem to explain the yield spread. It is important to note that this small sample does not include countries that have graduated in terms of stability, such as Chile, Peru, Mexico, or Brazil. Even without achieving such stability, the 10-year international bonds of these economies yield around 10.5%-11.5%. As the yield differential shows, Argentina's fiscal balance seems to be a necessary but not sufficient condition to achieve a reduction in country risk.

Monetary and FX Framework

Now let's turn to monetary policy. As we mentioned, the significant change in monetary policy is that the harmful fiscal dominance and money creation to finance the Treasury have ended. However, we do not see the elimination of remunerated liabilities as a fundamental issue; at the end of the day, it's simply a transfer of debt from the Central Bank to the Treasury. Many emerging countries have remunerated liabilities in their Central Banks, including those that have achieved investment grade. Ultimately, behind those liabilities are credibility and fiscal sustainability.

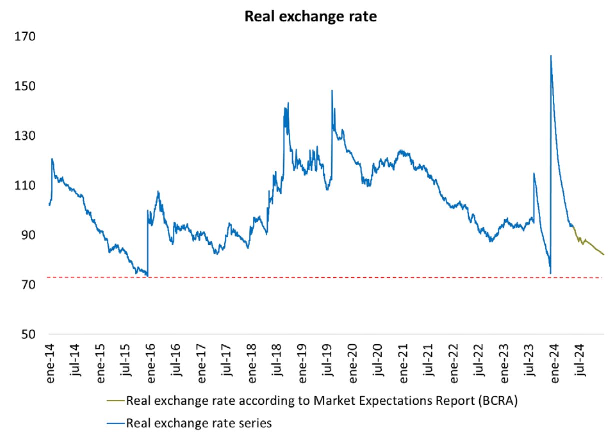
In short, the liabilities of Argentina's Consolidated Public Sector have shifted from one pocket to another within the same sack. The caveat is that the new interest burden will need to be camouflaged with some creative accounting in the Treasury (such as capitalizable or zero-coupon bonds) to prevent an increase in the financial deficit. We do not see significant changes in the migration of debt within the public sector. That said, we also do not foresee problems with the rollover of peso-denominated debt as long as current fiscal discipline is maintained. On the positive side, endogenous issuance (issuance to pay Central Bank interest) has also decreased due to lower interest rates and the positive fiscal result.

Where we see a significant imbalance is on the exchange rate scheme. This is where the weakness of our bonds and the sharp yield differential with our small sample of 10.5%-11.5% yield bonds is rooted. An example of this was the performance of the bonds during the sessions following the joint press conference by Caputo and Bausili at the end of June, where they announced that the Central Bank's net purchases of foreign currency in the official market would be offset by sales in the blue chip swap. Although the announcement helped narrow the FX gap, it also led to a drop in bond prices in the subsequent sessions. In our view, the government seems to be focusing 100% on narrowing the FX gap and controlling inflation, leaving behind the challenging goal of opening up the secondary debt market, at least in the short term. Accumulating reserves no longer seems to be a primary objective for the Central Bank. To make matters worse, the Central Bank's interventions in the FX market were partly conducted with dollars it does not possess. With negative reserves, there is no magic; if I sell dollars, they are borrowed.

Subtracting the payments for Bopreales over the next twelve months, the net reserves turn negative by around USD 5 billion. From now until February 2025, dollar payments exceed USD 4 billion. Assuming the rest of the foreign exchange market remains balanced, net reserves are headed towards the alarming negative figure of USD 10 billion, which were the values at the start of the administration. However, this assumption of equilibrium is somewhat strong, primarily because the level of imports is very low in an economy that is just emerging from a severe and prolonged recession. In the first half of this year, imports averaged around USD 4.7 billion per month. For context, between 2021 and 2023, monthly imports reached USD 6 billion.

