Political Risk Alert (4 Sep. 2019)

Willis Towers Watson

Argentina: Currency controls will not be enough to curb crisis
Event: The government announced currency controls on September 1.
Significance: The unexpectedly large margin of victory for opposition candidate Alberto Fernandez over President Mauricio Macri in the August 11 presidential primaries triggered a currency run and a sharp fall in international reserves. The government's subsequent announcement of a "voluntary reprofiling" of short-term debt was interpreted as a default, worsening investor expectations. With Macri now expected to lose the upcoming generation election, the debt crisis threatens the upcoming political transition. The gap of nearly two months before the scheduled polling day of October 27, and over three months until the next administration is due to take office on December 12, may leave the county without effective leadership for too long.
Analysis: The IMF gave strong political support to Macri's re-election effort: nearly 90% of the 57-billion-dollar stand-by loan was due to be disbursed before he left office in December. This would leave the next administration with virtually no new funds from the IMF, while debt repayments to the Fund will become increasingly burdensome from 2022.
Although the run on the currency and Standard & Poor's subsequent brief downgrade of Argentina's debt rating to 'selective default' came after Marci's poor showing in the August primaries, the drivers of the crisis were already in place before then.
Short-term debt repayments falling due before the Macri administration ends in December included dollar-denominated Treasury notes (Letes) totalling 9.8 billion dollars and peso-denominated paper (Lecap) equivalent to 3.5 billion dollars. The government's financial programme for 2019 assumed the rollover of 50% of the Letes due this year and when this was not possible, pressure increased on international reserves.
The peso plummeted from 46.5 to the dollar on August 9 to 57.3 on August 12, falling to a new all-time low of 62.2 on August 14. It subsequently recovered to around 57 to the dollar due to a 'political truce' between Macri and Fernandez and the central bank's announcement that it would intervene more actively in the exchange market to stabilise the currency. It has not done so earlier because it was constrained by the IMF deal, which sought to protect the stock of international reserves to guarantee debt-service payments.
However, a demonstration on August 24 by Macri's supporters prompted the end of the truce. Fernandez responded by meeting with IMF representatives and endorsing the stand-by agreement's broad goals of promoting growth and job creation, cutting inflation and lowering debt. Crucially, however, he said that Macri had not achieved these goals with the IMF funds but instead exacerbated the economic crisis, in part by helping to finance capital flight.
Fernandez's team denied rumours that his economic advisers had urged the IMF not to make the 5.4-billion-dollar disbursement expected in September. Despite the denials, the rumours raised fears that the IMF would not make the disbursement and, in this context, fuelled concerns about the government's ability to roll over debt due on August 30, triggering a new currency run in the last days of August. The peso fell from 57.2 to the dollar on August 26 to 60.2 on August

28, by when the central bank had spent 365 million dollars to defend it. International reserves fell by 11 billion dollars in during August, reaching 56.9 billion on August 28.
The rapid fall in international reserves led the central bank to announce that bank lending to major agricultural exporters would be capped at a total of 1.5 billion pesos, a move meant to encourage exporters to sell their export earnings on the local market and thus increase the exchange supply.
At the same time, the tender to roll over short-term Treasury paper (1.6 billion dollars of dollar-denominated Letes and 67 billion pesos of peso-denominated Lecap) scheduled for August 27 had to be cancelled, given the high interest rates demanded by investors. This triggered the decision to 'reprofile' debt maturities.
Hernan Lacunza, the new economy minister who had replaced Nicolas Dujovne following the latter’s resignation on August 17, announced that he planned to extend maturities of debt worth around 107 billion dollars, including 13 billion of short-term debt, 30 billion dollars of debt issued under foreign law, 20 billion of debt issued under domestic law and 44.5 billion owed to the IMF. The reprofiling, which will postpone repayments by 3-6 months, was initially expected to affect only institutional investors. Lacunza also announced that he would send to Congress a bill to encourage a voluntary debt swap for debt issued under domestic law.
Although S&P has now raised Argentina's rating from 'selective default' to CCC-, Moody's has cut its rating from B2 to Caa2 and Fitch has categorised short-term debt as in 'restricted default'. Moreover, the prices at which bonds are currently trading suggest that investors anticipate that any restructuring will involve a 'haircut'.
The government believed that limiting the reprofiling to institutional investors would protect small investors. However, the main investors in mutual funds are small savers and local businesses which, affected by the combined effect of recession and inflation, use mutual funds to protect their working capital.
On August 29, so many investors attempted to withdraw their funds that many mutual funds were forced to suspend withdrawals, putting some companies' payments at risk. In order to provide liquidity to investment funds and reduce small investors' fears, the central bank said that it would buy back Treasury notes so that funds are able to face potential withdrawals.
Although the measures implemented in recent days sought to restore confidence, in practice they have backfired. The currency run accelerated, and on August 30 the stock of international reserves fell by 2 billion dollars, driven by the central bank's intervention in the exchange market and by small investors' withdrawals of dollar-denominated bank deposits.
The central bank has responded with yet another measure to protect international reserves, saying that foreign-owned banks must now seek its authorisation to transfer profits abroad. On September 1, the government extended this provision to all companies, not just banks. Exporters will now be required to repatriate all export earnings; all companies and banks must be authorised to sell pesos for hard currency; and individuals will not be able to purchase or transfer abroad more than 10,000 dollars per month.
Looking ahead: With Macri now a lame duck, the government has virtually no prospect of surmounting the current crisis of confidence, and further controls appear inevitable. The financial crisis will delay any economic rebound and worsen social indicators. The next government will have to renegotiate the 2018 stand-by agreement with the IMF, as well as debt with private creditors.
