MONTHLY REPORT

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ECONOMÍA Y FINANZAS

July 2022
Issue #217

Time of **Courageous Decisions** to Avoid a **Full-blown Crisis**

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Facts and **Myths** about **Public Debt**

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THE MONTH AT A GLANCE

RECENT DEVELOPMENTS

- US inflation kept climbing to a new 41-year record of 9.1% in June. The 1.32% monthly variation beat March's, and markets are betting 70-30 on the Federal Reserve hiking 75 or 100 basis points on July 27th. Eurozone CPI also heated up to 8.6% last month and the ECB hiked rates for the first time since 2011, by 50 basis points. Russian gas pressures could further spur energy costs in winter.
- Minister Guzmán's resignation set off a financial meltdown on July 4th: the parallel FX rate jumped by 35 pesos, dollar debt sank 8% while Argentine stocks slumped 3% on Wall Street. Instability has been going on for two weeks since Silvina Batakis was sworn in as his replacement, without subsiding yet.
- June's CPI print read 5.3%, but all eyes are on July after the financial turmoil in the first week of the month set off a wave of retail mark-ups. We expect a figure above 7%, the highest since April 2002.
- On July 12th the BCRA unveiled a new put option on Treasury bills dated up to December 2023 and managed to reduce yield on CER bonds from 12 to 6% on average. On the 15th it hiked the repo rate by 600 basis points to 46.5% and announced a new corridor of rates to guide monetary policy. The Central Bank has increased its holdings of Government bonds by ARS 1.15 trillion since the beginning of the crisis in June.

FIGURE OF THE MONTH

The spread between the official FX rate and the BCS reached

160%

the highest since October 2020.

TO BE ALERT

Argentina's foreign trade balance struck USD

-115M

in June, its first negative reading in 18 months.

WHAT'S COMING NEXT?

- Analysts are warning that with the energy supply still choked by the Ukraine War, the Fed's hikes could sink the economy into a recession before bringing down inflation. The Atlanta Fed's GDP nowcast has a 1.5% contraction for Q2-2022, although St. Louis sees a (weaker) growth of 2.6% year-on-year. Job market signals are still strong.
- Import controls and runaway inflation will hammer local activity in the coming months, but we believe statistical carryover still ensures 3.5% growth in 2022. However, we have raised our inflation forecast from 85 to 90% for this year and 85 to 105% in 2023. Unions and social movements will not sit tight, and the CGT is rallying for a march in August.
- We believe the market will be reluctant to keep buying Treasury debt after June's bond meltdown and will limit itself to refinancing maturities. In this scenario, BCRA monetization of the deficit could amount to 2.1% of GDP this year and its liabilities could rise to 9%, the highest ratio since early 2018.
- Minister Batakis met with IMF authorities on July 7th and promised not to stray from the new EFF program, but after narrowly making the reserve accumulation target in June, Q3's goals should be recalibrated to avoid a breach.

