RBC BlueBay Asset Management

Polina's Perspective:

Argentina - living on the edge!

For professional investors only | Marketing communication

Polina Kurdyavko
Head of Emerging Markets
RBC BlueBay
Asset Management

Published September 2023

"Last week, I was in the Andean region visiting Chile, Peru and Argentina – a good contrast between the first two countries that 'live within their means' and the latter with a 'spending addiction'."

Are you a big spender? When it comes to spending, I always remember my mother's advice: "live within your means". In emerging markets (EM), most countries that follow this basic rule do well in the long term.

Given limited options with respect to lenders of last resort and the risk of a confidence crisis associated with printing money, most EM countries can't afford to maintain the indebtedness and fiscal burden assumed by their developed markets (DM) counterparts.

A democratic regime puts more challenges on EM governments to strike a fine balance between the electoral campaign when they are 'capturing the hearts' of their citizens and the 'having a relationship' stage when they must implement a less popular reform agenda and fiscal austerity. Even if it yields benefits in the long term, the latter stage requires courage and commitment. Not taking this difficult step can quickly lead governments to the trap of overspending. Last week, I was in the Andean region visiting Chile, Peru and Argentina – a good contrast between the first two countries that 'live within their means' and the latter with a 'spending addiction'.

Chile and Peru are steadily improving

Both Chile and Peru have improved their credit quality over the last 30 years. Chile's Moody's credit rating has been enhanced by three notches from Baa2 to A2. Meanwhile, Peru has achieved a seven-notch upgrade over the same period, raising its credit rating from high yield (B2) to investment grade (Baa1). These countries' spending patterns have been disciplined and bided by a tight fiscal rule. Even though both countries have gone through political turmoil over the last few years, the strength of the institutions has prevailed and kept the policy agenda and the spending discipline in check. Moreover, despite the potential growth rate halving over the last ten years, Chile and Peru's sovereign spreads are trading close to historical tights, reflecting their solid sovereign credit quality.

The same is true of some of the corporate stories. Even in the mining sector, some top corporates in Chile are being rewarded by investors for keeping prudent leverage matrices while leading the initiative on improving environmental risks in the industry and reducing carbon emissions. This is not to say that the countries don't have challenges.

Peru, for example, has struggled to implement infrastructure investments in the country. The challenge is raising the funds and spending them effectively due to corruption and lack of qualified resources. These problems also stem from Peru has one of the world's highest rates of informal employment, at 70%. While these issues are structural, they impact future growth and equity valuations more than credit quality and spreads.

Argentina is spending beyond its means

The same cannot be said about Argentina. It is classified as a high-income country by the World Bank, with an average GDP per capita of USD10k. Yet, Argentina's credit rating has deteriorated by five notches since 2001, from B2 to its current Ca rating. The country has continued to spend above its means for the last ten years, with the annual budget deficit jumping by 4% compared to the previous decade. This, combined with rigidity and indexation of the economy following a decade of both Kirschner governments, has increased inflation tenfold from 10% to 113% today. We also saw that the gradual approach of the previous market friendly Macri government, known as 'El gradualismo', failed in addressing either inflation or overspending.

Looking at the candidates ahead of the upcoming October presidential elections, it is unclear if they are willing to make difficult decisions. So far, the focus has been on winning the public's hearts. The three candidates - Patricia Bullrich from Macri's party Cambiemos, a radical libertarian Javier Milei and Sergio Massa from the incumbent Peronist party have all acknowledged the need for fiscal adjustment to varying degrees. Even the electorate seems to support candidates calling for radical action. However, history in Argentina has shown that when the time comes to execute the tough measures, successive governments have been unable (or unwilling) to follow through, especially given the potential risks around governability and social unrest.

What is the right path to help Argentina exit from crisis? When I arrived in Buenos Aires, one of my favourite cities, it felt as joyful and seductive to its visitors as before. The city was buzzing, restaurants were full, and the word 'crisis' didn't fit into this narrative until I tried exchanging US dollars. This was when I discovered that the exchange rate was heavily dependent on the amount I would exchange. I was offered the official Argentine peso (ARS) FX rate of 350 per USD for a small number of dollars and the black-market rate of 750 for a much larger amount.

Printing money is not working

Argentina is addicted to spending. The country has restructured its debt twice in the last two decades despite receiving USD50bn from the International Monetary Fund (IMF) just months before its second default in 2019. Even with the IMF program following the restructuring, the country still managed to overspend by increasing its monetary base by 18%, i.e., printing money to fund negative primary fiscal deficits over the last four years. This vicious circle of overspending translates into hyperinflation, loss of confidence in the currency and more challenges ahead.

