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# *The economic outlook of transition*

*Fernando Navajas*

*Council of the Americas, New York, May 25, 2016*

# The macroeconomics of transition

- A small scale case of the economics of transition from centrally planned, interventionist regimes
  - 12 year macroeconomics of populism with full menu
- Narrow degrees of freedom, urgencies and sequencing
  - All measures aligned towards restoring private investment. Exchange-rate, Anti-inflation bias, Hold-outs, Subsidies
- Impact effects vs. stabilization/growth effects, in real activity and prices
  - Outlook I: “impact effects are negligible”
  - Outlook II: “They are not”, and so they were not !!!!

# The chosen path

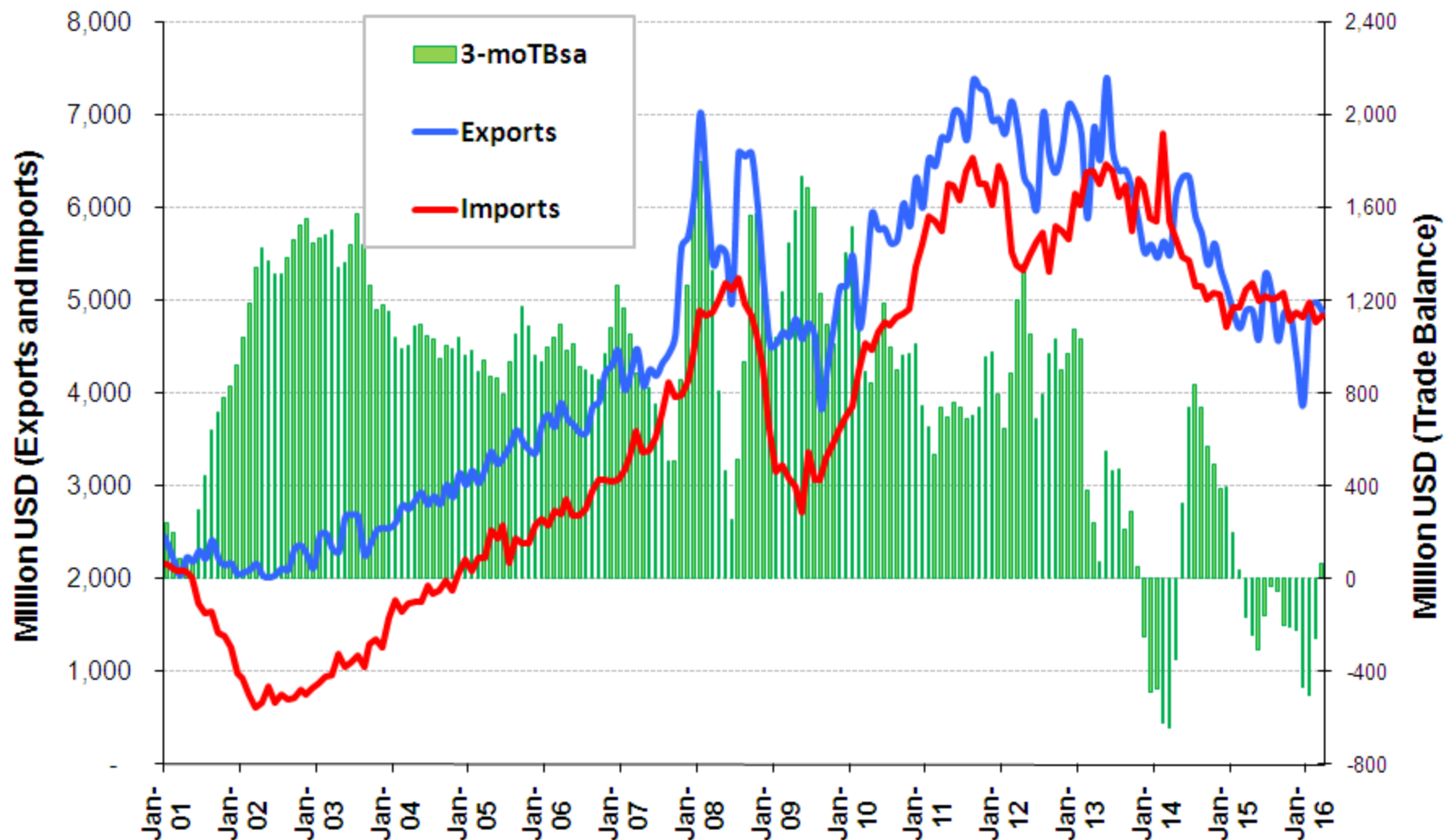
- Absent a full menu of policies in the fiscal, monetary, incomes fronts
  - “I can’t / I don’t believe” (fiscal policy, incomes policies)
- Stand alone monetary policy, with short and long run inconsistency problem
  - Adjustments of relative prices create non-core inflationary shocks that “contaminate” the core inflation and the wage setting process
  - Primary public expenditures at an expansion rate that is not consistent with low(er) inflation
- High interest rates and risk that the economy remains in a low-activity/inertial-inflation trap

# The short term outlook

- External front signals are mixed: Brazil, export prices, financial conditions
  - So, relevant drivers in the short run are domestic: impact vs. stabilization effects
- Data on real activity and inflation: How to read it?
  - Outlook I reading: mixed signals, green shoots, good nowcasting. Recovery is already on course, and is not affected by interest rates that do curb core inflation. Expectational upside ahead
  - Outlook II reading: mixed to bad signals, recovery not detected, interest rates impact on activity, shocks and inertia contaminate core inflation
- Outlook I gaining ground? or “false positive” problem?

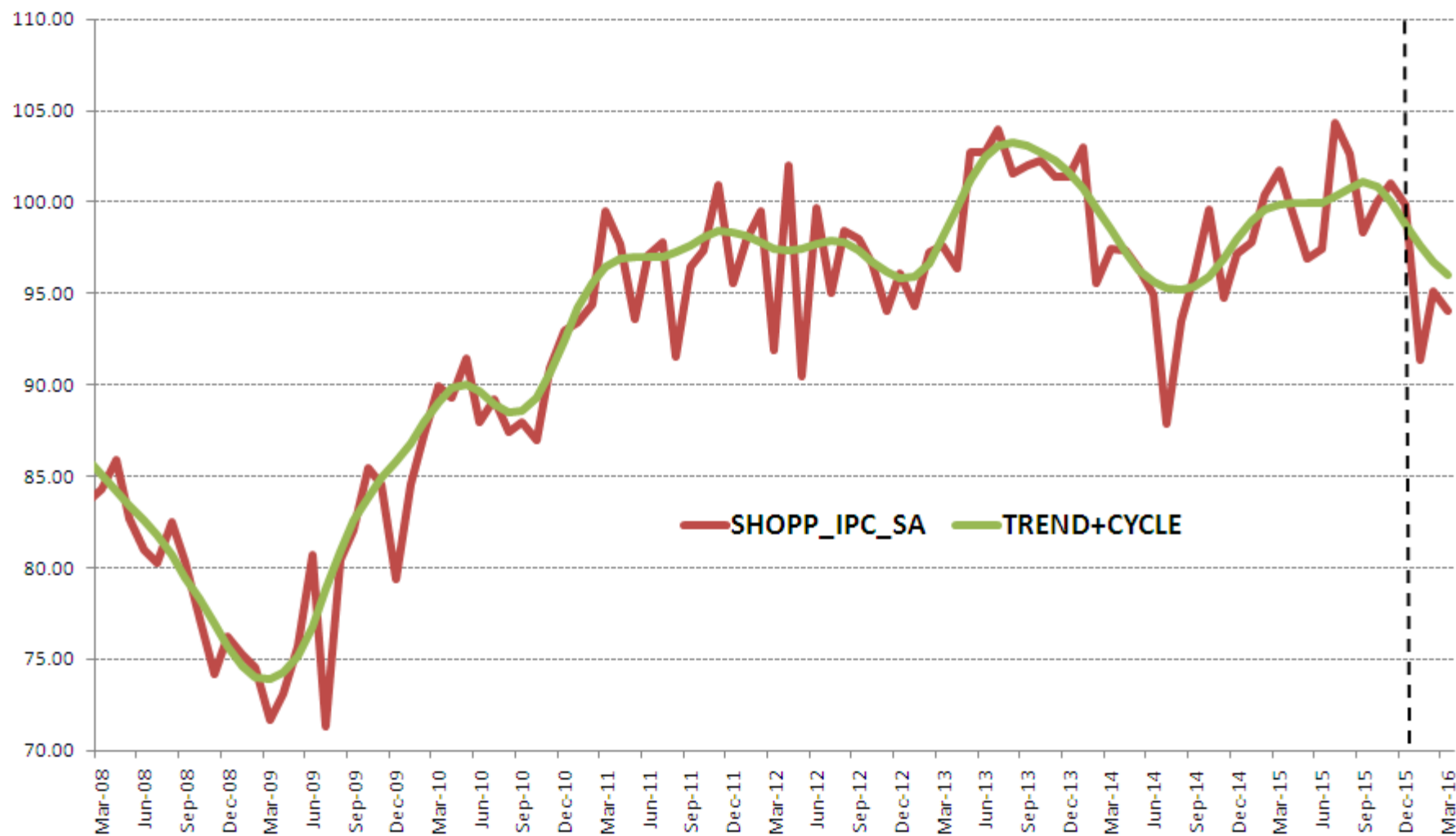
## ARGENTINA: Exports and Imports

- seasonally adjusted -



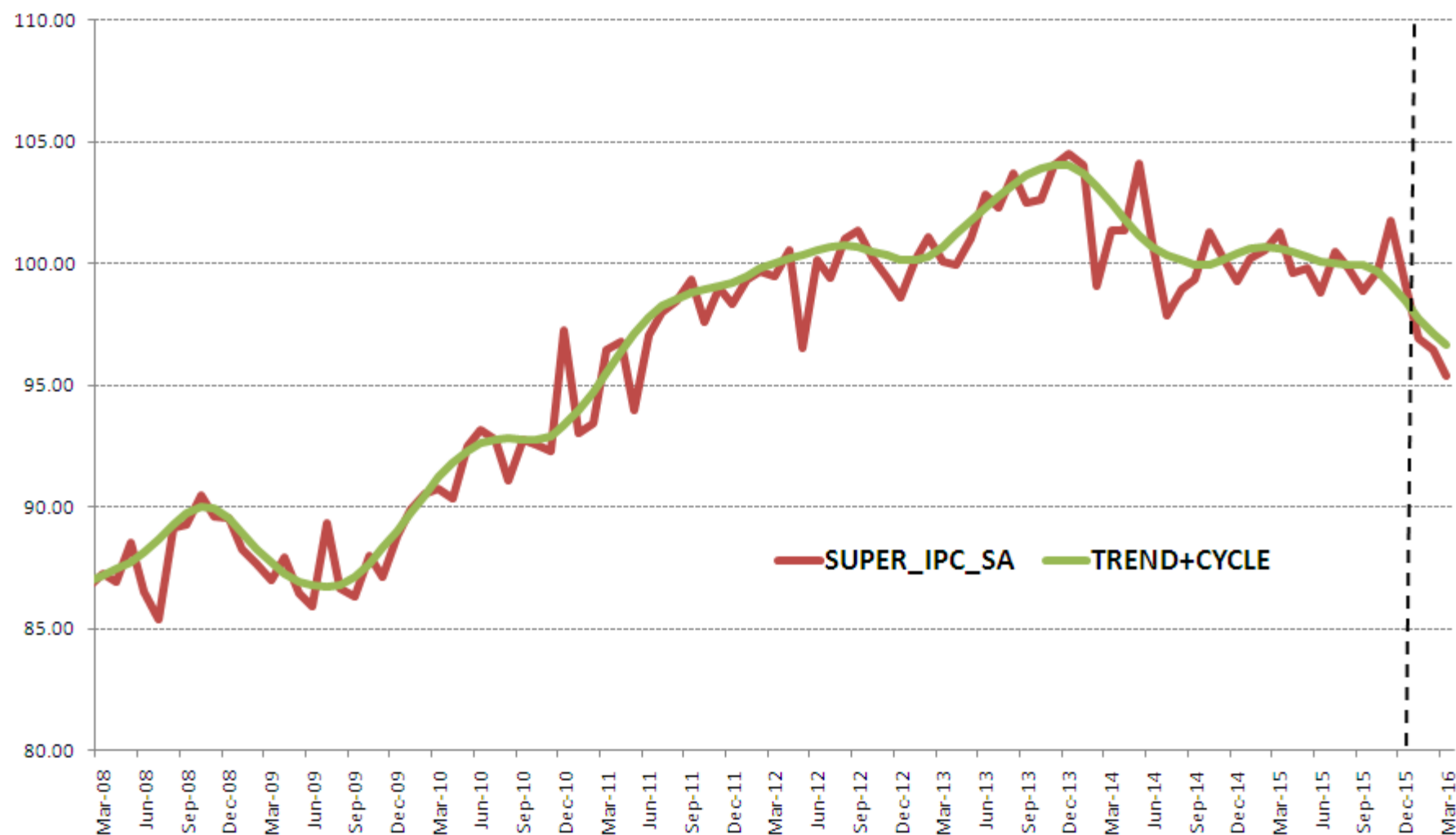
# Real sales in shopping centers

(CPI FIEL deflator, seasonally adjusted, 2015 = 100)



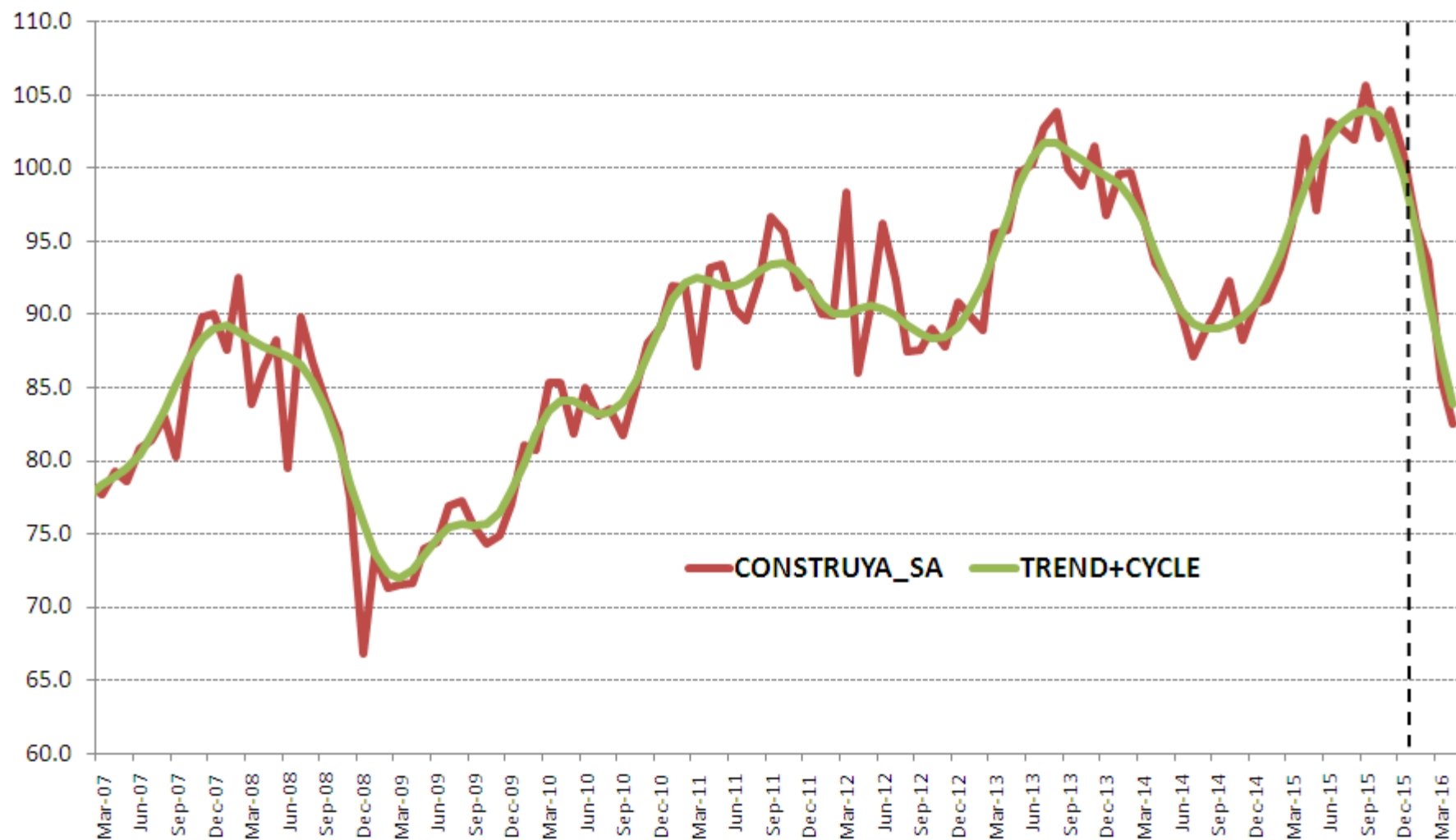
# Real sales in supermarkets

(CPI FIEL deflator, seasonally adjusted, 2015 = 100)



