THE WEEK AT A GLANCE

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Editorial: Cutting Rates: A Bet in Many Directions

The government decided to cut rates by 10 percentage points and now the monetary policy rate (the Central Bank's reverse repo rate) is 60% APR, an 82% effective rate. In our base scenario we expected a loosening in monetary policy, but perhaps in June after a more consolidated decline in inflation. Last week's decision was a surprise, but not a storm on a sunny day.

The government has many objectives. On the one hand, pure "Mileism" always looks at the amount of money as a key variable and the lower rate will mean less interest payments on Central Bank liabilities and speed up the process of cleaning up its balance sheet. Since the rate is negative in real terms, interest-bearing liabilities are falling as a percentage of GDP.

The second objective is to get the money multiplier to start working. Banks generated great utilities investing in Leliqs and Repos, in addition to juicing FX controls over the last years. Today margins are thinner. They can take time deposits at 51% and invest that money in repos that yield 55% after taxes. There is some juice left there, but not enough to support entities' big structures. Now they have to start taking risk and lending again. Many entities have already started. And two of them launched mortgage loans. This alone will not be enough leverage to reactivate the economy, but it can certainly help. Loans to the private sector in Argentina are just over 4% of GDP. The only other country in Latin America that has less credit penetration is Haiti. The numbers speak for themselves. Credit can only grow.

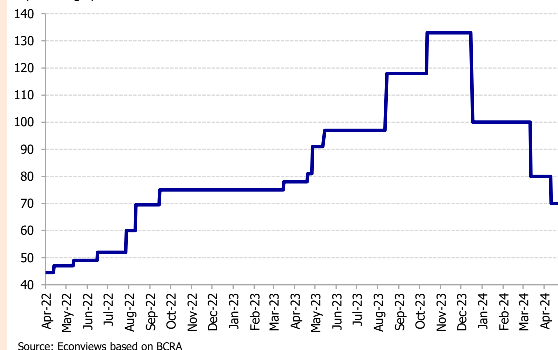
Lower rates also have risks. The FX spread may widen somewhat and did in fact grow at the margin. This is because whoever buys dollars pays an opportunity cost (the "carry trade") that is increasingly smaller. The feeling in the market is that the Blue Chip Swap has reached a floor, because its price is barely higher than the official exchange rate plus the PAIS tax on dollar purchases. An importer can pay imports through the BCS if they claim to be excluded from the official FX market. That is to say, there is a kind of arbitration there. But we think that if the FX spread widens from 20 to 25% it is neither an economic nor a political defeat for the government.

The last point is that this drop in rates is compatible with FX controls that will last longer than we thought a few months ago. Although we do not rule out that the government goes for an additional reduction in rates, our base scenario is that they remain at 60% until the Pandora's box is opened, that is, exchange rate controls are eliminated. In our criterion to open the capital account, a positive real rate (that is, greater than inflation) and a competitive exchange rate will be needed if what we want is to avoid shocks. And logically the idea is that lifting FX controls is a good thing. For this reason, we see the rate at 60%, which if inflation falls will be less and less negative, and then a jump to 80% to be able to lift controls, probably in the last quarter of the year.

LAST WEEK IN REVIEW

Last Thursday the Central Bank reduced again the monetary policy rate. Now overnight reverse repos have a nominal rate of 60%, which is equivalent to a monthly effective rate of 5.05% or 82.12% annually. We think this measure had two objectives: generating incentives for the peso holders to subscribe to Treasury instruments in the last auction and continuing to reduce the amount of money to be issued by the BCRA for interest payments.

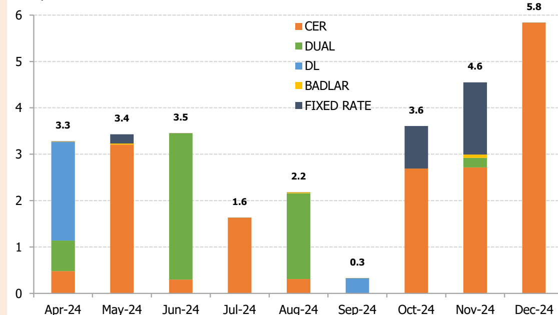
Another news from the BCRA is that it is **evaluating enabling the primary subscription of Bopreal series 3 for companies that want to pay dividends abroad.**



In the second auction of the month, the Treasury issued ARS 2.73 trillion while it faced maturities of ARS 2.82 trillion, so **it did not cover all the maturities**, even though the BCRA had injected a lot of liquidity by purchasing bonds during the week. The rollover for the month was 175%.

