MONTHLY REPORT

ECONVIEWS

ECONOMÍA Y FINANZAS

March 2024

Issue #237

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THE MONTH AT A GLANCE

RECENT DEVELOPMENTS

- Milei beckoned governors to join him in a "May 25th Pact", signing a joint declaratory on 10 guidelines to liberalize the Argentine economy. Reception was mostly positive. However, the Senate voted against Decree 70/2023 and its fate now depends on the Lower House.
- Country risk kept falling to 1,428 basis points in March, the lowest since early 2021. In the 130 days since Milei won the run-off, it has fallen nearly 1,000 bps. The Argentine stock market won 18% in March and sovereign bonds like the GD30 benchmark rallied 14%. The BCS trades at ARS 1,096, a 28% spread with the official exchange rate.
- Monthly inflation kept slowing from 20.6% in January to 13.2% in February. Our web scrapping of supermarkets showed a 1.3% increase in prices in the third week of March, the lowest since Milei took office.
- At its last meeting, the Federal Reserve kept the policy rate in the 5.25-5.50% range. However, board members revised GDP forecasts for 2025 and 2026 upwards and also forecast a 50 bps higher policy rate. That tighter monetary policy responds to increased growth and not inflation was a positive surprise for markets, though bond yields rose slightly.

FIGURE OF THE MONTH

Country risk (EMBI) fell to

1,428

basis points, the lowest since January 2021.

TO BE ALERT

Soybean prices are down

8.5%

YTD in real terms, despite a small rebound in March.

WHAT'S COMING NEXT?

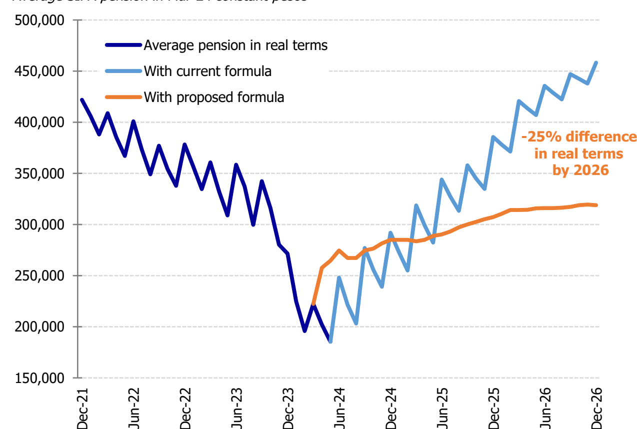
- The government wants to replace the current pension adjustment formula, which indexes them to wages and social security contributions on a quarterly basis, with a new one which indexes them to monthly inflation, plus a 12.5% bonus in April. Since pensions are down 38% in real terms year-on-year, this would freeze them at -25%, while under the current formula they would gradually recover in 2025 and 2026. The fiscal implication is above 1% of GDP.
- Aside from Decree 70/2023, Congress will also be discussing a new version of the "Omnibus Law" the government tried to pass in February. According to official sources, this version will include a labor reform.
- Caputo and the Central Bank insist on maintaining the 2% monthly crawling peg for the official exchange rate. Q2 does not appear challenging as there will be dollar inflows from the harvest and the FX spread is low. In the medium term, there are worries Argentina may become too expensive in dollars.
- Are we past the worst of the recession? Economic activity fell 5.8% between October and January, shrinking 1.2% that last month. We expect February and March to show negative monthly variations, though closer to -0.4-0.5%, and believe the economy could touch rock bottom in April. However, there are reasons to be conservative on the speed of recovery.

SUMMARY OF MAIN INDICATORS

	Last	Previous		Last	Previous
Economic activity			**Financial data**		
Economic activity (MoM s.a.)	-1.2%	-2.8%	Inflation (monthly)	13.2%	20.6%
Consumer confidence (MoM)	1.2%	-10.6%	FX spread (21day avg.)	26.0%	45.4%
Industrial activity (MoM s.a.)	-1.3%	-8.1%	Country risk (bps 21day avg.)	1,606	1,895
International accounts			**External data**		
Current Account (USD BN)	-3.42	-5.95	Soybean price (per ton, 21day avg.)	427.9	436.8
CB Reserves (USD BN 21day avg.)	27.93	26.45	Brazilian activity (MoM s.a.)	0.6%	0.8%
Primary balance (ARS BN)	1,232.5	2,010.7	Financial Conditions Index	35.4	26.2

Source: Econviews based on multiple sources - working days only

GRAPH OF THE MONTH:



RECENT ECONOMIC DEVELOPMENTS

FEB 28th	MAR 1st	MAR 11th	MAR 14th	MAR 18th	MAR 22nd	MAR 26th
Econviews Monthly #236: So far so good, but challenges ahead + special report on fiscal consolidation.	In address to Congress, **Milei calls governors to sign joint declaration on May 25th** to liberalize the economy.	Central Bank **lowers its policy rate from 100 to 80% APR** and removes minimum rate for fixed term deposits.	**Senate votes against Decree 70/2023**, in unexpected upset for govt, which now depends on Lower House.	February's CPI at 13.2%, below expectations, **Economy delays hikes in gas and bus fares,** to lower pressures.	Government announces it will **modify pension adjustment formula,** indexing it to CPI after April.	**Econviews Monthly #237**

POLITICS

Milei's enduring positive image, despite economic hardship, contrasts (or is perhaps partly explained by) his inability to pass bills in Congress. After the Omnibus bill's failure in February, in mid-March the Senate voted against Executive Decree 70/2023. The Lower House has the final call. Until then, the Decree is still in effect, but the possible overturning of positive aspects, like the deregulation of rentals, casts a shadow on the economy. On March 1st, Milei gave the annual address to Congress and called on governors to join him in signing a Pact on May 25th with 10 guidelines to liberalize the economy. Reception was mostly positive, and much will depend on the parallel negotiation to reimpose Income Tax, key for Provinces.

IMF

The IMF's director for the Western Hemisphere, Rodrigo Valdes, visited Argentina in late March to meet with Minister Caputo and private sector leaders. In a speech at a business forum on March 26th, Valdes was supportive of the government's "huge fiscal effort" and weighted January and February's fiscal surpluses positively. However, he warned authorities about improving "the quality" of the adjustment, to avoid disproportionate effort by lower-income groups. After paying USD 776 million in interest in February, the next maturity with the Fund is nearly 2 billion in April.

ECONOMIC ACTIVITY

After slumping 2.8% monthly in December, economic activity fell another 1.2% in January. November was also revised downwards, though 2023's GDP contraction remained at 1.6%. Year-on-year, GDP was down 4.3% in January 2024. Agriculture is already growing 11% year-on-year, as it begins to compare against the drought months. Mining, up 5.2%, is the other bright spot. However, manufacturing slumped 11% and construction lost 17% year-on-year. Retail (-8.2%) also did badly, while hotels and restaurants (-1%) are somewhat cushioned by a weak comparison base. We expect the economy to contract 3% on average in 2024, with the recession concentrated in Q1 and bottoming out around April or May.

INFLATION

Monthly inflation keeps slowing down: from 25.5% in December to 20.6% in January and 13.2% in February. Our web scrapping of Buenos Aires supermarkets shows prices rose 1.3% in the third week of March, down from 2.2 and 2.7% in the first half of the month. The government's decision to postpone gas and bus fare adjustments means March's print could be below 12%. Communication (+25%) and transport (+22%) led the index in February, while core CPI rose 12.3% and food and drink prices increased 11.9%. Year-on-year inflation is running at 276%. We expect it to close December around 230%. Monthly inflation should keep on a downward trajectory until the FX market unification, which could cause a one-off spike in prices.

MONETARY SECTOR

The Central Bank lowered the policy rate again on March 11th, from 100 to 80% APR, and eliminated the minimum rate for fixed term deposits, which fell from 110% to an average 70% APR, an effective monthly rate of 5.8%, that is, 5-6 points below expected inflation. This policy of negative real rates is helping the Central Bank heal its balance sheet but poses questions on what will happen when FX controls are loosened. For now, reserve accumulation is going well: net reserves increased by USD 8.9 billion since the 11th of December, when the new administration took office. However, import payments has not been normalized yet, and the difference between accrued and paid grew by USD 11 billion in that period.

FISCAL ACCOUNTS

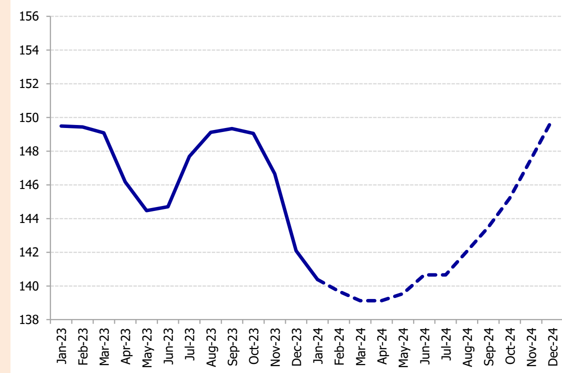
The national public sector achieved another ARS 1.23 trillion primary surplus and 338 billion fiscal surplus after interest payments. Tax revenues fell 5.7% year-on-year in real terms, with sharp contractions in social security contributions (-23%) and income tax (-36%). However, taxes on foreign trade such as export duties (+34%), import duties (+31%) or the PAIS tax on dollar purchases (+309%) are still bolstered by the weaker Peso. On the expenditures side, the erosion of pensions and other social programs (-30%), wages (-16%) and cuts in energy/transport subsidies (-43%) and transfers to provinces (-86%) are behind the adjustment. We expect a primary balance in 2024, with a smaller than 2% fiscal deficit.

