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Argentina legislative elections: is the continuity of the pro-business direction at stake?

Since Mauricio Macri took office in mid-December 2015, the economy has started to recover. The exchange rate was liberalised during Macri's first week in office, price controls were removed, import barriers were lifted, discredited national economic statistics were revamped, subsidies were reduced and the holdout saga was finally resolved in April 2016. The last of these measures allowed the country to regain access to the international financial market after a hiatus of 15 years. Coface subsequently upgraded Argentina's country assessment to B¹ in December 2016. The positive trend did however come, as expected, with short term side effects. Inflation picked up to 41 % in the end of the first year of government, reducing household purchasing power and leading the economy into recession (GDP -2.2 % in 2016). Social protests flourished in response.

The recovery could, however, be nipped in the bud by renewed political uncertainties against the backdrop of the legislative elections to be held on October 22 2017. The government is therefore in a rush to show that the economy is rebounding. This has taken longer than the ruling government expected, although activity is finally gaining strength (GDP + 1.6 % in the first half of 2017 on a yearly basis). A takeoff in the rebound will be subject to the outcome of the upcoming midterm elections. Linked to this, investors became more cautious on the country's medium term political prospects, after former president Cristina Kirchner announced that she would run for the Senate in the province of Buenos Aires. The upcoming elections that will renew one third of Senate and half of the Lower House will be an indication of the potential outcome for the 2019 presidential race. If Kirchner succeeds in gaining a positive outcome, she may try to return to *Casa Rosada*, thus putting the continuity of the pro-business direction at stake. On the other hand, if the government's coalition returns a good outcome, this would raise its political capital for passing reforms through Congress.

1 - Coface country risk assessment has 8 grades:
A1 - very low, A2- low, A3 - satisfactory, A4 - reasonable, B fairly high, C -high, D - very high and E - extreme.

A new economic growth engine for Argentina

After contracting by 2.2% in 2016, activity has shown improvements in 2017. According to the National Statistical Institute Indec, GDP grew by 2.7% year-on-year in the second quarter of 2017. This represents not only an improvement compared with the 0.4% hike registered in the previous quarter, but also the best performance since the fourth quarter of 2015. Breaking down the GDP, investments rose by 7.7% year on year in the 2Q2017, higher than the performance achieved by household and public consumption. The latter two components expanded by 3.8% and 2.9% respectively, using the same basis for comparison. External trade, on the other hand, contributed negatively to activity. Boosted by the recovery in internal demand, imports rose by 9.1% year on year in terms of volume, against a drop of 1.2% in exports. GDP subsequently grew by 1.6% year on year in the first half of 2017.

Leading indicators suggest that GDP gained further strength during the third quarter of the year. According to the monthly activity estimator from the National Statistical Institute Indec, the economy expanded by 4.9% in July 2017 (*chart 1*). Moreover the GDP proxy, developed by consulting firm OJF, registered a hike in activity of 5.1% in August 2017 (year-on-year).

CHART 1
Monthly Activity Estimator

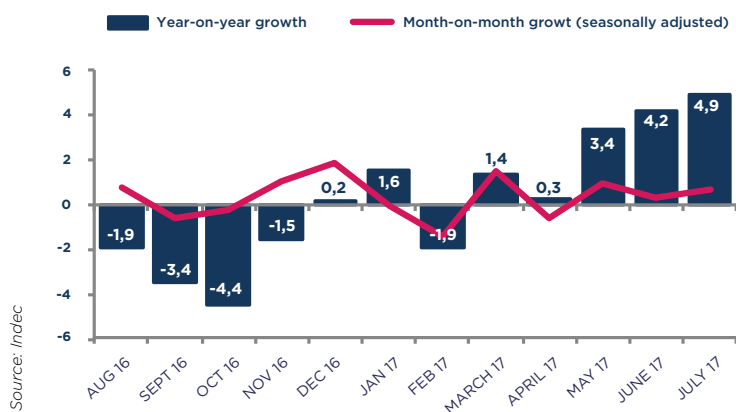
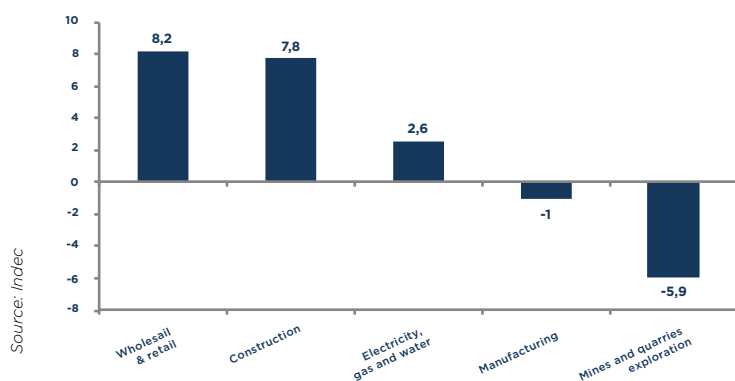


