

# Argentina

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# Country Risk

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## Argentina: StratInfo Grade and Evaluation April, 2001

### Grade

C	Trade finance, up to one year
C-	Other loans, up to two years
D+	Medium and Long Term

### Evaluation

Dramatic events during the second quarter of this year put in question the stability of the government's economic team. The Economy Minister was changed twice in just a few days and the head of the Central Bank was forced to exit. This is the third consecutive year of recession. We view a devaluation as a possibility before the end of this year. The \$40 billion so called *safety net package*, which is a euphemism for a financial rescue package, has helped, so far, to postpone an adjustment to the currency. The new money should cover payment of Argentina's debt obligations in 2001. At the same time, the IMF appears to have accepted the fact that Argentina will not meet its fiscal targets this year and will likely grant waivers. However, the large twin deficits, combined with an increasingly heavy debt burden, will continue to put pressure on Argentina's capacity to service its debt. We think some type of debt rescheduling may be necessary. Social pressures on the government to promote faster growth and to create employment will lead to the higher deficits and subsequent devaluation. Argentina could continue staving off a devaluation, as has been done so far, if the government keeps receiving the funds needed to cover its twin deficits from international lenders. In that case, Argentina's economy would continue with a stop-go pattern, with growth periods followed by increasingly longer recessions.

### Recent Events

President de la Rúa's economic team played a game of musical chairs during the first quarter of this year. After the resignation of Jose Luis Machinea as Minister of Finance, the President appointed former Minister of Defense Ricardo Lopez Murphy, a highly

regarded economist, who used to be director of the economic research firm FIEL. The resignation of Machinea was not surprising, considering the persistent economic stagnation and mounting pressures on the government to engineer a recovery.

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A second round of musical chairs occurred in March, as pervasive recession, combined with social pressures, and fast falling approval ratings, led President de la Rúa to appoint Domingo Cavallo as Economy Minister. At the request of the President, Congress promptly granted Mr. Cavallo special powers, making him an economy czar. Most recently, the President of the Central Bank was forced out, and replaced by Mr. Roque Maccarone. The question now is when will be the next round of musical chairs.

After his appointment, Mr. Cavallo immediately sought to calm the markets, by guaranteeing continued support for parity with the US\$. He also announced an economic program that seeks to cut fiscal spending mainly by consolidating and eliminating government agencies. The basic thrust of these measures is similar to the approach adopted by his less successful predecessors.

The backdrop to these political rumblings has been quite sobering. Preliminary estimates show a GDP decline of 1.4 percent during the first quarter, compared to the same period in 2000. Investment spending was down 6.0 percent and personal consumption dipped by 0.7 percent. If this trend continues, this will be the third consecutive year of recession. Industrial production was down 3.6 percent for the first quarter, with notable declines in textiles, automobiles, and metals manufacturing. Sales of automobiles continue in the doldrums, and government announcements of further tax increases are clearly not going to put more spending money into consumers'

pockets.

Another first quarter headline was that the government exceeded its fiscal deficit target with the IMF. As usual, a new revised target has been approved by the IMF, which accommodates the higher deficit figure, and clears the way for further disbursements under the mega-financial rescue package put together last year. The deficit target for this year is \$6.5 billion, and the first quarter overrun was about \$1.0 billion. The reason for the budget shortfall was mainly on the revenue side, due to the continued recession.

The government, backed by the IMF, has become obsessive about the fiscal deficit. Apparently, the government's view is that if they meet the IMF fiscal deficit target, Argentina's economic problems will be instantly solved, and foreign investors will flock with huge amounts of capital. In response to meeting the IMF targets, the government also hopes that businesses will announce major expansion plans and consumers will rush to the stores to spend. Unfortunately, managing an economy is not that simple. Argentina's difficulties in meeting IMF fiscal targets are almost legendary, and the IMF usually ends up agreeing to set new, easier targets, so that Argentina can continue to receive financing to cover its twin deficits and, more recently, to meet foreign debt obligations. Yet the economy is still stalled. Therefore, the problem with the economy must lie elsewhere.