I. 10 questions for 100 days of Milei

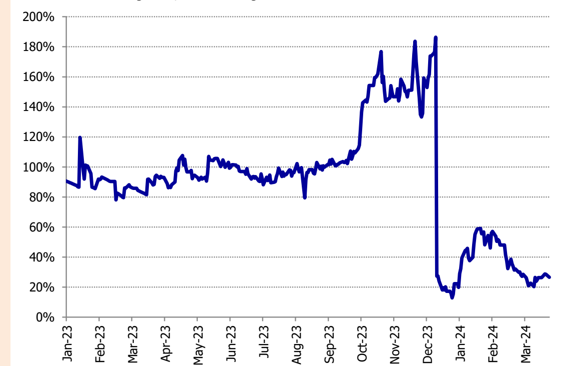
1) How would the economy look at the end of 2024 to be considered a success? A successful adjustment would mean most of the following features. Firstly, the inflation rate has to be comfortably in one digit. We think that unless there is a conventional stabilization plan (i.e. a regime change) inflation will hover around 6-7%. That fits the criteria of one digit, but it is probably higher than what the government is hoping for.

A second important feature is that the economy must be well into the recovery phase. We expect that the trough of the cycle comes at some point between March and May, but the end of the year needs to show a much more robust economy. The shape of the recovery is still being debated. Credit to the private sector, today at less than 5% of GDP, should have recovered somehow.

A third element is that by the end of this year the Central Bank will have around USD 4 billion in net reserves, so firmly in positive territory. There should be no major FX restrictions at least on the flows, and fewer restrictions (if any) on the stock (i.e. dividends, trade-related debts, etc).



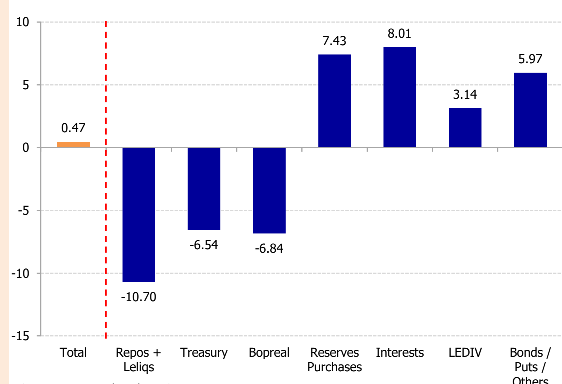
2) How and when will the FX restrictions be removed? Our educated guess is that the big announcement will come no sooner than May and no later than the end of July. This is the kind of thing that needs to surprise the market. But most people are waiting for it given that the spread between all types of dollars is below 30% and therefore the cost of unification (if the official dollar goes where the market is now) is rather small in terms of added inflation.



The devil will be in the details. The Central Bank will have to determine how many restrictions remain. A logical position would be to liberalize all the flows from then on and keep some restrictions on the stocks. This may include capping the dollar purchases to 200,000 per month. This would entail a virtual ban on all dividends but making sure that money earned in 2024 can move freely.

The removal of the "Cepo" would also include a liberalization of some features such as the ban on using the blue-chip swap for those importing goods. This would mean that those who want to pay dividends can do so paying a premium in the FX market if they do it through the blue-chip swap.

Since the full elimination of the Cepo means that the FX is unified, the government would not be able to maintain the "country" tax (impuesto pais) on all dollar purchases. It has become a useful fiscal tool representing 8% of the total tax revenues in February and over 6% in January. But its existence is incompatible with WTO rules, and it creates a wedge in the exchange rate. An alternative could be keeping it, but a much lower rate than the current 17.5% rate.



3) Is there still a money overhang? There is no easy way to measure it. In broad terms when people talk about the money overhang, they refer to the stock of peso assets that mostly companies cannot send out due to the cepo. They include payments of dividends, of imports and savings that that are "parked" in peso dollar MEP instruments.

