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Special Commentary

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What's Next for Argentina After the Devaluation?

Executive Summary

Normally, experience gives people an edge compared to those without it. However, when it comes to devaluing its currency, Argentina's experience over time has not proven to be an advantage. Essentially, countries tend to devalue the currency when there is no other alternative. The question then is, "why do countries get to the point where they must let the currency fall by a rapid and large amount instead of allowing them to follow the lead of the markets?" For example, in the United States the dollar depreciated slowly after 2001, losing more than 35 percent versus the euro, and this did not create a crisis in the foreign exchange market. Not that we are comparing Argentina's currency to the U.S. dollar, as the former is not traded internationally, while the latter is. However, by the same token, because the U.S. currency is so important in the global economy, it has more influence when it rises or falls relative to the Argentinean currency.

This recent episode in Argentina is similar to other such past circumstances as the government has kept trying to avoid/slow down an important loss in foreign reserves, which has been the case during the past several years. Why has Argentina lost so much in foreign reserves? First, there is speculation regarding the future of the Argentine peso and inflation, which has driven Argentineans to buy U.S. dollars for protection from a currency that loses value, and from paying a higher inflation tax (the tax the government collects when they print money). Second, the government needs more than $11 billion per year in foreign reserves just to buy petroleum and petroleum products from the rest of the world because Argentina has again become a net importer of such products.[1] Third, the country has utilized central bank reserves to pay government debt as it is still unable to access capital markets to finance itself, and this has helped to deplete dollar reserves held by the central bank.

On the other hand, the government is continuing with an expansive fiscal policy and has struggled to support this with genuine resources such as tax collections. Thus, Argentina's central bank and other institutions, like the social security and the pension system, are being used to finance the expansion. However, resources from the social security and pension system are limited, and while the central bank's capacity to print more money is not, the consequences of such printing are contributing to ever higher inflation and a run against the Argentine peso.[2]

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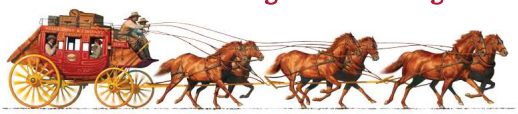
The Economy Will Be Hurt Even More

The Argentine economy continued its deterioration at the end of last year and the turmoil and uncertainty created by the recent exchange rate events probably will not change this deteriorating trend. In fact, the economy most likely will deteriorate further. The news coming from Argentina is not encouraging for businesses or consumers, and the uncertainty created by the central bank's decision to abandon the defense of the currency, and the large devaluation of the currency that ensued, has sent shock waves through the economy. Businesses of all types are struggling to price their products, and some are going as far as not selling their products until they have a better idea of the correct pricing. While some of the products are domestically produced and those prices

[1] Imports of fuels and motor oils was $11.4 billion in 2013.
[2] While in theory the central bank could print an infinite amount of money, the truth is that it is limited by the willingness of individuals and firms to hold the peso.

Together we'll go far



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may not change too much, many products are imported and the large devaluation of the currency threatens the firms' ability to restock those products while at the same time hurting the firms' expected profitability.

Even the prices of nationally produced goods most likely will be affected. Recall that private surveys put Argentina's inflation close to 25 percent to 30 percent in 2013, even though the government's controlled statistical institute says it averaged 10.6 for full-year 2013. It is true that firms are not misled by the statistical institute's numbers because they know their inputs/products costs and how much they are rising. However, the government negotiated some price freezes with supermarket chains during the summer and we believe this will affect the prices they originally agreed with the Kirchner administration. Furthermore, the large devaluation will bring in more sectorial cost-push inflationary pressures, as labor unions from all sectors pressure the government and firms for higher salary and wage increases than they received last year.

Recall that the country went through social upheaval at the end of last year when police forces across the country abandoned their jobs in a protest for higher wages and salaries. Unrest ensued in several provinces as thieves and different groups of people took advantage of the lack of police power, committing acts of violence and vandalism.