# Building sector index

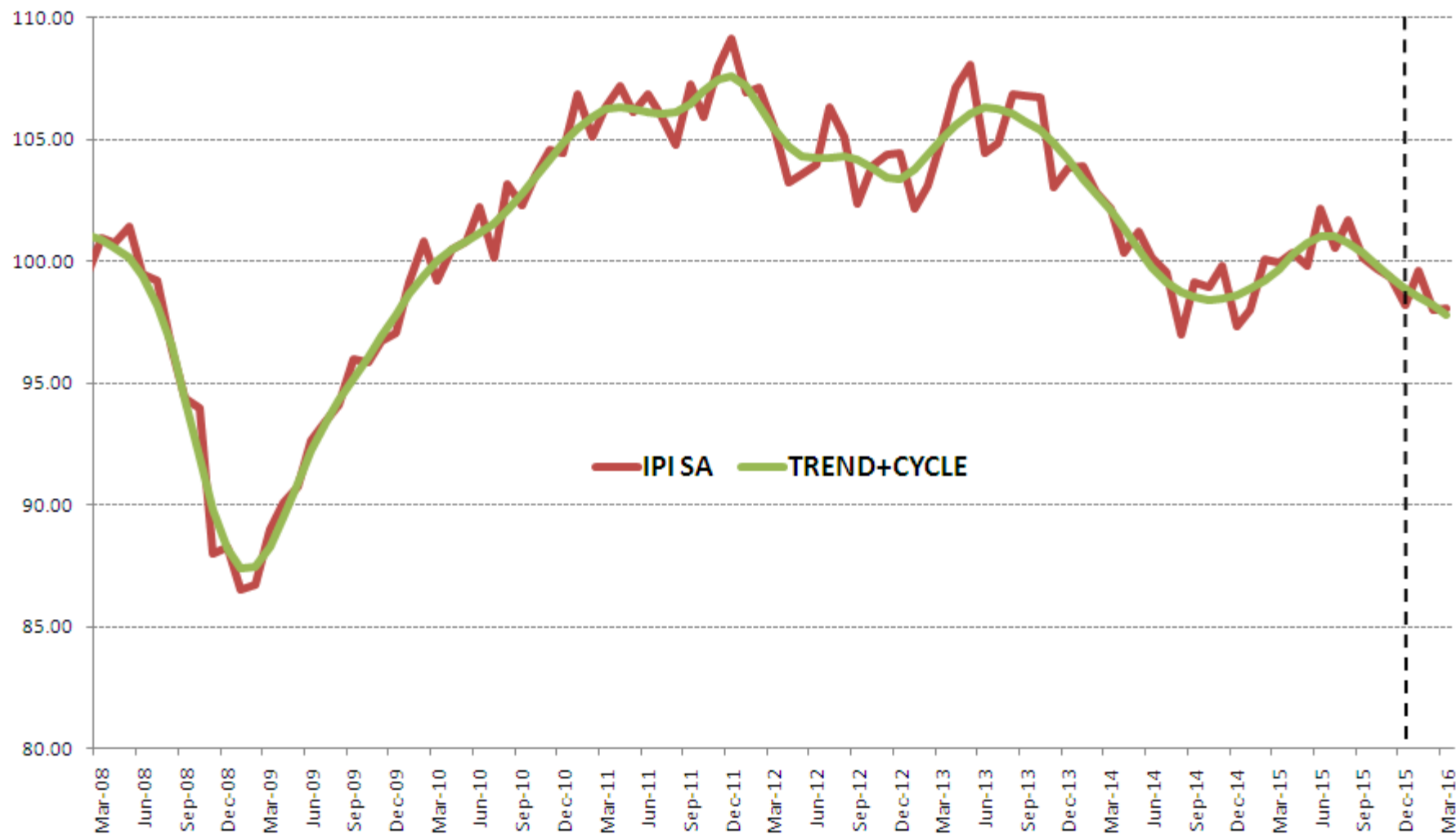
seasonally adjusted, 2015 = 100





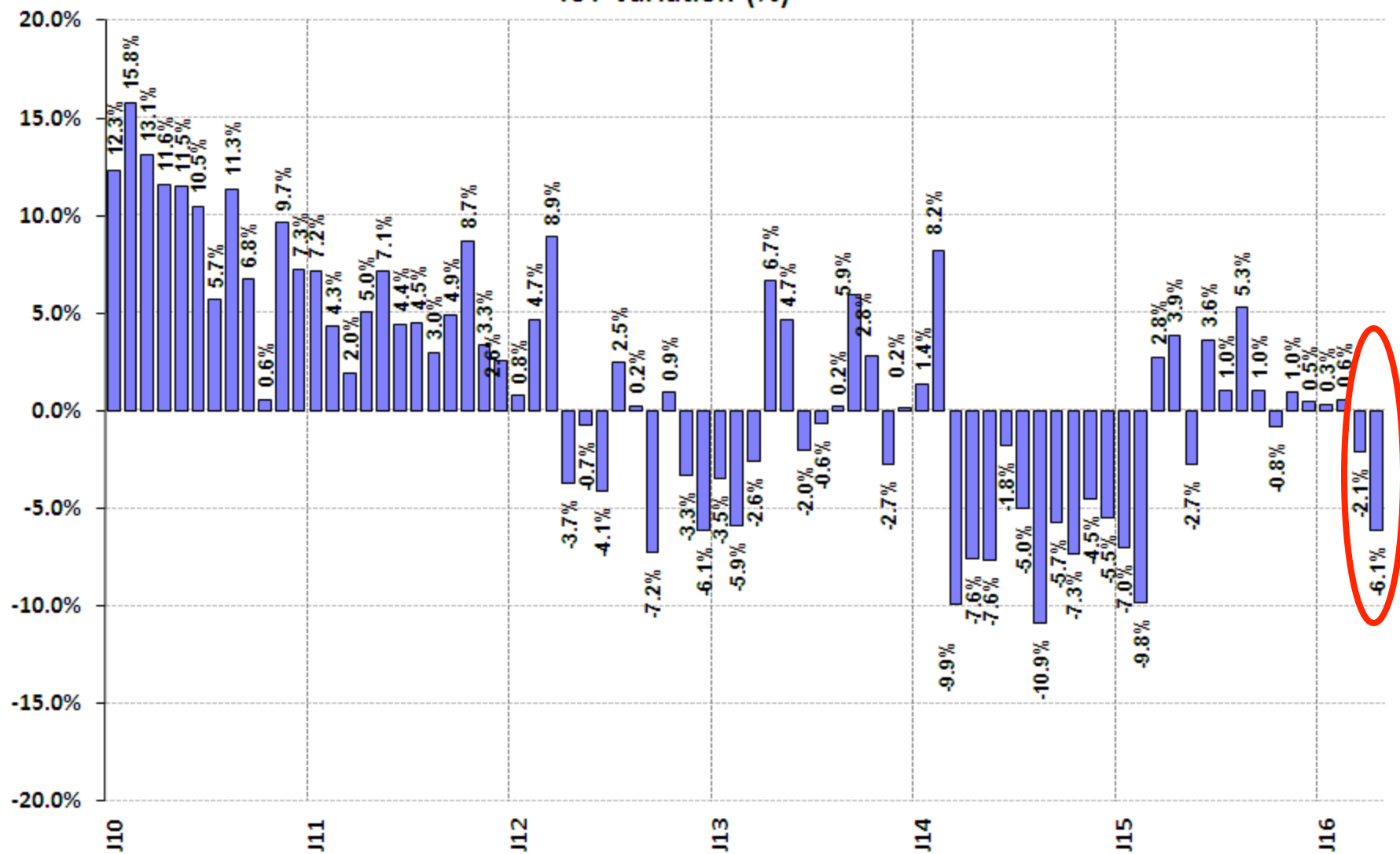
# Industrial Production Index

(IPI FIEL, seasonally adjusted, 2015 = 100)

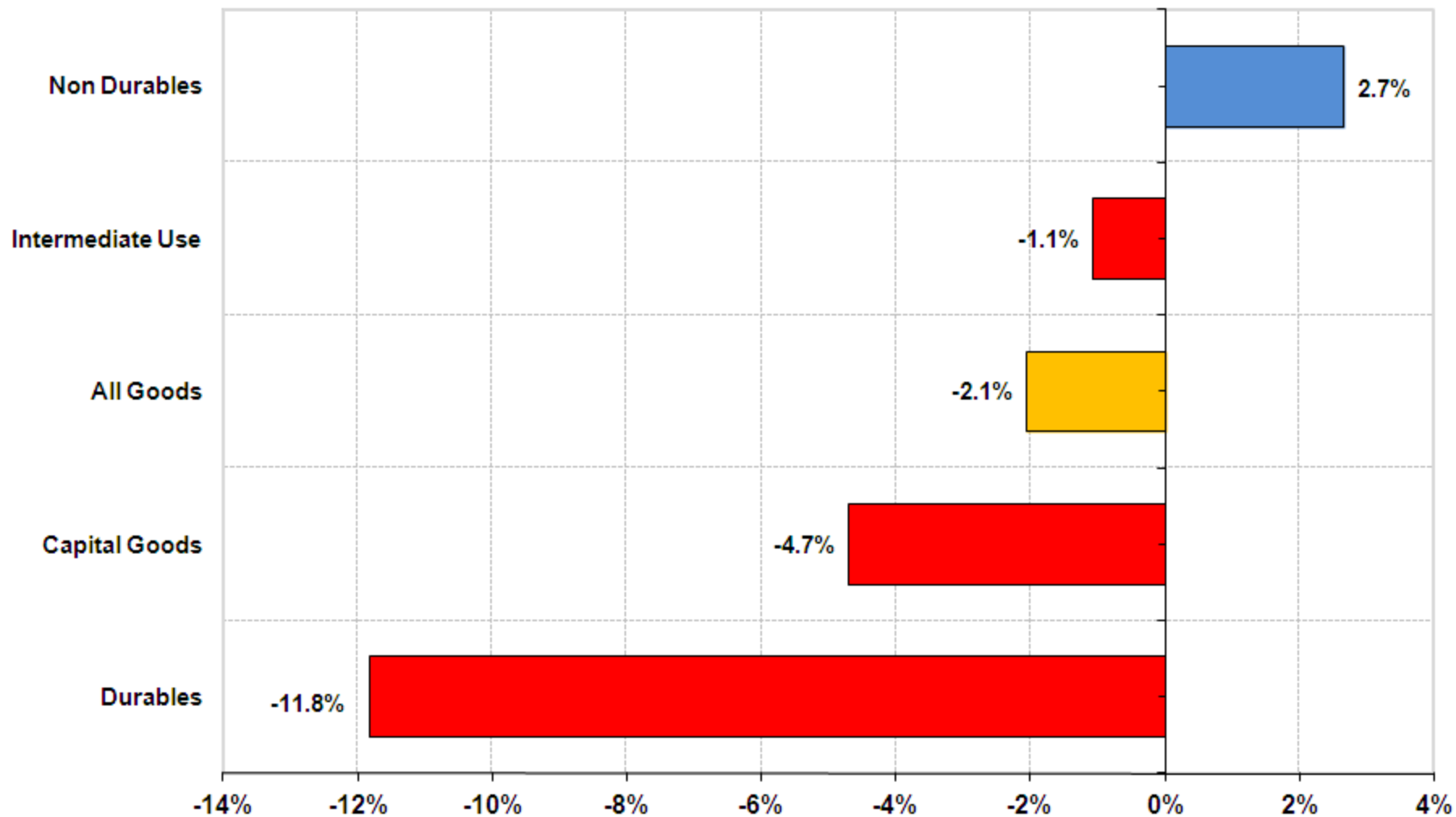


# Industrial Production Index (IPI)

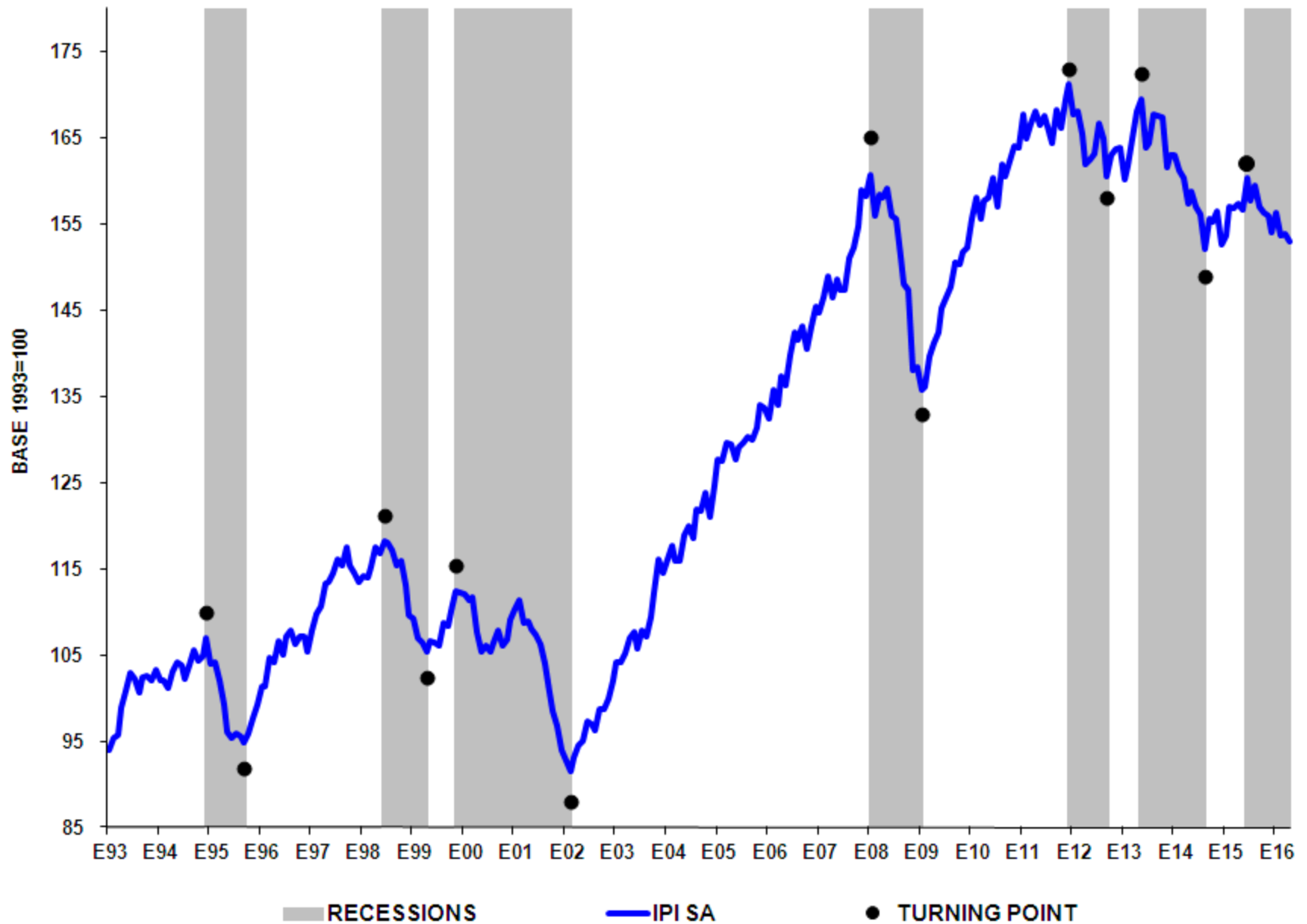
## YoY Variation (%)



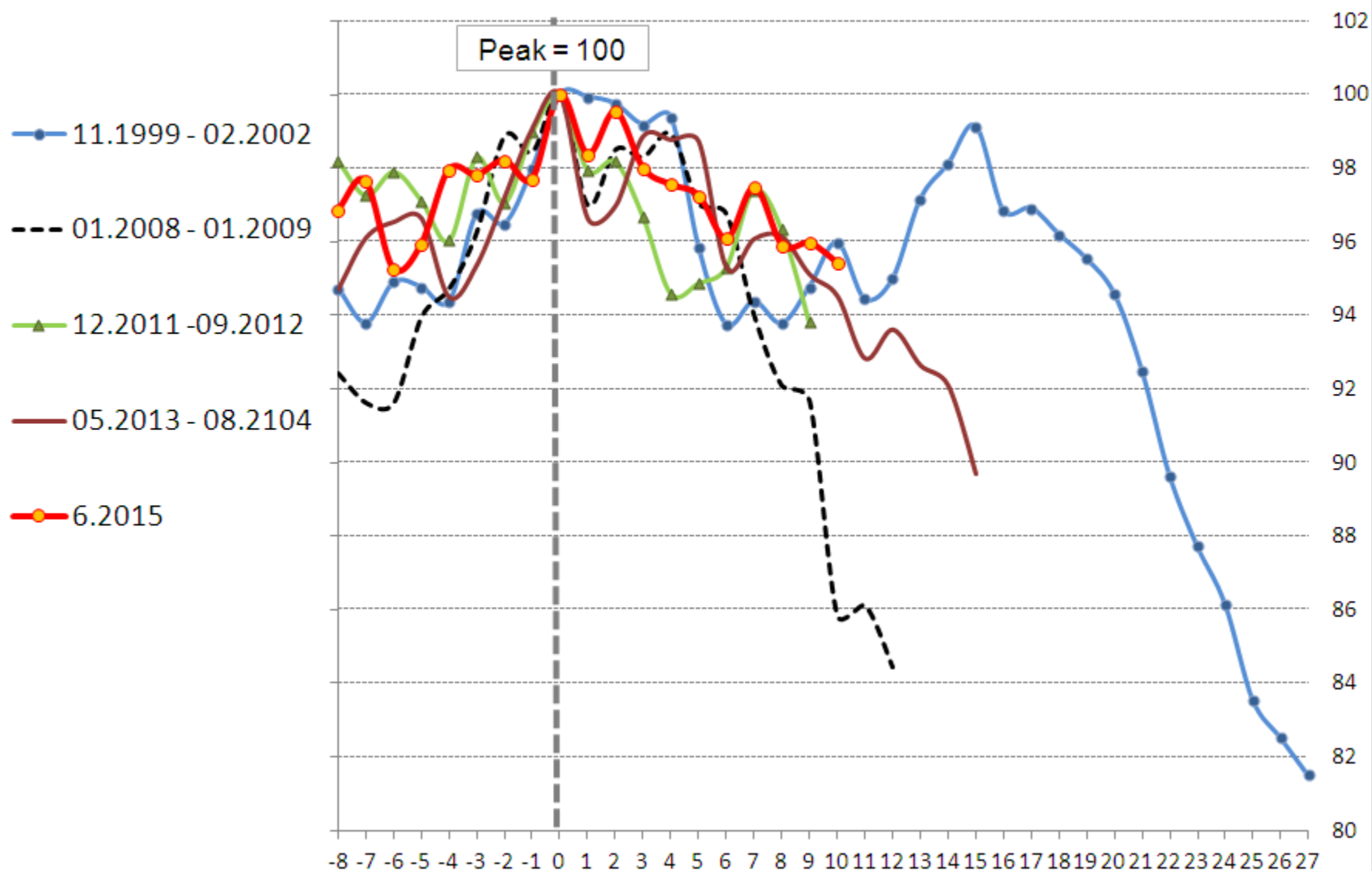
**INDUSTRIAL PRODUCTION INDEX BY TYPE OF GOOD**  
**YoY Variation First Four Months 2016 (%)**



