

Trip Notes



Southern Cone Road Trip 2022

Aktia

Southern Cone Policymaker Meetings

Overview

- We travelled to the Southern Cone in late May: Chile, Uruguay, and Argentina. The countries have some similarities but remarkable differences too, such as in the political outlook and institutional strength. Inequality and poor education are issues in all these countries. The Chilean economy is mostly based on copper mining, but Uruguay and Argentina are known as soft commodity producers. Our interest focused mostly on political developments due to recent events ie. the new constitution in Chile and the IMF-program in Argentina, and structural issues in the countries.
- In over 20 meetings we met representatives of central banks, ministries of finance, academics, consultants, political analysts, and politicians, which gave an updated picture on the current economic environment and the prospects for these countries.
- Common themes were post-Covid economic recovery and the effect of the war in Ukraine. Also, in all countries, there are lot of indexed items in the CPI, keeping inflation sticky. All the countries are well covered – there is a lot of information available – so in this note, we concentrate more on giving an inside view of the latest political developments.



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Picture of Casa Rosada in Buenos Aires, Argentina



Meetings With Policymakers

Chile

Chile

- Unsurprisingly, the main topic in the discussions was the constitutional reform. The current one was written during dictator Pinochet's administration and the need for the rewriting was one of the main demands during the protests in October 2019. However, the constitution was signed by the centre-left president Ricardo Lagos in 2005 and there has been a lot of amendments in the constitution during its life, which describes the political nature of the whole process. At the beginning of the renewal process, there was a lot of hope that a new constitution would be a game changer. However, it now seems that there is clearly less excitement around it. One reason was the process itself – there was no framework or common values to guide the work and the draft ended up being more of a list of wishes.
- A committee is trying to write the list of wishes in the form of a law, and the working group is highly professional. As a result, expectations are high that the final constitution will be acceptable. However, the views about the outcome differed a lot. Officials and academics were more positive about the acceptance, but the private sector had very negative views. The biggest issue has to do with property rights, which was seen to influence the possibilities of attracting future investments into Chile. Additionally, governance will become more complicated with new administrative layers, and some see that the risk of corruption might increase. The governance and the social responsibilities written into the constitution were seen to add fiscal pressures in the future. However, the final wording is still open.
- There will be a referendum about the new constitution and the political campaign is expected to be dirty. Especially the private sector will use a lot of money on campaigning to get the constitution rejected. Also, as the momentum for the new constitution has decreased, people are less interested about it, which adds to the probability of rejection. The odds are however in favour for acceptance. This might, however, partly be wishful thinking, as nobody knows what the next step will be if the constitution is rejected. That would increase the short-term volatility in Chilean markets.

- In addition to the constitutional reform, the current administration aims to reform taxation and the pension system. The tax reform should be finalised in June and the proposal includes an increase in income tax, subsidy evasion, some environmental tax, and changes to mining royalties. The implementation will take several years. For example, the current mining royalty has been agreed to last until 2024. The pension system reform is still in the middle of discussion and there are no expected changes in the basic principles. There is no consensus view in the government about the pension reform, but the target is to introduce the bill in the third quarter of 2022.
- Inequality is the biggest problem. The resulting violent protests are a phenomenon that Chileans are not used to. The country is rich with its copper reserves. However, the increase in wealth has benefitted only a small part of the population. Almost all agreed that something should be done to remedy the inequality, but no one has a clear answer on how to address the issue. Inequality also adds risks to a populist policy, which does not help in solving structural problems. Furthermore, rising prices have moved the focus to inflation and the cost of living.
- Inflation has been low in Chile for several years, so the current figures have been a shock both to the officials and the people. The central bank has hiked rates aggressively but has been a bit more cautious in its tone lately. There was some criticism to the guidance that the central bank has given but the board member we met described their thinking in a very detailed manner. The central bank follows all the possible indicators and does not like to affect market pricing. The focus is mostly on inflation expectations and the central bank fine tunes its policy according to short term, defined as 1–3 years, expected real rates. The Chilean peso has a role as an indicator but not in the monetary policy setting. The most worrying thing for longer term inflation expectations are the indexed costs which have a 20% weight in the CPI basket. If inflation stays high for a prolonged period, there could be a negative feedback loop. Although the current inflation is very high, there was a strong consensus view that it will converge back to the central bank target. If not immediately, then in the coming years.

Longer term growth was seen to be low, with the potential growth estimations varying between one and three percent. The biggest threat for growth was thought to be the new constitution and overall low productivity. The private sector is very pessimistic about the government's ability to solve structural problems and some companies are seeking to diversify their production abroad.

- We have been adding Chile in our traditional Local Currency Strategy and the trip did not change our view. We have Chilean green and sustainability bonds in our Hard Currency Strategy. Although locals were a bit pessimistic about prospects, we still see Chile's fundamentals as strong compared to regional peers. However, political noise might increase during the constitutional referendum.



