The government made a dynamic start to the year, defining a clear set of goals for 2017 and making changes to key posts. It is betting that high public works spending will generate an economic recovery and increase its electoral chances in the upcoming midterms, although inflation and securing foreign investment will continue to be major challenges. Moreover, as the elections approach, opposition actors will begin to more actively resist the government’s agenda, hinted at in recent weeks by a deterioration in relations with powerful labor unions. When Congress resumes sessions, this will likely be reflected in increased reluctance to back government-led legislation. However, the government’s position is stable enough to ensure that even a difficult year would not seriously threaten governability.

Prat-Gay departs in shake-up ahead of New Year

The resignation of Treasury and Finance Minister Alfonso Prat-Gay a day after Christmas was the first major change to President Mauricio Macri's cabinet since he took office a little more than a year ago.

Cabinet Chief Marcos Peña said Macri requested Prat-Gay's resignation due to disagreements about management style and structure of the economic policy team, and said the minister “never felt comfortable with the method of organization of the government.” However, rumors had circulated for months that Prat-Gay was being excluded from decision-making in the government and would potentially leave. These were reignited after the income-tax setback in December (see [here](#)). Additionally, it is likely Prat-Gay’s independent political aspirations did not sit well with Macri.

Prat-Gay departed the government with his reputation intact, having effectively spearheaded the majority of the government’s economic reforms and “return to the world”, including lifting currency controls and reaching a settlement with holdout creditors. He concluded his appointment with the announcement of a successful first phase of the government’s tax amnesty program (see [below](#)).

Following Prat-Gay’s departure, the government announced that the Finance Ministry had been split into two portfolios. Nicolas Dujovne, an economist and former TV show co-host who had previously served as an economic policy advisor to PRO’s think-tank, was named Treasury...
Minister. Then-Finance Secretary Luis Caputo, who led negotiations with the holdout bondholders, was designated Finance Minister. Dujovne’s ministry will focus on reducing the fiscal deficit, while Caputo’s ministry will work on seeking financing and developing capital markets.

For the government, its first major cabinet change provided an opportunity to show it had evaluated its performance over the past year, and more importantly, to ensure that key cabinet leaders are on board with its management style and policy objectives for the year ahead. Although the government has stated that having each focus on a different area will improve economic management, a divided ministry increases the potential for conflict amongst ministers and could make coordination of economic policy a challenge moving forward. There is some sense that economic policy now may lack an overall vision.

Other changes to key government posts

January saw several other changes in top government leadership positions. On January 18, Banco Nación President Carlos Melconian resigned at the request of the president and was replaced by economist Javier González Fraga. The government said that the change would not affect the bank’s policies and was part of its effort to unify the economic team. Melconian reportedly clashed with Peña, and the government was displeased with his criticisms against aspects of its economic policy. Along with the changes in the Finance Ministry, the move consolidates decision-making power vested in Peña and economic policy coordinator Mario Quintana.

Also on January 18, it was announced that Public Works Secretary Daniel Chain would be leaving his post, which covered infrastructure projects not related to energy or transit. Interior Minister Rogelio Frigerio reportedly had a strained relationship with Chain and was unhappy with the pace of public works projects. No replacement has been named, and it is expected that further reorganizational changes will take place in the ministry. Meanwhile, while some of the portfolio will likely be handled by Chain’s two sub-secretaries, Frigerio has said he will “personally take charge of that area”.

This dovetails with the government's focus on infrastructure and public works, which it is betting will be able to stimulate an economic recovery. This will be especially important in an election year as the government aims to show that it is creating economic growth and making concrete, visible improvements to the everyday lives of voters. Increased allocations to public works this year reflect these dual goals.

The 2017 national budget allocates 32.1 percent more funds to public works than in 2016. Meanwhile, the 2017 budget for Buenos Aires province, a key electoral battleground, almost triples funds allocated to public works to ARS 29.04 billion (USD 1.85 billion) compared to 2016. On January 18, Macri met with mayors from his PRO party to urge them to spend funds on infrastructure and not on current expenditures or public employment. However, it will be challenging to execute all planned works projects - there was under-execution of the budget in 2016, with the national ministry only having used 73 percent of allocated funds just before year’s end, according to one independent estimate.

Successful tax amnesty draws billions out of hiding

As of December 31, the government reported that USD 97.84 billion in assets had been declared as part of its tax amnesty program or “blanqueo”, USD 84.3 billion of which was held abroad. This far exceeded the government’s publicly stated goal of attracting USD 20 billion. More than 112,000 bank accounts had been opened and more than USD 1 billion had been used to buy real estate or government bonds by the end of 2016. Fines of ARS 106.7 billion (USD 6.8 billion)
were paid on the previously undeclared assets, a figure roughly equivalent to 1 percent of GDP. Individuals with undeclared assets can continue to declare these until March 31, but a higher penalty of 15 percent (compared to 10 percent previously) will be imposed.