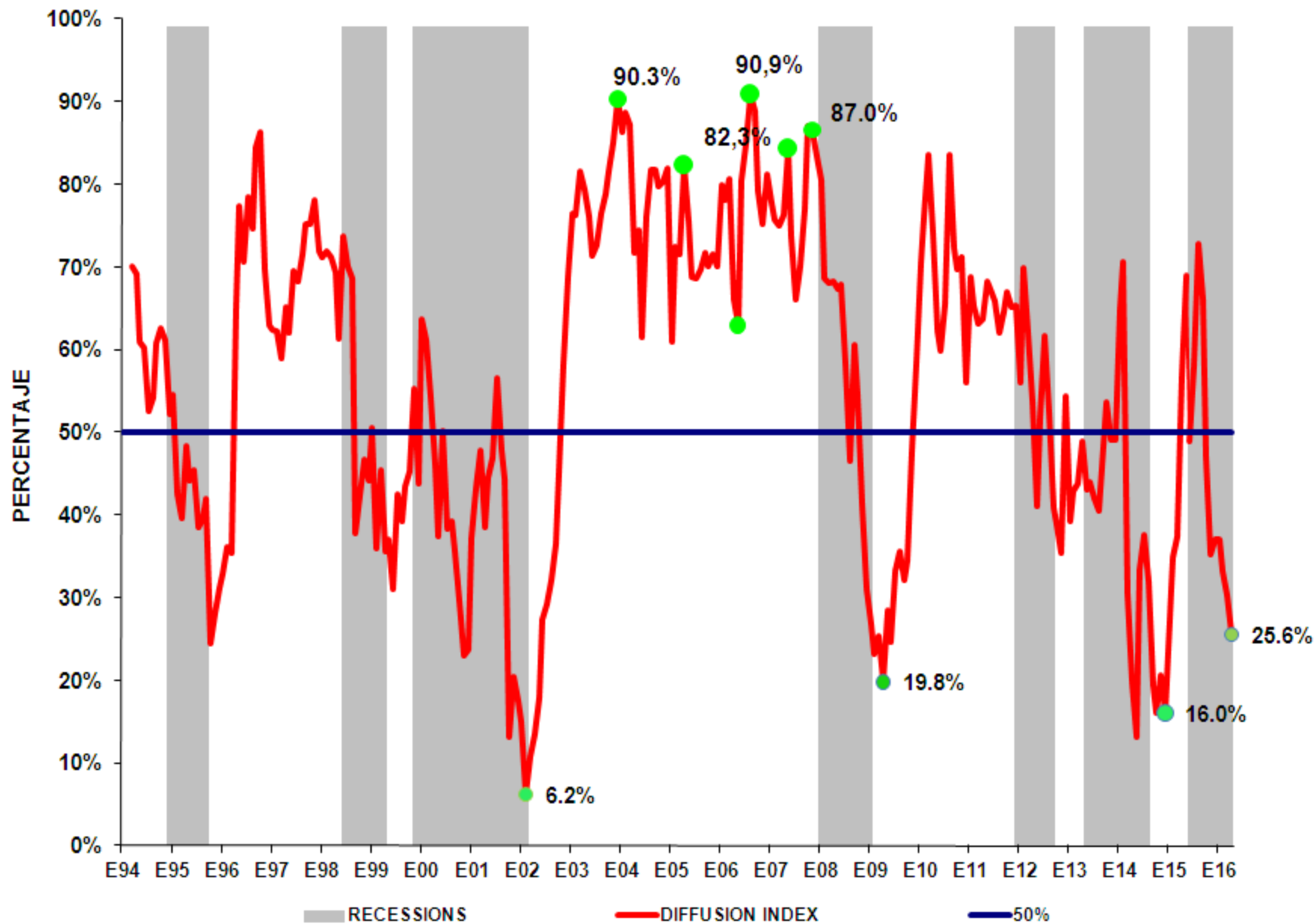
# INDUSTRIAL CYCLES: IPI Seas. Adjust.



IPI. Speed of Entry into Recessions from the Peak of Activity  
Entry month index = 100

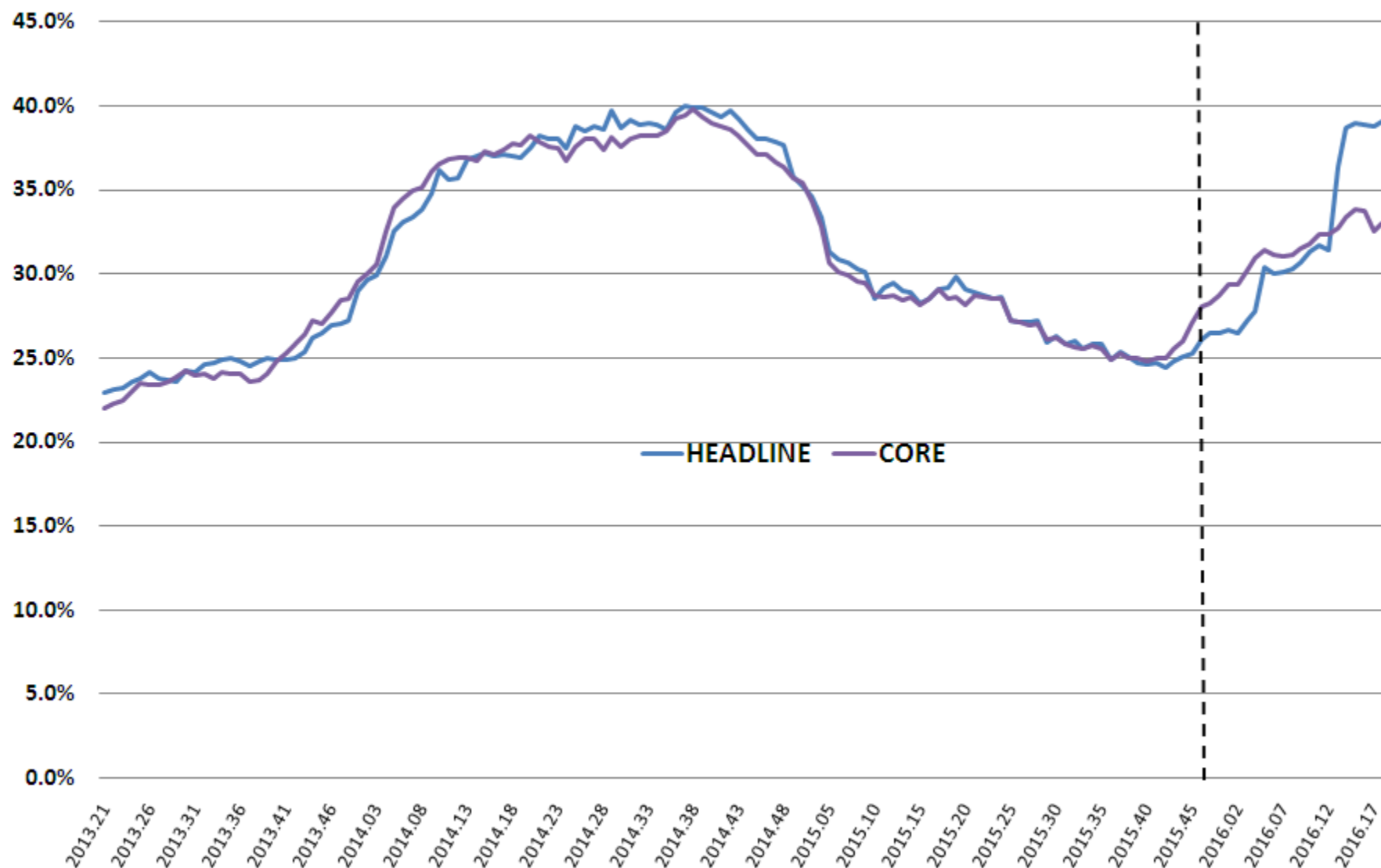


## IPI: DIFUSSION INDEX



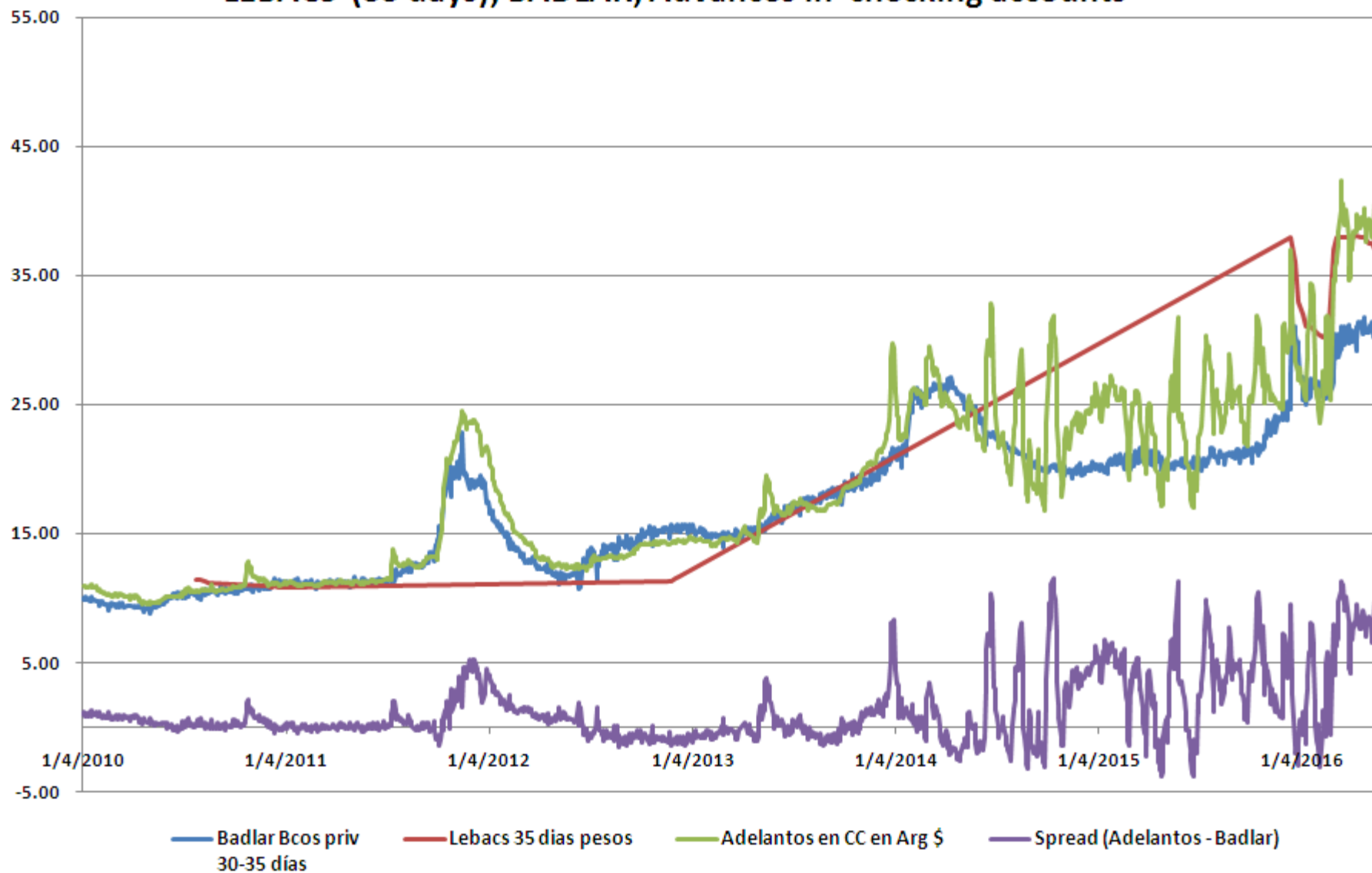
# Annual yoy inflation by week

*1st week June 2013 - 2nd week May 2016*



## Rates of Interest

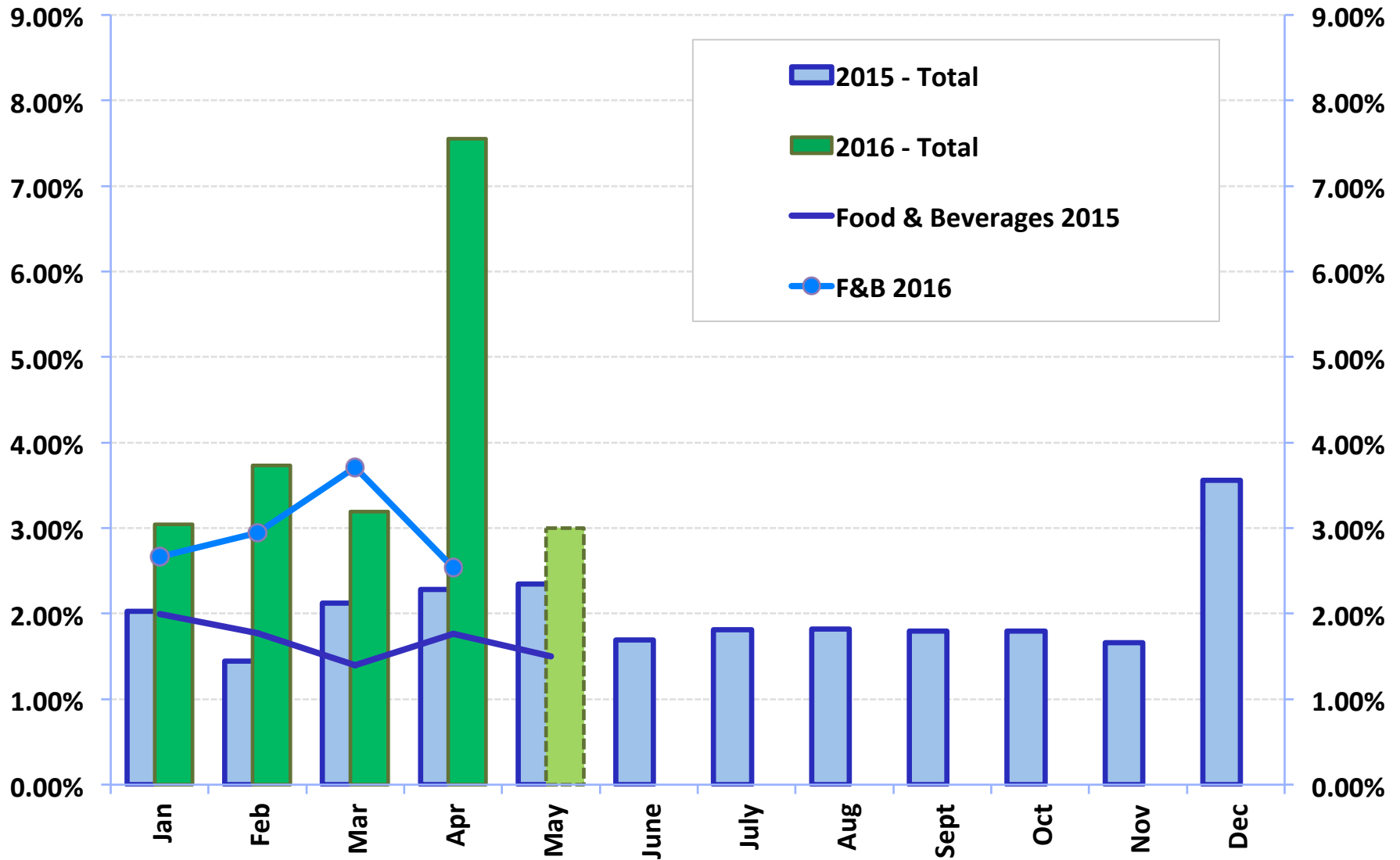
### LEBACS (35 days), BADLAR, Advances in checking accounts