CHART 2
Production index - Breakdown by Sector
(% change between December 2015 and July 2017)



In response to recent economic indicators, Coface increased its GDP growth forecast for 2017 and 2018 by 2.5% and 2.7% respectively.

The stronger performance in 2018 is likely to be led mainly by a further deceleration in inflation (analysts in the Central Bank survey expect the index to reach 15.8% in 2018, down from their estimate of 22% in December 2017 - and a sharp decline compared to the 41% in 2016). This will create a positive spillover effect on real wages. Nevertheless, inflation is still well above the target range of 12-17% established by the central bank for 2017. As this target is already considered out of reach, the monetary authorities are now more focused on assuring the continuity of the positive trend. New hikes in utility tariffs are scheduled for the coming months. With these factors in mind, the president of the central bank has stated that there is no room now for cuts in the policy rate (currently at 26.25%). He also suggested in a recent interview that a cut would only come when inflation hits 1% month on month. This is the level that would be required to hit the 10% target established for 2018.

Beyond these cyclical developments, the composition of the economic recovery also suggests a positive move in its growth model. The pickup in activity has been mainly driven by investments. This diverges from the consumption led model that prevailed during the previous government. The investment rate that, during the period of 2002 - 2015, averaged only 17% of GDP, reached 19.5% of GDP in the second quarter of 2017. Despite this climb, the ratio remains low when compared with neighbouring countries which face similar challenges. For instance, in 2016 Colombia registered an investment rate of 25%, Ecuador reported 22% and Mexico and Peru 23%. Argentina is faced with significant bottlenecks in its infrastructure which need to be addressed in order to improve its industrial and trade competitiveness². The country is ranked 81st out of 137 countries in the World Economic Forum survey for 2017-18 that evaluates infrastructure.

Breaking down activity and behaviour since Macri took office, sectors are now performing generally better than before. The chart below shows the evolution of economy's major industries from December 2015 until July 2017. Following a weak 2016, three out of the five sectors analysed are now performing at higher levels. These three sectors are electricity, gas & water, wholesale & retail and construction. Manufacturing is also close to breakeven (*chart 2*).

Following a similar upwards trend, Coface's sectorial barometer for Argentina also improved during the last year and is generally better than the Latin American average. In the third quarter 2017, three of Argentina's sectors were upgraded from high risk to medium risk (table 1): Automotive, construction and metals. During the first eight months of the year, the automotive industry registered an accumulated increase of 6% year-on-year. This hike is explained by the stronger exports (+11.3%) recorded over January-September 2017 compared to the same period of 2016. The lower sales to Brazil (Argentina's main market) were offset by higher demand from other countries - particularly Central America, Peru and Chile. Vehicles registered in the country also climbed by 28.3% in the first nine months of 2017, although it is worth bearing in mind the high import coefficient (currently at 69%).

The improvement in construction is related to the economic rebound detailed above and in particularly the recent performance of investments. According to INDEC, the construction activity index ISAC rose by 9.5% in first 8 months of 2017, year on year. Finally, the upgrade in **metals** comes against a backdrop of the recent performance in steel production, which

rose by +6.6% year on year during the first eight months of the year. This robust output is linked to the higher level of activity seen in several steel consuming segments (such as construction, as mentioned above). Among them are the construction of gas pipelines and investments in the energy sector in the Vaca Muerta zone, an increase in the production of agricultural machinery and the rise in manufacturing levels of certain durable goods (such as refrigerators) (table 1).

Economic and political cycles are usually linked in Argentina

Argentina has a long history of economic and social conflicts. Since its independence from Spain in 1816, the country has experienced interchangeable periods of strong growth with others of deep recession (see chart 3). Argentina has defaulted on its sovereign debt eight times. This means that attracting long-term investments is no easy task.