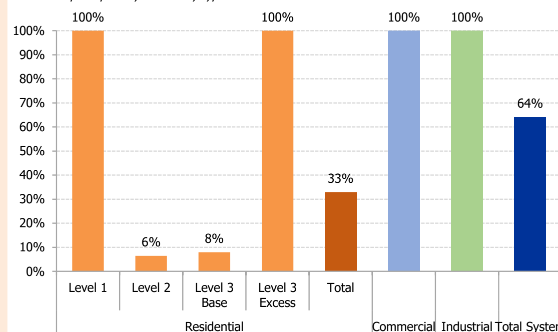
Despite the interest rate cut by the BCRA, **the Lecaps have been issued at higher rates than those being paid** in the market the day before the auction. The S29N4 monthly effective rate was 4.4% and for the S31M5 was 4.1%.

Although almost no offers were rejected (96% of the offers were adjudicated), the Treasury couldn't roll over all maturities.



In March, **the coverage of the wholesale cost of electricity reached 64%**. In February it had been 60.6% and last year's average was 48.5%. The best ratio was reached in February 2019 when 81.3% was covered**.**

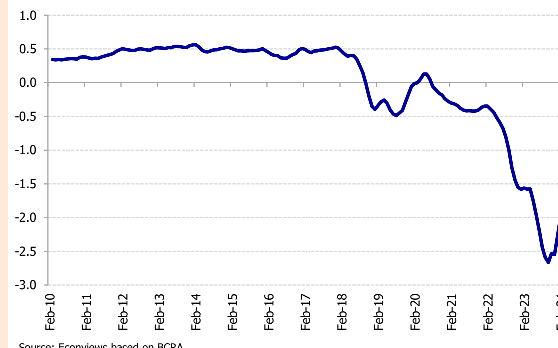
Within users, **industrial and commercial pay 100% of the cost. The residential users on average cover 33%** although there are differences inside. **The highest income segment pays the full rate**, while those in level 2 (lowest income) and level 3 (intermediate) cover 6 and 8% respectively.



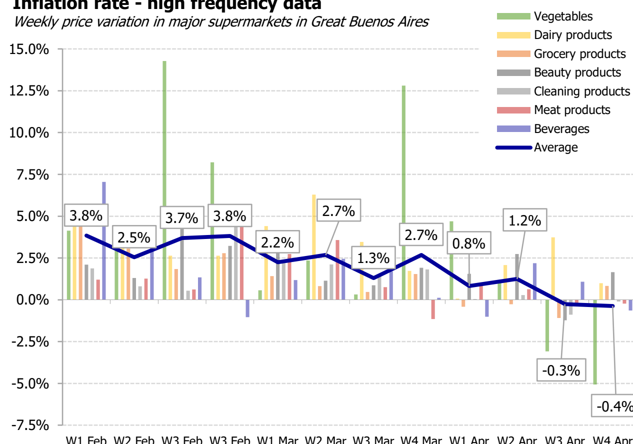
In February, **non-performing loans in the financial system fell to 2.02%.** In private banks, it was even lower (1.43%), and for public banks was 3.02%.

Regarding the **entities' profits**, in the first two months of the year, a positive result of ARS 771,076 million was accumulated, which implies an improvement of 77.1% in real terms compared to the same period last year.

Net interest income began to improve. In a context where the Treasury no longer has a deficit and with the reactivation of private credit, financial intermediation activity can grow again.



WEEKLY INFLATION



Note: The variations are based on the average price per week, from Friday to Thursday.
Source: Econviews based on own estimates

NEXT WEEK'S HIGHLIGHTS

- On **Tuesday 30**, the **Staffing of the national public administration, companies and societies** for the month of March will be published.

- On **Thursday 2**, INDEC will announce the **price and quantity indices of foreign trade** for the first quarter of 2024.

- On **Thursday 2**, **tax collection data** for April will be published.

- During the week, the **Government Confidence Index** of the Torcuato Di Tella University for the month of April will be announced.