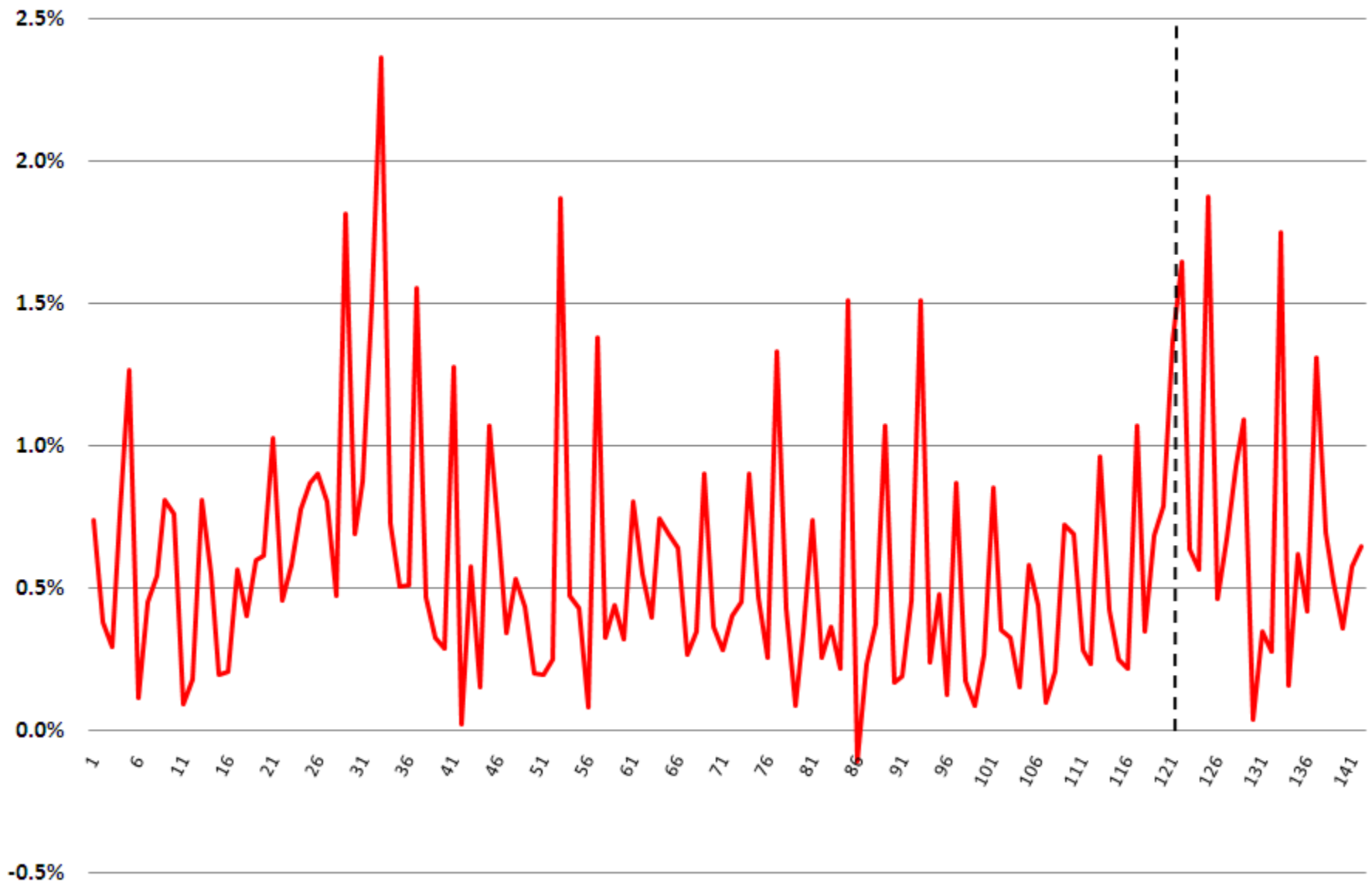
## Monthly inflation 2015 and 2016 in %

### *Total and Food & Beverages*



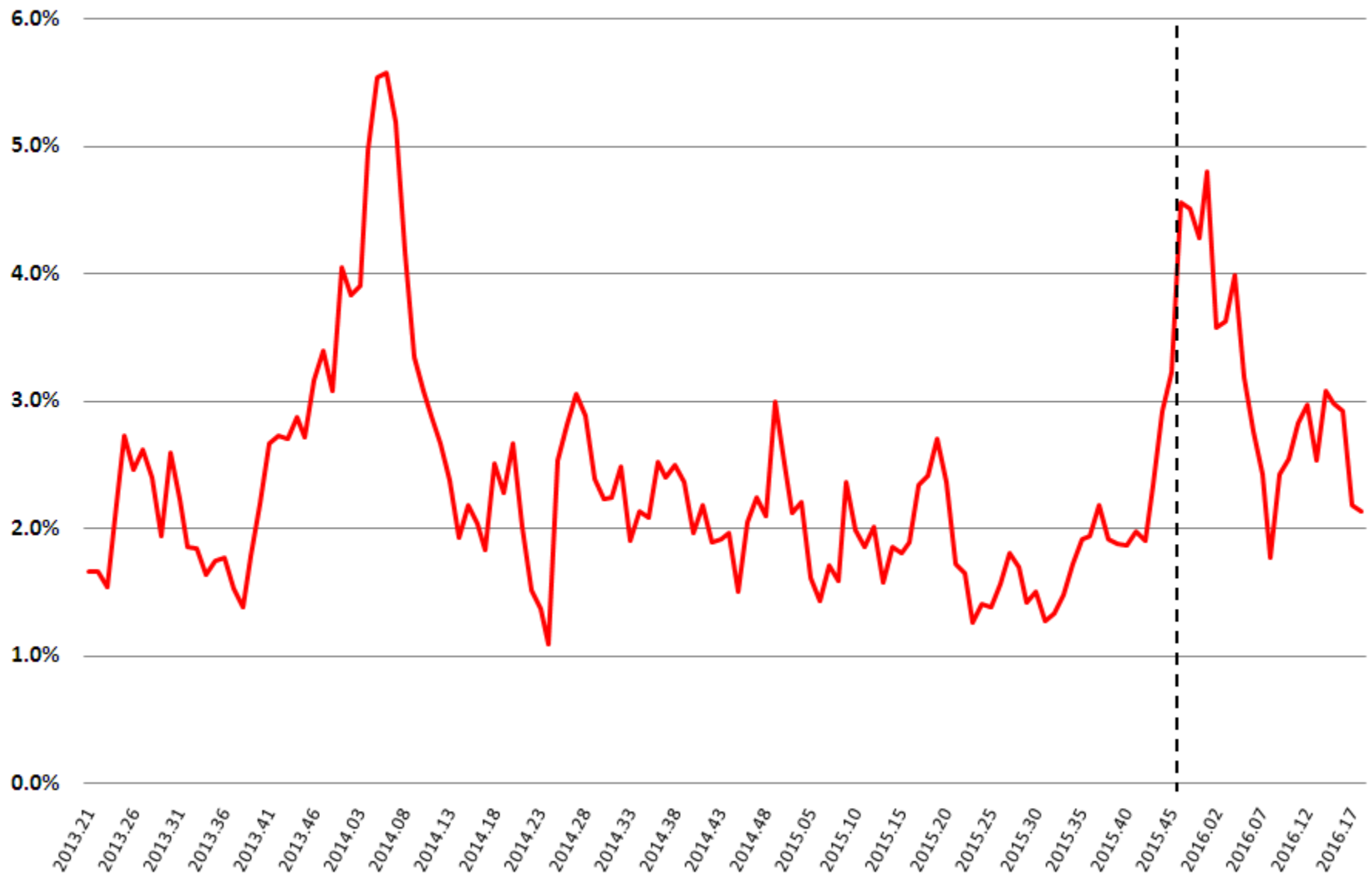
# Weekly "Core" Inflation

*1st week June 2013 - 2nd week May 2016*



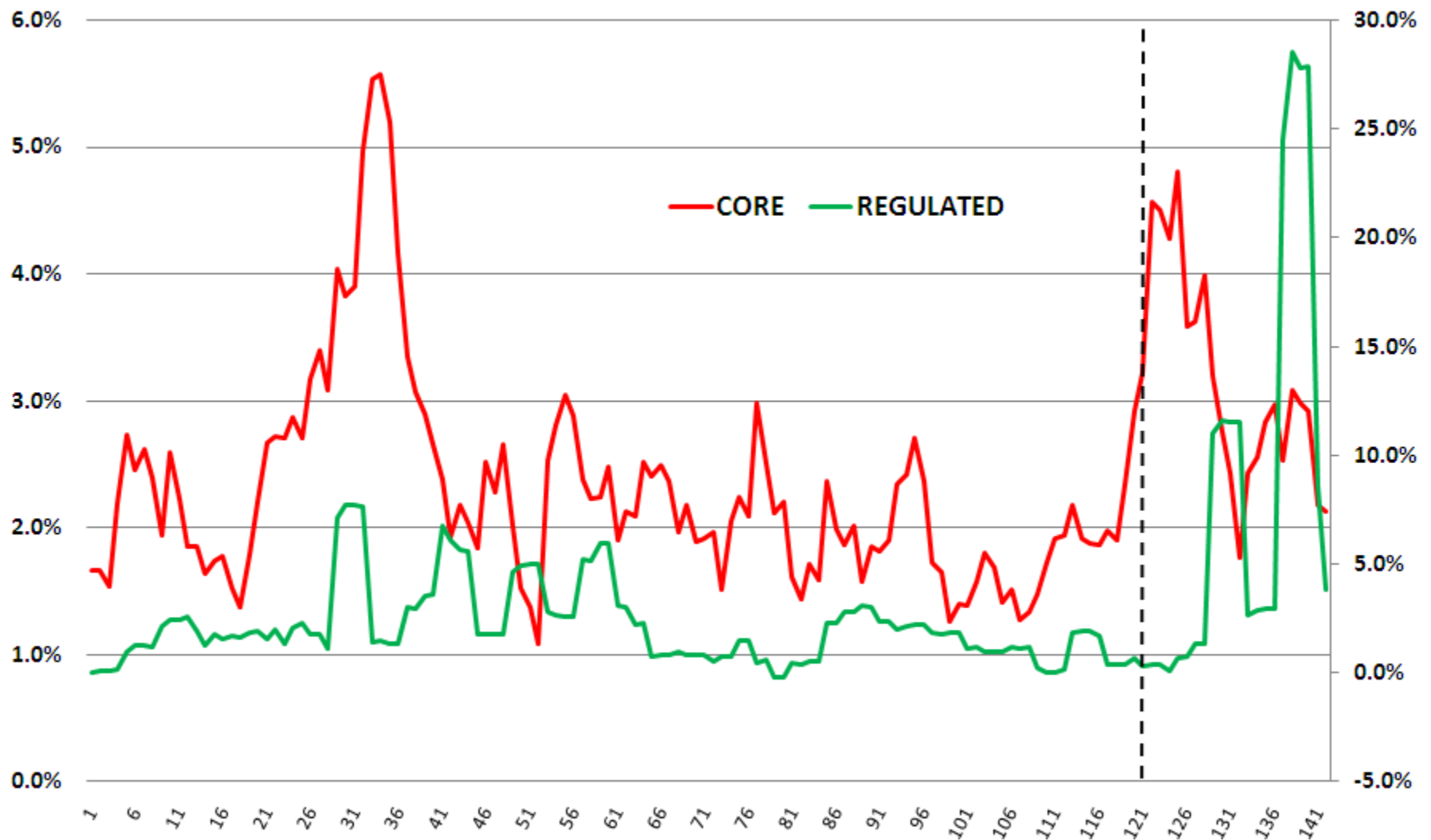
# Monthly "Core" Inflation by week

*1st week June 2013 - 2nd week May 2016*



# Montly "Core" Inflation and "non-core" shocks

*1st week June 2013 - 2nd week May 2016*





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# *Regulation of public utilities: abandoning the K model*

*Santiago Urbiztondo*

*Council of the Americas, New York, May 25, 2016*

# Regulation in the K (2003-2015) era

- During last 3 presidential periods, the regulatory paradigm proved itself increasingly “populist”, diverging from any broad “best-practice” ideal:
  - Short-run (myopic) perspective, promoting inefficient operation & investment through cost-plus tariff / subsidy adjustments, discriminating old & new investments
  - Direct & discriminatory price regulation in competitive segments (upstream natural gas & wholesale energy)
  - Confusion of public & private roles (government regulating through SOEs, intervened private operations)
  - Disregard to transparency, institutional credibility, consistent contracts, technical analysis, etc.

# Regulation in the K (2003-2015) era

- Consequences:
  1. Substantial reduction of (real) tariffs, covering a fraction of total costs
  2. Artificial consumption growth & investment contraction, exhausting capacity, reversing energy trade-balance
  3. Complications: exploding fiscal subsidies, not focalized, with deteriorating coverage, quality & higher total costs
- Challenge for new administration:
  1. Carry on major corrections, increasing tariffs & changing the regulatory paradigm to restore efficiency
  2. Corrections must be social, politically & economically feasible
  3. In a context a multiple hidden unsustainable unbalances

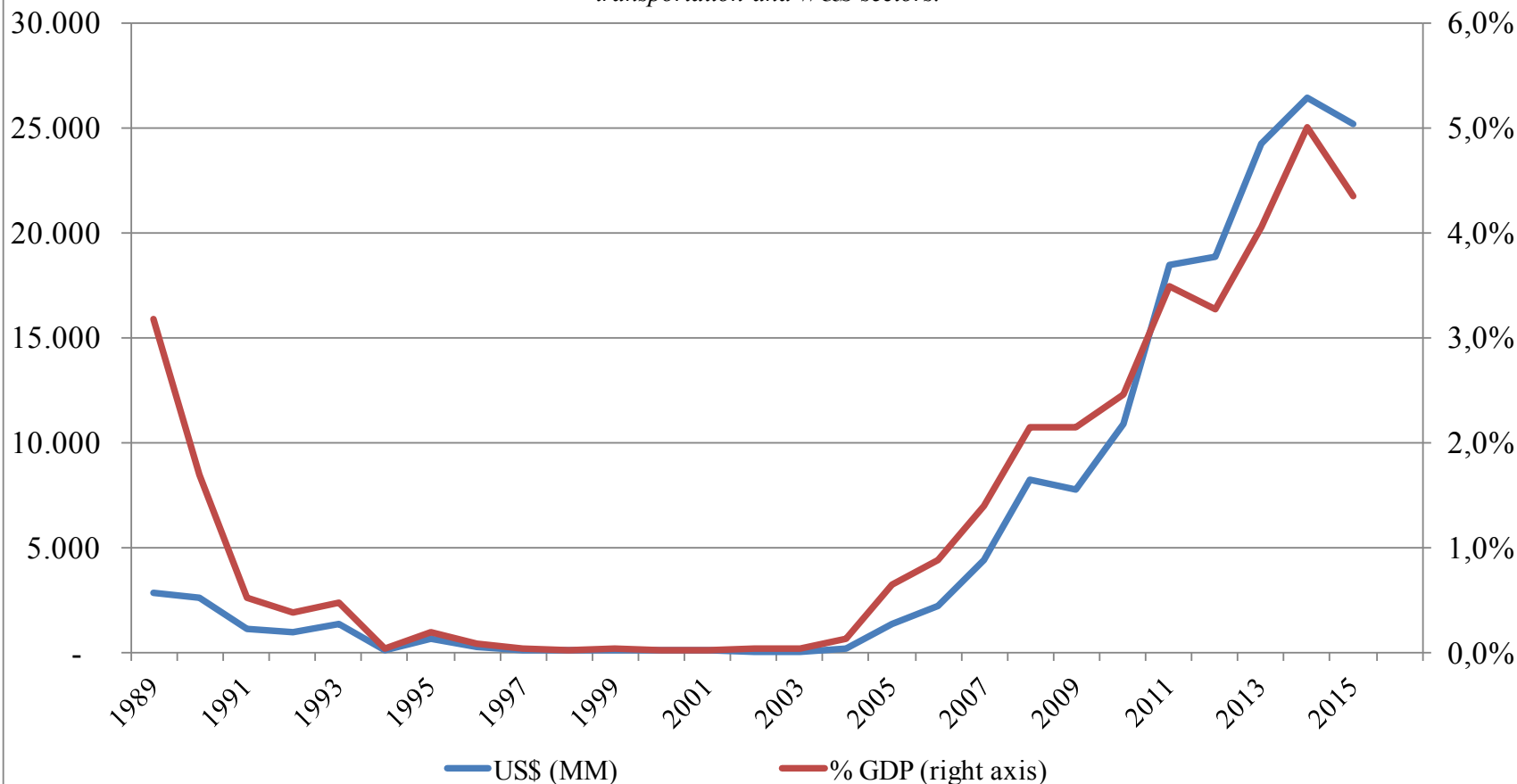
# End-result of K regulatory paradigm

2014: subsidies to public utilities added USD 26 billions, or 5% of GDP

2015: small reduction (mostly due to lower NG import prices)

## Subsidies to public utilities (in MM USD and as % of GDP), 1989-2016\*

Source: Own elaboration based on SIGEP (1989-1995, MECON (1996-2003) and ASAP (2004-2016): Until 2003 it includes YPF, GE, AyEE, Hidronor, AA, FFAA, ELMA, ENTEL, ENCOTEL and OSN. Since 2004 it includes subsidies to public and private firms in the energy, transportation and W&S sectors.

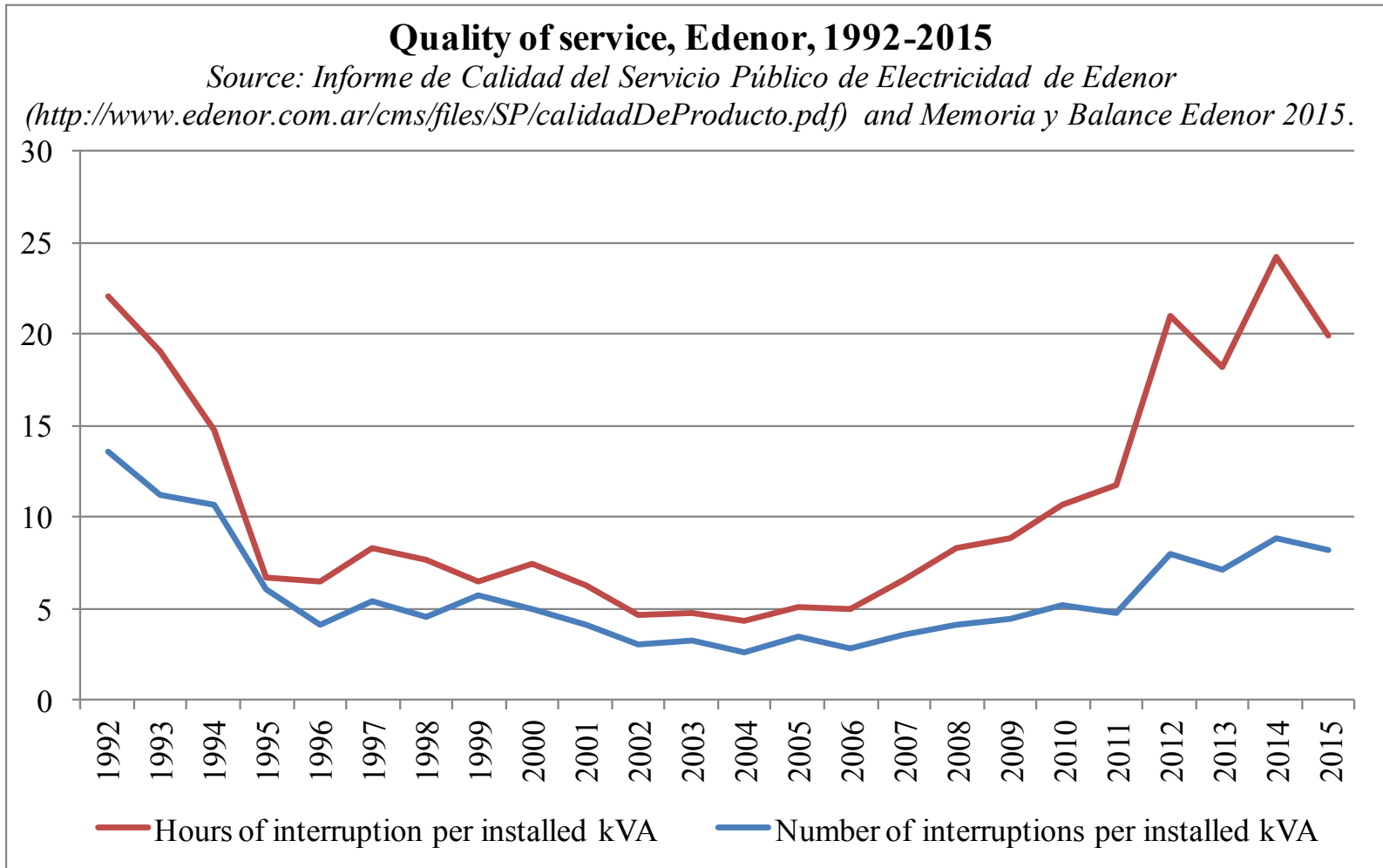




# End-result of K regulatory paradigm

## Example: deteriorating quality of electricity service

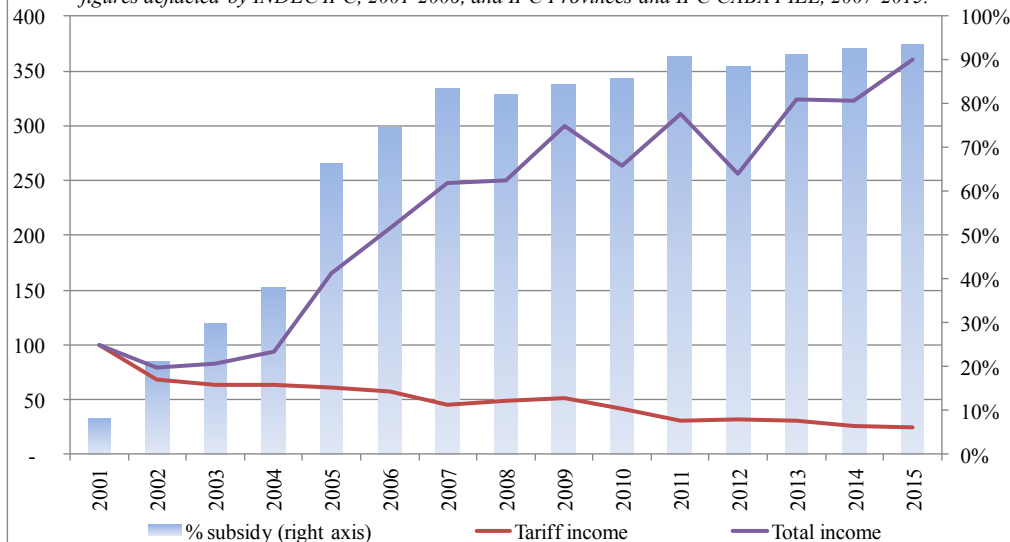
- Number & duration of interruptions in GBA (Edenor) firmly falling until mid-2000s
- But they both significantly increased since 2007



# End-result of K regulatory paradigm

**Subsidies, Tariffs and Costs of urban railway service, 2001-2015, Base 2001=100**

Source: Own elaboration based on CNRT and ASAP. It includes surface and subway services in GBA. Nominal figures deflated by INDEC IPC, 2001-2006, and IPC Provinces and IPC CABA FIEL, 2007-2015.