The amnesty program can be considered a success: it contributed to ending 2016 with a fiscal deficit of 4.6 percent, which exceeded the government’s goal of 4.8 percent. However, while revenue generated from the tax amnesty has helped meet the government’s financing needs, moving forward it will be important to entice individuals not only to declare assets held abroad, but to invest some of it in Argentina. To that end, one of the important tasks facing Caputo will be to develop a capital markets reform law that creates an attractive investment framework, for both foreign and domestic investors. The government recognizes that first attracting local investment from Argentines will be important to generating the confidence needed to then boost foreign investment.

Dujovne’s debut

Macri has tasked new Treasury Minister Dujovne with developing a tax reform as well as a fiscal responsibility law. Dujovne has said one of the main aspects will be reducing payroll taxes for employers, as well as advancing plans for a “labor amnesty” to fight informality in the economy. A tax reform proposal, however, would likely not be debated in Congress until 2018, after the elections.

This year, the government is clearly prioritizing reducing labor costs and improving productivity as a means to boost economic growth. This was evidenced in a recent agreement reached with unions to cut labor costs at the Vaca Muerta shale formation. The government hopes to replicate this model going forward, although the unique panoramas of distinct sectors will pose challenges and are likely to run into opposition from labor unions, which are becoming increasingly uncooperative (see below). A lack of support from unions would make such efforts virtually impossible. The same is true of the government’s “labor amnesty” plan, which would need support from the CGT umbrella union.

Ruling by decree

Following the unexpected introduction of an income tax reform proposal in Congress by opposition leader Sergio Massa, the government was ultimately able to achieve approval of its own measure, albeit with concessions to the opposition (see here for background).

Since the close of the congressional session at the end of 2016 and ahead of the opening of the 2017 session, Macri has issued a series of decrees, including:

- Modifying the framework for workers’ compensation;
• Adjusting the holiday schedule to remove “bridge holidays,” days given to create long weekends when holidays fell on weekdays; and
• Modifying immigration law to make it easier to deport foreigners with a criminal record and also to make it more difficult for them to enter.

The government has argued that changes to the worker’s compensation scheme and a reduction in the number of holidays will boost economic productivity.

The decision to rule by decree while Congress is on recess has allowed Macri to pursue his preferred policies without having to negotiate, but have also allowed the president to demonstrate decisiveness and strength, part of an electoral year strategy. However, these measures have been criticized by the opposition in Congress and umbrella union CGT. The measures, and the fact they were implemented by decree, will be especially controversial in an election year in which actors are vying to stake out stronger positions.

Challenges in the year ahead

In late 2016, the government released a series of 100 medium- and long-term goals covering eight areas: macroeconomic stability, national productivity, infrastructure development, integration with the world, state modernization, strengthening of institutions, promoting sustainable human development and fighting narcotrafficking and insecurity. More concretely, Dujovne said in early February that he expects FDI to double this year, especially due to auctions for renewable energy projects.

The government will face multiple challenges this year as it seeks to implement these goals. On the international front, geopolitical changes and uncertainty could complicate efforts to boost trade ties with other nations (see sidebar).

Domestically, the government will encounter difficulties in its efforts to reduce inflation and close the fiscal deficit in a year in which elections and efforts to execute public works will exert upward pressure on government spending. Recent increases to energy tariffs, while important to shrinking the fiscal deficit, will also fuel inflation by an estimated seven percentage points over the course of the year. Central Bank President Federico Sturzenegger has emphasized that

Will Trump’s policies sour Argentine-US ties?

Although Macri’s administration has sought to improve relations with the US as part of a wider goal of increasing investment and trade, Donald Trump’s first weeks as president cast a shadow of uncertainty over Argentina’s reset with the US.

Several measures taken by the Trump administration since taking office, while mostly not targeted at Argentina, have direct implications for the country. Trump imposed a 60-day halt on the lifting of a ban on the import of Argentine lemons, which was introduced in 2001. While not an unusual move for an incoming administration, it represents a minor setback, since the ban was lifted in December, and is a sign of changes in the bilateral relationship. The outcome after the 60 days could give a better indication of how the relationship will look going forward. Argentina is also being affected by sweeping protectionist policies introduced since Trump took office, such as the tightening of requirements for visas granted worldwide. Policies such as these could impact steps taken in the past year. For example, Argentina had begun negotiating with the Obama administration to regain access to the Generalized System of Preferences (GSP), a program which removes import taxes on certain goods. This now requires the Trump administration’s approval.

On the other hand, the US Senate has demonstrated a commitment to the bilateral partnership. On January 24, four US Senators introduced a bipartisan resolution recognizing Macri’s economic reforms and urging greater US-Argentine co-operation, especially in economics and defense. On February 2, at the National Prayer Breakfast held in Washington DC, Vice-President Gabriela Michetti met privately with US counterpart Mike Pence in the government’s first official contact with the Trump administration. Details of the conversation were not disclosed.