In many cases, Argentina's economic cycles have paralleled its political ones. Measuring political risk is therefore a key to assessing the economic outlook and, more specifically, corporate credit risks in the country. Coface produces its own political risk model³, which measures various types of political risks in relation to their impact on business activity. Two major groups are taken into account for each country: security risks (which include conflict risk and terrorism risk) and the risks arising from political and social fragility. Argentina's political risk is currently assessed as low.

It is worth noting however, that the political risk analysis is positively influenced by the security evaluation factor, insofar as there is no recent history of terrorism in the country. Nevertheless, Argentina is more vulnerable from a social standpoint. Within this criterion the country is assessed at high risk. It is riskier than some of its neighbours, such as Chile and Uruguay (see chart 4), but better positioned than Brazil, Mexico and definitely Venezuela. Some social pressure indicators that have had a negative impact on the score are inflation (a high level indicates a decline in purchasing power), unemployment and income inequality. Argentina has high levels of inflation and its job market was impacted by the recession in 2016 (which reached 9.3% in 2Q2016 before easing to 8.7% in 2Q2017). Moreover, in the 1H2017 period, 28.6% of the population was below the poverty line. This represents a drop of 1.7 p.p. compared to the ratio observed in 2H2016.

An election is often the occasion for expressing social frustration. Pro-business Mauricio Macri won the presidential elections in November 2015 - although by a tight margin in a runoff against the defeated Daniel Scioli from the Peronist Frente para La Victoria (endorsed by C.Kirchner). His victory did not come with a majority in Congress. Despite this, the government has been able to dismantle some of the populist measures of its predecessor and achieve good progress during the first half of its mandate. The generally stable Cambiemos alliance, against a directionless left-wing Peronist movement contributed to these achievements.

Since Macri took office, the performance of Merval, Argentina's benchmark stock index, reveals how the shift in the country's economic direction has been positively viewed by investors (chart 5 next page). The index rose by approximately 48% in 2016 and 57% in the year to date (breaking an all-time record).

TABLE 1
Sectorial Risk Assessment - third quarter 2017

	Latin America	Argentina
Automotive	High risk	High risk
Agrofood	High risk	High risk
Chemical	High risk	Medium risk
Construction	High risk	High risk
ICT*	High risk	High risk
Energy	High risk	High risk
Metals	High risk	High risk
Paper	Medium risk	Medium risk
Wood	High risk	Medium risk
Pharmacy	High risk	High risk
Retail	High risk	High risk
Textile	High risk	High risk
Transport	High risk	Medium risk

BUSINESS DEFAULT RISK

- Low risk
- Medium risk
- High risk
- Very high risk
- Upgrade
- Downgrade

* Information and Communication Technologies - Source Coface

CHART 3
GDP evolution

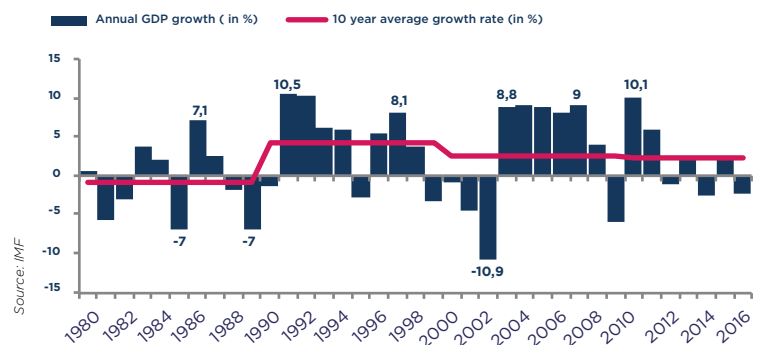
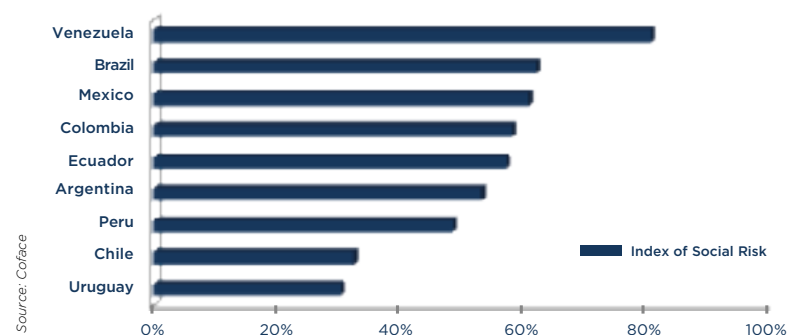


