For Those of you Wondering What's Happening with Argentina's Economy

If you live in Argentina, odds are you've had a nasty week. Multiply that by 10 if you work for the government. Whether you're a student, here for work, or even just traveling around, this week has been marked by bad economic news and negative predictions for the future.

And yes, it feels like yesterday that the country was celebrating Macri's *Cambiemos* party's overwhelming success in the midterm elections and lauding indications that inflation was abetting and Argentina was set to be on the receiving end of significant institutional investment from the likes of Blackrock and J.P. Morgan.

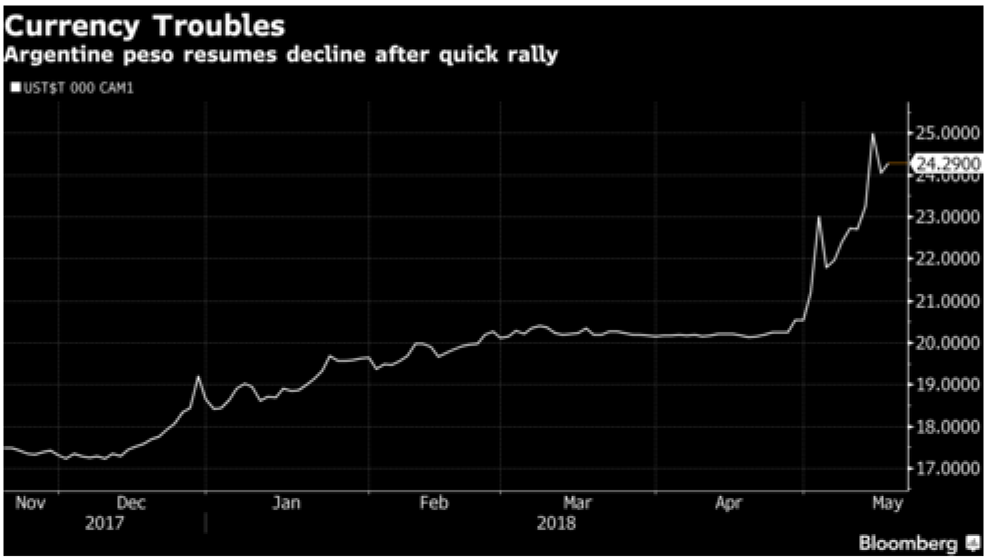
It looks like that pretty picture is not to be, at least in the next few years. The worst part about it is that this time, it's not directly Argentina's fault.

As much as everyone is enjoying spewing the same tired reiteration of an ideologically-based argument pontificating that Argentina just needed some orthodox shock therapy and an austerity program, that's simply not true. This administration inherited an economy that was in tatters and suffering from a decade of blatant "kleptocratic" theft, mismanagement, and misappropriation of public funds. To let it burn to the ground (literally, not figuratively) was neither a responsible nor intelligent option. Economies are not phoenixes. The free market does not magically fill power vacuums with rainbows and fairies and jobs and competition. Rather, power vacuums and poverty are the breeding ground for corruption and dictatorships.

So now that I've gotten that out of the way, let's take a look at what has happened so far, and what are the likely outcomes going forward.

1. The peso, the dollar, and other "too sensational" foreign exchange-related matters

In the last two weeks, the Argentine peso has lost 15 percent of its value against the US dollar, falling from about 20 ARS/USD to 25 ARS/USD. It has snagged the much-coveted Bloomberg "worst performer" award so far in 2018 having lost 23 percent of its value vis-à-vis the US dollar.



I've gotten a lot of questions about why Argentines are so concerned (and even obsessed) with the US dollar.

It's not so much the dollar (or any other currency) for that matter. It's the stability it represents. For all emerging markets, the **value** of the local currency against the dollar is a tangible, quantifiable, visible bellwether for how the economy is doing. It says what are we worth against a "basket" of basically everything else in the global economy. You don't need a degree in economics to not only comprehend that concept, but to really feel it. The **speed** with which that value can move is an equally reliable metric for how much control your leadership has over your basic wellbeing.

So when you see words like "lurch" or phrases like "death spiral," rather than picture the handy graph I've included above, pretend it's your ability to clothe or feed yourself and your family. The wiggly lines on the graphs showing you information about emerging markets represent economic actors, or in layman's terms, people.

The peso's rapid and relatively unanticipated (at least the timing) trip south is what we see that reflects the areas explained below. For today, lump inflation in with the peso's plunge.

2. Fiscal (and other) Deficits

It's tempting to treat Argentina's current predicament as textbook. Indeed, critics and supporters agree on quite a few metrics - the disagreement stems from their interpretation and context.

So let's start with the fiscal deficit. A fiscal deficit means when a government spends more than it generates in revenue, or what they collect in taxes. The difference between spending and revenue comes from borrowing money by issuing debt in the form of bonds. Argentina has issued US dollar denominated bonds (foreign currency debt) and Argentine peso denominated bonds (local currency debt).

The fiscal deficit can be measured in absolute terms (how much sweet cash) or relative terms, for example as a percentage of the economy as a whole as represented by the Gross Domestic Product (GDP). The portion of the fiscal deficit made up of foreign currency debt is of concern more immediate to economic stability. Why? Because Argentina needs US dollars to support it.

Also relevant but different is the trade deficit, or the difference between imports and exports. While the causes are different, the result of needing US dollars to support it is similar enough. In 2017, Argentina's trade deficit totaled US $8.5 billion - and there are two ways to make this number smaller. Either import less or export more.

While the fiscal deficit was an area everyone has been keeping their eye on, it was not considered a knife edge over which to plummet until...