Market dashboard

Weekly, monthly and yearly variations

	Last data	w/w	m/m	y/y	
Official exchange rate ARS/USD	874.8	0.5%	2.1%	294.8%	↑
MEP	1034.4	1.0%	0.8%	132.1%	↑
Blue Chip Swap	1083.7	1.9%	-1.4%	131.5%	↑
Parallel	1035.0	4.0%	4.0%	120.7%	↑
Official exchange rate BRL/USD	5.1	-1.7%	2.7%	1.4%	↓
CB reserves (USD million)	30,137	+287	+2,493	-6,217	↑
Policy rate (Leliq)	70.0%	0 p.p.	-10.00 p.p.	-11.00 p.p.	=
Badlar rate (private banks)	61.3%	+0.31 p.p	-9.94 p.p.	-15.13 p.p.	↑
Private Deposits (trillion ARS)	44.2	-0.2%	5.0%	134.4%	↓
Private Loans (trillion ARS)	20.1	3.3%	6.8%	139.6%	↑
Merval (in ARS)	1,276	7.3%	5.0%	318.6%	↑
Merval (in USD)	1,177	5.3%	6.5%	80.8%	↑
Country Risk (spread in %)	1,210	-0.3%	-15.1%	-54.2%	↓
Soybean (USD/tn)	426.0	0.8%	-3.3%	-19.3%	↑
Corn (USD/tn)	173.2	1.5%	1.7%	-31.4%	↑
Wheat (USD/tn)	221.6	9.6%	11.0%	-3.8%	↑
Oil - Brent (USD/barrel)	91.1	2.2%	5.6%	9.4%	↑
Oil - WTI (USD/barrel)	85.4	1.9%	3.6%	14.9%	↑
LNG (USD/MMBTU)	10.2	-2.9%	8.5%	-11.3%	↓
Gold (USD/oz.)	2,339.5	-2.1%	7.4%	17.6%	↓

Note: arrow depends on weekly variation

Stoplight for Economic Activity

Seasonally adjusted variations

		m/m	q/q	LD vs previous Q
Industrial production	*Feb-24*	-0.7%	-9.8%	-4.4%
Automobile production	*Mar-24*	-7.7%	-12.1%	-10.0%
Steel production	*Mar-24*	-45.1%	-6.0%	-43.4%
Poultry production	*Feb-24*	3.1%	0.4%	4.8%
Dairy production	*Mar-24*	-1.1%	-8.4%	-4.6%
Beef production	*Mar-24*	-11.6%	-2.2%	-8.7%
Real Estate transactions (CABA)	*Mar-24*	0.0%	-1.7%	8.4%
Flour Production	*Mar-24*	-3.8%	-3.2%	-2.2%
Oil production	*Mar-24*	-2.7%	1.7%	-1.0%
Gas production	*Mar-24*	-3.8%	9.4%	6.8%
Cement production	*Mar-24*	-20.1%	-16.7%	-23.6%
Construction activity	*Feb-24*	-2.6%	-17.7%	-12.6%
Gas sales	*Mar-24*	-2.7%	-5.8%	-2.6%
Motorcycle licenses	*Mar-24*	-23.5%	-25.0%	-27.7%
Use of electricity	*Feb-24*	0.8%	-3.0%	0.6%
Train rides (AMBA)	*Mar-24*	3.2%	0.7%	2.7%
Imports CIF	*Mar-24*	-0.9%	-9.2%	-3.3%
Exports FOB	*Mar-24*	-0.4%	14.8%	4.5%
Loans in ARS to private sector	*Mar-24*	-1.2%	-26.1%	-7.0%
VAT-DGI Revenues	*Mar-24*	-4.3%	-8.0%	-2.2%
Formal private jobs (SIPA)	*Jan-24*	-0.1%	-0.2%	-0.1%
Formal private jobs (EIL)	*Feb-24*	-0.3%	-0.7%	-0.6%
Consumer confidence	*Apr-24*	1.3%	-10.6%	2.9%
Government confidence	*Mar-24*	-0.4%	41.0%	-4.5%

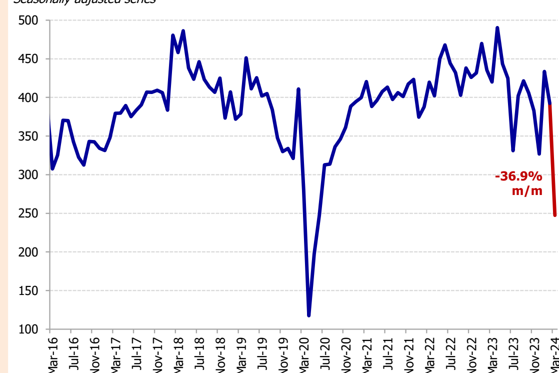
Note: stoplight color depends on last month vs previous quarter variation

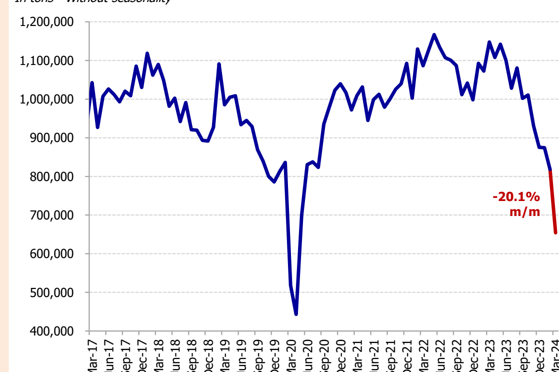
Was March the Bottom of Activity?