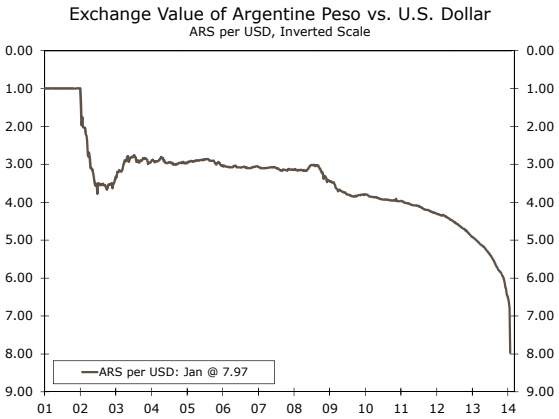
We believe things could get worse before getting better.

We believe things could get worse before getting better. Argentineans are in the midst of their summer season, which is probably keeping discontent with the recent measures limited. However, as soon as the school season approaches and families need to buy scarce supplies for the school year, the situation could worsen. Furthermore, we think teachers and teachers' unions will try to renegotiate their contracts and ask for higher wages. This most likely will happen in every industry, but especially in those with strong labor union representation. Thus, we are not very positive today on the outlook for the Argentine economy during the first half of the year.

The industrial production index shows how weak the economy was at year-end. The industrial production index dropped 5.4 percent in December compared to a year earlier while the month-on-month seasonally adjusted index was down 0.7 percent. While it may improve the sector's competitiveness versus the rest of the world in the short term, the devaluation of the peso will not last long enough for the country's industrial sector to take advantage of the situation, because we expect inflation will increase considerably, limiting the gain in competitiveness. The devaluation most likely will help the trade balance a bit as imports become more expensive in the domestic currency.

Figure 1

Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

The weakness has also been reflected on the economic activity index, a monthly proxy for GDP. The index has slowed since the early part of last year, and we expect it will continue to trend down. The index posted a year-over-year growth rate of only 2.2 percent in November 2013 and we expect it will probably point to a contraction in economic activity for December's year-over-

year figure. March 27 is the official release date for results from the December index and GDP for the last quarter of 2013 and for full-year 2013. However, if the current data is any indication of those numbers, things do not look promising.

On the positive side, private consumption seems to be still running strong. Argentina's real shopping center and supermarket sales have continued to post solid rates on a year-over-year basis. Shopping center sales were up 20.0 percent in December versus a year earlier while supermarket sales were even stronger, posting a rate of growth of 36.5 percent. Interestingly enough, looking at Figure 4, one wonders if Argentineans were expecting this crisis at the end of 2013 because the increase is very similar to the one that occurred when the world economy went into a recession due to the bursting of the U.S. housing bubble. Thus, this increase in supermarket sales is probably not going to be sustained in the coming months even though as inflation trends higher the more individuals will want to buy today to prevent inflation from eating into the purchasing power of the domestic currency in the future.

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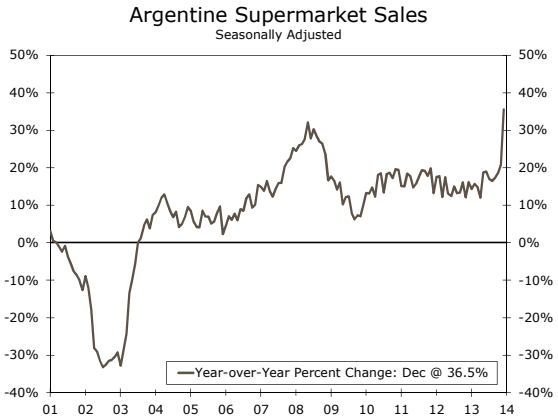
Figure 3

Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

Capital Controls: Never Underestimate Your Opponent

Since 2011 the Argentine government has implemented various capital controls to try to stop, minimize, reduce and/or slow down the central bank's reserve losses. While some of the controls were new and "innovative" in this new technological age, others were old fashioned, but refined to avoid/limit issues with other countries.

Since 2011 the Argentine government has implemented various capital controls to try to slow down the central bank's reserve losses.