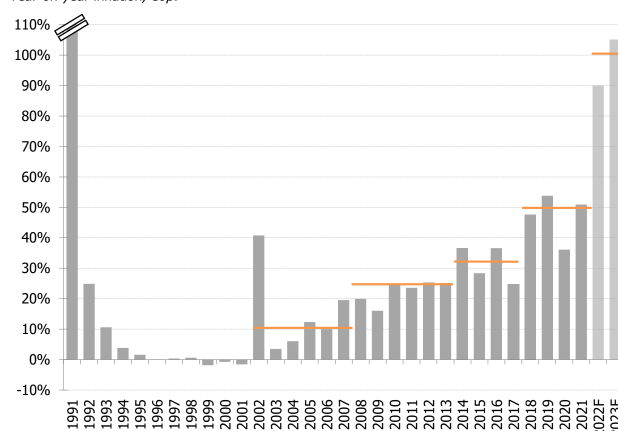
SUMMARY OF MAIN INDICATORS

	Last	Previous		Last	Previous
Economic activity			**Financial data**		
Economic activity (MoM s.a.)	0.3%	0.5%	Inflation (monthly)	5.3%	5.1%
Consumer confidence (MoM)	7.7%	1.6%	FX spread (21day avg.)	118.1%	83.2%
Industrial activity (MoM s.a.)	-1.1%	2.9%	Country risk (bps 21day avg.)	2,531	1,978
International accounts			**External data**		
Current Account (USD BN)	-1.13	0.29	Soybean price (per ton, 21day avg.)	586.3	628.3
CB Reserves (USD BN 21day avg.)	40.78	41.53	Brazilian activity (MoM s.a.)	-0.1%	-0.6%
Primary balance (ARS BN)	-321.64	-162.41	Financial Conditions Index	-14.0	-14.6

Source: Econviews base on multiple sources - Based on working days only

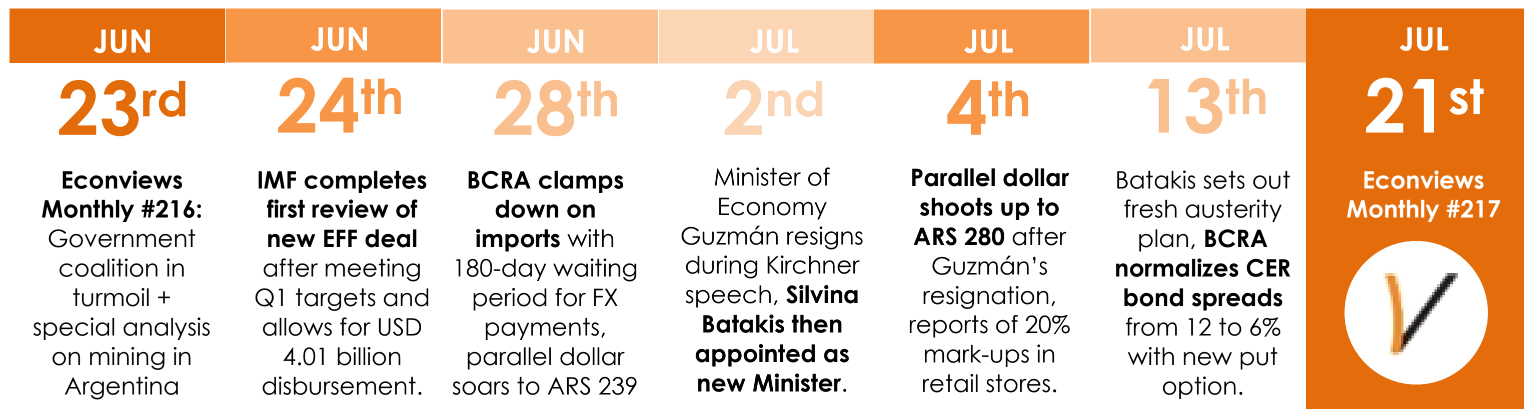
GRAPH OF THE MONTH:

¿Back to triple digits?
Year-on-year inflation, eop.



Source: Econviews based on INDEC and own forecasts

RECENT ECONOMIC DEVELOPMENTS



POLITICS

After Production boss Kulfas left in June, Minister of Economy Guzmán resigned on July 2nd, frustrated by the lack of advance on segmentation of energy subsidies. Over 24 hours passed before Silvina Batakis, a career economist from Buenos Aires Province, was announced as his successor. Markets reacted with a 15% jump in the parallel FX rate and the EMBI spread soared to 2,700 bps. Although President Fernández has reportedly negotiated a "truce" with VP Cristina Kirchner and the new Minister promised to go through with the IMF deal and fiscal austerity, the episode leaves the Government in a very weak spot. Allies such as unions and social movements are rallying against inflation, although avoiding direct confrontation.

