



PERSPECTIVE

A New Era for Argentina

May 12, 2016



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My colleagues and I recently visited Argentina, which is undergoing a transformation after last year's election ousted President Cristina Fernández de Kirchner, the wife of the previous President Nestor Kirchner. The center-right opposition candidate Mauricio Macri's win with his "Let's Change" slogan ended a regime that brought high inflation, dollar shortages, an erosion of foreign reserves, and government actions that undermined business confidence and limited access to international capital markets. Taking office in December, President Macri appointed a skilled technocratic team promising to improve the economic situation in the country, which the financial markets have welcomed.

Soon after the new government took office, rating agencies upgraded their outlook for the country from negative to stable as a result of the swift changes from the previous government's economic policies, including the elimination of currency controls and the reduction of exporting tariffs. These actions indicated the new government was rejecting the public-sector interventionism that hurt exports and reduced foreign-exchange earnings. Even more important than this vote of confidence was the ability of the new government to reach agreement on defaulted foreign debt the prior administration had refused to pay and had locked the country out of the international debt markets.



Obelisco de Buenos Aires (Obelisk of Buenos Aires) in Plaza de la República, Buenos Aires, Argentina – national historic monument and icon commemorating the fourth centenary of the first foundation of the city.

In March 2016, Macri was able to obtain approval from Argentina's Congress to reach an agreement settling a 15-year dispute with "holdout" hedge funds that owned substantial amounts of the debt. The Argentinian government issued US\$16.5 billion in debt, with US\$9.3 billion allocated to settle with holdouts, US\$2.5 billion to pay blocked restructured debt which was performing until 2014, and the remainder to be used to finance part of the fiscal imbalance during the 2016 fiscal year. Argentina's return to the international capital markets should be considered a major triumph and was extremely well received by investors; its bonds were oversubscribed.

It was remarkable that congressional approval was obtained, since Macri had won the presidential election by a margin of less than 3% nationally. Thankfully, Macri moved fast and immediately lifted capital controls, raised interest rates, liberalized the foreign-exchange market and cut export taxes. He still faced the problems of small and falling international foreign reserves, a bloated public sector, a fiscal deficit of 7% of gross domestic product (GDP) and a wage price spiral, but the global community has by and large welcomed Macri's policies. The Chinese had previously engaged in a currency-swap deal with the cash-strapped Argentinian government, giving them renminbi in exchange for Argentine pesos so the country would have Chinese currency to pay for Chinese imports, while the Chinese could use pesos to import the raw materials that Argentina produces. Under the new administration, the People's Bank of China stated that the swap could be converted into US dollars, which would add US\$11 billion to Argentina's central bank assets.

Signaling another boost of confidence in Argentina, US President Barack Obama made an official visit to the country in March after Macri took office. Obama praised the speed at which reforms were being made and signed a trade and investment framework agreement to cooperate in a number of areas, with the hope that US companies would add billions in investment dollars to Argentina's economy.

Short-Term Pain for Longer-Term Gain

When a populist, high-spending government leaves office, the need for reform results in short-term pain, since the debts generated by the previous government have to be paid. It's like a hangover after a big party. So it was no surprise to me that when we arrived in Argentina this spring that the English-language *Buenos Aires Herald* newspaper had the headline: "Electricity rates may jump by 300%." The article said that President Macri's administration had paved the way for increases in the wholesale prices of power nationwide that would mean a cut in subsidies for users, particularly in the Buenos Aires area, who had enjoyed the lowest electricity rates in the country. This would be positive for the government's budget, which has been drained by those subsidies, but also for electric power companies that had to share in the pain. This reform should enable power companies to increase capital spending and enable a reduction or even elimination of blackouts and brownouts, which have been experienced in recent years. We witnessed one case of a brownout when we traveled to the outskirts of Buenos Aires to visit one of the new shopping malls. On the way there, one whole section of the city was dark because of a cut in power for that area.



Puente de la Mujer (Women's Bridge) in Argentina.