In recent weeks, the BCRA has started to buy back some reserves, which is a positive development after the trend observed in June and July. Since late May, the balance for the BCRA has been essentially neutral. As the economy recovers momentum, we believe the BCRA will start selling foreign currency again. While the Blanqueo program might bring some net reserves to the BCRA since the 5% fine is paid in dollars, these amounts are relatively small (what counts towards net reserves is the fine, not the amount declared). Although Vaca Muerta is a significant positive development in terms of foreign currency, in the short term, the exportable surplus of energy is covering the decline in agricultural commodity prices. Even in an optimistic scenario where the BCRA is not a major net seller in the exchange market, the reserves situation remains alarming.

There are two ways to reverse this dynamic: from the stock side or from the flow side. Let's start with the more relevant point, which is the flows. Whenever the country has had large current account deficits, the outcome has been unfavorable. At the end of convertibility plan, the external deficit was one of the main causes of the 2001 crisis. A more recent example is 2017, when the Cambiemos government made the mistake of believing it could finance a current account deficit of 4% or 5% of GDP. If the crawling peg continues, the multilateral real exchange rate (REER) will appreciate to levels similar to those. The question is: what external deficit will we have with this REER? Fiscal balance favors a stronger peso, but even so, the exchange rate dynamics are alarming (see chart). For Vaca Muerta to change the external balance, more time will be required.



Source: Sekoia Research based on BCRA.

The government argues that the fiscal adjustment is so large that it will create a shortage of pesos in the economy, which in turn will lead the free exchange rate to converge with the official rate - in other words, that the FX gap will narrow at the bottom of the gap. Even in this hyper-optimistic scenario, the external sector problem is not resolved. Competitiveness ultimately depends on real variables. While the government is making progress in terms of competitiveness, it will take a very long time. The country has destroyed its productivity over the past decades. The private sector cannot be expected to compete with the rest of the world with an undervalued exchange rate overnight. This will take time. Countries with yields of 10.5%-11.5% have moderate current account deficits or surpluses (Angola) and external debts of 40% of GDP. For now, the figures are not too different from those of the Argentine economy. The major difference lies in international reserves, where these three economies have reserves to cover short-term maturities. Reserve levels range from 4% to 10% of GDP (Pakistan has fewer reserves and higher-yielding bonds), values that currently seem very distant for the Argentine economy. We are talking about an equivalent of USD 20 billion to USD 50 billion, considering the size of the economy.

How can net reserves improve without changing the exchange rate scheme? If not through flows (current account), it would have to be through stocks (debt). At this point, all eyes are on the IMF. The government is in negotiations with the Fund for a new agreement that would bring in fresh funds. However, there are two important issues to highlight. First, it is unlikely that the IMF will provide fresh funds to maintain the current exchange rate scheme. As has already been informed, the Fund would require changes in exchange rate policy as part of a new agreement. Second, the fresh funds that the IMF could provide this time around would not significantly alter the sovereign risk profile. Suppose the IMF grants a large sum of USD 10 billion. With this amount, the country could buy a year of time in terms of debt payments, but it does not change the debt sustainability nor guarantee the opening of the voluntary debt market. While the dollars sent to BONY for future payments and possible REPOs with banks for 2025 could help, this does not alter our conclusion.

Conclusion and Bond Prices

In summary, we do not see Argentine bonds joining the 10.5%-11.5% club until the exchange rate scheme is modified. Nonetheless, we still like sovereign bonds. Why? First, because the fiscal anchor is so strong that we see the bottom level for the bonds not far from current levels. Second, because the President shows a strong commitment to honoring debt obligations. If a debt restructuring occurs, we believe it would be a favorable agreement for bondholders. Third, because the current exchange rate scheme could change. This is, for us, the Achilles' heel of the program, as we mentioned in our reports. If the FX framework changes, the potential upside for sovereign bonds is very high, considering our small sample of comparable countries. Investing in risky assets, our bonds fall into the "distressed debt" category, or in other words, a category "not suitable for the faint of heart." In those potential scenarios, we view Argentine sovereign bonds favorably. As usual, we prefer those with lower parities, such as the ARGENT 2035 and 2041 (GD35 and GD41). Finally, a not insignificant issue is the international rate. We believe we are heading toward a scenario of lower global rates, which would also support the valuation of Argentine bonds.

Best regards,

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