IMF

While the Q1-2022 targets were met with ease, the Government appeared hard-pressed to achieve Q2's goals and there was talk of "recalibrating" the intra-year quarterly figures for the primary fiscal deficit and reserve accumulation. Surprisingly, the BCRA practically froze import payments on June 27th and pushed exporters to speed up proceeds and managed to acquire USD 1.3 billion in a few days. Of course, this is only a short-term solution, as imports backlogged in Q2 conspire against Q3's targets. The IMF completed the first review of the EFF program on June 24th, allowing for an USD 4.01 billion disbursement. The next mission to Argentina is scheduled for September 10th.

ECONOMIC ACTIVITY

Activity managed to advance 0.26% s.a. between April and May, lining up two straight months of growth for the first time in 2022. Manufacturing slumped 1.1% monthly and Construction decelerated from 6.6 to 0.4%, but retail, hotels and restaurants are still going strong. In year-on-year terms, the economy grew 7.4% in May, thanks to a very low comparison base due to Covid. However, we expect activity to contract in June and July from a mix of import restrictions, soaring parallel FX rates and inflation eating away at real wages. June's trade balance was USD 115 million in the red, its first negative mark since December 2020. Statistical carryover will allow for 3.5% GDP growth this year, but we expect a 1.5% register in 2023.

INFLATION

CPI accelerated slightly from 5.1 to 5.3% in June, accumulating a 36.2% price increase in the first semester of 2022. However, all eyes are on July's print: the Blue Chip Swap dollar shot up 24% this month, and tighter restrictions have forced many companies to finance imports through this market, weakening the official rate as a reference for retailers. Mark-ups of up to 20% were observed the week after Guzmán resigned. We believe July's CPI will be above 7%. In the coming months, wage renegotiations, utility hikes and inertia could lock inflation into a 5-6% monthly average, which would leave the year-on-year variation at 90% by December. We have also raised our forecast for 2023 from 85 to 105% end-of-period.

MONETARY SECTOR

The BCRA managed to calm down the peso-nominated bond market, but dollar debt and the parallel FX rates are still on fire. On July 12th, the BCRA announced a new put option on Treasury instruments for banks in order to reduce volatility. CER bonds dated March 2023 are trading at a 5.2% yield in the market, down from 11% a month ago. Batakis' first auction as Economy Minister was also successful, managing to lower July's maturities by ARS 189 billion. However, increased FX controls and political instability are taking their toll on FX markets: the BCS swap soared to ARS 337, a 160% spread against the official rate, while the parallel dollar is also trading at ARS 337. The current 5.3% monthly depreciation rate appears insufficient.

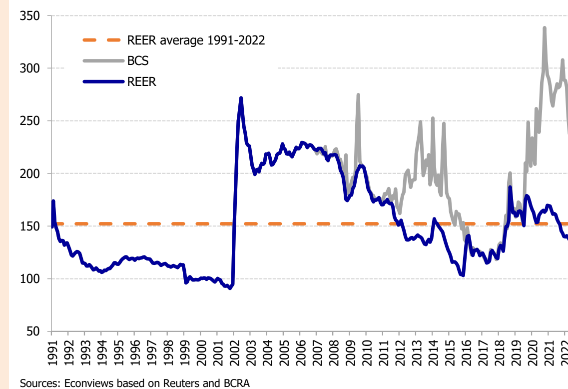
FISCAL ACCOUNTS

The public sector's primary deficit leapt to ARS 321.6 billion in June, more than doubling last year's figure. Revenues grew 56.8% year-on-year, 8 points below inflation, with a very weak performance from export taxes (+18%). Primary expenditures grew 65.6%, slightly above inflation, and amounted to ARS 1.52 trillion. Social spending increased 76% and made up 63% of the total. Energy subsidies only rose 39% and transport subsidies fell 11% nominally as the Government deferred payments, but this will weight on coming months. The accumulated primary deficit, net of rents from CER-bonds issuance, reached 1.4% and we expect it to end at 3.5% by year's end.

