



SPECIAL REPORT

Argentina: The next six months of Macri's presidency

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I. INTRODUCTION

1. INTRODUCTION
2. INFLATION, ARGENTINA'S PATHOLOGY
3. THE COSTS OF ADJUSTMENT
4. THE END OF THE TRAP, NEW ALLIANCES
5. THE POLITICAL SITUATION
6. ENERGY, MINING, AND AGRICULTURE
7. CONCLUSIONS

AUTHOR

Mauricio Macri's administration hopes to start with a clean slate and launch a new era of governance during the second half of 2016. To do so, the Casa Rosada attempted to consolidate adjustments during the first few months and, with a set of measures and agreements now in place, is turning its focus toward completing the framework that will generate the investments the country has been awaiting for more than a decade. Positive predictions for the period between now and December have become common for government officials to such a degree that jokes are being made on social media about the matter, like the one referring to the famous rural novel *Don Segundo Sombra*, which forms such a part of classic education in Argentina's schools that it should be called *Don Segundo Semestre*.

President Macri completed the first stretch of his presidency with decision. Without a powerful structure of followers like that of the opposing Justicialist Party's (Peronist), he has worked hard to position himself as a strong leader who applies energy, responsiveness and practicality in adopting the measures necessary to adjust the economic imbalances left by his predecessors. These decisions have been well received by the business world in general—although there is no shortage of mutual disappointment between the president and certain business sectors—and by most of the population.

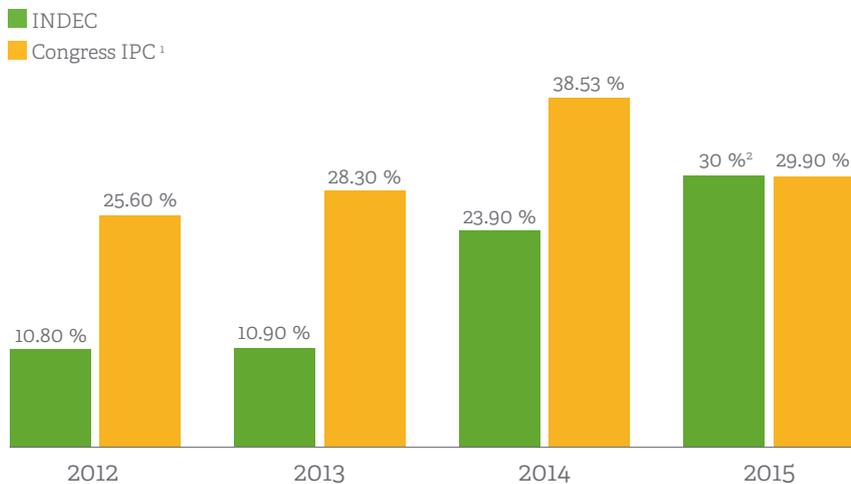
Macri has started to experience the erosion that results from exercising power during times of adjustment. However, a number of assessments have confirmed that he still has enough credit to handle the remaining economic reforms, which may be drastic even if the positive effects on everyday life are not immediately apparent.

2. INFLATION, ARGENTINA'S PATHOLOGY

The government's main goal is to move the country toward economic growth by the end of 2016. This milestone date is not random; there will be midterm elections the following year, and without concrete results, Macri's government could experience a voting loss that would allow Peronism to regroup and reposition itself to be the powerful threat non-Peronist governments have faced since 1983.

Expected and necessary decisions, such as the significant increase in public service fees, resulted in faster inflation, lower purchasing power for salaried employees and a drop in economic activity, which the government has acknowledged. The basis of optimistic thinking lies in the belief that the rising inflation in these past few months is the result of relative prices that have readjusted and, with the normalization of primary variables, the productive investments necessary for Argentina's economy to begin the path toward recovery will take place.