Urban passenger railways total income (and cost) increased 250% + since 2001, in constant AR\$

Service fees (tariffs), decreased 70%+

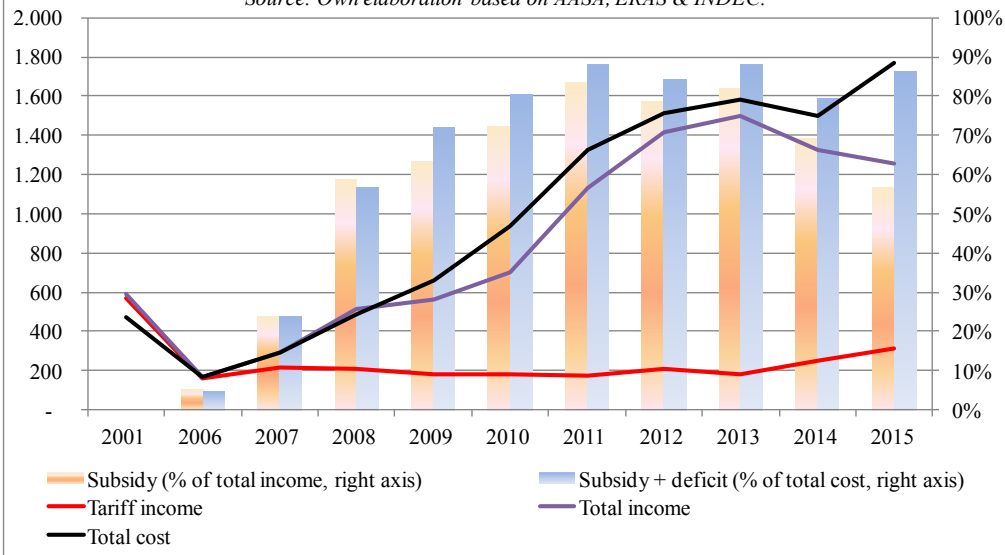
2011-2015: Fiscal subsidy represents 90% of total income

W&S services in GBA (SOE AySA since 2006) shows the same pattern:

- US\$ tariff income highly reduced post-2001, stable 2006-2013 at 60%+ below
- Fiscal subsidy reached 80% of total income in 2011, then decreased to 60% in 2015
- But AySA's costs are higher than total income (debt accumulation), so subsidy + deficit remains at 80%-90% of costs

**AySA: Tariff income, total income, subsidies & total costs, 2001 & 2006-2015, in MM US\$**

Source: Own elaboration based on AASA, ERAS & INDEC.



# ¿What is the new administration doing?

## Significant tariff hikes (in ARG\$):

- February: 330% average tariff increases in electricity (including wholesale –countrywide– and Distribution –in GBA–, for all users)
- April: 170% average tariff increases in natural gas (upstream and downstream countrywide, excluding power plants), 240% average increase in W&S, & 70%-100% hike in public transportation in GBA
- May: remaining upstream NG users (power plants, 170%, to 5 US\$/MMBTU), fixed telephony (200%+), gasoline (10% –adding 30% in 2016–), countrywide
- Characteristics:
  - Major discriminations eased (across R users of NG & electricity)
  - Social tariffs explicitly created, better designed / focalized
  - Rewards for reduced consumption, NG & electricity
  - Global impact on CPI-GBA (short-term inflation, Feb-May): 9 pp



# ¿What is the new administration doing?

- Emergency power additions: contest to contract 1,000 MW for short-run availability (small scale, high cost thermal plants)
- Renewable energy (green, small, costly, subsidized), to add 1,000 MW by contest (1.5 to 2 billion USD investment), mostly wind (60%) and solar (30%)
- Miscellaneous:
  - domestic oil price floor (+/- 60 US\$/barrel)
  - revising huge committed public investments (large southern “Chinese” hydro plants)
  - NG imports from Chile (accepting “take-it-or-leave-it” offer)
  - more professional management of SOE
  - initial moves towards increased transparency
- Integral tariff revision of T&D in NG & electricity concessions (within next 9 months approx.)



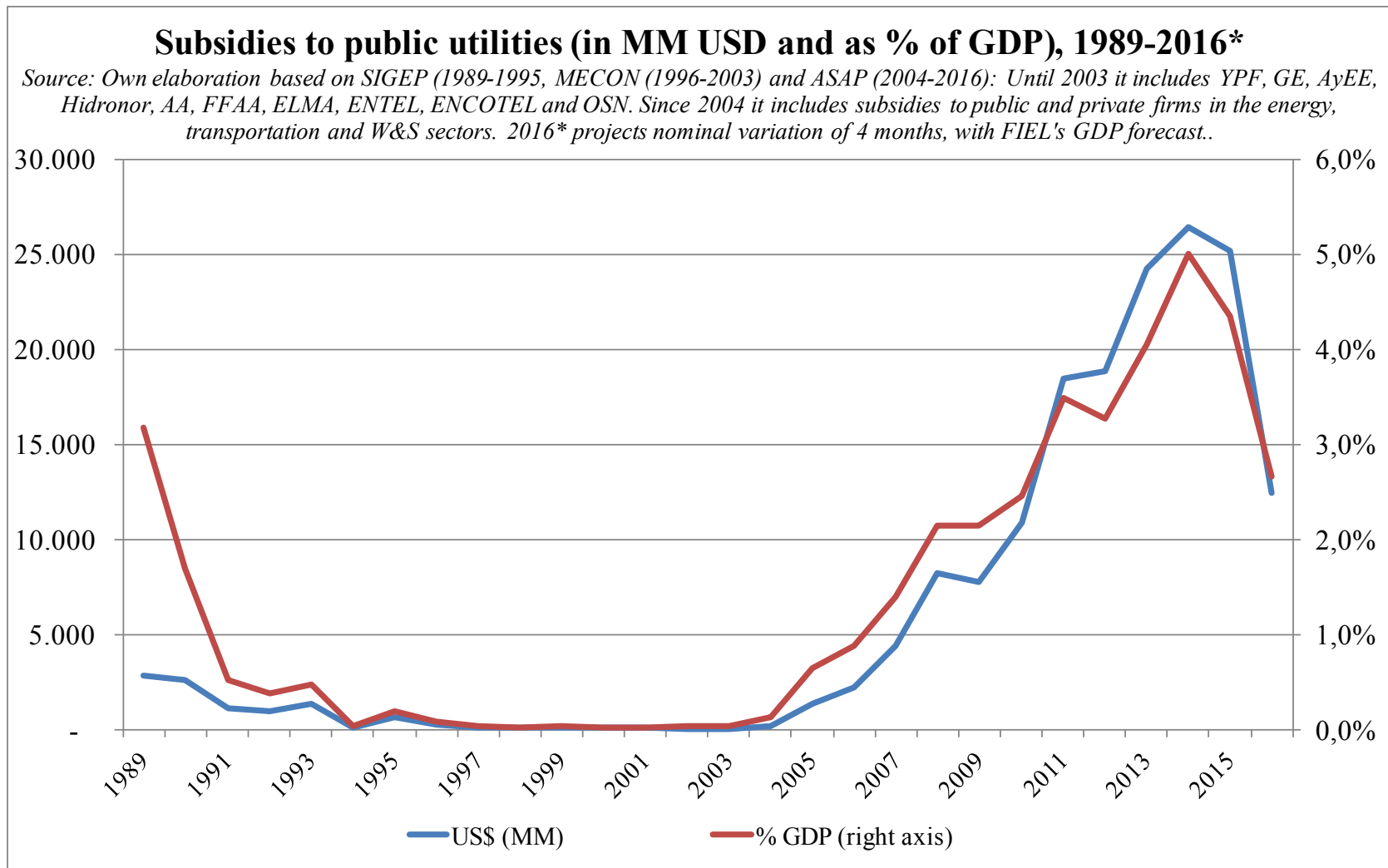
# ¿What is the new administration *not* doing?

- Institutional normalization absent so far
- Most important, new rules for price adjustments in competitive markets (energy) not announced yet:
  - Upstream NG & wholesale energy prices still set by the government, under cost-plus principle
  - New investments require knowledge of the rules that will govern them in the future, and those rules should converge to unique prices (with only temporary or initial departures)
  - New investments under current rules will be stranded costs in the future
- Raising tariffs without anchoring long-run costs (keeping K cost-plus model) might be excessive, and deceiving

# Impact on fiscal subsidies

2016 (4-m): significant fall (50% in USD, 1.7 pp down, to 2.7% of GDP)

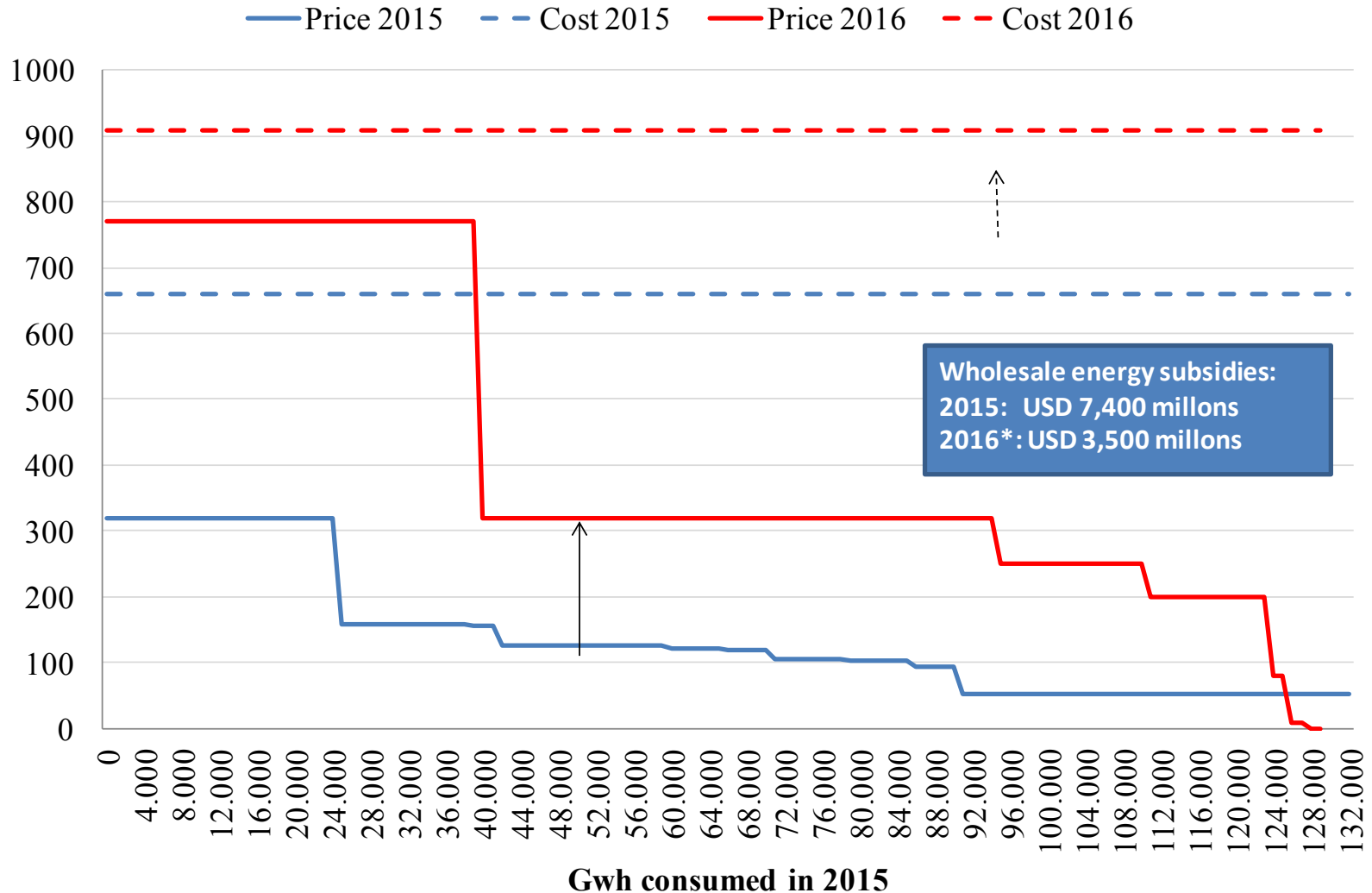
2016 projected: optimism (full effect of tariff hikes still ahead) & pessimism (new investments of emergency and renewable energy left out)



# Price & tariff adjustments

Wholesale electricity prices: 35% cost recognition, 220% average price hikes

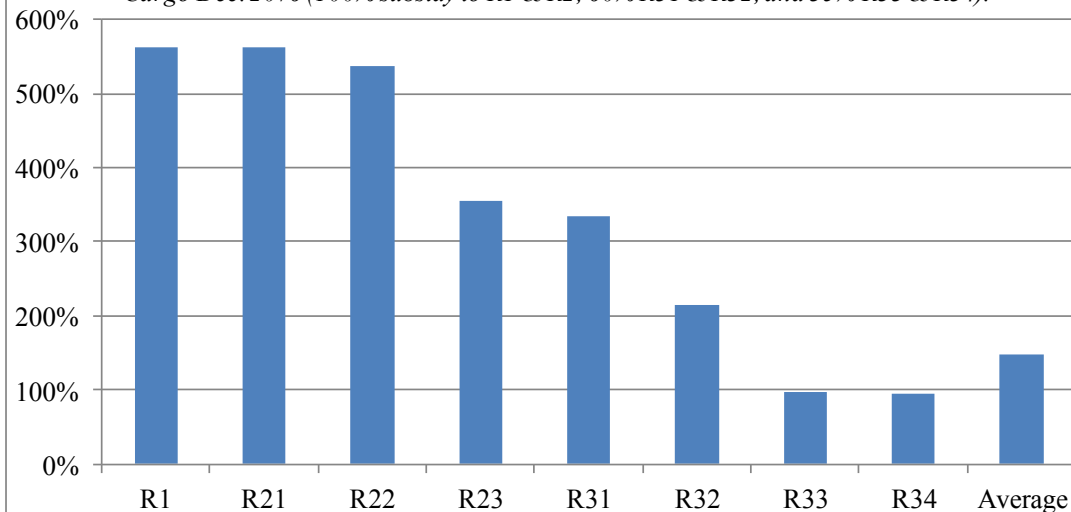
**MEM: Energy prices and costs, in AR\$/MWh, 2015-2016**



# Price & tariff adjustments

## Increase of *upstream* natural gas prices for residential users, Apr-2016

Source: Own elaboration based on ME&M 2016 Resolutions. Prior prices include estimated effective Cargo Dec. 2076 (100% subsidy to R1 & R2, 60% R31 & R32, and 35% R33 & R34).



Residential users faced, on average, 150% upstream price increase

- Low-R (<400 m<sup>3</sup>/month) faced 550% hikes
- High-R (>750 m<sup>3</sup>/month) faced hikes of 95%-

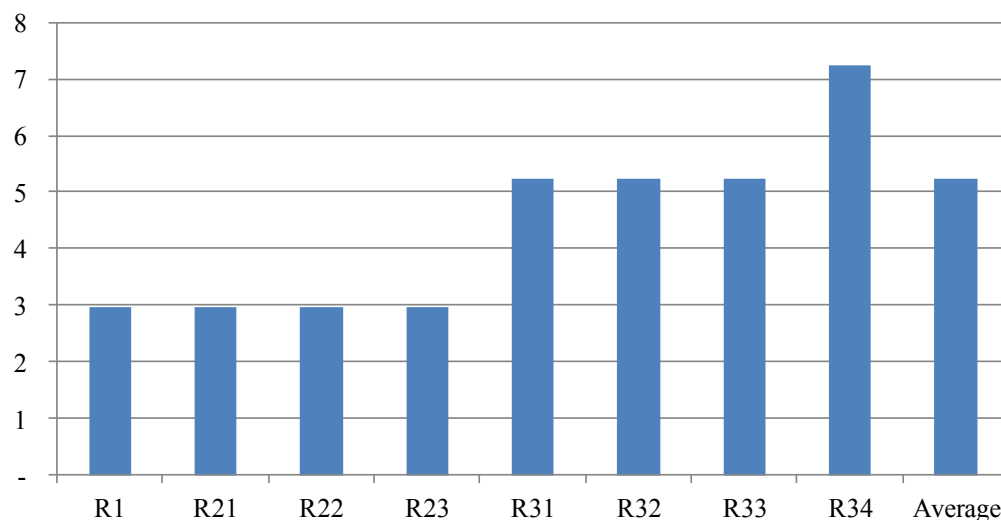
Still, higher R categories face a NG upstream price doubling low-Rs:

- Low-R, 3 US\$/MMBTU
- High-R, 7 US\$/MMBTU

High-R pay a cross-subsidy to Low-R (average cost of NG around 5 US\$/MMBTU)

## Natural gas *upstream* prices for Residential users, Apr-2016, in US\$/MMBTU

Source: Own elaboration based on ME&M 2016 Resolutions. Exchange rate: 15 ARG\$/US\$.