CHART 4
Coface 2016 Index of Social Risk - 2016

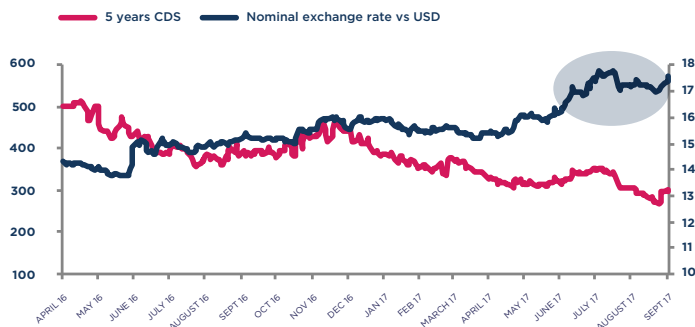


Despite this, in June 2017 Argentina failed to recover its status as an emerging market in the influential MSCI benchmark equity index. The index provider explained that it was too soon to promote the country, adding that the irreversibility of recent changes still needs to be assessed. This reinforces the importance of the midterm elections. Let's Change needs to validate its position as the current main political force and prove that 2015 was not just a one-off event.

Moreover, Macri's popularity among households has become more subdued. The elimination of subsidies on public tariffs, as well as the end of controls on exchange rates, drove inflation to very high levels in 2016. This had negative impacts on household purchasing power, which led to a series of protests in the country.

The recent improvement in the economic environment has however brought a rise in support for the ruling coalition ahead of the elections. According to a survey by Poliarquia, Macri's approval rating rose by 2 p.p. to 54% in September 2017. This shows a continuation in the recovery of his approval rating, following a dip down to 45% in July. He is now returning to similar levels of support he enjoyed during his first three months in government. This has increased the chances of a good outcome for the incumbent government during the midterm elections.

CHART 5
Sovereign risk and Argentinean Peso evolution



Sources: Datastream and Central Bank of Argentina

Despite the recent market-friendly reforms, investors are remaining cautious due to the possibility that a populist government could return to power and undo all the progress achieved in the last year and a half. This became clear with the negative reaction of exchange rates just after Cristina Kirchner first mentioned (in late May 2017) that she could return to politics (see chart 5) and run for the Senate in the province of Buenos Aires.

The Cambiemos coalition is set to increase its representation in Congress in the upcoming elections - although a majority will not be achieved. The result of the mandatory primary elections for Congress showed a better than expected performance from the governing coalition. Cambiemos accounted for 37% of the total votes at national level (5.9% more than in the first round of the 2015 presidential elections), followed by the Unidad Ciudadana (party of Kirchner), with 21% and the Peronist Party, with 18%.

As the legislative balance is unlikely to change much, the focus has been directed on the Senatorial election in Buenos Aires.

The province represents the country's largest electoral circuit, accounting for 40% of the national vote. With three benches in the Senate being contested, the Buenos Aires election has been considered as a proxy for the upcoming presidential election. In the primaries for Buenos Aires, Cambiemos candidate Esteban Bullrich came in second, only 0.2 p.p. behind Cristina. This narrow loss margin could encourage voters opposed to the former president to come out in support of the government, even if they do not fully support Macri. Recent polls are actually suggesting an increase for Bullrich.

According to the latest M&R and Query polls, the government's candidate has a 39.6% of the intention votes, which is three percentage points ahead of Kirchner. The third position belongs to Sergio Massa, a dissident Peronist, who saw his support shrink to just 10.9% (a full loss of 5 percentage points).

A strong victory for the ruling party would allow policymakers to become more active in their reforms. Labour and tax system reforms, for example, are expected to be addressed after the race. It is worth noting however, that the large fiscal deficit (expected to end 2017 at 4.2% of GDP) and the government's commitment to reduce it, could limit its freedom to implement deep changes. This would also mean that the divided Peronist opposition would need to seek new leadership for the 2019 race.

If, against all the odds, Cristina does win with a consistent margin, she will probably run for the next presidential elections. In economic terms, this would mean that the government will probably need to increase the use of decrees to make economic policy. Strong support for the former president would certainly cause deterioration in business and investor confidence and dissuade investors from making long term investments in the country.

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