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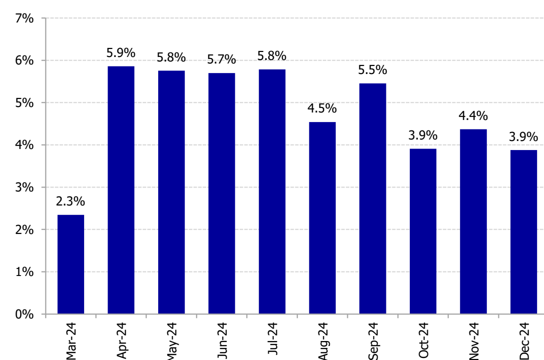
In our view, most of the money overhang has been dealt with through the Bopreal or by sending the funds abroad through the BCS market. It is true that banks have trillions of pesos in Central Bank paper. Private sector deposits and holdings of bonds are the other side of the same coin. But our view is that is that most people that wanted to dollarize their assets must have done so already. More so when the spread with the blue-chip swap or the local version (MEP) is so low.

The cost of removing the cepo too early while there are still funds that want to be dollarize could be a temporary depreciation of the currency.

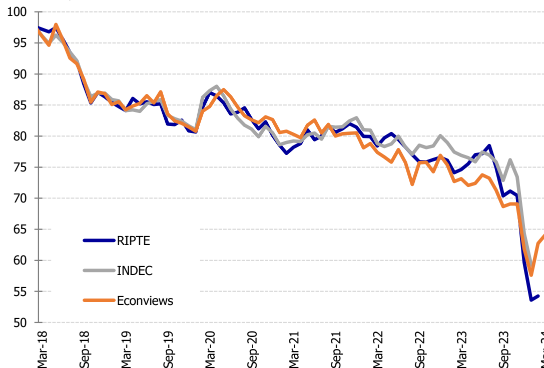
4) Is a policy of 2% per month depreciation sustainable? For how long? How could it be corrected if needed? It is not sustainable in our view, unless inflation surprises us with a sharp decline, which we do not foresee. The more the government procrastinates on this front, the more likely it is that we see a step devaluation in the future. The problem with this is twofold. Firstly, inflation would interrupt its downward trend. Secondly, the political patience from the public opinion might run out of gas.



Although everything has pros and cons, our preferred solution would be one in which the crawling peg accelerates soon, perhaps to a few percentage points than the monthly inflation rate. Our hypothesis is that the marginal effect on inflation of such a move is minimal. But the government is naturally risk-averse on this and fears a new increment of inflation. Dollar futures are pricing in that the crawling peg runs closer to 6% monthly in Q2, although contracts have adjusted downwards in the last weeks.

In the medium run, Argentina should not have a real exchange rate target. But in the short run, Argentina has several problems that it needs to address well before structural reforms mature. It has no reserves. The economy is weak, and it cannot afford to be expensive in USD. Argentina needs FDI projects viable (i.e. mining) and to generate jobs in sectors such tourism, knowledge-based economy which depends in not having expensive salaries. This does not mean that Argentina needs a peso as week as it was in 2002 (1,650 ARS per dollar at today's prices), but ARS 850 could be more appropriate for a Central Bank with more dollars and a stronger economy.

5) How deep is the recession in 2024 and when will the economic recovery start? The economy should stop going down by March or April, unless there is a political event that jeopardizes confidence. The steep fall of the Argentine summer leaves little room for more pain. If salaries start beating inflation as we expect (on a month basis, as salaries will still be below the October 23 level for a while), then the recovery will start in May or June and might be noticeable for the people in Q3. The jury is still out on the speed of the recovery. Traditionally, when declines are quite deep, recoveries are faster. This time around we have some doubts. Monetary policy and fiscal policy are both tight. The exchange rate does not anticipate an export led recovery. And the same can be said about investment. For example, construction prices measured in USD are anything but cheap.



6) What underlies the reduction in interest rates? There are several interpretations. One is that the government wanted to deal with the money overhang. This view contradicts our assessment that the overhang is long gone. A second interpretation is that their chief goal was to dilute further the liabilities of the Central Bank. So both in real terms and as a share of GDP the liabilities shrink. A combined explanation is that they needed to do this to eliminate the minimum interest rates that banks had to pay to their clients for term deposits. The latter was a positive measure, but the causality is far from obvious. The same could have been done without lowering rates.

7) What explains the stability of the parallel exchange rates recently? There are multiple explanations here. In the case of the blue-chip swap, there is more supply coming from exports. Let's remember that exporters surrender their dollars in a blend made of 80% at the official rate and 20% in the blue-chip swap. In the blue (black) market, there is a larger supply in the market coming from small firms and households. Probably this group overbought dollars last year and the current recession is forcing them to sell them to pay the bills. This will happen until numbers improve or they reallocate consumption or structures in the case of small firms.