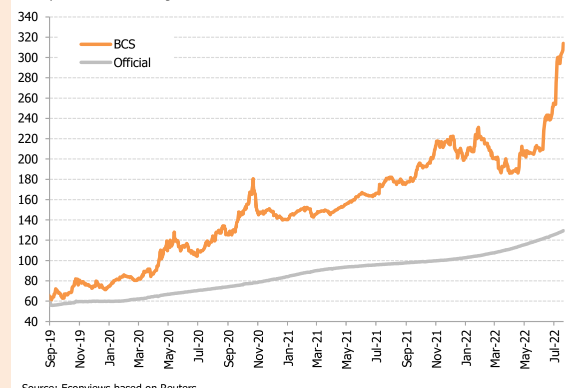
I. Time of courageous decisions to avoid a full-blown crisis

Batakis takes over the Ministry of the Economy at an extremely difficult time. Reserves are at a critical level, as they just cover less than two weeks of imports, inflation is accelerating, and the parallel exchange rates seem to be out of control. If we add to these problems a fiscal deficit that far exceeds the targets set with the IMF and severe problems to roll-over the domestic debt, everything points to a perfect storm that can take place at any time.

Batakis seems to be moving towards reasonable policies, especially on the fiscal front. She ratified the IMF program and wants to use it as a guide for policy decisions. In the first press conference, she emphasized the importance of reducing the fiscal deficit, and she also mentioned the intention to have real positive interest rates. The most fragile front is the external one, where she still argues that the real exchange rate is at reasonable levels and there is no need for a devaluation, in spite of a huge spread between the official and the parallel rates, a current account that is roughly in balance when the economy needs a large surplus, and persistent and significant capital outflows.

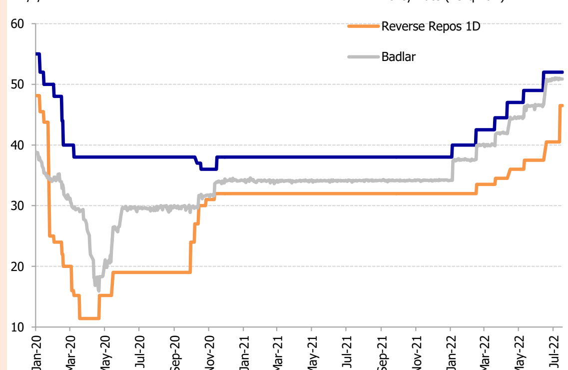


But the challenges do not stop there. In addition to the pressing economic issues, she also faces difficulties in the decision-making process within the government coalition. She will have to deal with a weak president who does not have the courage to make tough decisions, and with Cristina Kirchner, who represents a filter to the implementation of unpopular policy measures. **This implies that even a well-intended minister will have difficulties implementing the necessary policies.**



The most pressing issue is the evolution of international reserves, that are rapidly falling, at the risk of losing the few dollars that Central Bank still has. It seems that the government does not have a strategy to deal with the situation, in part because it still argues that the real exchange rate is "right" and that a devaluation is not needed. In the meantime, the parallel exchange rates continue to go up (depreciate), and the new levels exceed what markets were expecting, but they do not appear to find a ceiling.

The most worrisome element is that the government is not responding to the crisis. A they see reserves going down and the blue chip swap going up they do not put in place any substantial policy measures to deal with the situation. The last "explosion" of the BCS that took place in October 2020 was stopped in its tracks through a combination of fiscal and monetary measures. The Central Bank increased the one-day repo rate from 19 to 32 percent to make peso deposits more attractive while the Treasury announced some spending cuts (mainly in the emergency subsidies to deal with the pandemic, the "IFE"), and a pre-payment of Central Bank transitory advances to the Treasury that signaled a more responsible fiscal policy.