When I first visited Buenos Aires in the 1990s, the Puerto Madero area was a rundown collection of derelict warehouses along the canal connected to the Rio de la Plata (Silver River). In 1989, city and federal governments formed a joint stock company to urbanize the area, which led to a major restoration and conversion program, which included transforming the old warehouses into trendy restaurants, offices and apartments. The place blossomed, further resulting in entirely new developments of high-rise apartments and office buildings along the river canal. With good city planning, a network of wide roads and picturesque riverside walkways was developed. A number of architects were involved in creating beautiful structures, including my favorite architect, Santiago Calatrava, who designed an ultramodern pedestrian bridge, the Puente de la Mujer (Women's Bridge), which swings to the side allowing ships to pass. In 2008, the heir to a cement fortune and reputedly Argentina's richest woman, Amalia Lacroze de Fortabat, financed the construction along the canal of a beautiful museum housing her extensive art collection. When I visited, I found it to be quite an impressive collection, particularly of Latin American art. More international hotels are currently planned for the area.



Visiting a high-end shopping mall in Buenos Aires, Argentina.

On my most recent trip, the first thing I noticed when driving from the Buenos Aires airport to the Puerto Madero area was a tall, modern skyscraper at the end of the port channel with large logo initials of a Chinese bank at the top. The influence of China has been growing in Latin America and globally. Argentina has imported substantial amounts of telecommunications equipment from the likes of Huawei, China's electronics equipment giant. Discussing this with the Argentinian telecom companies during our recent visit, we heard that the Chinese payment terms and conditions were very generous and that large teams of Chinese technicians were brought in to do the maintenance, which was deemed as superb.

A Legacy of Mismanagement

In our view, one of the key reforms going forward for Argentina will need to come from the country's statistical agency. The Kirchner government had fired the head of the agency when she issued (accurate) inflation numbers of over 20% and installed a new agency head to issue false inflation numbers and other inaccurate information. The Kirchnerist policy mismanagement also banned the export of meat in an attempt to protect domestic consumers and keep prices down, but this policy forced many companies that had lost overseas profits to close. At the same time, since it was not profitable to invest in new cattle, the stock of cattlehead declined from 60 million heads in 2006 to 52 million by 2012. This Kirchnerist policy actually created the opposite effect that it originally intended, and prices skyrocketed.

Labor, an issue deeply related to inflation, remains a challenge for Macri's administration today. The new government wanted to make the 2016 inflation target of 25% the benchmark for wage negotiations, but leaders of the powerful General Confederation of Labor warned that they expected wage increases in 2016 to be at least 30%, the number that they considered the real inflation rate. This put the Macri government in a bind, since wage restrictions were part of the administration's promise to rein in inflation. The labor unions were concerned about the surge in inflation coming from the peso depreciation in addition to job losses in the oil industry. Ever since the Kirchner administration forced the government statistical agency to issue false inflation data, there has been mistrust in the official numbers. Another problem facing Macri is that traditionally, labor unions were aligned with the opposition Peronists instead of Macri's center-right Republican Proposal Party. Additionally, thousands of public employees hired by the previous administration have been dismissed, but many are still receiving salaries without having to show up for work.

Taking a walk from our hotel to the business district, we saw signs of the Kirchner heritage's ability to survive even though she is no longer in power. At the time when Argentina was one of the world's wealthiest countries, construction started in 1908 on an elegant French Second Empire-style building designed by a French architect as a post office. At the time of its dedication, the huge eight-story building with a floor area of 88,050 square meters (947,800 square feet) was considered the largest in Latin America. The building is lavish with marble all over, stained-glass windows, many bronze sculptures and a four-story-high domed ceiling. The grand setting led President Juan Perón to move his offices into the building during the early years of his 1946-1955 reign, and his First Lady, Eva Perón (remember "Don't Cry for Me, Argentina"), assigned one wing as the first headquarters of the so-called charitable Eva Perón Foundation. Former President Cristina Kirchner had the building fully restored and renamed it the "Kirchner Centro Cultural," which is carved in stone at the top. It includes a concert hall, five other auditoriums for theater and concerts, 18 halls for other performances and events, 40 rooms of art and history galleries, 16 rehearsal rooms and two rooftop terraces. When I entered the building and went to the counter where a young man and woman were sitting, I said what I wanted to see, but the man answered that it was closed. When I asked why, he said matter-of-factly: "There has been a change in the government." Nevertheless, outside on the curb were painted stenciled signs with a profile of Mrs. Kirchner and the words in Spanish translating in English as, "I will be back."

A New Era for Argentina

In an effort to dismantle the structure of corruption left over from the Kirchner era, the new government took action to block money allocated for infrastructure projects in a number of provinces due to the lack of transparency on contracts signed by the previous government. Audits showed that in some cases 80% of the payments for some projects were made despite the fact that only 10% of the work was completed. The audits would impact major projects such as two hydroelectric dams being built by Chinese companies at an estimated US\$5 billion in a Kirchner stronghold province.