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Meetings With Policymakers

Uruguay and Argentina

Uruguay

- Uruguay has been one of our strategic investments for a long time. Based on several measures, Uruguay looks like a developed country. However, the main concern has been structurally high inflation and the central bank's inability to achieve its inflation target. Inflation has been closer to 10 percent in the last 20 years. Although inflation is high, it is stable, and the central bank sees inflation anchored at 7-10 percent. The main reason behind high inflation is the wage negotiation system where unions, employers and the government negotiate wage hikes together and there is very strong indexation. The wage-price spiral is avoided by the subsidised prices – in wage negotiations the government promises to keep energy costs stable, for example.
- The central bank target has been redefined lately. The legal mandate has not changed but its interpretation is different: although the central bank has an inflation target range, the emphasis was on supporting growth. The current wording is more towards inflation targeting but the central bank can support growth during crisis. However, the central bank is not completely independent, the term of the directors, coincide with the government and both are appointed by the president, which may threaten its credibility. The inflation target range will be reduced by a percentage point next September to 3–6 percent. There was wide agreement that the new target will be missed.
- The main risk is the expensive peso, as the rising commodity prices have been supporting the currency. The peso is overvalued by approximately 50% against Argentine peso and 25% against the Brazilian real. Tourism is important for Uruguay, and Argentina and Brazil are the main sources for tourism. Therefore, the pressures to let the peso to depreciate will increase. The dollarisation rate in the economy is high. Cheap items are priced in pesos, but more expensive items are priced in dollars. A common phrase among the locals was "tell me, how much does your car cost in pesos?"

- One of the biggest longer-term problems have to do with slow growth and low productivity. The central bank saw potential growth around 2.5% but the private sector players were more pessimistic and expected under 2% growth on the longer-term. There are no significant investment projects in the horizon and especially the year 2023 looks challenging when all the old projects are finished. There are some reforms, but they sound more like fine-tuning than a real attempt to make the economy more dynamic.
- In the previous years, Uruguay has been trying to improve money and bond market liquidity. The local currency market is divided into domestic and global bonds. The size of domestic market is around USD 13 billion and the global market is around USD 6 billion. Domestic investors are very active players also on the global market. Foreign investors own approximately 30% of the global inflation linkers. Nonetheless, the amount is not large compared to the whole market size and the ability of local players to absorb the supply during possible selloff sounded weak.
- Overall, our view about Uruguay did not change during the meetings. The country is very stable, the biggest short-term risk is a correction in FX. Uruguay has been a long time one of the core holdings in all our strategies.
- 2022 has started spot on from budget point of view, both revenues and expenditures are inline. Government will reduce fuel subsidies gradually via tax reforms but not before pipeline conversion to carry finished diesel is completed (estimated to happen in June/July). Pipeline conversion is done since Zambia has closed down its own oil refinery business. Copper price for the budget is \$9000 but at the same time production is slightly below target.

Argentina

- Argentina has a reputation as a serial defaulter. Therefore, we were very eager to get a better picture of the latest developments in the country in advance. High inflation, persistent budget deficits, low growth, a big grey economy, and no access to market financing are the biggest problems. Despite economic challenges, the development of the economy and national income levels are high compared to peers. The economy keeps running with the help of the IMF and achieving the targets under the EFF (Extended Fund Facility) program is crucial in 2022.
- The latest EFF program was agreed before the war in Ukraine started. The aim of the agreement is to give time to Argentina to carry out necessary adjustments. The IMF set three fiscal targets for Argentina: a cumulative floor on federal government primary balance, a ceiling on federal government stock of domestic arrears, and a non-accumulation of external debt payments arrears by the federal government. In addition to the fiscal targets, there were two monetary targets and a couple of structural benchmarks.
- The first review is ongoing and the dialogue has been constructive. The program was mainly on track. There are some areas where the IMF would like to see more commitment, but the policy setting was seen mostly consistent to meet the targets. The economic environment has dramatically changed after the beginning of the war and the IMF will be flexible. As a co-operative organisation it wants to help Argentina in a deteriorating situation and the aim is to get Argentina back to the markets – although not without Argentina's commitment to the targets. The fiscal target is the most challenging and the discussion were mostly concentrated on that.

Meetings With Policymakers

Argentina

- The central government subsidizes many prices, so high inflation may make it difficult to achieve the budget targets set by the IMF. Approximately 60% of the budget is based on laws, so most of the expenses are fixed in the short term. The current administration does not see an urgent need for adjustments and there is no plan how to cut fiscal deficit, if needed.
- The market is not pricing short-term risks (NDF yields are flat) but, at least 2023 was seen as challenging – some saw even the immediate devaluation of the peso as possible. The improving terms of trade helps, but the spread between the official exchange rate and the black market is wide (120 vs 210).
- The central bank has multiple targets. Inflation is one of the targets, the central bank saw that rate hikes are necessary, but not sufficient for bringing inflation down. Other policies and conditions will contribute too: the fiscal situation and financing, monetary aggregates, income policies, foreign exchange rate level, to name a few. The policy toolkit looked very complicated.
- We also met some representative of the political opposition who were very worried about the recent economic development. People are angry about the rising prices, and the opposition saw an opportunity to get into power in the next elections late 2023.
- The country has strong long-term prospects. In addition to being one of the biggest soft commodity producers in the world, it has remarkable gas, oil, and lithium reserves. According to estimates, lithium reserves are the second largest in the world, but many had doubts about the current administration's ability to utilise the potential. The estimated growth is 71% in petroleum production and 30% in gas up to 2026. The level of private sector debt is low.
- We see that it's too early to invest in Argentina. All the problems are unsolved, and we would like to see a clearer path for Argentina to get back on track.



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Obelisco in Buenos Aires

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