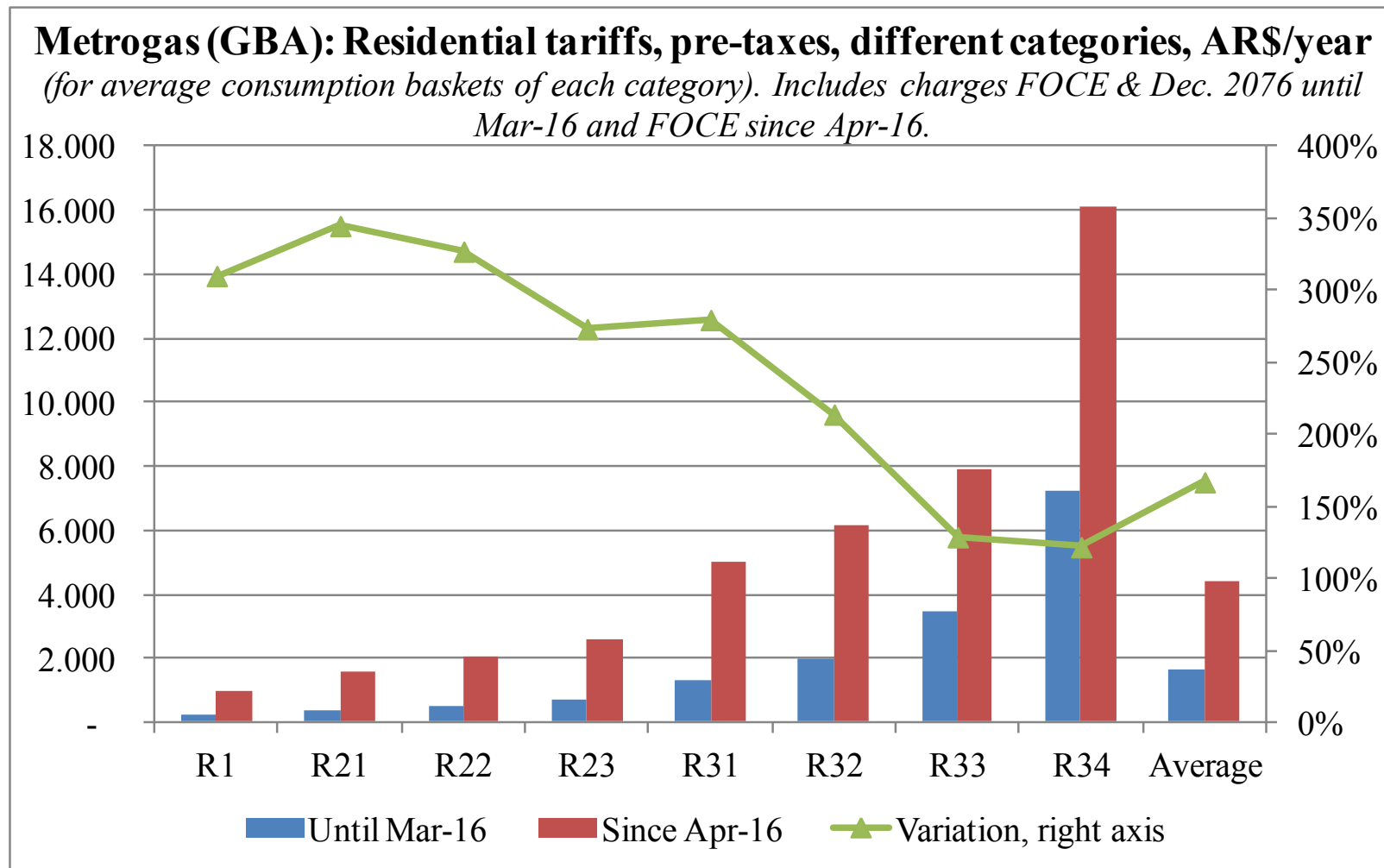




# Price & tariff adjustments

Residential final tariffs show the same pattern as upstream NG prices

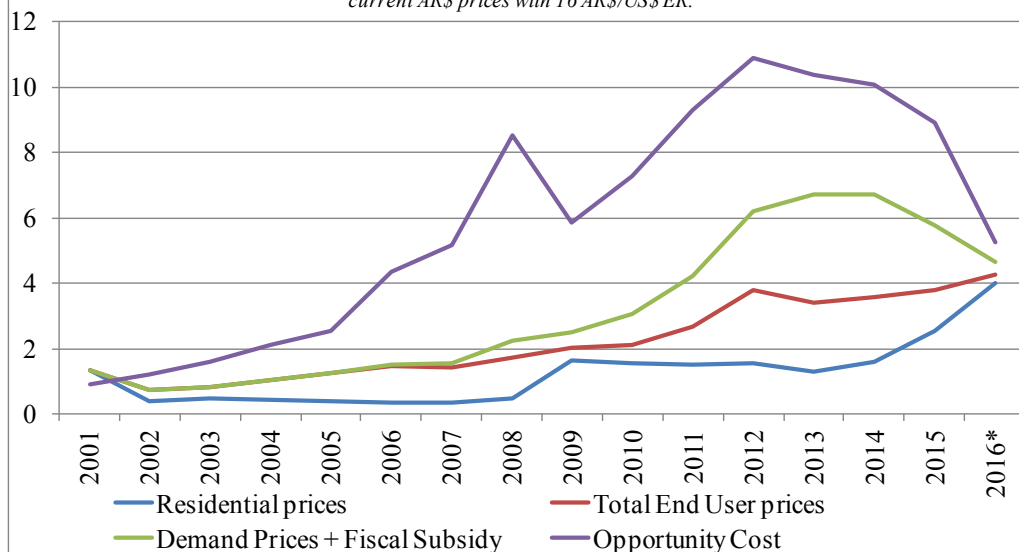
For Metrogas R users, hikes range from 350% (low categories) to 120% (high categories), averaging 170% (weighting by consumption)



# Price & tariff adjustments in perspective

## Natural gas upstream prices and costs, US\$/MMBTU, 2001-2016\*

Source: Own elaboration based on ENARGAS, ENGH and ASAP. Opportunity cost: Bolivian imports. \* 2016 projects current AR\$ prices with 16 AR\$/US\$ ER.



## Upstream natural gas

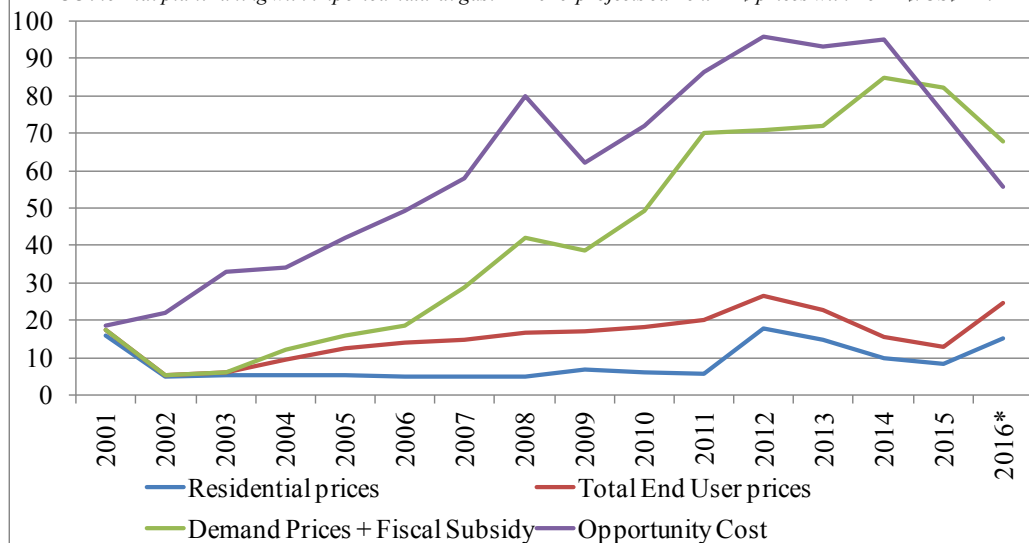
- Huge disconnection between costs and demand prices since 2002-2003
- Closing since 2015 due to lower costs of imported natural gas since, and increased demand prices in 2014 & 2016
- Remaining gap close to zero

## Wholesale electricity

- Same as with NG, except without adjusting tariffs in 2014
- Significant remaining gap (prices still under 50% of final costs)

## Wholesale electricity prices and costs, US\$/MWh, 2001-2016\*

Source: Own elaboration based on CAMMESA and ASAP. Prices include charges for imported gas. Opportunity cost: a CC thermal plant running with imported natural gas. \* 2016 projects current AR\$ prices with 16 AR\$/US\$ ER.



# Conclusions

1. End-results of K regulatory policy were devastating
2. The new administration of Cambiemos has adopted important, hard measures, specially on tariffs, with 300%+ hikes
3. Too much too soon?
  - Hard to tell: political reasons (“do it now while you politically can”) against economic consensus (“be firm, but need not –and should not– do the entire tariff correction at once”)
  - Current political difficulties of spiking short-term inflation (and partial retreats for special groups) increasingly suggestive
4. In any case, clear directions about the new organization of regulated sectors (rules & institutions), particularly for competition-compatible price-setting in upstream energy markets, are critical to attract new & efficient investment
5. The coin is in the air: will Argentina successfully abandon the K regulatory model? Are we already going that way?



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# *The long and winding road to the mid-term elections*

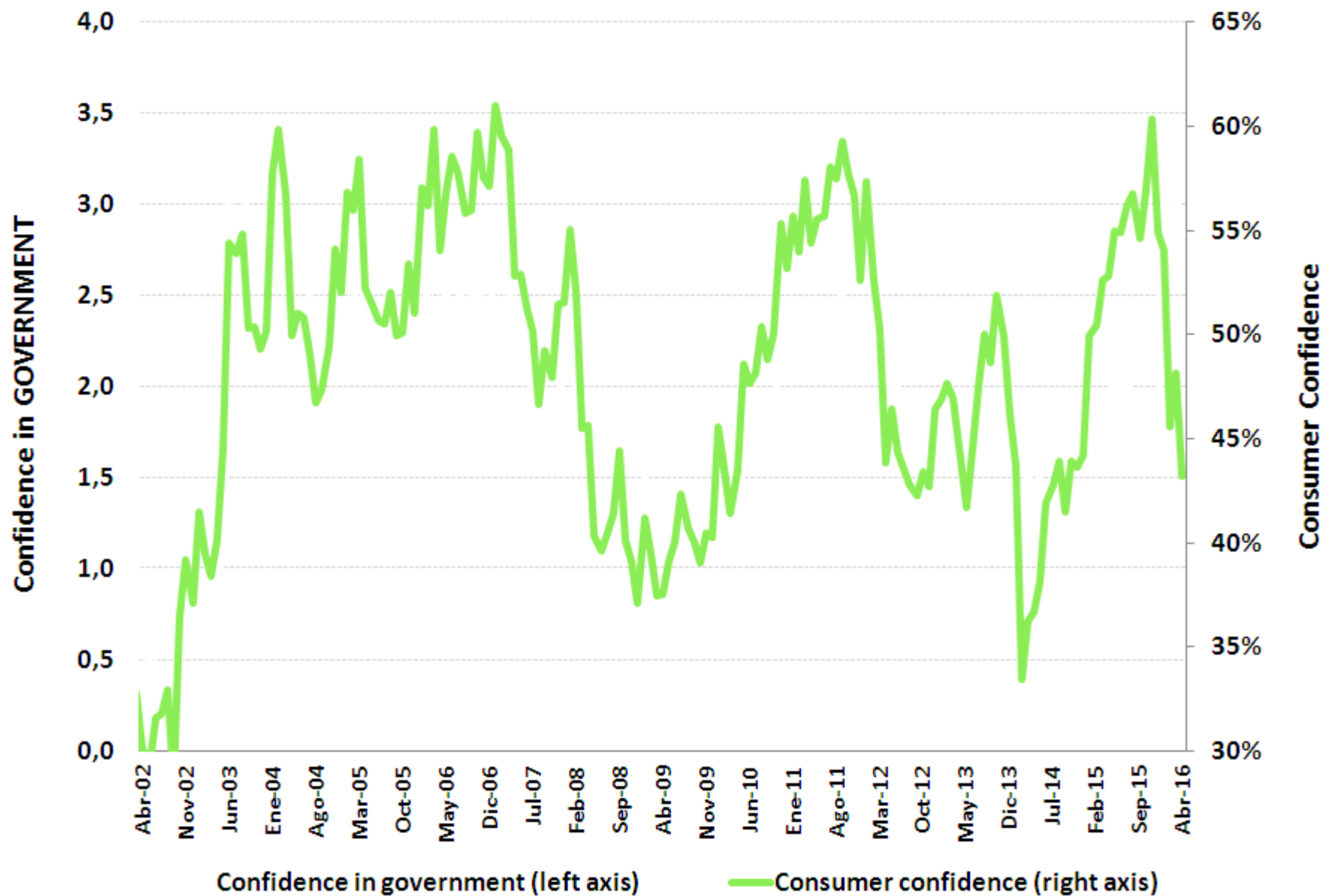
*Daniel Artana*

*Council of the Americas, New York, May 25, 2016*

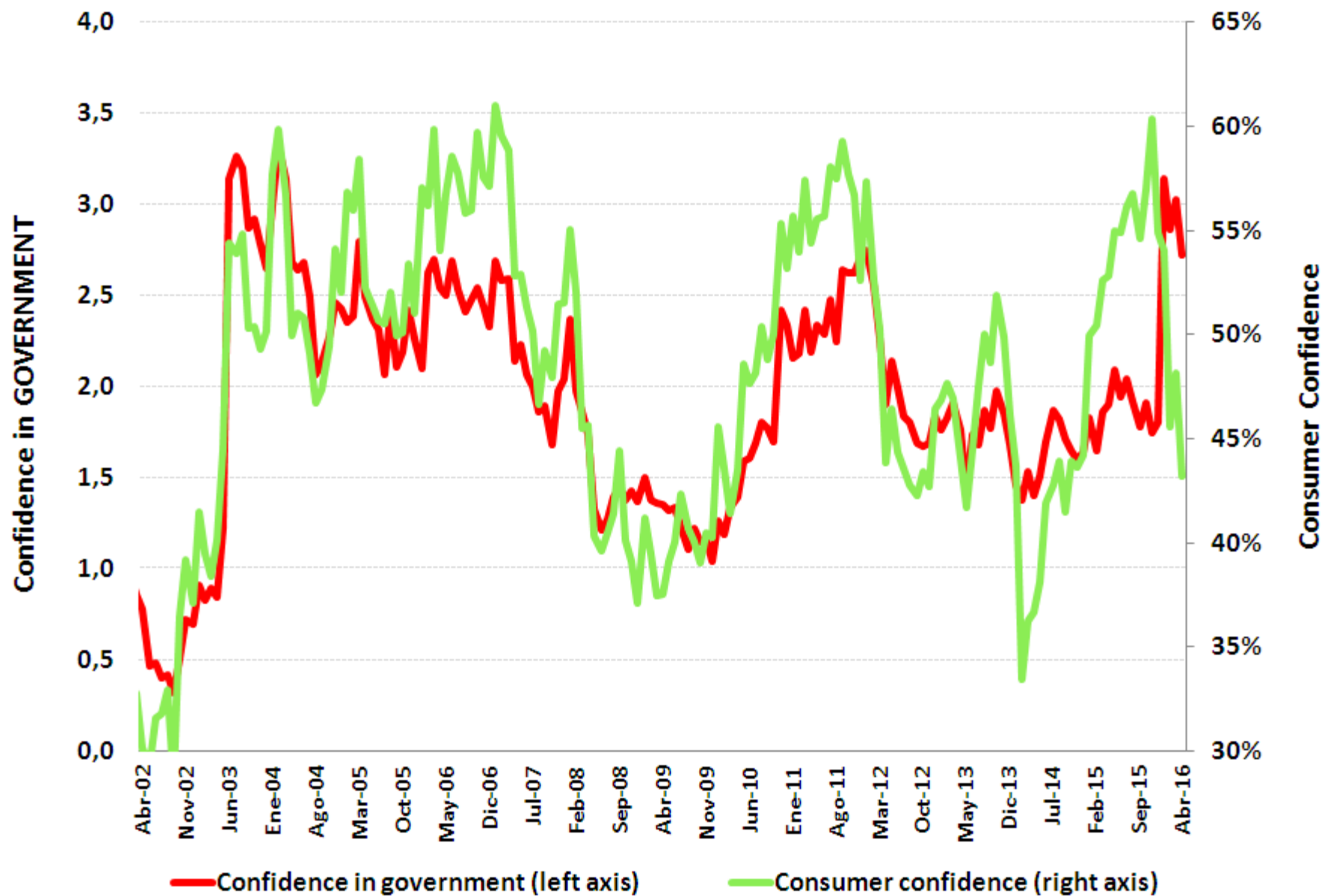
# The road to the mid-term elections

- The question marks:
  - Will inflation be substantially lower in the second semester of 2016?
  - When will economic activity recover?
  - What can ignite economic activity with Brazil in recession?
- The opportunities
  - Risk of becoming Venezuela is now negligible
  - “Low” leverage of the government and the private sector
- The government urgencies
  - Growth and low inflation should be visible by the median voter before August/October 2017