Besides demystifying the Kirchner heritage, another challenge is the issue of tax sharing between the federal government and the provinces. After the election, Argentina's Supreme Court ruled it was unconstitutional for the federal government to take a 15% greater share of its tax-sharing agreement with the provinces, a practice in place since 1992. This meant that the federal government would have additional budget constraints and would be liable to repay billions that had been withheld in previous years.

The issue of law and order is another legacy of the Kirchner administration that the new government has to grapple with. In December 2015, three convicted murderers in a high-profile case escaped a Buenos Aires province prison. That, along with a rising crime wave, resulted in criticism of the Ministry of Security and the police in general, and the rising belief that there were direct links between criminal networks, the police and politicians. Since Argentina has good ports and infrastructure, drug traffickers were relocating from Colombia and Mexico using Argentina as a transit point for trafficking cocaine to consumer markets in North America and Europe. When he entered office, President Macri declared a 365-day nationwide state of emergency and outlined a new security policy, including increased control at entry points to prevent transport of drugs, and renewed international cooperative efforts (specifically with Israel) on security and defense technology.

On a more positive note, the change in government was good news for Argentina's major media group, which had been battling with the Kirchner administration and had been subject to laws and regulations designed to break it up. Now the group has the ability to expand and consolidate its media empire to offer a full range of so-called "quad play" services (wireless, TV, Internet and home phone services), newspapers and magazines, free-to-air television, Internet broadband, telecommunications and cable). We had visited the group in the dark days, when the Kirchner administration was attacking it and even going as far as sending gangs of political agitators to break into their offices and disrupt their operations. This time when we arrived at their offices, the executives were in much better spirits, and the company is a strong political and social force.

We also visited a steel producer located in Argentina. The officials there mentioned that Mexico was a particularly important market because of its large manufacturing base for automobiles—which has been increasing. In 2015, Mexico's production of vehicles reached 3 million units and is expected to reach more than 5 million units by 2020.¹ The challenge, of course, was coming from China where steel was being sold at a far lower price than US steel. They said that it was important to protect local markets with anti-dumping duties which were being put into effect, although lower steel prices weren't negatively impacting all of their operations. We discussed the situation of China's steel industry; roughly half of the world's output of steel comes from China, and issues of excess capacity have caused some plants there to close, but there has been tremendous resistance to putting people out of work. I had to laugh when one of the officials at the steel company told me he heard in one case, the Chinese government sent an executive to close down a plant in one of the provinces and the workers threw him out of the window, a story which I certainly can't verify!

Visiting a company that makes seamless steel pipes mainly used in the oil industry, it was not a surprise to hear of a decline in demand in the United States and Canada and subsequent increase in inventory amid the oil price drop in 2014-2015. While they felt certain a large part of production would be taken out of the market with continued low prices, they believed their business would recover as oil prices recovered.

Experiencing Nearby Sights—and Currency Challenges

Over the weekend, my colleagues and I took a short ferry trip to Colonia del Sacramento, Uruguay, right across the Rio de la Plata. When we went to buy tickets for the Buquebus (the Argentinian ferry operator), the teller said they would not accept local peso currency—only US dollars. After discussing some other exchange-related anomalies, we proceeded to Colonia, one of the oldest towns in Uruguay developed on a peninsula that protrudes into the river. It is renowned for its historic quarter, a UNESCO World Heritage Site. It's a popular tourist attraction for visitors from Buenos Aires, and there is frequent ferry service between the two cities, with fast ferries completing the journey in less than an hour. The historical section of Colonia, which has some cobblestone streets built by the Portuguese in the 17th century, is within walking distance of the ferry terminal. The ferry company operates services from Buenos Aires not only to Colonia but to Montevideo, Uruguay's capital, entry to the famous summer resort area of Punta del Este.

Renting a bicycle, I enjoyed the opportunity to soak up some sun and local sights along the coast. We were encouraged to see many vacationers and bustling traffic. Overall, our visit to Argentina confirmed our views that its economy was gradually on the recovery path—and I believe if the pace of reforms continues there, Argentina's turnaround could be even faster than expected.

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1. Source: Mexican Auto Industry Association (Asociación Mexicana de la Industria Automotriz), based on 2014 data. There is no assurance that any estimate or forecast will be realized.