Is the country better off by addressing the hyperinflation problem first? Candidate Milei proposes dollarisation as a solution. Fiscal austerity is a necessary condition for dollarisation to be sustainable, but can the political system deliver it? While a radical concept of dollarisation is appealing to some, the key risk lies in the cost of implementation. After Milei's victory in a primary election in mid-August, the currency devalued by 20% within a couple of days. The confidence crisis is so deep that further stress could cause a run on the banks, which could translate into a banking crisis. There is also a cost to dollarisation. With a monetary base of ARS8tn and local deposits of ARS12tn, using an ARS/USD rate of 500, Argentina would need USD40bn to make the swap. Given Argentina's central bank has negative net foreign currency reserves of USD7.9bn, it's unclear who could provide this dollar liquidity.

As for the other two candidates, their respective parties' failure to deliver in the past on their objectives doesn't fill one with confidence in their future delivery. The current pricing of sovereign bonds would suggest that the market is sceptical of the government's ability to deliver. And one could argue that a fair bit of bad news is in the price.

In the future, the market will need to see evidence of the commitment and delivery from the new government. This will determine whether Argentina's sovereign debt continues to trade within a distressed price range or can finally leap into sustainable debt territory.

I believe the only way to fix Argentina's problem is to truly commit to stopping overspending. This will cause pain for citizens in the short term as the discrepancy between the cost of living and salaries will grow even further. But it would also set the base for a long-term structural change in the economy. The country is going through a deep confidence crisis, with only 3% of its monetary base in circulation. With this level of fragility, accidents are more likely to happen.

This year, the country has been particularly unlucky with droughts that subtracted 2.5% of GDP. Still, the hopes for an increase in gas exports of USD25bn can also quickly vanish if the currency crisis puts 'capital expenditure' investments on hold. Argentina's new government and its people must fully commit to taking the tough medicine to exit this vicious circle of living on the edge. It's decision time.

This document is a marketing communication and it may be produced and issued by the following entities: in the European Economic Area (EEA), by BlueBay Funds Management Company S.A. (BBFM S.A.), which is regulated by the Commission de Surveillance du Secteur Financier (CSSF). In Germany, Italy, Spain and Netherlands the BBFM S.A is operating under a branch passport pursuant to the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC) and the Alternative Investment Fund Managers Directive (2011/61/EU). In the United Kingdom (UK) by RBC Global Asset Management (UK) Limited (RBC GAM UK), which is authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). In Switzerland, by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. The place of performance is at the registered office of the Representative. The courts at the registered office of the Swiss representative or at the registered office or place of residence of the investor shall have jurisdiction pertaining to claims in connection with the offering and/or advertising of shares in Switzerland. The Prospectus, the Key Investor Information Documents (KIIDs), the Packaged Retail and Insurance-based Investment Products - Key Information Documents (PRIIPs KID), where applicable, the Articles of Incorporation and any other document required, such as the Annual and Semi-Annual Reports, may be obtained free of charge from the Representative in Switzerland. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Asia, by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong. In Australia, RBC GAM UK is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, by RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US"), an SEC registered investment adviser. The entities noted above are collectively referred to as "RBC BlueBay" within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of RBC BlueBay by the respective licensing or registering authorities. Not all products, services or investments described herein are available in all jurisdictions and some are available on a limited basis only, due to local regulatory and legal requirements.

This document is intended only for "Professional Clients" and "Eligible Counterparties" (as defined by the Markets in Financial Instruments Directive ("MiFID") or the FCA); or in Switzerland for "Qualified Investors", as defined in Article 10 of the Swiss Collective Investment Schemes Act and its implementing ordinance, or in the US by "Accredited Investors" (as defined in the Securities Act of 1933) or "Qualified Purchasers" (as defined in the Investment Company Act of 1940) as applicable and should not be relied upon by any other category of customer.

Unless otherwise stated, all data has been sourced by RBC BlueBay. To the best of RBC BlueBay's knowledge and belief this document is true and accurate at the date hereof. RBC BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. Opinions and estimates constitute our judgment and are subject to change without notice. RBC BlueBay does not provide investment or other advice and nothing in this document constitutes any advice, nor should be interpreted as such. This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product in any jurisdiction and is for information purposes only.

Published September 2023

RBC BlueBay
Asset Management