Interestingly, one of the first laws pushed through by Mr. Cavallo was a measure to introduce the formal floating of the peso.

It has been dubbed the expansion of the Convertibility Program, when in fact it undermines the program. The law describes how the floating of the peso would result in a devaluation.

The scheme is based on the introduction of a mini-currency basket, comprised of two currencies: the US\$ and the Euro, with one unit of each of these currencies included in the basket. Thus, the value of the peso relative to the US\$ will be derived from a simple average of the US\$ and the US\$ value of the Euro. For example, if the value of the Euro is \$0.9, then one peso =  $(\$1.0 + 0.9) / 2$ ; or 1.05 pesos per US\$.

While the mini-basket introduces a floating exchange rate, the actual variability will be minimal, in view of the strength of the currencies in the basket, and the fact that the peso is still pegged to the US\$. Our principal objection to this scheme is the initial par rate. As we have said repeatedly, the one peso to one US\$ rate is not viable. Theoretically a mini-currency basket might work if the initial par rate were to be set at 1.7 pesos per US\$. Subsequently, that par rate would have to be adjusted whenever market forces established that it was over-valued. This process was very familiar to the Europeans during the time of the European Monetary System, on which Mr. Cavallo probably based his idea.

On a positive note, the continued recession has helped to bring down the external deficit. Last year the current account deficit fell to \$9.8 billion from \$14.6 billion in 1998. Foreign exchange reserves have also remained stable at about 12 months of imports.

## The Outlook

The central assumption in our forecast is that Mr. Cavallo will not succeed in reactivating the economy. In fact, we think he will have the unpleasant job of dismantling the very system he designed: the Convertibility Program. As we have said in our previous reports, there are two major issues in this outlook: the devaluation of the currency and the restructuring of the external debt.

The latest economic program, which has been strongly endorsed by the IMF, lacks any new creative initiatives to bolster domestic production. Reducing the fiscal deficit through further expenditure cuts and additional taxes, as per the new financial transactions tax, will not address the fundamental problem of competitiveness. This myopic view fails to address the challenges being faced by businesses and the difficulties encountered by workers. We think this situation is comparable to that of a company that is losing market share because its competitors have significantly cut prices for their products. However, the company's unwillingness to change its prices prevents it from engaging in an aggressive marketing strategy. Instead, management and their advisors are obsessed with cutting expenses, while telling their bankers that once back office jobs are eliminated, the company will return to profitability.

We think the government will miss the remaining quarterly targets, although the IMF is likely to grant the necessary waivers. Undoubtedly, the government has made an extraordinary effort to

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meet those targets, at a high social cost. We think the deficit could reach 3.5 percent of GDP this year, up from 2.5 percent in 2000. The increasing government deficits will put further strain on the financial system, thus crowding out the private sector. Credit to the public sector from private banks has surged at an annual rate of about 40 percent during the past two years, and this trend should continue.

Mr. Cavallo's draconian measures are also likely to incite labor protests. Three years of recession have taken a heavy toll on the population. Social tensions are going to intensify in the future.

We think this is the calm before the next storm, which could unleash severe financial turbulence, and eventually trigger a devaluation of the peso. We have timed such a devaluation at the end of this year, but it could be sooner. At the same time, we think that Argentina will have to enter into some type of debt restructuring exercise with its creditors.

One of the fundamental obstacles to a recovery is the fixed exchange rate. Even though the mini-currency basket will formally allow the peso to float, we think the currency requires a maxi-devaluation. As we have explained in previous Updates, manufactured exports are being held back by high costs. At the same time, a temporary recovery, fueled by more loans, would only result in a surge in imports, since these are much less expensive than locally produced goods.

One of the arguments against a

devaluation is that it would result in serious financial sector problems. Once again, this is a weak argument. It is similar to the case of a company that is technically insolvent, yet tries to convince its bank not to call its loans, but rather to lend it more money. If banks followed prudent credit risk analysis, then a devaluation will not necessarily cause any major financial sector disruption.