3. External Shocks

Argentina was able to rack up aforementioned fiscal deficit because the developing world has been more than willing to lend emerging markets a bunch of money for the last decade because interest rate paid on similar debt issued by low-risk countries such as the US has been close to zero. So investors have been willing to take the risk on countries like Argentina by offering between 5 and 8 percent. As the US starts to raise rates, investors choose to forego the emerging market risk and take their money back to safer seas.

This has a reinforcing cyclical effect on emerging market currencies. As more and more investors pull out, the worse emerging markets perform, and the greater the incentive to get out. You can read more here. It's basically pre-school. Everything you need to know about the global economy you learned playing "hot potato".

4. Monetary Policy (or all things Central Bank)

A Central Bank tries to nudge the economy by issuing bonds, buying and selling bonds, setting the interest rate, and buying and selling foreign currency reserves. They measure the relative effectiveness of these actions by looking at changes in the exchange rate, inflation, and other measure related to the money.

The last two weeks Argentina's Central Bank the BCRA has kicked into overdrive - it just hasn't been very effective. This week on Tuesday they rolled over US $30 billion of expiring notes, and the finance ministry sold US $3 billion in local bonds. They've sold US $8 billion or so in foreign reserves. For now the peso has leveled out around 25 ARS/USD, but the reality is that if the global economy is a majestic stallion, the Argentine Central bank is a horse fly. It can buzz in ears and sting exposed sensitive spots, but if that horse decides to run it doesn't have meaningful scale in the global context.

5. Fiscal Policy (or what Congress does)

It's up to Congress to decide how much money to spend, where, and how much to charge who in taxes. Two weeks ago, the government lowered the primary fiscal deficit to 2.7 percent of GDP by slashing the spending budget for public works. While this will lower the fiscal deficit, it does so at the expense of economic growth, as the people who were going to build the roads, bridges, etc. will now be out of a job, less concrete and steel will be required, and so on and so forth. A smaller economy also means there are fewer taxes that will be collected. While it may be an oversimplification, think of these equations:

$$Economy\ Size = Consumer\ Spending + Investment + Government\ Spending$$

We've basically already conceded that investment in Argentina is on the down and out. Consumers are losing purchasing power hand over fist so they won't be running out to stock up on goods. The government is reducing spending to reduce the fiscal deficit so the country doesn't go bankrupt and have a crisis.

$$Fiscal\ Deficit\ (GDP\%) = \frac{Government\ Spending - Tax\ Revenue}{Economy\ Size}$$

Ladies and gentlemen, we have a recession. And if you're doing the math at home (good for you), you'll notice that by reducing government spending, tax revenue and the economy size will also go down, so while reducing government spending is necessary, it's not a simple one to one pass through relationship

6. Does Anyone Still Like Argentina?

Yes. Franklin Templeton is a big investment management company with significant holdings in Argentina and other emerging market bonds. Rather than scurry out of Argentina, this Tuesday they bought US $2.3 billion more of bonds denominated in Argentine pesos via the Templeton Global Bond Fund. This was done by a "reverse inquiry" made by funds run by Franklin Templeton.

While this is certainly not a bad sign, Templeton holds more than 40 percent of all of one of the kinds of bonds that Argentina reissued this week so it's possible they're past the point of not crying over spilt milk at this point.

7. Christine Lagarde & The IMF

Treasury Minister Nicolas Dujovne is negotiating a stand-by arrangement of US $30 billion with the International Monetary Fund, which is drudging up a lot of horrific memories among Argentines who remember what happened in 2001, the last time the IMF dipped its toe into the mix down here. Back then, the IMF tied financing to harsh conditions to reduce spending referred to as "austerity".

If you're about 17 seasons behind on your history reading, **spoiler alert** it failed spectacularly and the peso actually crashed and (figuratively) burned.

The IMF was literally created by the global community in the wake of World War II as part of an effort to remove what were considered preconditions that lead to war - including economic crises

The IMF has publicly released statements that they back Macri, they want to conclude talks as soon as possible, and the issue will be discussed today (Friday) at an informal meeting. They've openly confirmed that they encourage the peso to float. Clearly they missed the mark on how they've been quantifying and monitoring Argentina's risk situation, but that's not irreparable.

This is what they've been preparing for since the global crisis in 2001 pushed global interest rates near zero. The day of reckoning has arrived and Argentina is a test. And if it doesn't turn out well for Argentina, it's not good news for the rest of the emerging markets who will feel the same bite if the US continues course.

8. So what should I do?

Read The Bubble.

I kid, but this situation has far from reached a stable resting point. Uncertainty abound, the best move is to update your opinions as new information becomes available. This article and anything written by the author will provide meaningful insight.

Argentina is not a perfect country by a long shot, and it's economy is not the best foot to put forward. The political risk is more imminent than the economic risk. Unless the world really has gone mad, it would be detrimental to global economic stability for the IMF and other international institutions to leave Argentina to reap the consequences of a being unable to right decades of economic mismanagement in two years.

Of course the IMF led coalition has a responsibility to create conditions that will enable Argentina to pay these loans back and emerge from this crisis-cumrecession. I hope these include pushing the more politically contentious bureaucracy reduction, labor, and union-related reforms across the line where Macri has been unable to succeed, to really create the preconditions for direct investment and business linked economic growth.

This isn't the time or the place to make moral judgements rooted in a sort of protestant work ethic- related ideological conception of how economies should function. Reality is messy and economic reset buttons don't exist, and *ad hominem* diatribes on what Macri should have done are cheap.

Argentina in the past two years has done a very good job facing up to a number of extremely tough realities. If Macri and his team continue to do so over the next 18 months, they will leave Argentina better than they found it.

Whether they're loved or despised as a result remains to be seen.