- *The first activity data for March are pessimistic.*
- *Not all consumption data is bad, and consumer confidence is rising little by little.*
- *Rather than a V-shaped recovery, we expect a flat U.*

Activity probably bottomed out in March. In the worst case it may be in April. For now, we estimate that it continued to fall in March, although how much it fell is debatable. After -0.2% in February, it can be predicted that the inter-monthly variation was 0, but we see it as more likely that it will have a minus sign (although we do not lose hope). As can be seen in our economic activity traffic light (page 4), the vast majority of early indicators worsened on a monthly basis in the third month of the year.

Steel production fell 36.9%, due to low demand from the manufacturing, agriculture and construction sectors. In particular, Acindar, one of the largest steel companies in the country, decided to temporarily close its four plants from mid-March to April 15. Car production is another reflection of how the industry is doing, with a monthly drop of 7.7% in the seasonally adjusted series.





Within the **agricultural sector**, dairy production fell 1.1%, beef slaughter 11.6%, and flour production 3.8%. **Energy did not do well either**, although it is expected to be one of the shock absorbers of the recession. Oil and gas production fell 2.7% and 3.8% respectively. Going to **construction**, -20.1% in cement production is nothing new for a sector that feels the effect of an appreciated Peso and also of the cut in public works.

The sale of gasoline fell 2.7% and motorcycle registrations plummeted 23.5%. Loans to the private sector did not recover in March, and fell 1.2% in real terms. In April loans could rebound. VAT-DGI collection, linked to the level of activity, fell 4.3%.

The positive data for March is train travel, which increased by 3.2% possibly in response to the increase in the cost of traveling by own vehicle. The deeds in CABA had zero variation compared to February. CAME's retail sales improved and according to FIEL the industry rose 0.5% month-on-month. So it's not all bad news. Furthermore, we have doubts about deseasonalization. March 2024 was very different from March 2023.

With all these leading indicators, **the chances are great that March has been recessive**. This would be the seventh consecutive month of decline, given that **in February economic activity fell 0.2% monthly**. Compared to the falls in December and January, this result implies that the economic contraction is becoming softer. In year-on-year terms, activity fell 3.2%.

The year-on-year decline is mainly attributed to the contraction of key sectors: industry, construction and commerce. Industrial manufacturing production decreased by 8.4%. Commerce and construction also had drops of 5.5% and 19.1%, respectively, which translated into a strong negative influence on the general index.

Energy and agriculture helped mitigate the general decline. The extractive activity sector grew 11.7% year-on-year and the agricultural sector 5.5%. The electricity, gas and water category also contributed positively, registering an increase of 7.6% year-on-year.

From our own deseasonalization we see that in the monthly variations the energy and agricultural sectors performed better. In contrast, construction cannot get out of the critical state. As we mentioned previously, the very low FX spread and the increase in dollar costs do not help the sector. **Hotels and restaurants continued to experience difficulties**, reflecting the decline in real wages and the consequent drop in consumption.

In any case, not everything is bad in consumption data. Although on the street it feels like these are difficult months, there are indicators that are not so discouraging.

In February, **commercial activity** had a slight rebound of 0.4%, according to our seasonally adjusted EMAE series. It is the second month in a row of recovery. **Supermarket sales improved** 0.5% compared to January, although they are still 11.4% below the previous year. **Sales in shopping malls also showed signs of recovery**. After four consecutive months of sharp falls since October, in February they grew 3.4% m/m.

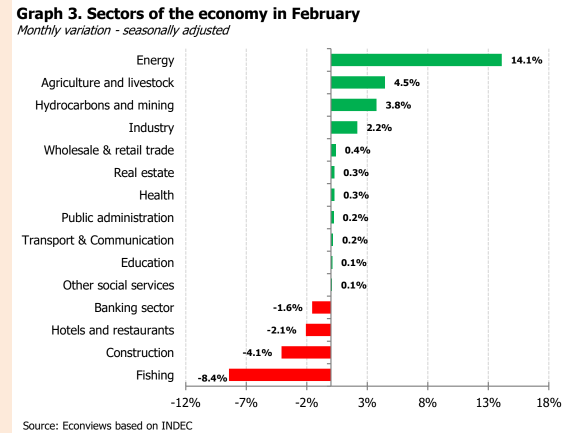
On the contrary, **wholesale sales continued to fall**, with a variation of -1.7% monthly and a year-on-year drop of 6.2%. So far this year, they are down 7.2% compared to the first two months of 2023.

Thinking about how consumption can continue, **consumer confidence rose in April**. The index prepared by Di Tella University showed an increase of 1.3% compared to March, marking the third consecutive month of increase after the falls recorded in December (-16.2%) and January (-10.6%).