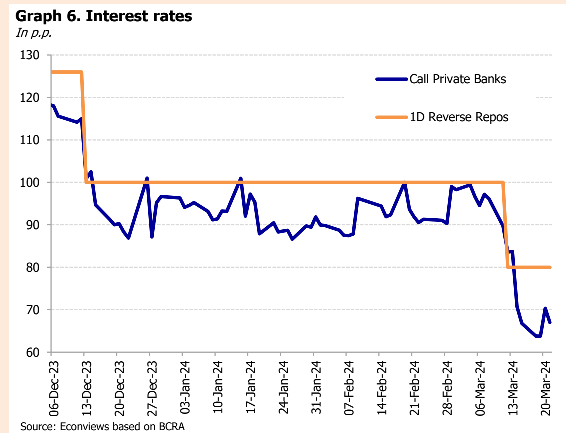
There is probably a monetary explanation too. The Central Bank has left the monetary base roughly stable in nominal terms, resulting in an almost 40% reduction in real terms. This is generating a shortage of pesos. This is also questionable, because such a shortage should generate an upward pressure in interest rates, and this has not happened. So, it is not crystal clear.

8) Why is public opinion coping so well with the recession? Confidence in the government fell slightly in March but is still above 50%, despite no meaningful improvement in the economy. People want to see change in how the situation is managed. Probably many see this process as an experiment, but at least the government is not doing the same as previous governments. Milei is a savvy communicator, and his team is very good in showcasing the mismanagement of previous authorities, be it with corruption cases or with examples of inefficient government spending. There is no guarantee over how long this support can last. It is in the public domain the prospect that the economy must get better in the coming months. If that does not happen, the situation may become complicated for a government that has no territorial control (no governors or mayors) and is weak in Congress.

9) Is fiscal policy sustainable? January and February's fiscal surpluses, and an accumulated primary surplus worth 0.5% of GDP, surprised even some of the government's most staunch supporters. So far, the adjustment has been a 50-50 mix between the "chainsaw", cutting energy and transport subsidies, CAPEX and transfers to provinces, and the "blender", inflation's erosion of real wages and pensions.

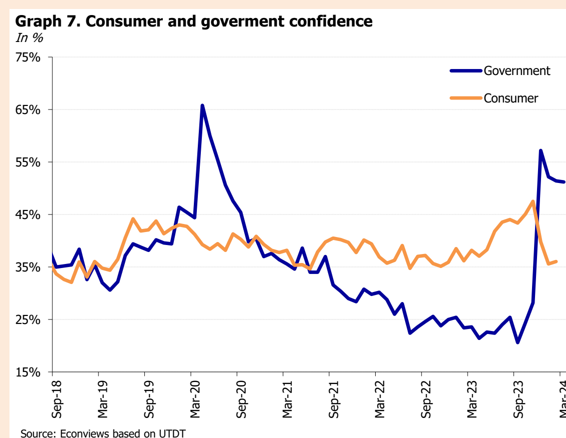
Going forward, things get trickier. The proposed change in the adjustment formula for pensions (indexing them to CPI) could reduce spending 25% in real terms by 2026, but ironically increases spending this year, on virtue of updating them more frequently. Lifting FX controls means resigning 1% of GDP in PAIS tax revenues, which could be partially compensated by the increase in fuel taxes (in progress) and recomposing income tax (stalled in Congress).

Graph 6. Interest rates
In p.p.



Source: Econviews based on BCRA

Graph 7. Consumer and goverment confidence
In %



Source: Econviews based on UTDT

Chart 1. 2024 fiscal program

Main changes in revenues and spending as a % of GDP

	2023	2024E	Variation in p.p.
Revenues	**17.0%**	**16.9%**	**-0.1%**
5G tender	0.2%	-	-0.2%
Export duties	0.8%	1.7%	0.9%
PAIS tax on dollar purchases	0.8%	0.8%	0.0%
Less revenues due to recession	-	-0.8%	-0.8%
Fuel taxes	0.3%	0.5%	0.2%
Income tax (reverting reform)	1.6%	1.4%	-0.2%
Expenses	**19.8%**	**17.0%**	**-2.8%**
Pensions (exc. bonuses)	7.7%	7.3%	-0.4%
Transfers to provinces	0.8%	0.2%	-0.6%
Energy and transport subsidies	2.1%	1.4%	-0.7%
CAPEX	1.6%	0.8%	-0.8%
Social programs	3.0%	3.0%	0.0%
OPEX (inc. wages)	3.3%	3.0%	-0.3%
Primary result	**-2.7%**	**0.0%**	
Net interest	-3.3%	-2.0%	
Fiscal result	**-6.0%**	**-2.0%**	