Inflation: Annual comparison 2012-2015



¹ Consumer Price Index released by the National Congress, known as the "CPI Congress." This index emerges as an average of nine private and public inflation indexes. The initiative was a response to opposition in Parliament to the judicial and administrative persecution that placed the then-Trade Secretary Guillermo Moreno against private consultants. Its purpose was to provide an alternative number to the official one. It began to be implemented in 2011.

² Reference numbers are from the City of Buenos Aires, which had 26.9 percent inflation in 2015, and the province of San Luis (center west), which stood at 31.6 percent. Both were established as benchmarks until the INDEC completed the development of a new methodology of measuring these changes.

With this goal in mind, Macri and his economic team have set their focus on creating conditions capable of attracting capital to generate employment in the nation through a program based on reducing the government's involvement in the economy, which was a hallmark of the Néstor Kirchner and Cristina Fernández administrations.

Another priority for the government is to reduce inflation, which reached a record of more than 6 percent in May. To do so, it has lowered the amount of money being issued and set interest rates close to 40 percent to stimulate a reduction of cash in circulation.

Argentina has experienced a number of inflationary periods throughout history, but this time the task is challenging. Despite the slowdown in rising prices during the second half of the year due to the recessive impact of the measures implemented, private analysts predict inflation will reach an average of 35 percent in 2016.

President Macri's projection had been 25 percent.

3. THE COSTS OF ADJUSTMENT

The government has been criticized for its shortcomings in addressing the social consequences of reorganizing the economy and for certain

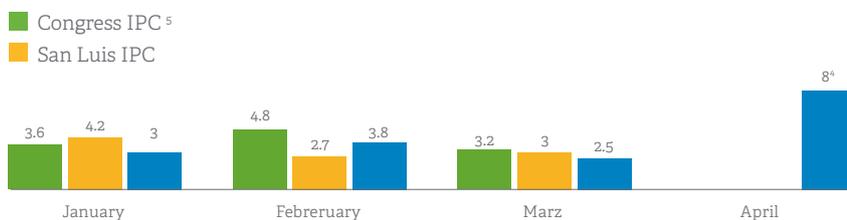
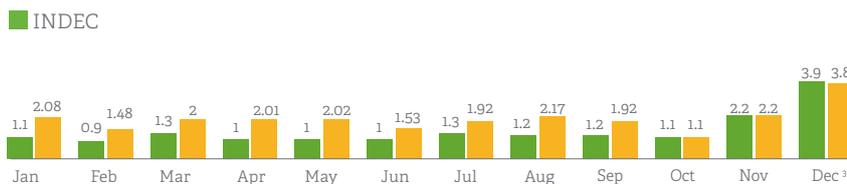
decisions that boosted inflation, such as authorizing a number of fuel price increases.

A UNICEF report published in May stated that 4 million children in Argentina live in poverty. Although the data are from December 2015, when Kirchnerism departed, everyone is aware that so far this year, the situation has worsened for disadvantaged groups. Rising inflation has had a strong impact on the poor, and consumption data from major supermarket chains reflect this: in April, sales dropped by 3.6 percent in a year-over-year comparison.

Most analysts believe that the government was late in launching social containment measures. One is a proposed law to reimburse the value added tax (VAT) for food purchases made by recently retired individuals and recipients of direct social aid. The initiative was approved by the chamber of deputies and must now make its way through the Senate.

President Macri has recently made more public appearances in order to build empathy with the populations who have suffered most from economic readjustments made during the first months of his presidency. The message is clear: The medicine tastes bitter, but it is necessary to create a situation that is better for everyone.

Inflation: Monthly comparison 2015-2016 (%)



³ In December, with the change in administration, the head of INDEC said they could not publish official data, which would be taken as "Alternative CPI" inflation measurements calculated by the City of Buenos Aires (3.9 percent) and San Luis (6.5 percent).

⁴ This figure is an estimate.

⁵ Given the lack of credibility of the official CPI, other indices were used in this analysis.