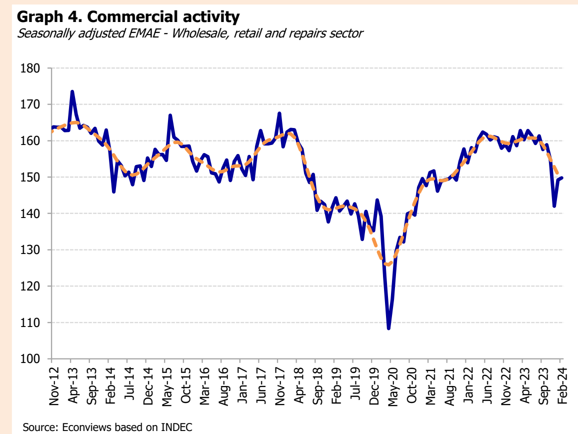
Breaking down the index, we see that the general increase is exclusively due to the **5.46% improvement in the perception of Personal Situation**. On the contrary, the perception of the **Macroeconomic Situation experienced a slight decrease** of 0.74%, and the **purchase intention of Durable Goods decreased** by 2.14%.

How and when does the recession end?

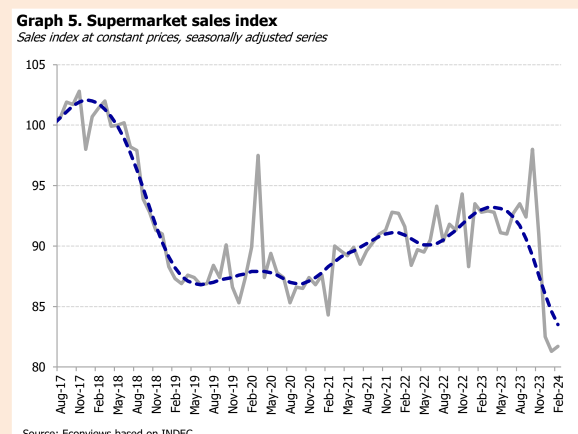
Analyzing the recessions and recoveries of the last 30 years we see that **in the Tequila and Subprime crises the shape that the level of activity followed was quite similar to a V. The point in common between both is that they were external shocks.** At the same time, when the economic contraction was due to the effect of devaluations (Jan-14 and Dec-15), the fall was softer and so was the recovery. **Here the shape would be more similar to a flat U.**



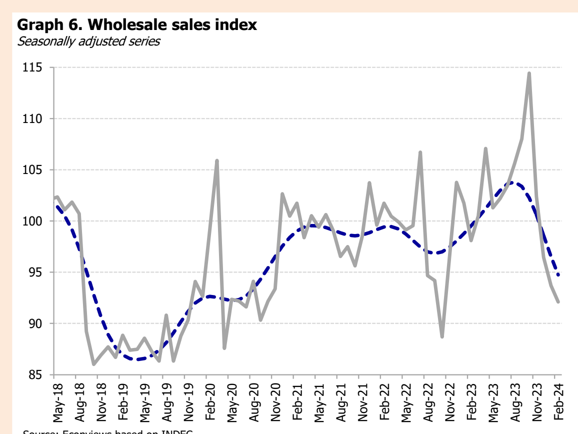
Graph 3. Sectors of the economy in February
Monthly variation - seasonally adjusted
Source: Econviews based on INDEC



Graph 4. Commercial activity
Seasonally adjusted EMAE - Wholesale, retail and repairs sector
Source: Econviews based on INDEC



Graph 5. Supermarket sales index
Sales index at constant prices, seasonally adjusted series
Source: Econviews based on INDEC



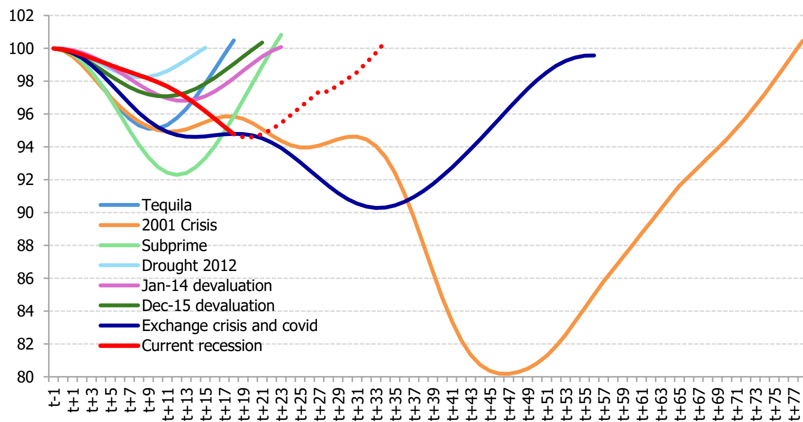
Graph 6. Wholesale sales index
Seasonally adjusted series
Source: Econviews based on INDEC