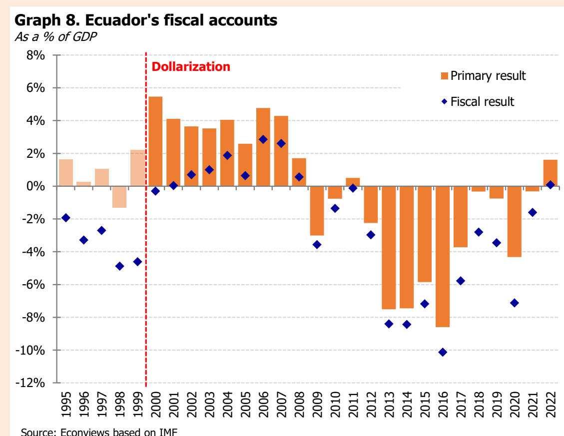
Source: Econviews based on Min. of Economy and own forecasts

In the second half of the year, the government will probably go easier on both the "chainsaw" (a total freeze on CAPEX is not an optimal solution) and the "blender" (as inflation slows down). Some degree of tax reform is thus a necessity to ensure primary balance is achievable. We believe that fiscal balance in 2024 is a too ambitious goal, though the Treasury is able to shift peso debt interest payments from this year to the next, through financial engineering, reducing the distance between fiscal and primary results and making its end goal easier.

10) Is dollarization possible or desirable? We think that Argentina does not have enough dollars to go to full dollarization. It will need a combination of fewer pesos outstanding and more dollars in the Central Bank. Also, the rate of conversion is important because there is inertial inflation. So, dollarization could reduce inflation relatively quickly, but not immediately. After the convertibility, inflation took a year to converge to international standards.

In terms of desire, our view is that dollarization is not the best regime.

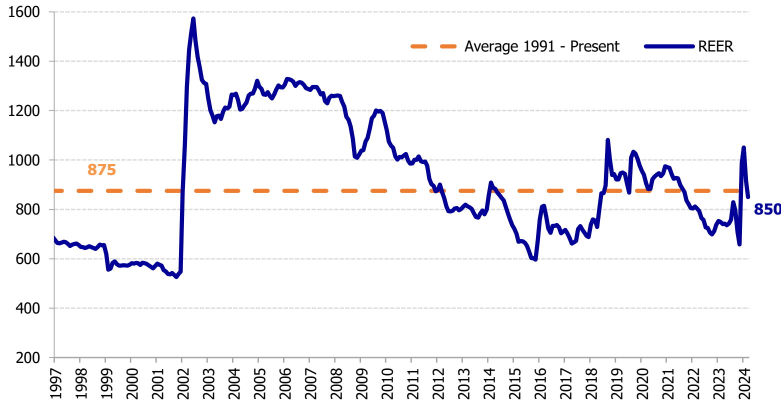
- It would deprive Argentina from having a lender of last resort.
- The Argentina economic cycle is not aligned with the US cycle. Something with Brazil would make more sense.
- Not having FX policy would require that all external shocks affect quantities and therefore recessions should be deeper than with an FX alternative. A reduction of soybean prices, for instance, would impact the economy harder.
- Dollarization fans say that this policy induces responsibility in fiscal policy. We are not sure about this. Ecuador has had countless fiscal issues in these years. The currency board in Argentina should have done the same and time after time Argentina broke the system.



II. Is the exchange rate right?

There is much discussion nowadays on whether the currency is overvalued, undervalued, or just right. While there is no obvious answer to this question, it is helpful to look at the evolution of the real exchange rate (RER), which, over the years, has shown large fluctuations. In general, a high value of the RER indicates that the currency is undervalued, while the opposite happens when it is low. Graph 1 shows that the RER is close to the average in the last three decades, which might indicate that it could be at a reasonable level.

Graph 1. Real Effective Exchange Rate
At March 2024 prices - Monthly average up to 25-Mar



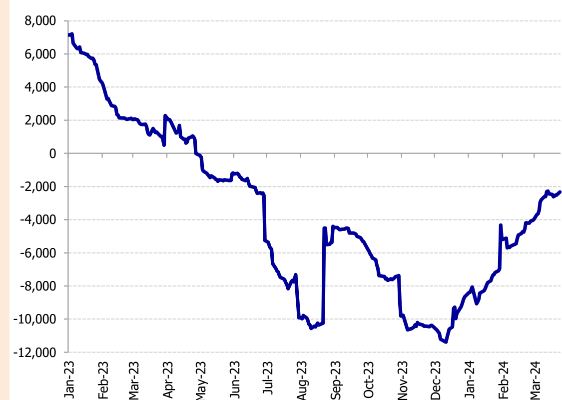
Source: Econviews based on Reuters & BCRA

However, being close to the average is not necessarily a sign that the RER is where it needs to be now. Over the years, when the RER was high, the country needed to accumulate reserves and have a current account surplus, as was the case in the aftermath of the 2001 crisis. At other times, when the RER was low, for example, between 2011 and 2015, the country ran a current account deficit and lost reserves.