“Subsidies represent 80 % of the fiscal deficit”

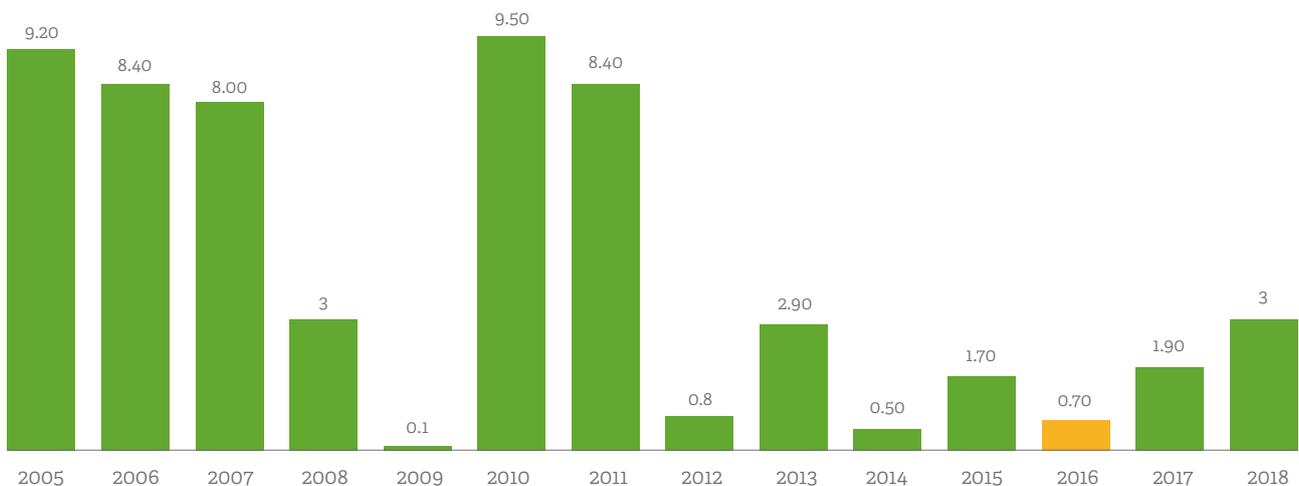
There have also been protests in certain cities, driven by residual Kirchnerism and other disgruntled sectors. Nearly every day, the president can be seen on television asking the people of Argentina to believe in the positive results that will come from the implemented measures, which will begin to appear sooner rather than later. His cabinet, which is not very diverse, has explained some of the aspects of these adjustments through comments that have been rather unfortunate due to their lack of sensitivity.

Although reducing inflation is one of the government's top priorities, public spending has not undergone significant cuts. Direct subsidies for public services were 5.1 percent of the gross domestic product

(GDP) in 2015, and despite being lowered, they will still represent 3.9 percent of the GDP according to private projections. Similarly, although the prices paid by users rose sharply (by an average of 200 percent in the cases of electricity and natural gas), the actual costs of services are still not being covered. For example, the price of public transportation in the Buenos Aires metropolitan area is stuck at half its actual value.

Today, subsidies represent 80 percent of the fiscal deficit, which continues to remain high (5.4 percent of the GDP), and which the government is funding through external debt. In this scenario, the goal of lowering inflation is expected to be reached, but primarily because of the economic slowdown.

GDP: Comparison and forecasts (%)



Source: Banco Mundial

“The Government's paths in Congress will not be easy. Peronism holds the majority in the Senate and is the first minority in the Chamber of Deputies”

4. THE END OF THE TRAP, NEW ALLIANCES

Beyond the attack on inflation, the release of exchange controls (“the trap”), rate adjustments and agreements and payments for the Vulture Funds that allowed Macri to win the legal battle with Argentina's government are the economic measures he implemented, all with the aim of sparking foreign investors' interest in the nation.