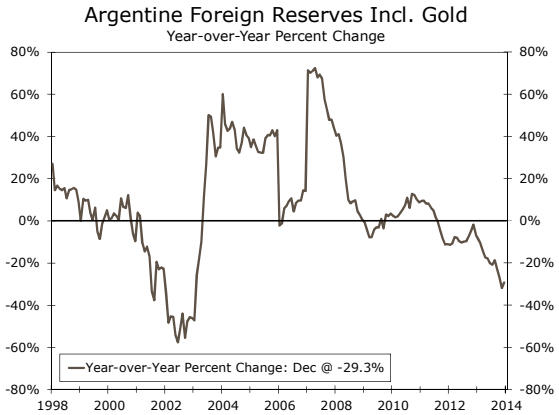
Probably one of the most obscure mechanisms was the inability of Argentina's industries and businesses to import inputs and goods into the country. Argentine firms and businesses needed to gain permission from the office of the Secretary of Commerce to import inputs and/or goods into the country and permission was seldom given. At the same time an importer of goods into the country would have had to export a similar dollar amount to the rest of the world. Sometimes this was easy for firms that exported their goods worldwide. However, many of these firms had no export operations, which meant that they had to create export operations to justify importing what they needed. As an example of how this would work, some importing firms went as far as setting up a grain export operations (even though they did not produce grains) so they would be able to import tractors from other countries.

The government's objective was to prevent the loss of foreign reserves due to foreign trade transactions. That is, whoever imported $1 dollar in products had to export $1 dollar in products, matching export and import values. Of course, this was costly for many firms wanting to continue doing business. The idea was to try to keep the trade sector in surplus because in this way the country's central bank was able to accumulate foreign reserves. The system has been relatively successful as it has tended to stabilize the trade surplus, but it has implied an increase in the cost

of doing business for Argentinean firms and businesses, which has affected economic growth negatively.

Figure 5

Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

The strategy of preventing imports into the country is not a new one; but, the way in which it was done was. In the past, the country just increased trade barriers or increased taxes (duties) on imports to protect domestic industries. However, because the Argentine government has signed trade agreements with neighboring countries, such as the Mercosur custom union agreement, the government did not want to impose overt measures that likely would cause disagreement within the trade pact, especially with neighboring countries. Thus, it was easier to delay processing of import authorization requests rather than overtly to go against the members of the custom union.

On the other hand, the government instituted a highly cumbersome system for individuals to buy U.S. dollars. Those needing to buy dollars in Argentina would have to go to the website of the country's Federal Administration of Government Receipts/Revenues (AFIP for its Spanish acronym), the institution that regulates and handles tax collections from businesses and individuals, and apply for them. More often than not, the AFIP rejected individuals arguing that they could not purchase dollars because the income reported by such individuals to the government was not enough to support the purchase of dollars. End of story.

This is not the first time that Argentina has had capital controls and a black market has developed.

Why has the government put this system in place? Basically, since the beginning of the latest capital control cycle a black, or illegal, market for dollars developed in the country and the spread between the official dollar quotation and the black market quotation had increased continuously as Argentineans wanting to buy U.S. dollars were turned down by the AFIP and had no choice but to buy dollars in the black market.[3] Furthermore, as the government was keeping the official value of the dollar cheap (compared to the black market) the individuals tried to attain "cheap" dollars if they could. This is not the first time that Argentina has had capital controls and a black market has developed. At the same time, because of high inflation and the devaluation of the peso, Argentineans have become accustomed to using U.S. dollars to avoid the inflation tax imposed by the central bank's printing of pesos. Thus, this time around they just went back to old habits. As the saying goes, "old habits die hard."

On Jan. 23rd, the day of the devaluation, the peso was trading close to 13.2 pesos per dollar on the "blue" market, while the official exchange rate pre-devaluation was close to 7 pesos per dollar. Dollar demand in Argentina is normally a seasonal event as Argentineans try to buy dollars for summer vacation travel. The summer season of 2013 was no different as the spread between the official exchange rate and the "blue" market exchange rate widened. However, this time the central bank did not like the values it was achieving and decided to abandon the defense of the currency at 7 pesos per dollar. The consequence was the peso dropped immediately from 7 pesos

[3] **Argentineans call this black market exchange rate for U.S. dollars the "blue" market.**

to 8 pesos and government policymakers, from the minister of the interior to the minister of economics, seemed uncertain in terms of the future steps regarding the exchange rate market.

