

A crucial week ahead for Argentina

The intensity of the confidence crisis faced by the Macri administration in recent days suggests that investors will not tolerate policy mistakes this week. Decisive action is needed to address the vulnerabilities represented by the large fiscal deficit and hard-currency needs. Lack of progress this week could threaten governability



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Government will aim to rebuild investor confidence

This is going to be a busy week for Argentina. President Macri's crisis management skills will continue to be tested, with investors expecting a broad range of announcements. The focus will be on assessing the impact of the new fiscal policy initiatives and progress on the new International Monetary Fund (IMF) negotiations.

Until recently, investors seemed willing to tolerate reasonable levels of rollover risk for maturing sovereign debt, but market reaction this past week suggested that the administration has lost much of its credibility. Monetary policy actions, such as last week's 15 percentage point increase in the benchmark interest rate, to 60%, no longer seem sufficient to stabilise local financial markets.

Decisive action to address Argentina's chief vulnerability, i.e. the large fiscal deficit and the country's heavy reliance of FX-denominated financing, should be the administration's primary focus now.

The renewed fiscal effort is likely to include revenue-enhancing measures, such as the re-introduction of export taxes to a broad range of exports (including corn and wheat), as well as some spending cuts. Planned tax cuts to soy exports, corporate profits and labour taxes are also likely to be (temporarily) shelved. The government's aim may be to eliminate the primary fiscal deficit by next year, down from the current primary deficit targets of 2.7%-of-GDP for 2018 and 1.3% for 2019.

Frontloading a significant part of the disbursements from the US\$50 billion three-year Stand-by Agreement with the IMF also appears to be a necessary step to prevent the crisis from escalating further. Argentina already withdrew US\$15 billion in June. In light of signs of broader emerging market contagion seen over the past week, we expect the Fund to find common ground with Argentina and agree to a sufficiently robust fast-tracking of planned disbursements.

Once the new disbursement schedule is agreed, the administration must also update its 2018-19 fiscal financing plan. Reassuring words of support by the IMF will not be sufficient to extend the market reprieve too much longer. Without a detailed and credible financing plan, confidence is unlikely to be fully restored.

President Macri is also expected to announce substantial cabinet changes, possibly with the elimination of several ministerial posts and the appointment of new ministers, to boost market credibility in the administration.

Ultimately, should the Argentine peso fail to stabilise even after all the measures announced this week, more drastic policy options (eg, capital controls) may have to be considered.

This reflects the fact that, given how high-interest rates already are and the difficulty in adjusting fiscal accounts further, beyond what should be announced this week, there may be very limited room left for further course-correction on the domestic economic policy front.

The dramatic confidence crisis Argentina is facing, and the aggressive monetary and fiscal policy tightening the administration has been forced to adopt, has increased the risk of a deeper economic recession, possibly with GDP contracting by more than 2% in 2018, while experiencing higher inflation than previously expected.

The severity of the medicine suggests that concerns regarding Argentina's twin deficits, totalling more than 10% of GDP now, are likely to recede sooner than expected. But locals

have begun to worry about social unrest and the risk of a governability crisis, which suggests that the situation will continue to require close monitoring.

President Macri's chances of getting re-elected in next year's presidential elections have fallen sharply, but investor concerns may be tempered by the fact that Cristina Kirchner's popularity has also taken a severe hit, affected by a brewing corruption scandal.