The release of exchange controls did not cause chaos (despite what many had predicted), and major devaluations are not currently expected for the remainder of the year. Private estimates expect an average of one dollar per 16.50 pesos by the end of 2016 (the figure was 14 pesos at midyear). Taxes on fish farming and mining exports have also been lowered, and credits with subsidized rates have been announced for small and medium-sized enterprises. According to official data, medium-sized businesses are responsible for 71 percent of formal employment in the private sector.

The government also redesigned the country's system of international alliances and gave positive signals to the United States and Western European nations. These gestures were well received, as proven by the high-level visits that Macri hosted in Buenos Aires during the first months of his term, including the president of the United States, Barack

Obama; the president of France, Francois Hollande; and Italy's prime minister, Matteo Renzi. All showed hope regarding Argentina's new open-policy era and promised governmental support to companies from their nations that intended to do business there.

The president celebrated this news, saying Argentina “is once again a part of the world.” He also says this to differentiate himself from the Kirchnerism alliances with governments, such as those of Venezuela, Iran and Russia. In any case, one of Argentina's most serious issues is abroad: Brazil.

The government seemed to confirm President Dilma Rousseff's suspension and her replacement with Vice President Michel Temer when the Chancellorship announced that the nation respected the institutional process and would continue discussions with the new authorities. The evolution of the Brazil situation is a source of tremendous concern for Argentina, which needs the economy of its powerful neighbor to recover.

Brazil is Argentina's main commercial partner, and its crisis has had a huge impact. In the first months of the year, Argentina imports from Brazil were higher than its exports. As a result, the bilateral commercial balance had a deficit of \$1.4 billion. This is occurring in the context of a shrinking pie: in 2015, the commercial exchanges

“The legal system and Congress are two areas that the Casa Rosada has yet to manage with the necessary precision and thoroughness”

between the two countries barely surpassed \$23 billion, compared to \$40 billion in 2011.

5. THE POLITICAL SITUATION

Since democracy was reinstated, Macri is the first president of Argentina to begin their term of office without control of the National Congress. Along the various internal lines, Peronism holds the majority in the Senate and is the first minority in the chamber of deputies. For this reason, the quick parliamentary support the ruling party obtained for the agreement with the Vulture Funds was surprising, and it was interpreted as a sign of political strength.

However, it soon became clear that the government's path in Congress would not be so easy when Unionism (also Peronist) promoted a law prohibiting companies from laying off workers during a six-month period and giving employees who accept their dismissal the option of demanding double compensation.

The president publicly has stated that the initiative should not move forward because, according to him, it will increase employment costs and hinder job creation. When the project was approved by Congress, the president vetoed it. He took advantage of the opportunity to show another sign of firmness and that, above

all, Argentina is creating the conditions necessary to receive investments.

The layoff issue is controversial because reliable data about Argentina's job market is not currently available. According to official, yet unreliable data, Cristina Kirchner left office with 5.9 percent unemployment, although private consulting firms estimate unemployment figures closer to two digits. So far this year, the government has turned down a report from the opposition, stating simply that there is a “wave of layoffs.”

In any case, the most serious situation is that a significant proportion of workers (nearly 40 percent) do not have employment contracts. According to figures provided by the Department of Production, Argentina's job market currently employs between 18 and 19 million individuals. Of this total, 6.5 million work in the private sector, 4.5 million in the public sector and the remainder without employment contracts.

The government promised to work to change this reality, although so far no specific policies have been announced.

6. ENERGY, MINING, AND AGRICULTURE

The government and major players from the private sector have announced several investments intended to take place during the remainder of 2016 and in 2017.

“Legal system reforms are another pending task that Macri’s government has on its list”

Alongside the president of the Development Bank of Latin America (CAF), Macri announced the financial institution would contribute \$2 billion for infrastructure projects in northern provinces, which is the nation's most neglected region. A total of \$5 billion in loans from the Inter-American Development Bank (IDB) has also been announced. According to the government, the public works initiatives could provide employment for 60,000 people in 2017, and the major projects linked to hydraulic and transportation efforts would create 400,000 new jobs.

