Argentine default fosters uncertainty for soy farmers exacerbating contract frustration, taxation, and currency risks

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Amid ongoing uncertainty surrounding Argentina's state of selective default, IHS assesses the implications for the country's vital soy sector.

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A soy harvester in Ines Indart, Argentina, in March 2010. Argentina's state of selective default means producers are likely to stockpile crops.

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Argentina entered a state of selective default on 31 July after the country failed to make a USD539-million payment to exchanged bondholders. The default followed a New York court ruling preventing that payment from being made (see 31 July 2014: Failure of negotiations with holdout investors puts Argentina into selective default exacerbating risk to currency and contracts). Continued negotiations to satisfy the hold-out plaintiffs in the New York case and the potential risk of Argentina's defaulted debt being accelerated and becoming due for early repayment are generating high levels of uncertainty as to the length of time Argentina will be in default, and the severity of the default itself. These problems are likely to have significant implications for Argentina's soy sector, on which the government and broader economy is heavily dependent.
Access to foreign finance is likely to be constrained

Pre-financing abroad has been one of the main contributors to the "stocking-up" strategy of Argentine agricultural exporters. In this regard, it previously has enabled them to sell part of their harvest – just enough to cover financial and operational costs – and hoard the rest in expectation of further devaluation of the official exchange rate. Sovereign default is jeopardising this strategy as banks may increase interest rates to account for increased risk. Argentine borrowers will be perceived as carrying higher risk and therefore borrowing costs would likely reflect that. As a result, soy producers potentially face more constrained overall access to foreign finance and higher funding costs.

The expected sizeable peso devaluation, further monetisation of fiscal deficits, and rising inflation all threaten negative impacts on domestic credit availability as well as a steep hike in nominal interest rates. However, there is a strong likelihood that an official devaluation will be undertaken in late 2014. This would provide a temporary boost to farmers during late 2014 and the early part of 2015. Devaluation carries several positive elements for the soy sector:

Initially, it increases export competitiveness and makes Argentine produce more attractive for international buyers. For domestically based companies, it increases the peso value of the dollar-denominated proceeds of export sales, increasing profit margins. For larger, international firms, it lowers the costs of doing business by making local production costs worth less in dollar terms.

All these factors should bode positively for the sector in the event of devaluation. Notwithstanding this, farmers know that the benefits of devaluation would impart good news for only a limited period of time. In particular, devaluation would encourage a further surge in inflation, and would be likely to encourage increased labour market disruption and pressure for expensive wage settlements, as workers attempt to offset the adverse impact of devaluation on their living standards. Devaluation does little if anything to address the need to develop a sound business climate, which is essential for the sector to prosper in a sustainable way in the longer-term.

During 2014, the international context has been negative for most soy farmers. So far, soy prices have already fallen 15%. This scenario has negatively impacted profitability for soy businesses at large. In addition, high taxes for soy farmers in Argentina remain a constant, both when commodity prices are soaring and when falling. During the current poor market conditions, soy taxes are the main transactional cost for the sector, followed by cargo.

Whether to hoard grain or not will depend on the level of uncertainty. The longer the default negotiations to settle the dispute take to achieve a resolution, the higher the currency risk and therefore the incentives to hoard. Under a protracted default, the sector would anticipate more devaluations, more governmental intervention, and legal uncertainties associated with contract breaches.

**Large soy producers have room to manoeuvre, but small producers have limited options**

Big soy producers, which are large multinational companies, will continue to operate strategically. This means they are likely to continue selling minimum amounts of produce to cover costs and maintain business operations, while attempting to hold back sizeable soybean stocks until the next peso devaluation to achieve a higher peso value from their sale. Large producers also are likely to promote China-Argentina bilateral commercial relations aggressively. Small soy players are likely to have less room to manoeuvre; their main concern would be to stay in business. They are likely to continue to struggle with inflation, undue government intervention, and heavy taxation. In this context, if profitability continues to be threatened, with heavy taxes conditioning business performance and debt default unresolved, farmers will limit investments to their minimum essential levels for the forthcoming harvest season (2014/15).

In light of the challenging environment, there is unlikely to be significant scope for expansion of agribusiness operational capacities in Argentina. Larger soy producers are likely to restrict sales just to cover operational costs until market conditions settle and there is more clarity in terms of economic policy and the future exchange rate. This stand-off could be exacerbated if the country stays in default for an extended period. Markets expect a short default. If that is not the case import controls are likely to be significantly tightened (to protect foreign reserves, currently at USD29 billion, compared with USD52 billion in 2011), and this would be likely to negatively impact machinery imports.

Default will erode access to competitive domestic credit for soy farmers. There is likely to be minimum or no access to credit from local banks while default is ongoing. The implications are expected to be straightforward. Farmers are unlikely to be able to finance new technologies to develop their businesses nor to finance their projected exports: 10 those most affected will be smaller and domestically-owned firms. Larger, international producers will be far less reliant on Argentine domestic funding sources, and are thus better able to hoard production.

**Outlook and implications**

The uncertainty over the length of the default means that the next six months will be critical for producers at all levels. Soy producers, in particular, will face two main problems: constrained access to credit and the risk of higher taxation. Regarding the latter, there is a limited risk that the federal government would try to increase export taxes in light of the rapidly growing fiscal deficit. However, this would be a last-resort measure given the significant risk that this would trigger nationwide protests by farmers. Export taxes levied on soy currently stands at 35%; the last time that the government tried to increase them (2008) resulted in a nationwide farmers' strike that paralysed the country for several months. It is doubtful that President Cristina Fernández de Kirchner’s government would consider challenging the powerful farmers’ confederations at a time when labour unrest is also on the increase.

However, an increase in taxation at the provincial level is a distinct possibility. Most Argentine provinces are heavily indebted and in desperate need to issue fresh debt, which is proving increasingly difficult because of the default. Under these circumstances the provincial governors have only two options: a sharp reduction in public expenditure (improbable in a pre-electoral year) or to squeeze farmers via new taxes.

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