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Political Climate Report - ARGENTINA

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Economic adjustment and an evolving foreign policy agenda continue to dominate Macri's mandate. Now on the verge of settling Argentina's international debts, the government has shown commitment to improving strained relations towards Europe and the US in recent weeks. On the domestic front, the administration has taken further steps to control government spending, through further job cuts and reduction of subsidies.

Way cleared for Argentina to pay holdouts following US appeals court ruling

On April 13, a New York appeals court upheld Judge Thomas Griesa's ruling to lift the pari passu injunction or 'stay', in place since 2012. The 'stay' had previously prevented Argentina from paying exchange bondholders until the country had paid the main group of holdout creditors (led by NML Capital). The Court's decision, coupled with the lifting of local laws means Argentina can now legally pay all bondholders. Argentina plans to issue new bonds on Monday 18 and Tuesday 19 April and intends to pay the holdouts on Friday 22 April. This will come after members of Macri's economic team complete a five-day road show with investors in London, Boston, New York, Washington and Los Angeles. As much as USD 15 billion of bonds will be sold with maturities of five, ten and 30 years and with yields of around seven and nine percent. The sale will be coordinated by Deutsche Bank, HSBC, JP Morgan and Santander and bonds will include a collective action clause (CAC). This CAC means in the event of a future debt restructuring, new terms can be forced on holdouts if a super majority of the bondholders accepts restructuring. If the government is successful in raising the required amount of bonds, Argentina will be able to pay the holdout creditors, exit technical default and cover the deficit.

Griesa originally requested that Argentina pay the four main holdout creditors by April 14, the day after the hearing. Griesa's ruling was contingent on the government repealing legislation – passed under the previous administration – that prevented Argentina from offering the holdouts more generous terms than those offered under restructurings in 2005

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and 2010. This condition was met last month: on March 16, Congress' Lower House passed the bill by 165 votes for to 86 against. On March 31, the legislation was overwhelmingly approved by Congress' Upper House (54 votes for to 16 against). Compliance with the April 14 deadline is now impossible, but we expect the deal to progress regardless.

On March 24, the same day President Barack Obama visited Argentina, the US Department of Justice (DOJ) filed an amicus curie brief stating that it supported Griesa's decision to lift the injunctions. Since Macri took office, "Argentina has taken significant steps to normalize its relations with its creditors," the brief said, adding that the lifting of the 'stay' is "in the public interest" and that "the United States has significant foreign policy interests in supporting a swift resolution to this long running litigation". It is highly likely the DOJ's decision to back Argentina in advance of the hearing influenced the appeals court's decision.

End in sight: a political win for Macri's government

The Court's decision not to reject Griesa's request to lift the injunction did not come as a surprise. Assuming the debt payments go through and in a timely manner, Argentina will recover market access shortly. This will enable the government to finance its 'gradual' strategy of fiscal adjustment. However, it remains to be seen how the government will raise the sizeable amount of money it needs both to pay the holdouts, and to cover the deficit. It is virtually inevitable that in order to issue sufficient new bonds in time, the government will have to offer attractive conditions, such as high yields. The terms of the deal represent an excellent outcome for the holdout creditors. Undeniably, however, resolving the holdouts dispute represents a clear political victory for the Macri administration. The government

demonstrated considerable skill in garnering sufficient opposition support for a deal that evidently benefitted the holdouts. Pushing the necessary legislation through Congress was only possible because the government secured the governors' support by offering financial assistance for their provinces. This proved a successful strategy, helped by the fact that governors also had a vested interest in resolving the dispute (they are now themselves poised to be able to take on debt for their provinces). This said it is unlikely that the government will be able to rely on the same level of support from opposition members for other major reform measures (see below for further analysis).

Panama Papers: Macri feels the heat

On April 3, it was revealed Macri's name featured among the 11.5 million documents leaked from Panamanian law firm Mossack Fonseca. The President has been linked with Fleg Holding Ltd, founded by Macri's father, business magnate Francisco Macri. Macri participated as a director of the company between 1998 and 2009. The President has been quick to deny any wrongdoing, stating he did not disclose his connection to the company because he was never a shareholder. The government's poor handling of the situation was reflected in its subsequent response. Meanwhile, head of the anticorruption office Laura Alonso (PRO)'s quick defense of Macri will do little to bolster the ostensibly independent anticorruption office's credibility, re-launched under the new administration.

Since the revelation of the leaked documents, opposition figures from across the political spectrum have called for clarification from Macri. On April 7, federal prosecutor Federico Delgado called for

a probe into Macri's connection with Fleg Holding Ltd and Kagemusha SA, another company registered in Panama. Judge Sebastián Casanello will seek to determine if Macri had "maliciously failed to complete his tax declaration", and if there is sufficient evidence to open a criminal probe. The President's lawyers appeared before the civil court on April 8, the same day the government submitted a public information access bill to Congress. On behalf of the President, they presented a judicial "declaration of certainty" (*acción declarativa de certeza*) before the court so the "judge can see [he] is telling the truth".