On the other hand, the combination of a fixed exchange rate and a bi-monetary system have resulted in some imbalances that could trigger systemic problems in the banking sector. Since every peso of the monetary base has to be backed by one dollar of international reserves, with the exception of some government-issued debt, the real expansion of liquidity has occurred through the growth in banks' deposit liabilities. The broad money multiplier,  $M3^*$  divided by the monetary base, has risen from 4.6 times the base in January 1995 to 7.2 times in October of last year. Most of this growth is due to savings and time deposits denominated in US\$. Basically, a major portion of the banking system's deposit liabilities are not covered by US\$ reserves (the amount is roughly 6.2 times the monetary base). While banks are required to set aside 18 percent of deposits in the form of liquidity reserves in US\$ offshore, there is still a large gap in terms of the US\$ reserve coverage of deposit liabilities. To the extent that the banks' assets are in the form of loans to domestic companies that would have difficulties in repaying the loans after a devaluation, then the banks could in that case face significant liquidity problems. Once again, the issue is

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whether banks have pursued prudent credit and currency risk policies.

Profitability for private sector banks has fallen from a rate of return on equity of 5.1 percent in 1998 to only 0.75 percent last year. Increasingly, banks are funding the growth in their balance sheets with borrowed funds, rather than core deposits, which also adds to liquidity risk. Bank lending to the private sector fell 5.5 percent last year. Mr. Cavallo hopes to bring relief to the banks by lowering the required liquidity reserves. However, this could further aggravate systemic risk. On the other hand, banks may not be willing to increase their lending if the economy is still in recession; although they may moderately reduce interest rates to reflect the lower cost of funds.

The external debt may have to be rescheduled; perhaps even before a devaluation. Recently, the government announced a refinancing program in order to reduce the bunching of maturities scheduled for the next four years. During the rescheduling of the 1980's, this type of operation was referred to as a "carve-out," whereby maturities for several years were grouped and refinanced with a new large loan with a much longer maturity. If the financial markets are not willing to go along with this refinancing operation on a voluntary basis, then Argentina would have to seek a formal rescheduling. In an effort to help troubled Argentina, the U.S. government is also nudging U.S. banks to postpone for one year Argentina's payments on about \$7.0 billion owed to those banks. The debt to export ratio is around 5.5 times, or twice as high as the average for

Latin America.

As in our previous reports, we are assuming a devaluation of the peso in 2001, by year end. This could take place through the establishment of a financial sector exchange rate. In projecting the likely outcome, we have used the experience in Brazil as indicative of what could happen in Argentina. We think the Argentinian government would show a positive response to a devaluation. At the same time, the excellent economic management and substantial structural improvements in the economy since 1992 bode well for the medium term outlook.

Our forecast calls for moderate GDP growth of 1.5 percent this year, followed by a recovery to 3.1 percent in 2002. The recovery will be supported by the devaluation, which should bolster exports and diminish imports through domestic substitution. The inflation rate is projected to average 14.9 percent in 2002, when the brunt of the devaluation will be felt.

One of the risks to this forecast is the possibility of financial system problems arising from a change in the exchange rate. While this risk is significant, we think the government will in that case be compelled to provide financial support to the banking system, even though a bank bailout would further contribute to an already high public sector debt burden. Another risk deals with the large external debt of non-financial corporations, which is currently at \$36 billion, once again, some of these corporations may encounter debt servicing problems.