Regarding the current recession, we do not see that it can be as strong as that of the 2018-2020 period (exchange crisis + Covid) nor as that of the exit from convertibility. In any case, it will be the third longest contraction in the entire sample. The series that measures the trend-cycle (used to see the breaking points) shows us that this recession has already been going on for 20 months, doubling in duration several of the previous crises. We estimate that we are passing through the bottom of activity. In other words, April could be the turning point for the economy to grow again. As the latest summer EMAE data were not so bad, we maintain our projection for 2024, but with a slightly warmer second half.

There are several factors that are not going to help. On the one hand, it is very likely that the FX restrictions will remain in place. That can help on the fiscal and international reserves side, but it will also hinder new investments. Public spending is not going to be something that pushes either. Added to this is the exchange rate appreciation that can also work against it. **On a positive note, the reactivation of credit can boost some investment and also consumption.** Already in April, credit appears to have not fallen for the first time since October, although data is still missing.

From all this **we see a GDP drop of 3.3% for this year**. Given that the second half will not be as strong as we expected, there will be less statistical carryover for next year. That led us to lower our projection from 8 to 5.5%, although there is still a long way to go to reach 2025.

Graph 7. Recessions and recoveries of the last 30 years
Cycle trend series - t-1 = 100 (month prior to the first fall)



Source: Econviews based on INDEC

The Fiscal Outlook Improves Due to a New Income Tax Law and Extended FX Controls

- *The government celebrated a 1.1 trillion fiscal surplus in Q1-2024.*
- *With more collection from income tax and the PAIS tax on dollar purchases and less debt interest, we changed our primary result forecast from 0 to 0.5% and the fiscal result from -2 to -1% of GDP.*
- *In the Q2, the bulk of the adjustment should shift from pensions and wages to cuts in economic subsidies, mainly energy.*

Chart 1. 2024 fiscal program

Main changes in revenues and spending as a % of GDP

	2023	2024E	Variation in p.p.
Revenues	**17.0%**	**17.1%**	**0.1%**
5G tender	0.2%	-	-0.2%
Export duties	0.8%	1.5%	0.7%
PAIS tax on dollar purchases	0.8%	1.3%	0.5%
Less revenues due to recession	-	-0.8%	-0.8%
Fuel taxes	0.3%	0.5%	0.2%
Income tax (reverting reform)	1.6%	1.3%	-0.3%
Expenses	**19.8%**	**16.7%**	**-3.1%**
Pensions (exc. bonuses)	7.7%	7.0%	-0.7%
Transfers to provinces	0.8%	0.2%	-0.6%
Energy and transport subsidies	2.1%	1.4%	-0.7%
CAPEX	1.6%	0.6%	-1.0%
Social programs	3.0%	3.3%	0.3%
OPEX (inc. wages)	3.3%	2.9%	-0.4%
Primary result	**-2.7%**	**0.5%**	
Net interest	-3.3%	-1.5%	
Fiscal result	**-6.0%**	**-1.0%**	

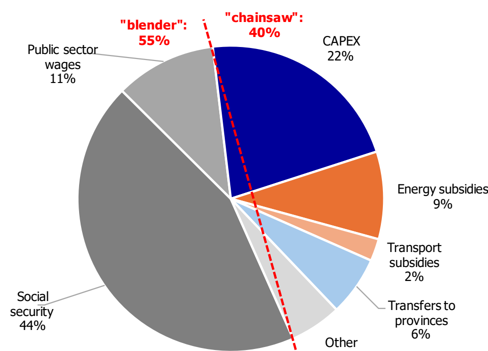
Source: Econviews based on Min. of Economy and own forecasts

The government announced a fiscal surplus in Q1, the first since 2008. With revenues down 4.5% year-on-year in real terms - the increase in taxes on foreign trade was not enough to compensate the drop in activity and the reform in income tax – the bulk of the effort came from primary spending, which was cut by more than a third, 35% year-on-year.

There are two ways to look at how the adjustment has been distributed so far. One is each area's absolute contribution to the fall in spending, and there it emerges that the "blender", or erosion in real terms, of pensions and other social expenses (44%) and public sector wages (11%) explains 55%. The "chainsaw", cuts in public works (22%), economic subsidies (12%) and transfers to the provinces (6%) is the other 40% (the provinces' share is partly due to lower automatic transfers from federal shared taxes).