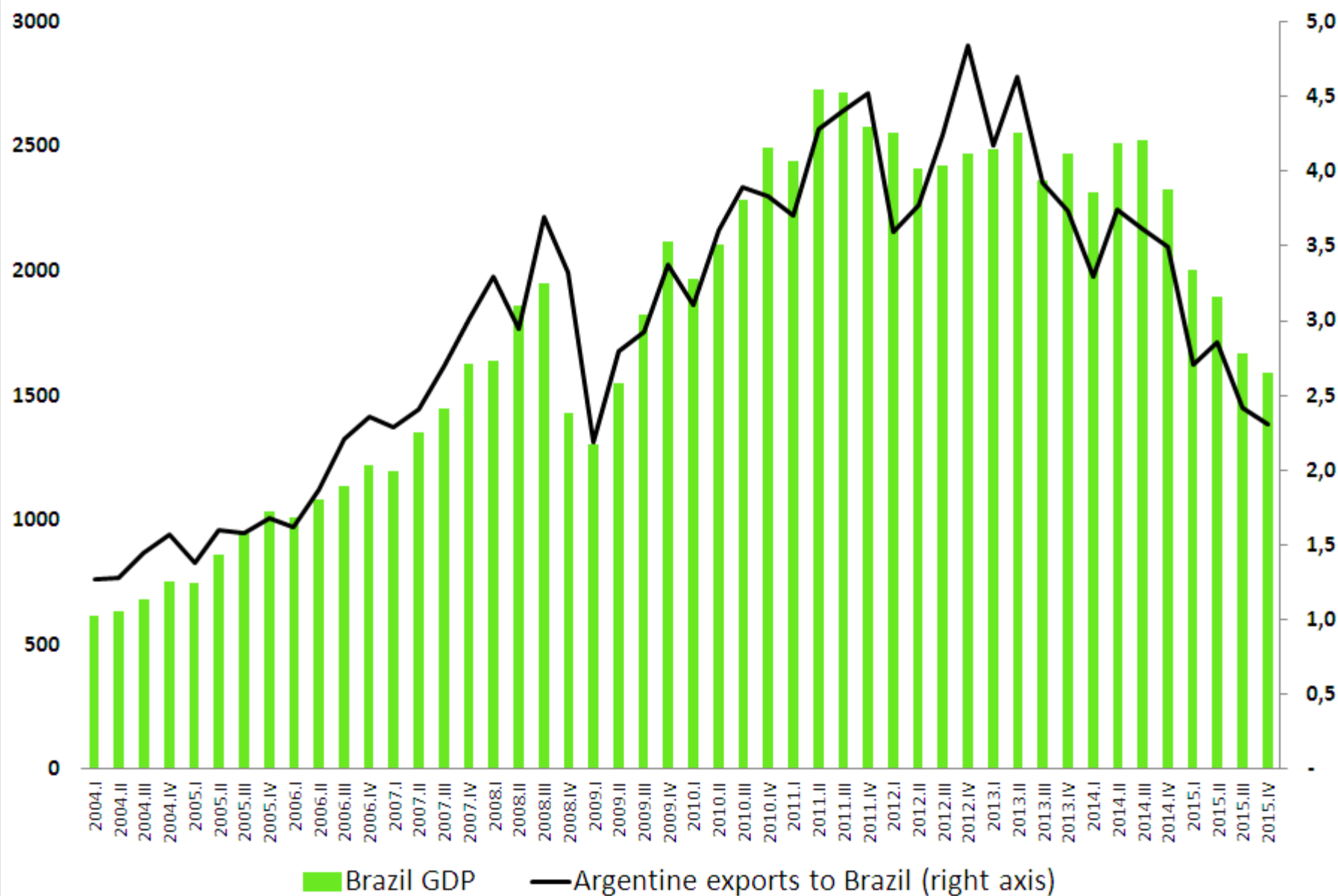
## Consumer Confidence and Confidence in the Government