Argentineans are now able to buy U.S. dollars as another instrument for individuals to save.

On Jan. 24th, the minister of the interior and the minister of economics appeared at a press conference and explained that Argentineans would now be able to buy U.S. dollars as another instrument for individuals to save. However, two or three days after saying that, the government backtracked somewhat and has qualified its position regarding the purchase of U.S. dollars. Now the following are the rules from the central bank and the AFIP: Argentineans will be able to buy U.S. dollars only if they earn 7,200 pesos per month (about $900 dollars per month according to the official exchange rate) or more and they will be able to buy up to a limit of $2,000 per month. However, there are several catches. First, individuals will have to keep the U.S. dollars deposited at the banking institution where they bought them at a special account and keep them there for one full year or pay the AFIP 20 percent as an advanced income tax payment, which may not be a bad idea to pay because inflation continues to affect the purchasing value of the peso and Argentineans could buy the dollars, pay the 20 percent advance tax and take the money out of the system. The second catch is that individuals cannot buy U.S. dollars with cash. Rather, they must use their bank accounts to purchase dollars. Third, the AFIP has limited the purchase/access to dollars to only 20 percent of the individual's declared income. So, while individuals can buy up to $2,000 dollars per month, the actual quantity of dollars they can purchase cannot surpass 20 percent of their income.

Furthermore, the latest commentaries from the minister of economics was that everyone who buys dollars will be investigated to see if they receive any type of government home subsidies on natural gas and electricity consumption. In this case, the government would eliminate the subsidies because it would conclude that households able to buy dollars would not need subsidies. These commentaries probably result from the fact that even these measures have not been successful in slowing the drainage of reserves.

Is Another Debt Crisis Brewing for Argentina?

While a balance of payments crisis is disruptive on its own, a large currency devaluation also limits the government's ability to pay its debt, especially if it is denominated in foreign currency, such as dollars and euros. Thus, a default on its debt, especially the one denominated in foreign currency remains a possibility, especially if the government is not able to access capital markets. Argentina's net public debt through the end of June 2013 was estimated at $80.4 billion, or 17.9 percent of GDP, according to government calculations. Of this debt, 80 percent was denominated in either dollars (57 percent) or euros (23 percent), which could be susceptible to default.

However, this is not the debt that is coming due. The financing needs to service this debt, (i.e., capital and interest coming due in 2014, including capital interests) is approximately $10 billion while it will increase to $13 billion in 2015.[4] In 2016, the picture improves a bit with only $5.8 billion, only to worsen again in 2017 with an estimate of almost $10 billion. That is, if the government cannot refinance, and has more and more difficulty getting access to financing, things could worsen. The problems will be worse if they are pushed by the market to devalue the currency even more. If the government is not able to access funding for refinancing, a new debt crisis is a definite possibility.

After the 2012 default on its debt, Argentina still does not have access to capital markets and this could make the devaluation even larger and the economic recovery much more difficult. As is always the case, however, the timing of events of this type is very difficult to predict.

[4] **"Evolución de la Deuda Neta del Sector Público Nacional," Oficina Nacional de Crédito Público, Ministerio de Economía, Obras y Servicios Públicos (MECON). Data until 06/30/2013.**

Conclusion

The Argentine economy is in the news again, and the picture going forward is not a bright one. The problems facing the country are proving difficult to overcome with the measures taken by the government. The loss of reserves, in terms of the level as well as the speed at which this loss has occurred, are a clear indication that the economy could suffer another balance of payments crisis that will necessitate a further devaluation of the currency, and a relatively severe contraction in economic activity. While the limited measures the government takes today probably will delay the day of reckoning, it will be difficult to avoid a balance of payments crisis in the near future if reserves continue to fall. Perhaps the harvest season will be good and exports strong, which will increase government coffers; but, these resources likely will not improve the situation. At the current juncture, there remains a notable risk that Argentina could repeat its crises of the past.

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