Graph 1. Distribution of fiscal adjustment by area

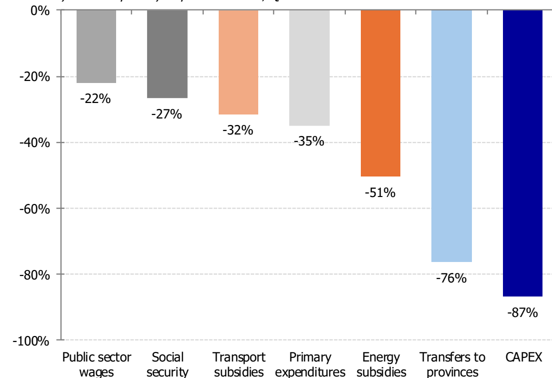
Contribution of each area to the year-on-year fall in primary exp., Q1-2023



Source: Econviews based on Min. of Economy and INDEC

Graph 2. Magnitude of fiscal adjustment by area

Year-on-year fall in primary exp. in real terms, Q1-2023



Source: Econviews based on Min. of Economy and INDEC

Another angle is checking on the "over-adjusted" areas, where real spending fell more than the 35% average. In this sense, the main victims were public works (-87%), transfers to provinces (-76%) and economic subsidies (-46%), especially energy (-51%). Spending on contributory pensions (-36%) fell in line with the average, while spending on the child allowance (+11%) increased in real terms. The cuts in energy subsidies is partly due to delayed payments. Some of these arrears may be paid with bonds, improving the balance on a cash basis, but an unorthodox accounting procedure.

This first act is not the full play. With the 12.5% bonus and indexation to CPI starting in April, pensions will have a slight recovery in the second semester (the new formula freezes them in real terms over 2025, but that's another discussion). We hope that the fall in salaries has hit a floor, although it is true that the second quarter started with many layoffs in the government. Regarding public works, the delay in starting or resuming projects may mean that this year ends below 1% of GDP, but it would be desirable to increase investment in infrastructure in 2025. The focus of the adjustment should shift from "quantity" to "quality", one of the IMF's requests, a process that has already begun with the removal of subsidies for gas and electricity.

We think the government will have more space on the revenue side. Congress is treating a new version of income tax – with a floor of 9 minimum wages and semiannual adjustment – which is great news. The news that the removal of FX controls will take longer than expected is not so great in terms of credibility and economic activity, but will help a lot on the fiscal front due to the PAIS tax on dollar purchases. **We raised our primary balance forecast for 2024 from 0 to 0.5% of GDP.**

The government is also reducing the interest burden for this year. In addition to the issuance of Capitalizable Letters (LECAPS) to 2025 that do not accrue interest in 2024, the exchange rate appreciation reduces the weight of payments in dollars to the IMF and bondholders in GDP. Taking this into account, **we corrected our 2024 fiscal deficit forecast from -2 to -1% of GDP,** due to a better primary result and lower interest payments.

April will be another month of surplus. Public sector deposits (at all levels of government) increased by 3 trillion between March 27 and April 23. In January, February and March this dynamic anticipated the national government's positive results (2023 is different because the provinces were running a surplus).

Some expenses were swept under the carpet. The floating debt reached 2 trillion pesos in March. 680 billion are inherited from 2023 and 1.3 trillion are liabilities generated by this government, 66% in transfers. It is not a historically high amount; inflation erased a lot of debt between November and January.

But the number does not include one of the most important debts, that of CAMMESA with the energy generating companies for around 1.2 billion dollars, technically between private parties but which in the long run must be paid by the government. Yesterday it was rumored that Minister Caputo wants to cancel the debt with AE38 bonds (which trade at 52 cents). But if this debt was recorded "below the line," the fiscal surplus for the quarter would shrink from 1.1 trillion pesos to 130 billion.

The adjustment is beginning to improve in "quality". With the latest increases, the average user is paying 64% of the cost of electricity. High and middle income households (above 400 kWh), commercial and industrial users already pay 100%, so there is not much room for further adjustment without hurting low-income users. Gas' situation is similar after the April increases. The weight of the fuel taxes in each liter of gasoline will have risen from 4 to 23% so far in 2024.