## Consumer Confidence and Confidence in the Government

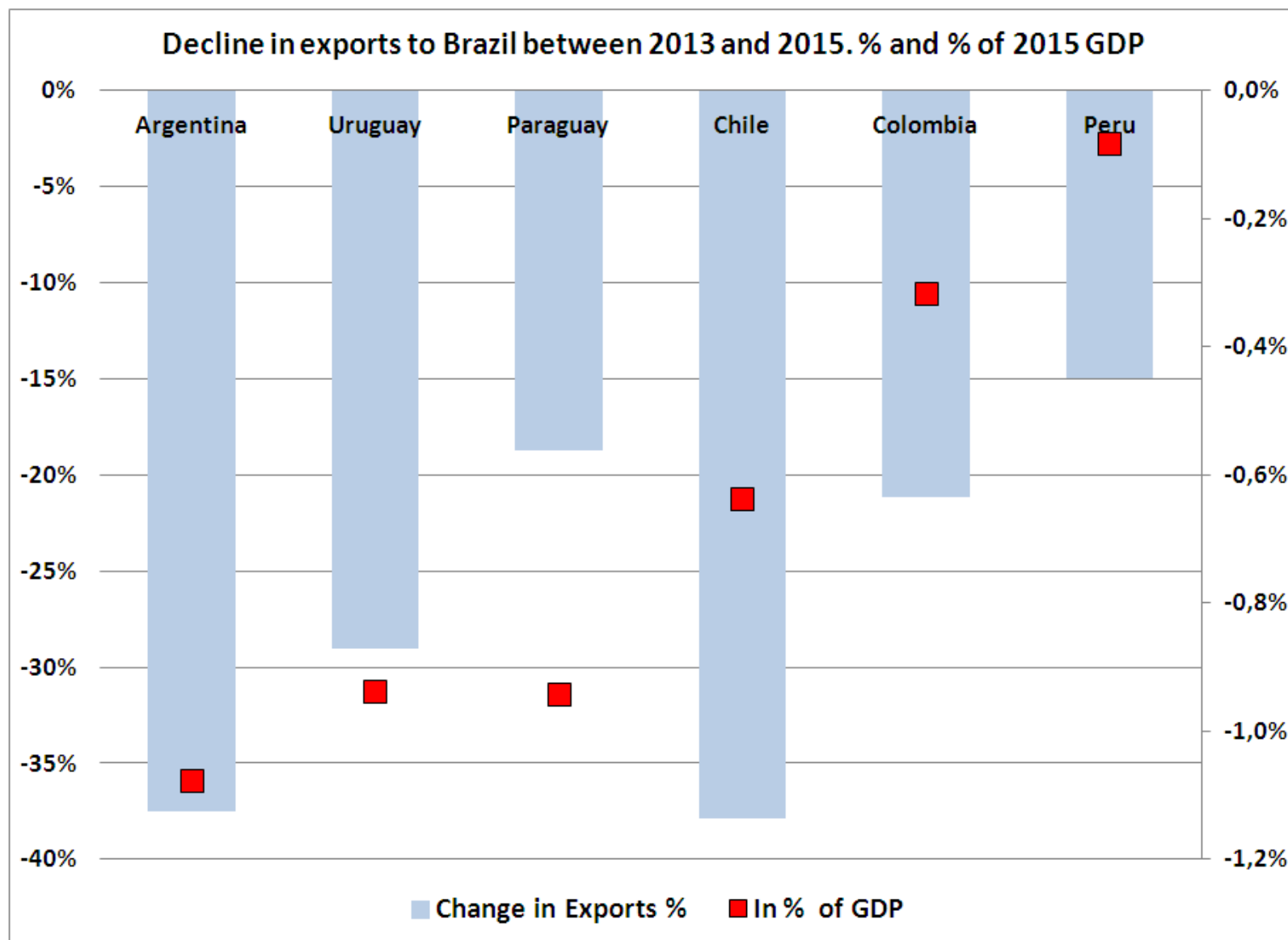


# Brazil's GDP in US\$ and Argentine exports to Brazil



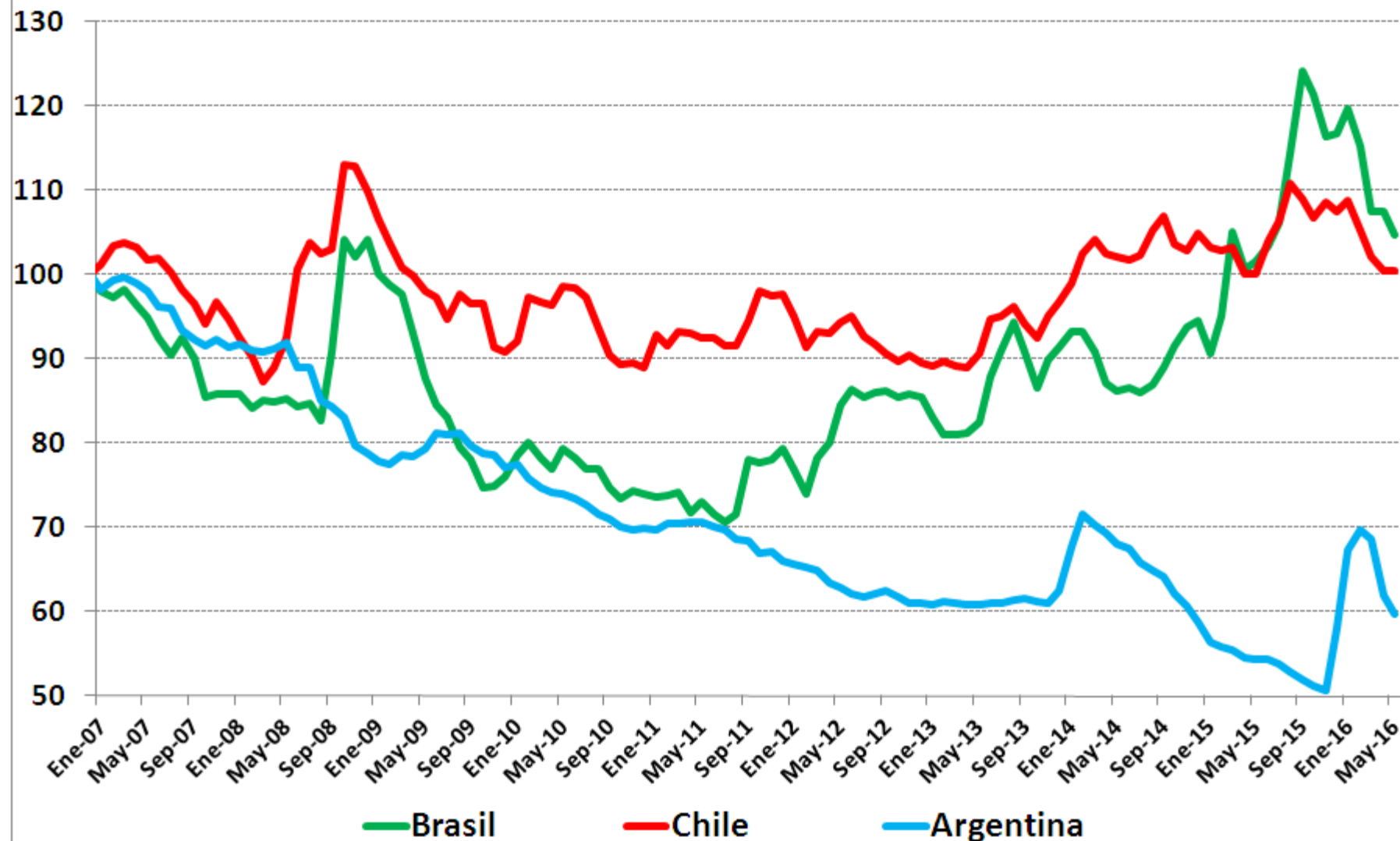


## Brazil's GDP measured in US\$ declined 27% between 2013 and 2015

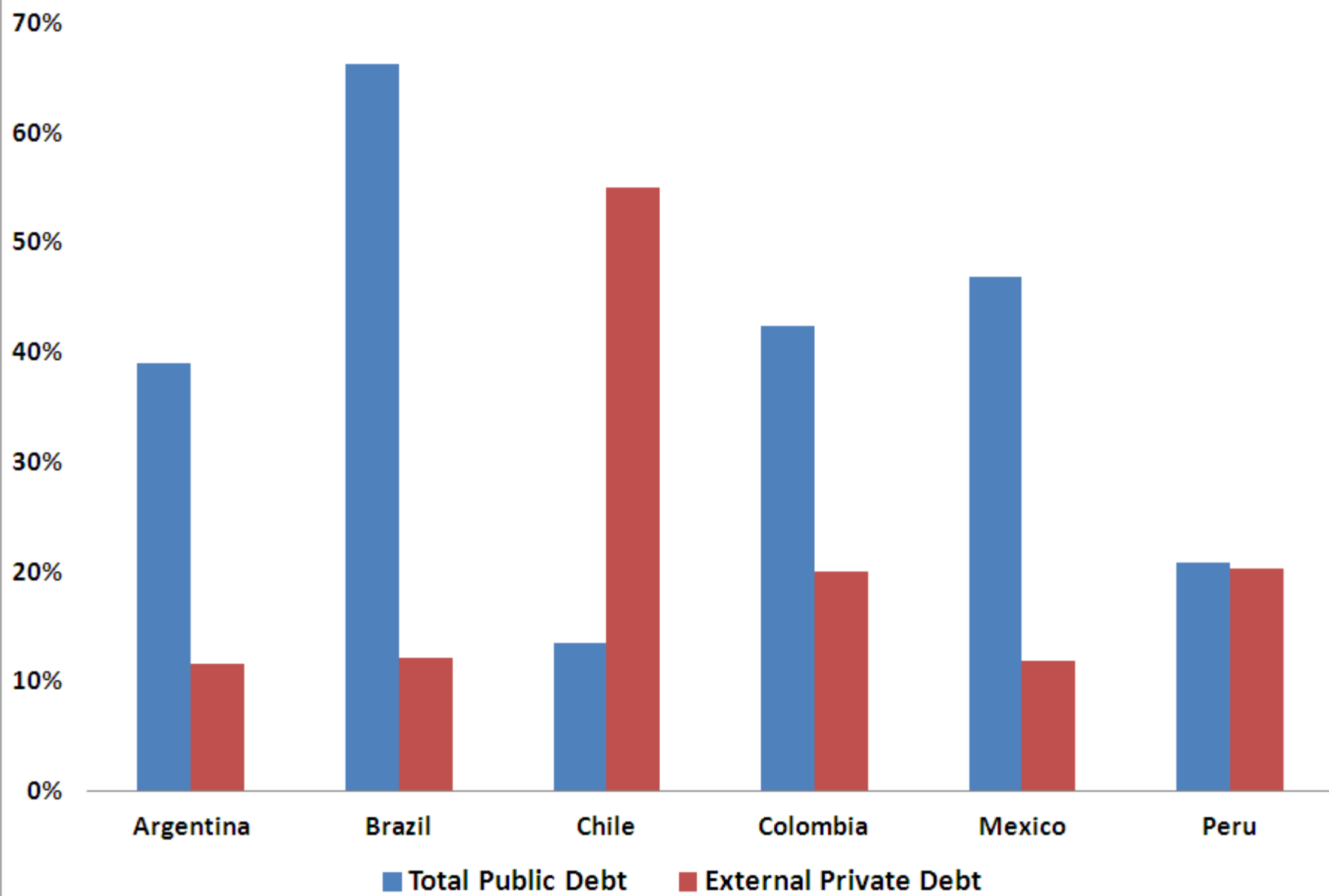


# Bilateral Real Exchange Rates (Domestic Currency per USDollar)

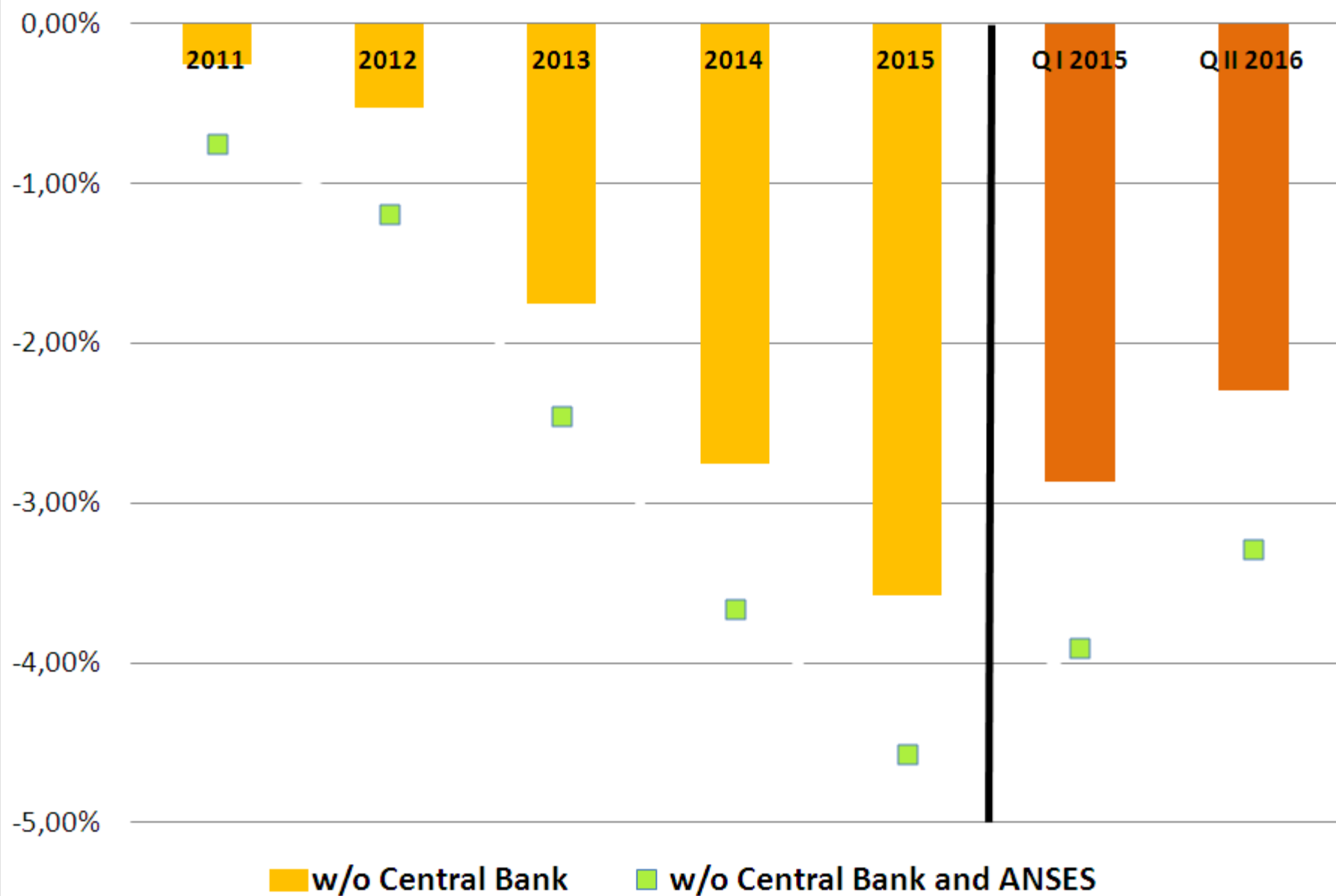
Dec 2006=100



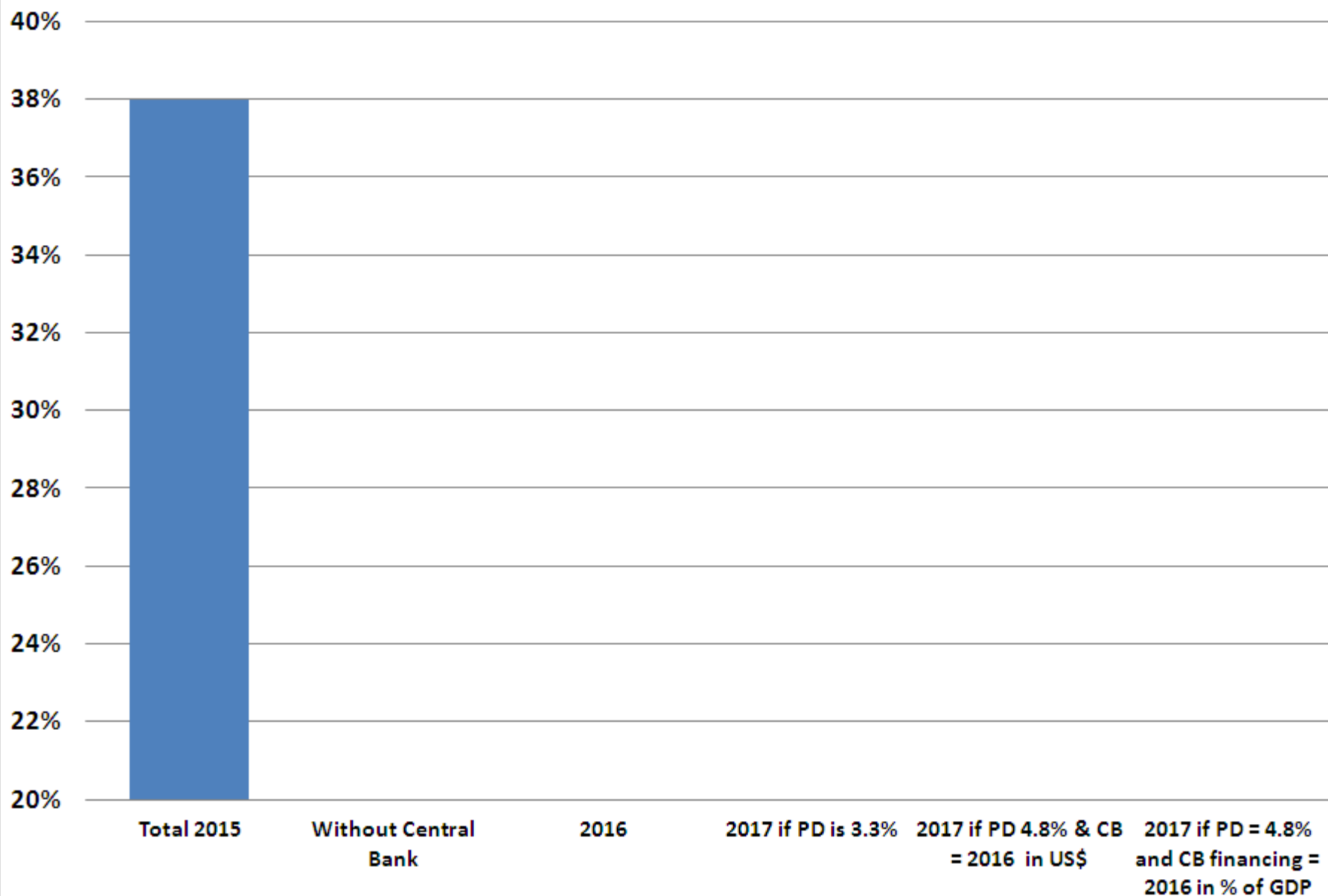
**Debt (% of GDP)**



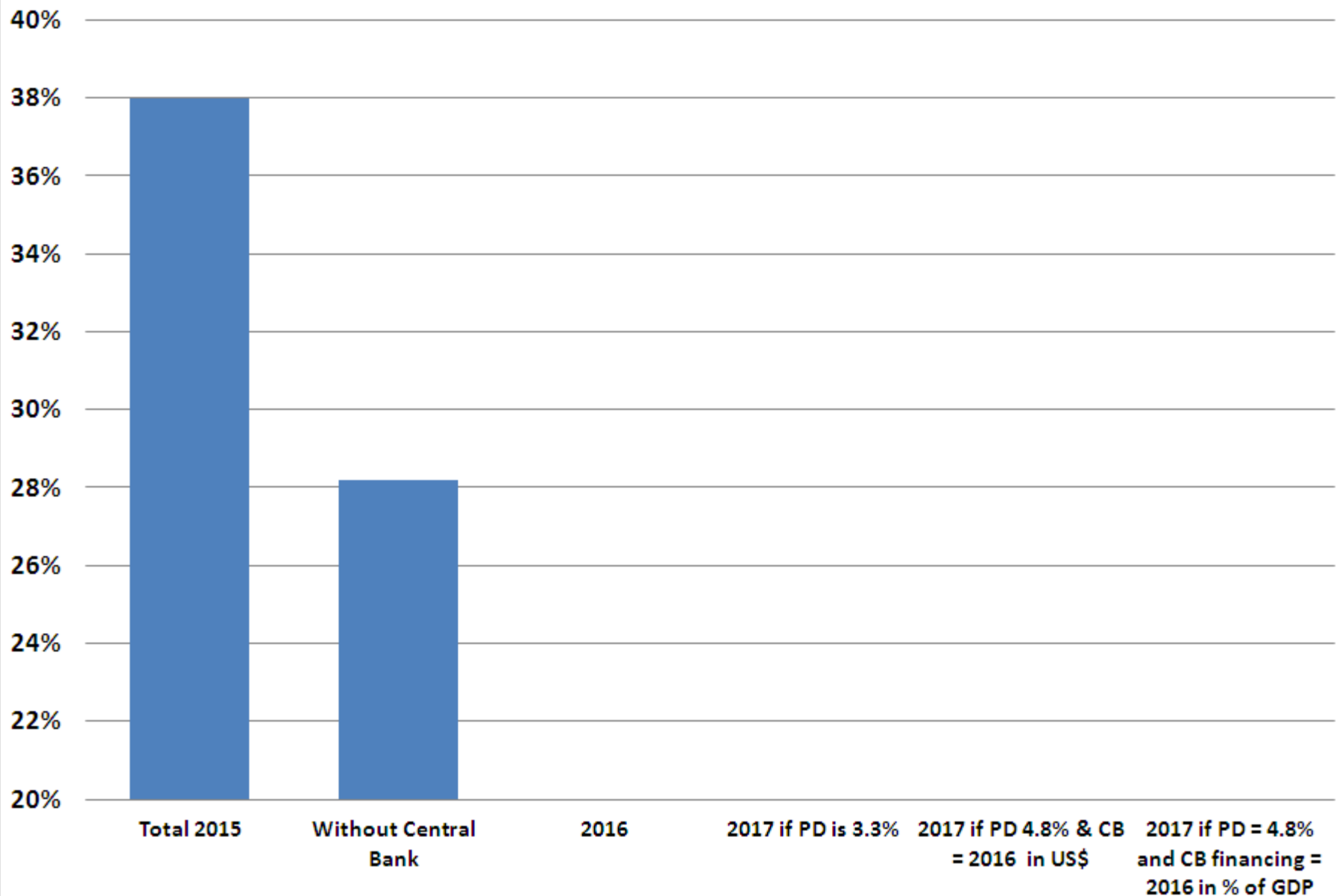
### Federal government: Primary Balance (% of GDP)



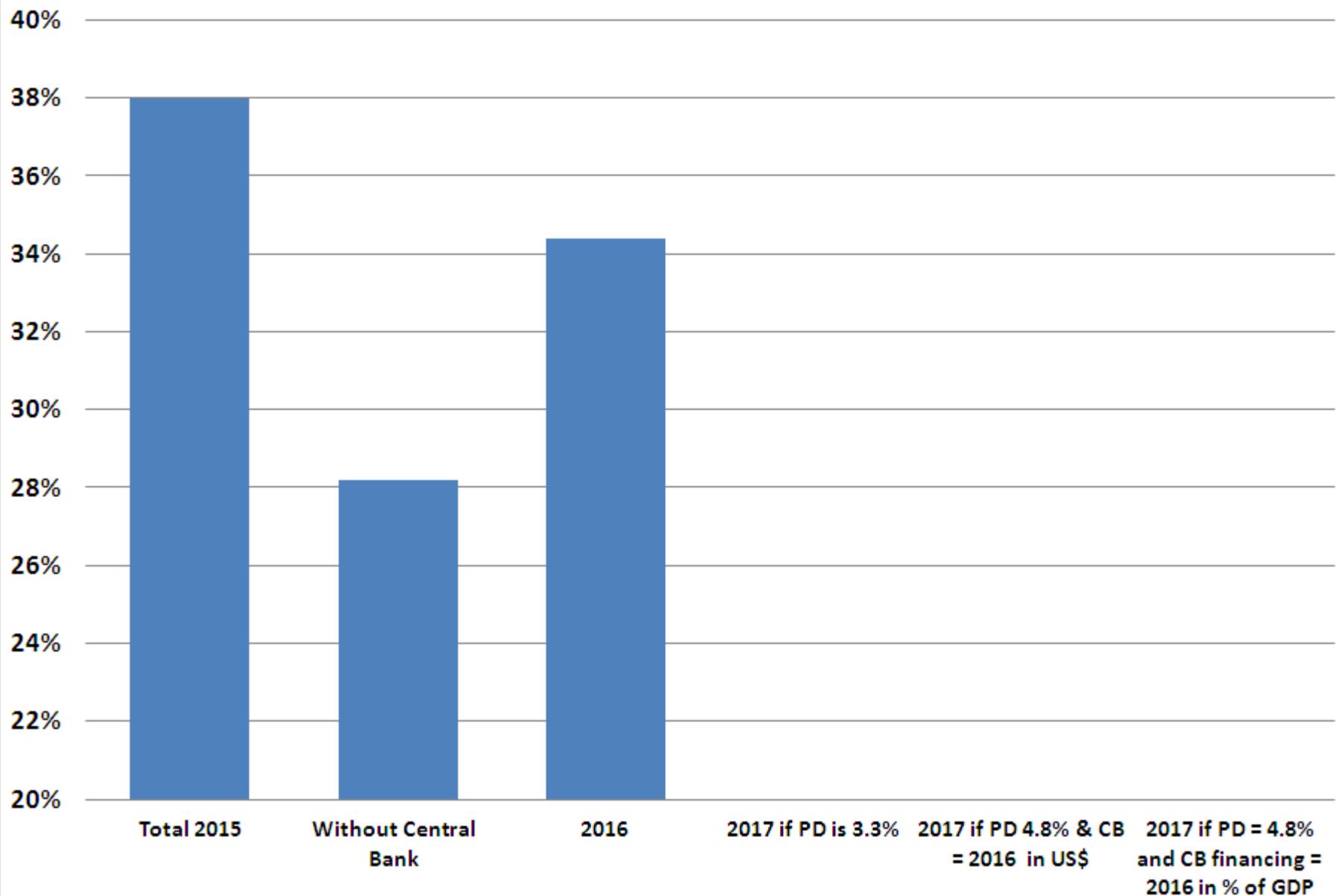
## Federal Public Debt (% of GDP)



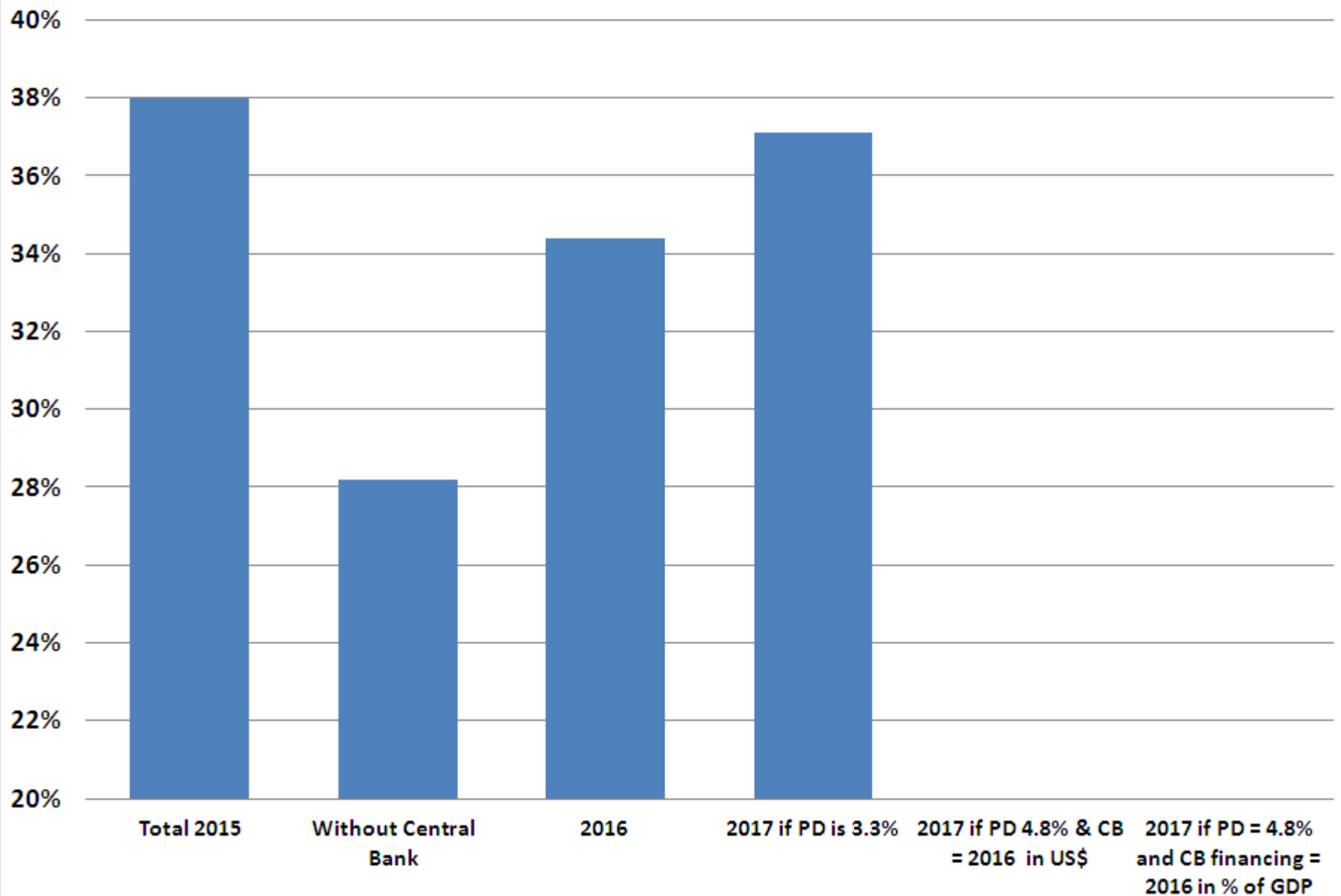
## Federal Public Debt (% of GDP)



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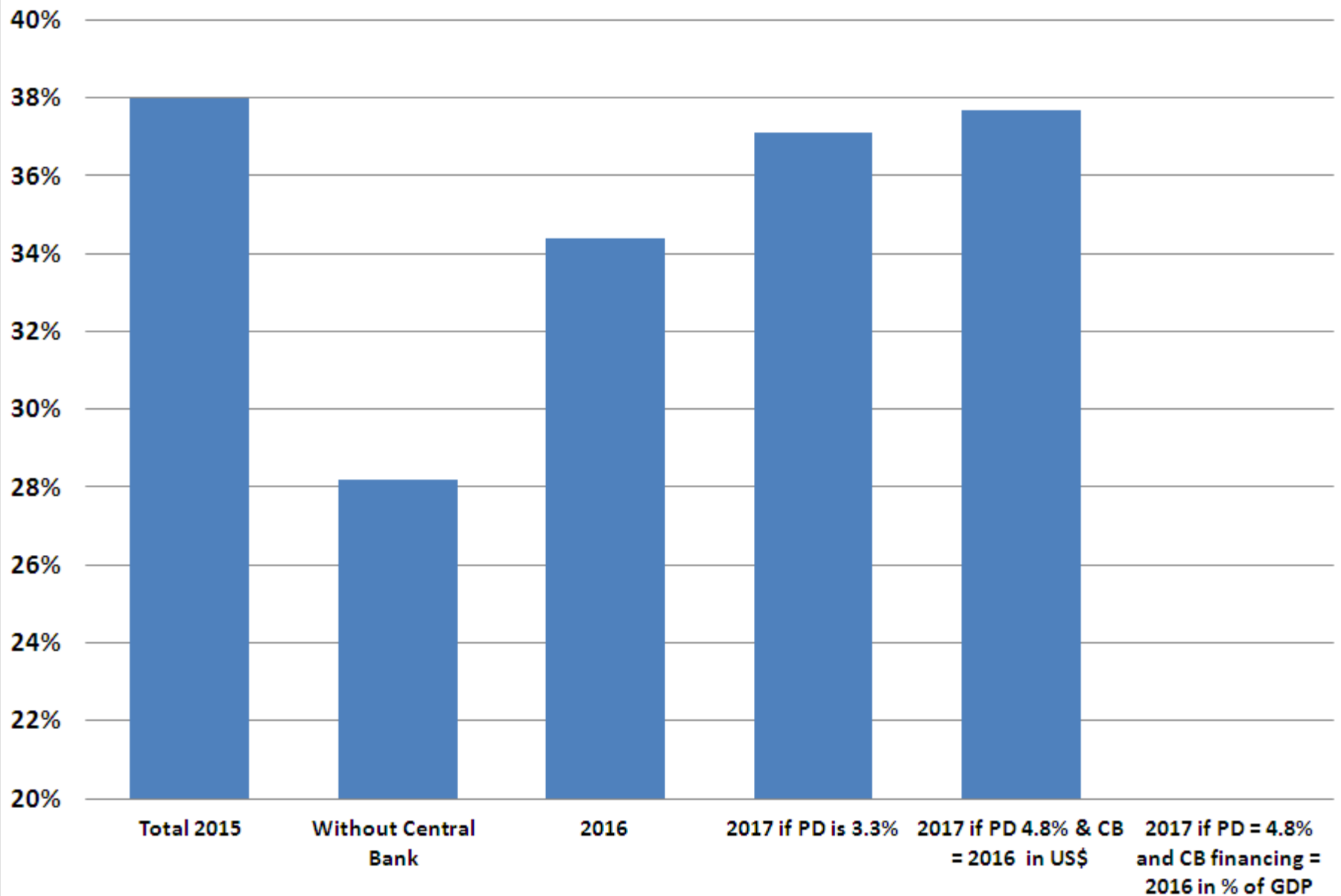


## Federal Public Debt (% of GDP)





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