StratInfo Country Analysis

ARGENTINA

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	1995	1996	1997	1998	1999	2000	2001	2002	
GDP (US\$m)	\$255,737.8	\$276,574.7	\$299,213.8	\$302,340.9	\$290,365.1	\$283,007.2	\$270,935.8	\$229,957.4	
GDP (growth,%)	-2.8	5.5	8.1	3.9	-3.4	0.0	1.5	3.1	
Inflation(avg.%)	3.4	0.2	0.5	0.9	-1.2	-1.0	0.5	14.9	
Deposit Interest Rate:	11.90	7.36	6.97	7.56	8.05	8.34	15.00	20.00	
INTL.SECTOR(US\$m):									
Exports	\$21,161.0	\$24,043.0	\$26,431.0	\$26,441.0	\$23,333.0	\$26,298.6	\$28,665.5	\$32,105.4	
growth(%)	32.07	13.62	9.93	0.04	-11.75	12.71	9.00	12.00	
Imports	\$18,804.0	\$22,283.0	\$28,554.0	\$29,558.0	\$24,103.0	\$23,837.9	\$25,029.8	\$29,535.1	
growth(%)	-6.74	18.50	28.14	3.52	-18.46	-1.10	5.00	18.00	
Trade Balance	\$2,357.0	\$1,760.0	(\$2,123.0)	(\$3,117.0)	(\$770.0)	\$2,460.8	\$3,635.7	\$2,570.2	
Net Services		(\$7,548.0)	(\$8,602.0)	(\$10,374.0)	(\$11,485.0)	(\$11,542.0)	(\$12,278.2)	(\$12,815.0)	(\$11,684.9)
Current Account		(\$5,191.0)	(\$6,842.0)	(\$12,497.0)	(\$14,602.0)	(\$12,312.0)	(\$9,817.5)	(\$9,179.2)	(\$9,114.6)
External Debt	\$98,547.0	\$109,756.0	\$124,696.0	\$140,884.0	\$146,219.0	\$150,100.0	\$156,628.8	\$164,007.0	
Exchange rate(avg)	0.9998	0.9997	0.9995	0.9995	0.9995	0.9995	1.0811	1.7509	
change (%)	0.08	-0.01	-0.02	0.00	-0.00	0.00	8.16	61.95	
Real Apprc(+)/Deprc(-)	0.5	-2.6	-1.8	-0.7	-3.3	-4.2	-10.2	-31.1	
FX Reserves (US\$m)	\$13,749.0	\$17,705.0	\$22,153.0	\$24,488.0	\$26,114.0	\$24,414.0	\$25,000.0	\$27,000.0	
OTHER:									
Population (mn)	34.77	35.22	35.67	36.12	36.58	37.04	37.51	37.99	
GDP (mill. Pesos)	258,032	272,150	292,859	298,948	283,260	271,921	269,258	309,691	
RATIOS:									
GDP per capita(US\$)	\$7,355	\$7,853	\$8,388	\$8,370	\$7,938	\$7,640	\$7,222	\$6,053	
CrrntAcct/GDP(%)	-2.03	-2.47	-4.18	-4.83	-4.24	-3.47	-3.39	-3.96	
Debt/GDP(%)	38.53	39.68	41.67	46.60	50.36	53.04	57.81	71.32	
Debt/Exports(ratio)	4.66	4.56	4.72	5.33	6.27	5.71	5.46	5.11	
ImportCoverage(months)	8.77	9.53	9.31	9.94	13.00	12.29	11.99	10.97	

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### Notes:

- \_\_\_ GDP is Gross Domestic Product, US\$GDP is based on a purchasing power parity adjusted exchange rate, growth of GDP refers to real GDP.
- \_\_\_ Inflation is the percent change in the consumer price index based on the year average value.
- \_\_\_ Deposit interest rate is a short-term rate on deposits, mostly up to 180 days.
- \_\_\_ Exchange rate is expressed as domestic currency per US\$. It is the year average exchange rate.
- \_\_\_ Real appreciation or depreciation is the percent change in the nominal exchange rate adjusted by the relative inflation rates(domestic & US). Real appreciation/depreciation means that the domestic currency has increased/decreased in value in real terms, and could indicate over/under-valuation.
- \_\_\_ Foreign exchange(FX) reserves are international reserves in the form of convertible currencies.
- \_\_\_ CrrntAcct/GDP is the Current Account Balance to GDP ratio.
- \_\_\_ Debt/Exports is external debt to exports of goods ratio.
- \_\_\_ Import Coverage is foreign exchange reserves in terms of months of imports of goods.
- \_\_\_ Sources: IMF, World Bank, Central Bank, other country sources, and StratInfo estimates and forecast.