Overall, we do not anticipate any major shake-ups at the bilateral level. While trade ties may falter, there are opportunities for increased, mutually beneficial cooperation in energy and security. However, Trump’s isolationism means that the Argentine government will need to continue its efforts to diversify economic partnerships away from the US, as will be the case for other countries in the region. Mexican President Enrique Peña Nieto has already spoken about diversifying trade and expressed plans to work more closely with Argentina.
clear anti-inflationary measures will remain in place in order to keep to 2017’s official target of 12-17 percent, although private estimates indicate the figure will be several points higher than the government’s upper limit. High inflation, a continuing fiscal deficit, and political uncertainty in an election year will make meeting investment targets difficult.

On the political front, the government will find it more difficult to move legislation through Congress ahead of elections, and it is likely there will be fewer initiatives passed this year in comparison to 2016. Political actors will take more oppositional stances this year. 

Collective bargaining season looms in key test for gov’t

Taking into account the challenges outlined above, upcoming annual salary negotiations will be a key test of the government’s ability to balance pressure from labor unions with the political need to deliver economic results. In fact, meeting its inflation and fiscal deficit targets will likely be impossible if salary raises are set above the projected inflation figure of 17 percent (accounted for in this year’s budget). Failure to do this will, in turn, undermine its chance both of securing foreign investment, and performing well in October’s elections.

In order to hit its annual inflation target, provincial governments and labor unions will need to agree to salary increases close to this figure. However, this is a delicate balance. While high increases will reduce chances of lowering inflation, refusal to compromise risks widespread social unrest, which would be equally, if not more, damaging to the government’s chances in the elections.

Many more combative unions and union groups - including the CTA and elements of the CGT - are demanding that this year’s salary increases take into account the loss of purchasing power they claim workers experienced in 2016. Recent hikes in electricity prices¹ are being used by these same elements to bolster their demands for salary increases significantly higher than projected inflation. The teachers’ union in Buenos Aires Province, which accounts for 40 percent of national student enrolment, has opened negotiations with demands of 35 percent; despite the fact that state-owned companies in the province had agreed to an 18 percent raise in December.

Ahead of meeting with teachers’ unions - the outcome of which typically sets the precedent for talks with other unions - the government has taken a number of steps to strengthen its position. Firstly, it has announced that inflation for 2016 came in at 36 percent - a figure calculated using the revamped CPI, (which returned in May), and conservative estimates for the first trimester of the year. This sets a conservative benchmark for salary negotiations to occur.

Secondly, in an unusual move, the executive branch has handed responsibility for collective bargaining with public sector workers to provincial governments. These talks had been historically led at the national level. The government’s public take is that this gives provinces the autonomy to set salary increases for the workers they pay themselves - although not intervening also gives them with a useful opportunity to sidestep responsibility in the event provinces concede too much ground. This is a shrewd move, the result of a deal struck between Macri and provincial governors following the government’s weak performance in leading negotiations last year (see here), which had strong fiscal ramifications for the provinces.

Notably, provinces with fiscal deficits have agreed to reduce those deficits by 10 percent in 2017 (as part of 2016’s budget negotiations), and face additional restrictions on public

¹ Between 60-148 percent for residents of Buenos Aires and greater Buenos Aires, lower increases for the rest of the country.
spending. If they meet the federal government’s expectations, they will eventually be able to take on debt without federal approval. This therefore creates an extra incentive for them to negotiate aggressively with unions, although again, a fine balance must be struck. On February 2, representatives of 16 provincial governments agreed to lead negotiations as a bloc. Although they have not yet defined a single benchmark for raises, the agreement strengthens their negotiating position. The move was most likely motivated by a need to avoid conflict with the CGT, which met the same day to define an ‘action plan’.

**CGT cuts ties in major blow for gov’t**

After several months of relative peace, the government’s relationship with the CGT became increasingly tense in January. The umbrella union’s main objections are that dismissals have continued in spite of an agreement to freeze layoffs from December 2016 until March 2017, and the government’s economic policies. As a result, on February 1 the CGT suspended its dialogue with the government because, according to the leadership, “trust has been broken”. The following day, the tripartite leadership announced an ‘action plan’, which will involve a CGT-led strike set for March 7, followed by a general strike later that month. **This would be the first general strike of Macri’s presidency.**

This deterioration in relations comes as the government attempts to win the CGT’s support for a proposed labor reform package. Since the principal objective of these initiatives is to cut labor costs in a bid to shore up foreign investment, the risk of confrontation was always going to be high. Key parts of the reform include a major initiative to reduce the size of Argentina’s informal labor market (estimated at 38 percent of workers), which aims to incorporate over 300,000 informal workers into formal employment annually through 2019, changes to the collective bargaining framework, and modifications to the labor risk insurance system.