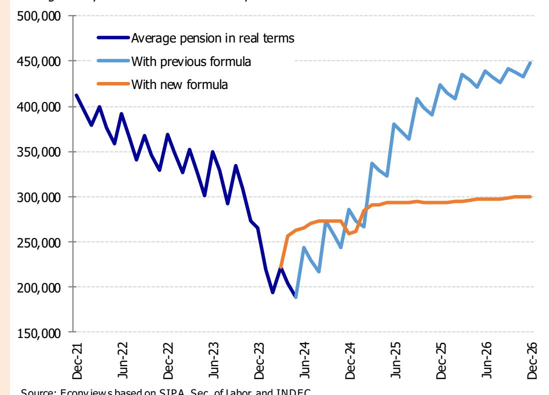
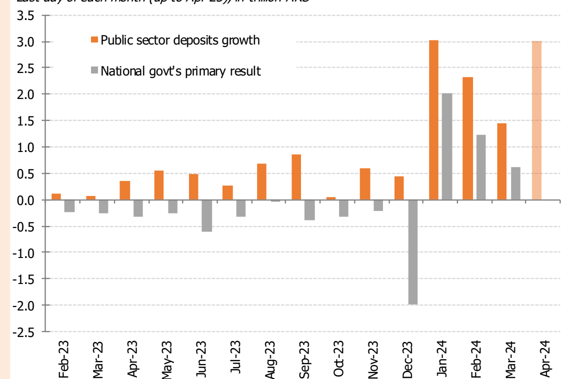


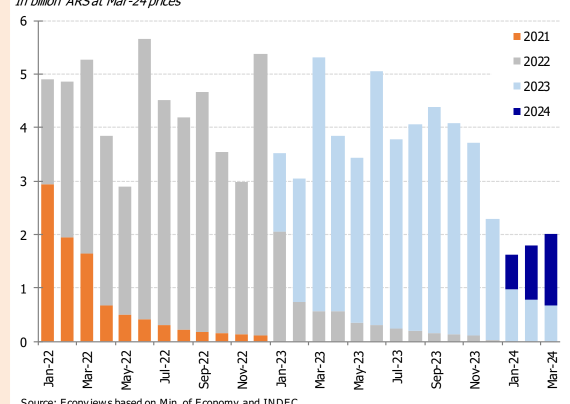
Chart 2. Interest payments in 2024E

National government

	In million USD	As a % of GDP
Bonds in pesos (including CER and DLK)	1,703	0.3%
Bonds in dollars	3,120	0.4%
IMF	3,267	0.5%
Other multilaterals, etc.	1,993	0.3%
Total	**10,083**	**1.5%**

Source: Econviews based on Min. of Economy





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The removal of subsidies is one of the prettier areas of the adjustment, since it falls on high-income sectors and rationalizes energy consumption. It remains to be seen if tax revenues from energy use also improve: in 2016-17 it did not happen because companies had accumulated tax credit during the years of low rates, but with inflation that credit evaporates quickly.

The government is going to juice the PAIS tax. In the last Midweek report, we argued that Milei is in no hurry to lift FX controls and that we adjusted our base scenario accordingly. With low imports, the PAIS tax on dollar purchases collected 0.3% of GDP in the first quarter. If FX controls were lifted after the gross harvest (our previous base scenario), it could raise 0.8% of GDP and maintaining FX controls all year round it would raise 1.7%. We believe that the final number will be halfway, 1.3% of GDP, assuming a gradual exit from FX controls which could include lowering the PAIS tax rate or the exemption of more products. But the government will hold on to an important source of income which, until a few weeks, seemed set for expiration in June or July.

The exchange rate appreciation reduces income from export duties – we lowered our estimate from 1.7 to 1.5% of GDP – although if the blend dollar (20% Blue Chip Swap) is kept, the impact won't be as much. As for import duties, the price effect – dollars are exchanged for fewer pesos – clashes with the incentive to increase imports generated by a cheap dollar.

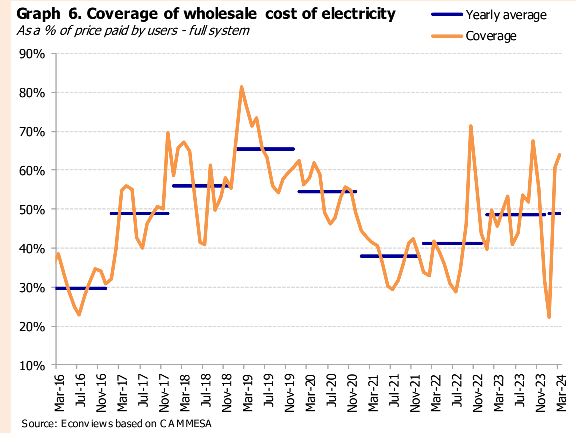

Chart 3. Fiscal implications of exchange rate policy

Revenues from taxes on foreign trade as a % of GDP

	Accum. Q1-2024	2024E unifying FX market in July	2024E with gradual exit from FX controls	2024E without unifying FX market
Total	**0.6%**	**3.0%**	**3.4%**	**3.6%**
PAIS tax	0.3%	0.8%	1.3%	1.7%
Export duties	0.2%	1.5%	1.5%	1.5%
Import duties	0.1%	0.7%	0.6%	0.5%

Source: Econviews based on INDEC and own estimates