Finally, it is helpful to distinguish between the short-run and the long-run equilibrium. It may well be that the RER exchange rate that Argentina is likely to have in the long run is not very different from what it has today, or perhaps even lower. This will be the case if the Central Bank manages to increase reserves to more comfortable levels in the coming years, and it can generate more exports from oil and gas, agriculture, mining, and other sectors. However, to get to this “theoretical” long-term equilibrium, the economy might need an undervalued currency to accumulate reserves for some years, as happened in 2002-2010.

Argentina needs to accumulate reserves urgently to normalize the external accounts. During the Alberto Fernandez/Sergio Massa years, reserves moved into negative territory. At the peak, the Central Bank ended financing the stock of reserves with short-term debt, which meant that at the worst time, it had negative net reserves to the tune of minus twelve thousand (see Graph 2).

Graph 2. Net International Reserves
In milllion USD - IMF methodology

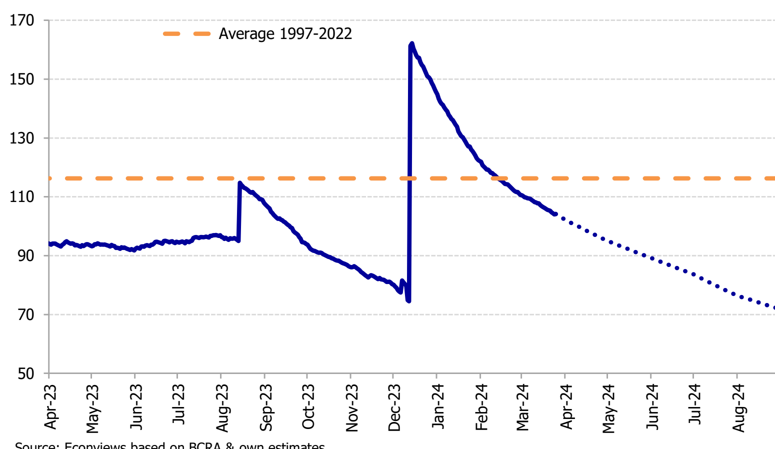


Source: Econviews based on BCRA, IMF & own estimates

The current situation suggests that while the exchange rate might not be a problem if we analyze it from a long-term perspective, the current RER might not be enough to reverse the vulnerability that exists now. In addition, in the current environment where the Central Bank depreciates

the currency at 2% per month, with inflation running in the 8 to 12 percent range, the exchange will likely become overvalued, generating the need for a correction in a few months (see Graph 3).

Graph 3. Real Effective Exchange Rate
Base 100 = 17/12/2015



Source: Econviews based on BCRA & own estimates

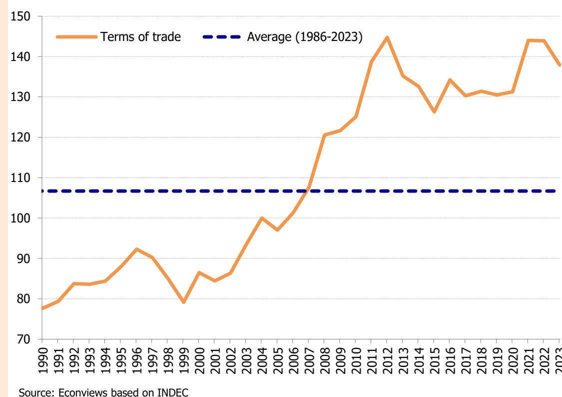
To maintain the policy of two percent devaluation, inflation would have to drop quickly to the 1 to 3 percent range, and the Central Bank would need to accumulate a significant amount of reserves from the very good crop expected for the second quarter. However, without capital inflows, accumulating reserves will be a daunting task, and hence, a change in the exchange rate policy seems unavoidable.

Box 1: The exchange rate is a relative price

The real exchange rate (RER) is an indicator of the price competitiveness of local goods. It consists of adjusting the nominal exchange rate for the evolution of international and domestic prices. The RER represents the domestic goods that one unit of foreign goods can purchase. When the real exchange rate is high, it means that the currency is undervalued, and domestic services and wages are low in dollar terms. In other words, the economy gains competitiveness at the international level.