The weak initial response to Macri's implication in the 'Panama Papers' undermined *Cambiamos'* strategy of presenting themselves as an alliance – in contrast to the previous government – committed to fighting corruption, as promised during campaigning. We believe that while Macri and his party have not responded well to the situation, the current outcry is unlikely to gain significant traction at this early stage in his mandate.

Investigations widen against CFK, Kirchnerist allies and former government officials

On April 13, former President Cristina Fernández de Kirchner (CFK) appeared before a civil court in Buenos Aires City. The case relates to the former President's involvement in the sale of dollar-futures contracts at below-market rates. CFK did not respond to questions from federal judge Claudio Bonadio, but instead submitted a written statement in which the former President accused the government of creating a case against her to "deprive [her] of [her] liberty". Former Economy Minister Axel Kicillof and former Central Bank head Alejandro Vanoli appeared in court the same day, with both also only submitting written statements.

Obama in Argentina

On March 23 and 24, Barack Obama visited Argentina – the first official visit by a US President to the country in two decades. Obama's visit came directly after a historic trip to Cuba, and coincided with the 40th anniversary of the coup that marked the beginning of Argentina's military junta (1976-83). The President was accompanied by an 800-strong business delegation. Over the two-day visit, talks between the two leaders revolved around expanding collaboration on defense and security, trade, anti-drug trafficking and energy issues. Obama also delivered a speech to 400 local entrepreneurs and honored the victims of Argentina's military dictatorship in a ceremony held on March 24. In a speech delivered at the Remembrance Park in Buenos Aires on March 24, Obama formally confirmed that the US government would declassify further documents relating to the dictatorship. The declassification process will begin with the signing of an agreement between the two countries on April 22.

Obama's visit is an indication of rapidly improving bilateral ties between Argentina and the US after years of tension, with the President stating "the United States stands ready to work with Argentina through this historic transition in any way that we can". In the past 25 years, Argentina's stance towards the US has swung between strong alignment and confrontational hostility. In contrast, the Macri administration will endeavor to construct a "mature relationship" with the US, whereby the countries strengthen mutually beneficial areas of cooperation (including human rights, nuclear security and the fight against drug-trafficking and climate change).

For Argentina's government, a ringing endorsement from Obama will boost Macri's credentials as he seeks to reintegrate the country into the international community. More broadly, Obama's visit sends a strong signal that the US government backs a shift to the political center in the region. By thawing diplomatic relations with Cuba and Argentina, Washington hopes to begin to strengthen the US' standing in Latin America, particularly in the face of an increasingly strong Chinese presence.

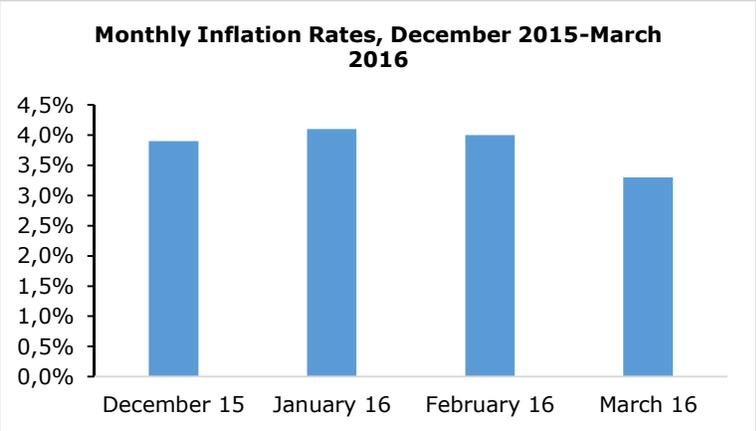


Separately, on April 9 federal prosecutor Guillermo Marijuán requested to have CFK indicted for her alleged involvement in a wide-ranging money-laundering and embezzlement probe. If approved by Judge Casanello, a formal investigation will be launched. Former federal Planning Minister Julio de Vido would be investigated as part of the same probe. Marijuán's request followed 12 hours of testimony from a former associate of the figure at the center of the investigation, businessman Lázaro Baez. Baez, who allegedly has strong links to the Kirchner administrations, was arrested on April 6. On April 4, former Transport Secretary Ricardo Jaime was detained on embezzlement charges related to a separate case. Jaime is the first former Kirchner government official to be arrested on corruption charges. A separate money-laundering probe allegedly implicating hotels owned by the Kirchner family has also been relaunched.