Argentina has a variety of areas that could potentially attract investments that have been delayed in recent years. For example, the mining sector announced its intent to invest \$20 billion in the next five years, which could create 40,000 new jobs. The Department of Energy estimated that, in the next two or three years, the country would receive \$5 billion in investments for renewable energy, an area in which Argentina has fallen far behind compared to other countries in the region, such as Uruguay and Chile. Also, the Vaca Muerta shale formation in the Andes Mountains still holds many opportunities for development, such as the traditional agri-food industry.

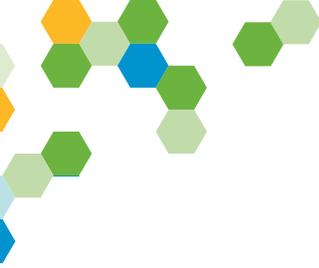
The government speaks of “latent” investments worth \$20 billion that could take shape during the remainder of 2016 and in 2017.

7. CONCLUSIONS

Kirchner’s departure from office has led to a spike in criminal investigations involving the former president and some of her ministers, with serious suspicions of corruption in their public duties. The judges carrying out these matters are the same ones who not long ago made little to no progress with the same proceedings.

Legal system reforms are another pending task Macri’s government has on its to-do list, seeking to create a safer investment scenario in a country that does not abide by most of the traditional game rules. These reforms are probably not a priority. The legal system and Congress are two areas the Casa Rosada has yet to manage with the necessary precision and thoroughness.

Controlling inflation, increasing activity, attracting investments and creating jobs are the matters the Macri administration has decided to address during its first term of office. The government hopes the drop in consumption will slow in the third quarter, allowing the economic recovery to begin by the end of the year.



“The government hopes that the drop in consumption will slow down in the third quarter and that the economic recovery will begin by the end of the year”

Another popular joke about the future of the Macri administration says the second semester “is like the Magi: it does not exist.” The government is determined to reinforce the idea that it is going in the right direction and, at most, their changes will begin to take effect by December, then flourish in 2017.

With the goal of attracting investors, the Casa Rosada is preparing to launch a tax plan for natural and legal people have undeclared income from abroad. The fine details of the regulation are still controversial, but the Macri administration projects a \$25 billion volume of acceptance that, in the end, could be presented as more proof to investors of the changes carried out in Argentina.

Macri is a president truly in a class of his own. Firstly, he is not a Peronist; almost an anomaly in the country’s modern history. In fact, he won in a runoff with Peronism for the first time in history, and is obliged to negotiate many of his initiatives in a country unaccustomed to dialogue. His party is practically a novelty, a product of the institutional emergence of 2001.

A key fact that allows him to hold credit for many Argentines: Macri represents the opposite side of what Kirchnerism left behind. Emphasizing this differentiation has earned Macri both the electoral victory and a relatively quiet path during his first semester in office. From now on, however, the government must show specific results.

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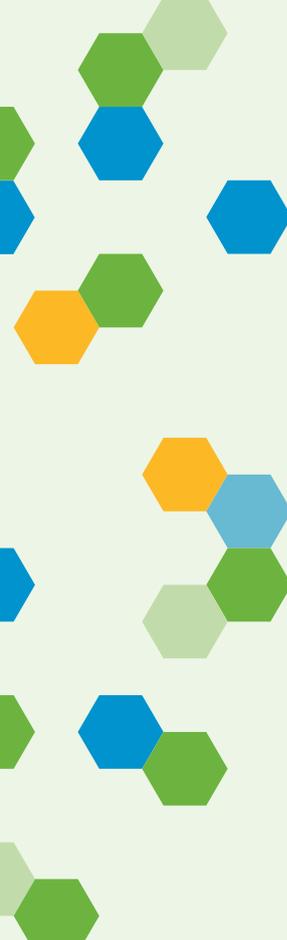
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