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Weekly Economic Update

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Friday the 13th was a scary day for leaders in Latin America with the impeachment of Brazilian President Dilma Rousseff, the indictment of former Argentine President Cristina Kirchner, and a state of emergency declared in Venezuela by embattled President Nicolas Maduro. We were able to witness this air of change first hand as we visited Buenos Aires this week for the first time in three and a half years to discuss the new business environment with leaders of the Macri government elected five months ago. Rarely have we seen so profound a shift in the economic environment.

The new government is moving quickly to capitalize on the desire for change – but in a political situation where they do not control either chamber of the legislature. Their approach is one of complete openness, where they state specific goals and move rapidly to achieve them believing that freeing the economy from the constraints of Kirchnerism will provide growth which validates the need for even freer markets. Settling with the holdouts from the default in 2001 was the first step. This allowed them to raise $16.5 billion in badly needed funds from the world markets – but they consciously left a lot of money on the table as bids were for $69 billion in new Argentine debt. They moved just as quickly with the removal of subsidies on electricity, resulting in a 7% spike in inflation in April alone. Today's papers carry news of a $216 million settlement with energy producers for 2001 issues clearing the path for fresh investment. Their bottom line is the bottom line. Encourage investment in Argentina's huge – but long dormant – potential and good things will happen.

Interestingly, the concentration of power into the hands of the President during the de Kirchner government will actually help Macri as he has the power of the purse to negotiate with provincial governors and members of other parties. Half of Argentina is encompassed in greater Buenos Aires, and for the first time in the country's history the Mayor of the City of Buenos Aires, the Governor of the Province of Buenos Aires and the President of Argentina are all from the same party. They all have worked closely in the past as Macri was Mayor of Buenos Aires before his election to the Presidency. However, most of the other ministers and officials we met were not career politicians, but business leaders who had left lucrative positions to try and make a difference. We noted that many had returned from abroad to work for the government – however, it is less clear that their money has yet returned. Locals frequently noted that there was only $80 billion in financial assets in Argentina, but $400 billion outside. Clearly, the government does not need to convince Wall Street or anyone other than their own citizens that it is time to bring at least some money home.

The number one concern is inflation, which is currently running north of 40% due to the removal of subsidies which drove many long managed prices sharply higher. In a nation where inflation has routinely run over 2% a month, high inflationary expectations are imbedded in wage negotiations and the business mentality. The government is seeking to break this dependency through the power of the invisible hand by just getting out of the way. Yet, even here their options are limited. Wage contracts often have fixed escalators priced in for three years, so progress on limiting price hikes must be tempered or a massive profit squeeze would result. One step has been to move negotiations from every year to each six months to limit COLAs as inflation ebbs. They are targeting a slowing of inflation to below 17% for 2017 and 5% by the end of Macri's first term.

We believe they will be successful as the major cause of money creation in Argentina is not profligate lending by banks – but rather good old fashion peso printing by the Treasury. Indeed, with limited reserves in the banking system and highly concentrated wealth, there isn't much lending in Argentina. Indeed, banks pay zero on deposits despite high inflation, so few depositors hold more there than necessary. Meanwhile, banks can invest in Government paper at high rates due to inflation and fund the 2.5% of GDP budget deficit -- so why lend to the public. With the developing pro-business environment, the banking sector is attracting a lot of foreign interest.

Macri aims for a balanced budget by the end of his first term. Clearly, if revenues rise and spending falls as expected, the printing press will not be needed and inflation will abate. A lot of this depends on confidence. The Government is betting on dynamics as lower export tariffs are expected to substantially boost export sales, leading to higher tax collections in an expanding economy. Moreover, with roughly 30% of Argentines currently living in poverty, a stronger economy will reduce demands on Government services. In any case, it is the Government which is in charge of the printing press, so this is not a philosophical debate or an economic one – but pure politics.

Hence, the Government's need to take bold action and score early successes to build toward the mid-term elections in 2017. Many ministers reiterated their view that their focus was on the medium to long term – rather than a series of short term fixes as under the previous Government. They were also careful to keep their eyes on the road ahead given the strength of the Peronists – not all of whom supported Cristina – who still control the legislature. There was an almost universal feeling that success would buy both time and more room for flexibility in trying strategies which would never have occurred under Kirchnerism. Conversely, the greatest risk is that if the economic wind luffs in their sails, the Macri Government's successes could simply be clearing the way for a new Peronist leadership – similar to Nestor Kirchner after the 2001 default.

Will the events in Argentina be a precursor for developments in Brazil and Venezuela? First, it should be noted that Argentina is looking at Chile's long recovery from the Pinochet dictatorship to a more pro-business environment as its template. Technocrats are favored over politicians. Argentina's new Finance Minister, Alfonso Prat Gay, was the 37 year old central banker who reduced inflation from 40% to 5% from 2002-2004. With the elevation of Michel Temer to the Presidency in Brazil, he immediately named Henrique Meirelles, the widely acclaimed central banker from 2003-2010, as his Minister of Finance. Meanwhile, the aggressiveness of the Argentine judiciary in indicting former President Kirchner and investigating her associates mirrors the corruption campaign in Brazil, where the judiciary appears to be the only uncorrupted adult in the room. With the demise of Presidential control, other government institutions are seeing the opportunity to do what many felt was always their duty. The question is will enough success reach the masses to allow for stability during these changes. These events are being watched closely not only in Venezuela, but Cuba and Iran as well.

Too much external optimism about the shift away from left leaning governments to pro-business environments is actually a problem for these Latin nations. In Argentina, the government appears to be talking down the pace of change, because a rousing success would attract far too many dollars – driving up the value of the Argentine Peso. Argentina sells soybeans in hard dollars to China and needs to maintain a weaker currency to maximize the peso benefits of those sales for domestic entities which still face rampant inflationary pressure on wages. Unfortunately, with few emerging markets looking attractive right now, the success of a virtually debt free Argentina has a lot of outsiders looking for a way to participate. Brazil has faced similar pressures, as the value of the real has risen and fallen as Rousseff approached or dodged impeachment.

We view the shifts in Latin America as part of the policy response in this first year of a global recovery. Politics moves more slowly than financial flows, but they are more long lasting in direction. We expect that Latin America will be adopting more pro-business environments for the next several years – and attracting more money from the developed world where investment opportunities are likely to remain paltry. US growth is now estimated by GDP Now at 2.8% in Q2 following the upbeat retail sales report. Coming off a 0.5% Q1, this still points to growth running at our new anemic 1.8% potential. Europe was better at 2.1% growth in Q1, but like the US is expected to moderate to 1.5% for the year – which adjusted for population is almost 1% better than the US. China's latest statistics suggest a bottoming, with real GDP growth at 6% -- but closer to 0% nominal in the tradable sectors. Bottom line, the big economies are no longer getting worse – but they are not getting much stronger either. Thus, we expect receding risk aversion will increase interest in promising emerging markets – like Argentina, and maybe more of Latin America soon.

Michael Drury is McVean Trading's Chief Economist and Chairman of the Global Interdependence Center. McVean Trading is a proud sponsor of GIC, a non-profit headquartered at the Federal Reserve Bank of Philadelphia, which holds 15-20 public events each year binging together global business leaders and policy makers to discuss critical issues including monetary policy, energy and trade. In addition, GIC's off-the-record private roundtables promote frank conversations about often delicate topics and a deeper understanding between participants in our increasingly interdependent global economy. To learn more visit www.interdependence.org.