The timing of Marijuán's request suggests an attempt on the part of the government to divert attention away from Macri's involvement in the 'Panama Papers' affair. However, it also comes as part of a broader strategy: to redefine former Presidents Néstor and Cristina Kirchner's legacy. Macri and his party also hope to deepen existing divisions within the Peronist Party, which will strengthen *Cambiamos'* position in Congress. It should be highlighted that although the accusations are currently generating a lot of 'noise', even if these investigations do result in prosecution and eventual sentencing, this will most likely take years to be passed down. Moreover, it is uncertain if the investigation into the sale of dollar-futures will gain any legal traction: while the alleged actions certainly represent a bad policy decision, it is not clear if they involve breaking the law.

Subsidies cuts continue; high inflation persists

The government has taken further steps to reduce Argentina's fiscal deficit. As was widely expected, the government has announced the reduction of subsidies on public transport in Buenos Aires City. On April 8, metropolitan bus and train fares – which have remained frozen since 2014 – increased by up to 100 percent. A hike in subway fares will also be implemented from May. Those meeting the requirements for a social tariff will continue to benefit from the rates set under the previous administration. Subsidies for water and natural gas bills will also be reduced this month, with bills to increase by up to 500 percent and 200 percent respectively. Gasoline prices were also raised by around six percent on April 1.



Source: IPCBA (Inflation index for Buenos Aires City)
 In the absence of official INDEC data, IPCBA has been used as a proxy

On March 31, Finance Minister Alfonso Prat-Gay stated that no further price hikes are expected in 2016. The government hopes that by introducing all tariff adjustments simultaneously, inflation in the second half of the year will be significantly reduced. According to Prat-Gay, it expects that by the end of 2016,

“monthly inflation will be around one percent”. However, it is virtually guaranteed the government’s inflation target for 2016 (20-25 percent) will be missed. Accumulated inflation has reached around 12 percent in the first quarter alone; reaching the target would imply a steep recession. Further, the government chose to implement price hikes before salary negotiations with labor unions have ended. As such, it is highly unlikely that – in the face of 200-500 percent increases in public utilities tariffs – the unions will ask for anything less than a 35-40 percent raise, plainly incompatible with the government’s target of 25 percent. On April 5, Interior Minister Rogelio Frigerio admitted there is a high possibility the government will fail to meet its annual inflation target. This represents the first time a government official has acknowledged the administration will not deliver on its promises.

Separately, according to a report published by the Pontifical Catholic University of Argentina, poverty levels increased from 29 percent in December 2015 to 34.5 percent in March 2016. The report also predicted levels will drop to 32.9 percent for the first part of April. However, the report does not take into account the recently announced price hikes on public utilities and services. Jorge Tedesca, head of the national statistics agency INDEC (currently being revamped) has said that official poverty statistics will be published “in August or September”.

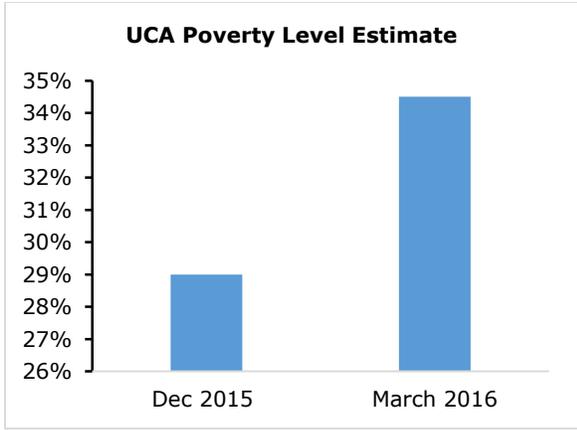
The government has shown some signs it intends to address the impact of economic reforms on Argentina’s poorest demographics, with a bill to reduce Value Added Tax (VAT) for the most vulnerable sectors of society will be submitted to Congress in the coming days. This followed Labor Minister Jorge Triaca April

Macri seeks to consolidate future with China

On April 1, Macri met his Chinese counterpart Xi Jinping at the Nuclear Security Summit, held between March 31 and April 1 in Washington. Sources indicate the two leaders agreed to forge closer ties during the meeting, and to increase investment flow between the countries. On April 6, it was announced a USD 4.7 billion Chinese-sponsored dam project in Santa Cruz will move forward. Certain aspects of the agreement related to the environment will be reviewed. The Argentine government also hopes to review all agreements related to nuclear energy. It is speculated that amendments to the deals will allow US companies to provide uranium for two planned nuclear reactors. The deal for these reactors, which will be constructed with Chinese financing, was signed in November 2015.