Argentina needs an undervalued currency. An overvalued currency adds more complications than benefits in the near term as a nominal anchor. On the one hand, it turns the trade balance negative, thus affecting the accumulation of international reserves. Additionally, it fosters price increases through higher expectations of devaluation. Between 2013 and 2015, during the second term of Cristina Kirchner's government, the peso was overvalued. Faced with the decline in terms of trade in 2013 (see Graph 4), the government implemented a series of measures to prevent a devaluation of the peso. These measures limited access to the official dollar market for imports, savings, or travel. A parallel market emerged where the exchange rate reflected the true value that the exchange rate should have taken (see Graph 5). Additionally, the government maintained demand through constant expansion through increased spending and boosting domestic consumption. This expansive fiscal policy further pressured the exchange rate to remain lagging as the domestic prices rose.

Graph 4. Terms of trade
Base 100=2004



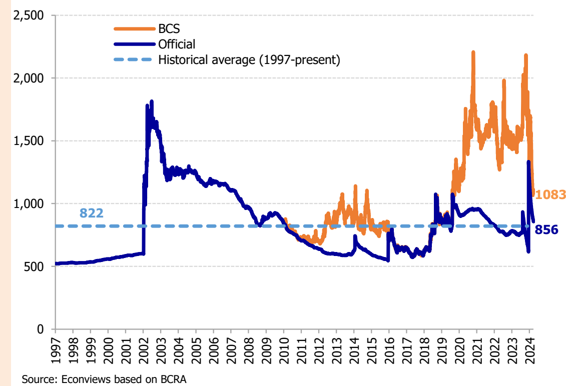
Source: Econviews based on INDEC

The economy needs an undervalued currency for the coming months to help it recover from the recession and to accumulate reserves. **There are two alternatives to achieve this. One option is a more aggressive crawling peg**. In other words, Argentina needs an exchange rate that moves at least as fast as prices, and the earlier this happens the better. If not, a step adjustment will be necessary. Our concern is that if it reaches the point of a discrete correction, the pass-through effect will once again destabilize nominal values. In Argentina, approximately 30% of devaluation impacts on prices.

Another path the government could take is to unify the exchange rate and implement a dirty or managed floating regime to bring the official parity closer to the parallel value. This way, considering the current gap, would lead to a nominal depreciation of 30%.

Once that transitional stage is over, when the level of exports has recovered, the international reserve stock is healthy, and the country's risk has decreased, **the exchange rate can be lower**. This way, it could be used as a nominal anchor without affecting the productivity of local goods.

Graph 5. Exchange rate at constant prices
At March-24 prices, official and BCS rate



Source: Econviews based on BCRA

Base Scenario

	2021	2022	2023 E	2024 F	2025 F
Inflation (eop)	50.9%	94.8%	211.4%	230.0%	85.0%
Exchange rate ARS/USD (eop)	102.8	177.1	808.5	2,222.8	4,086.1
Exchange rate ARS/USD (eop, YoY)	22.1%	72.4%	356.4%	174.9%	70.0%
Real exchange rate ARS/USD (eop, Dec-01=100)	137.5	129.8	196.4	169.0	169.1
Paralell exchange rate ARS/USD (eop)	203.1	340.8	972.8	2,222.8	4,086.1
Spread with official exchange rate (eop)	97.7%	92.4%	20.3%	0.0%	0.0%
Gross reserves (USD billion, eop)	39.7	44.9	23.1	36.9	40.7
Net international reserves (USD billion, eop)	2.3	7.7	-8.6	3.7	9.0
Policy rate (eop)	38.0%	75.0%	100.0%	85.0%	60.0%
GDP (YoY)	10.7%	5.0%	-1.6%	-3.0%	7.9%
Formal wages in real terms (aop, YoY)	0.4%	0.3%	-2.0%	-3.0%	4.0%
Primary result (% GDP)*	-3.3%	-2.7%	-2.7%	0.0%	1.0%
Fiscal result (% GDP)*	-4.8%	-4.1%	-6.0%	-2.0%	-1.0%
EMBI Argentina (spread in bps, eop)	1,703	2,196	1,907	800	600
Public net debt (% GDP)	45.5%	46.1%	47.2%	48.2%	48.2%
Current account (% GDP)	3.0%	3.0%	-3.8%	1.5%	1.4%

Source: EconViews

*Excludes rents from primary debt issuance in 2022; PIPs below the line in 2019

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