**Implications**

**We consider this latest rupture to constitute a genuine threat to the government’s relationship with the CGT, and it marks the first time the confederation is actively moving against the government.** A more combative CGT will present a new challenge for the Labor Ministry. A cooperative relationship with Argentina’s most powerful labor union grouping enabled the Macri administration to govern effectively for its first year in office. Losing the support of this actor means the Macri administration is now more likely than ever to face widespread union mobilization, which has the potential to seriously undermine midterm campaigning efforts. In addition, if the government is forced to grant concessions to the unions in order to rein in social conflict, this will almost certainly have fiscal implications.

That said, the break in dialogue is not a particular surprise: the climate of social tension that typically precedes collective bargaining negotiations explains the timing of the CGT’s more combative approach to its dealings with the government. In addition, as this is an election year, politics is inevitably playing a more important role than before. **Although there are still reasons for the CGT to continue cooperating (the potential to secure pro-worker benefits through negotiation), the mainly Peronist confederation is now under increasing pressure from its base to characterize itself as a key opposition actor.**

This development is a serious blow for the government, even more so considering the timing of the break in dialogue. While the CGT does not play a formal role in collective bargaining negotiations, it is essential for the government that the confederation is on side ahead of talks beginning due to the political weight their support carries. The same goes for the labor reform package, which, assuming the CGT maintains its newly combative stance, looks to be jeopardy. All this will increase the risk of rising social conflict and lost votes in the upcoming elections.
Election Watch: 2017 Midterms

The 2017 legislative elections, which will see the replacement of 24 Senators (representing a third of the Upper House), and 127 deputies (half of the Lower House) will be the first electoral test of the Macri administration. Two gubernatorial elections will take place (Corrientes and Santiago del Estero).

As always, the main electoral battleground will be Buenos Aires province, where approximately a quarter of total seats will be in play. At this point, it is still too early to say who candidates will be, with actors including Cristina Fernández de Kirchner (CFK), Sergio Massa, Elisa Carrió and Margarita Stolbizer all “flirting” with the idea of running—this way, they benefit from the uncertainty (which translates into continual media coverage) surrounding their candidacies. The opposition in the province remains fractured into three divisions. The Peronists include the “cristinistas,” the hardline elements that remain from kirchnerismo (which has been shrinking in size and popularity since CFK left office). Naturally, CFK loyalists would support a CFK candidacy. Meanwhile, centrist Peronist Party elements do not yet have a clear candidate. The third faction is the Frente Renovador (Renewal Front), led by Sergio Massa. However, after breaking with the Peronists, Massa has established his status as an independent outsider, and it is uncertain if PJ loyalists would accept him back into the fold. His popularity has also dipped since the income tax reform fallout. CFK retains a solid base of support and has the greatest chance to provide a win for the opposition. The Peronist Party may have no alternative but to back CFK on the ticket, especially if moderate Peronist elements are unable to field their own candidate. This state of affairs, in which Peronist candidates would split the vote, could give the government an important advantage come October. In addition, it is important to note that the government’s hopes in the province are pinned not so much on the candidates themselves, as much as the high popularity of Governor Maria Eugenia Vidal translating into votes for Cambiemos.

Things are equally unconsolidated on the government’s side. In Buenos Aires province, there have been some signals that the government will back Vicente López Mayor Jorge Macri (who also happens to be the president’s cousin) to run for one of the province-wide posts. Otherwise, potential candidacies for the government remain largely undetermined. Candidacies are likely to remain in flux over the next few months, until closer to the election, when each side will be forced to reveal its hand.

While the battle for Buenos Aires province will of symbolic importance, the majority of seats will be voted on in other provinces. Winning a majority of the seats on offer nationally would clearly demonstrate that Cambiemos has a mandate to continue along the path it has laid out. However, it is a virtual impossibility that the government will win a majority in either house of Congress. Nevertheless, even in a scenario where the opposition wins Buenos Aires province and a greater number of seats overall, we do not believe this would represent a resounding defeat for the government. Most of the seats up for grabs this year were won in the 2013 elections, at a time when CFK was enjoying strong support. This meant that many of these legislators were aligned with her and responded to her interests. Conversely, Peronists elected this year are more likely to have been chosen by the state party structure, meaning that governors will exercise more influence over their behavior. This is key, as the Macri administration has established a good working relationship with most opposition governors, cooperation we believe will continue. There is an ongoing need for transfers from the national government. In addition, most governors (with the possible exception of Salta Governor, Juan Manuel Urtubey) do not have presidential aspirations, and will likely prioritize re-election. Therefore, having new Peronist legislators that respond to provincial leaders, while not ideal, would in any case be more beneficial to the government than the current scenario.