On March 27, Argentine Ambassador to China Diego Guelar announced Macri will travel to Beijing in September, adding China has an “ambitious investment program” for Argentina. Even as the Macri administration moves closer to Europe and the US, the government has made it clear it will seek to maintain the bilateral ties with China built by former president Cristina Fernández de Kirchner. While the Macri administration may advocate certain ‘cosmetic’ changes to the relationship – for example, in the case of the dam project in Santa Cruz – we believe a structural change in Sino-Argentine trade relations is highly unlikely. In the face of the steep recession in Brazil, we expect Argentina to remain economically dependent on China – its second biggest export partner after the South American country.

13 announcement that the government will present a plan to modify income tax scales in the next few months (to be implemented from 2017).



Source: Pontifical Catholic University of Argentina (UCA)

Outlook

As the result of a combination of skilful political maneuvering, negotiations in good faith and an overall sense of weariness, the Macri administration is poised to make its biggest achievement to date: settling with the holdout creditors. Working on the assumption Argentina pays its debts promptly, the country will exit default in the coming days. Looking forward, it is expected Argentina’s companies and provincial governments will also seek to issue significant debt abroad in 2016.

Now on the brink of returning to international markets, Argentina’s government is focusing on pursuing an open and engaged position towards the rest of the world. Although much will depend on the outcome of the debt issuance, this strategy may also prove to be a success. What is certain is that the international community continues to come out in strong favor of the government’s policy agenda. A more pragmatic approach to international relations combined with the return to credit markets will undoubtedly play a role in making Argentina a more attractive place to do business. However, this will not happen overnight: recession and high inflation are still in place, and there is a potential political storm on the horizon in the event of CFK being prosecuted.

EU & MERCOSUR set to move forward with free trade deal

There are signs that Europe and MERCOSUR will move towards completion of a free-trade agreement after years of successive setbacks. Although talks were stalled for years, Argentina is now set to play a key role in advancing negotiations. On April 8 in Brussels, Uruguay’s foreign minister Rodolfo Nin Novoa (Uruguay currently holds Mercosur’s rotating presidency) inked a deal with EU Trade Commissioner Cecilia Malmström that will see the two blocs exchanging trade offers in the second week of May.

This follows High Representative of the European Union for Foreign Affairs and Security Policy Federica Mogherini’s visit to Buenos Aires on March 9 where she met Macri and foreign minister Susana Malcorra. Mogherini praised the government’s economic reform program and invited the President to Brussels in the second half of the year. She announced the European Investment Bank (EIB) will begin investing in the country once more, with special focus on small-medium sized businesses (SMEs), job creation for young people and climate change.

Argentina opening trade links with the EU depends on the two blocs negotiating an agreement on a common list of products. Separately, during a visit to Buenos Aires on March 31, a delegation of high-ranking EU lawmakers welcomed the Macri administration’s economic policies. Elmar Brok, Chairman of the European Parliament Committee on Foreign Affairs, said during a press conference that the reforms “will lead to economic growth and attract more investments.” Brok added that containing inflation will be key to attracting foreign investment.

Meanwhile, the Foreign Ministry has confirmed Macri will travel to Berlin in July to meet with Chancellor Angela Merkel.

Above all, the time it will take to build confidence in what has long been considered a hostile environment for investors should not be underestimated.



The progress the government has made on certain issues should be contrasted against weak management of others, particularly relating to the government's administration of tariff adjustments and salary negotiations. The public remains broadly supportive of a deal with the holdouts and other investor-friendly policies. However, the economy is the main concern for the Argentine people. Reducing subsidies is key to reducing the fiscal deficit. This said, the Macri administration may face repercussions of having announced a series of hikes in April, in a context of high inflation. April is the month that will likely represent the biggest loss of purchasing power in 2016, particularly in Buenos Aires City and Buenos Aires Province.

The longer the administration's policies take to produce results – in the form of growth, job creation and slowed inflation – the higher the likelihood of public discontent triggering widespread social unrest. The next few months will be key in determining whether the administration's decision to introduce the majority of hikes

at the same time proves a risk worth taking.

Further, the support of the Peronist governors should not be taken for granted: while it is not in the interest of Peronist elements to stand in the way of the government's reform program, they will show little support for inflation and economic adjustments. It is important to highlight that the government will not be able to rely on the same level of support from Peronist governors going forward as it has enjoyed regarding the holdouts bill. Backing from this group will instead have to be considered on a case-by-case basis. The same can be said of dissident Peronist Sergio Massa (*Unidos para una Nueva Alternativa*). In other words, support from opposition elements is by no means guaranteed. Further, the deal struck with the governors comes at a cost for the federal government, as providing the promised financing for their provinces will have a fiscal impact. Cambiemos' need for political support in Congress therefore competes with the equally pressing need to normalize the economy and stimulate growth.

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