The situation today is more complex to handle, in part because the government is weaker politically and is reluctant to put in place orthodox policy measures, and in part because inflation is much higher,

less anchored and the risk of runaway inflation moving into the low three digits is alive and kicking.**

Given the difficulties that the government is facing on the external front, one would have expected the announcement of strong policy measures. However, the authorities are still reflecting about what to do and in the meantime the situation is getting worse and worse. Reserves keep falling, the parallel exchange rate continues to rise, and the Central Bank seems reluctant to increase interest rates.

There is no easy way to deal with the FX crisis and any response involves costs and risks. The traditional recipe is to depreciate the currency or let the exchange rate float and announce simultaneously policy measures to reduce the fiscal deficit and a sharp increase in interest rates. However, at this stage we do not expect the textbook response, namely because the government is extremely reluctant to do it and there are clear risks that the policy backfires and triggers a more dramatic inflation process due to lack of credibility. **A weak and disoriented government is certainly a handicap for the implementation of any policy.**

The second option is to tighten the FX restrictions even more. This would mean a disguised devaluation because there would be shortages of imported goods and hence prices would go up. To some extent this is what is happening this month, when the tightening of the *restrictions* has been at the heart of the increase in inflation. In addition, tighter restrictions will also slow down economic activity and might move the economy into recession. It does not sound like a good option, but we cannot rule it out with a government that is a strong believer in controls.

The third option is to adopt a multiple exchange rate system. To some extent we have it now with the official exchange rate and the BCS and other parallel exchange rates. However, a formal splitting of the FX market would imply that the Central Bank would set different exchange rates for the different goods and services. For instance, there could be one exchange rate for imports and exports of goods (typically called the commercial rate) and another for tourism and a few other transactions. This idea has been floating around for some time, though the government seems reluctant to adopt it.

There is a fourth option, of course, which is to do nothing, increase somewhat the rate of crawl of the exchange rate and pray, pray and pray and hope for a miracle. This is a collision course.

It is difficult to understand why the government does not take any action, especially because there are alternatives at least to delay of soften the costs of a collision. The logical thing to do is to avoid an accident and take preemptive policy measures, but it is not what the government has been doing. **They are still betting on a miracle that rarely happens.**

Unfortunately, the other fronts are also extremely cumbersome. Fiscal accounts have continued to deteriorate in June with an accumulated primary deficit on a cash basis of almost 1.0% of GDP. The situation is in fact worse, because this figure includes fictitious capital gains on the issuance of CER bonds, which should be excluded when one calculates the actual financial needs. **The actual deficit is closer to 1.36% of GDP**, a worrisome figure especially because domestic debt is now under

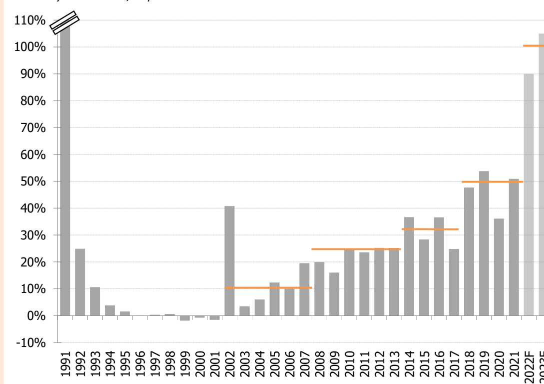
Net and Liquid International Reserves

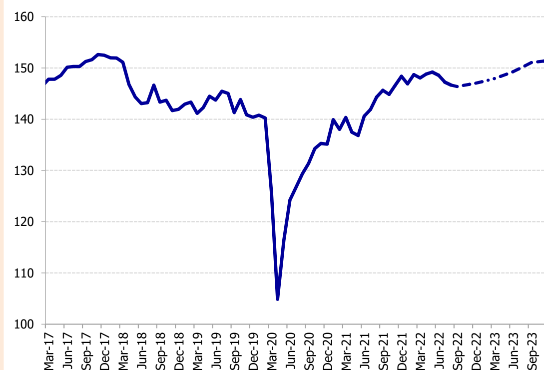
In billion USD

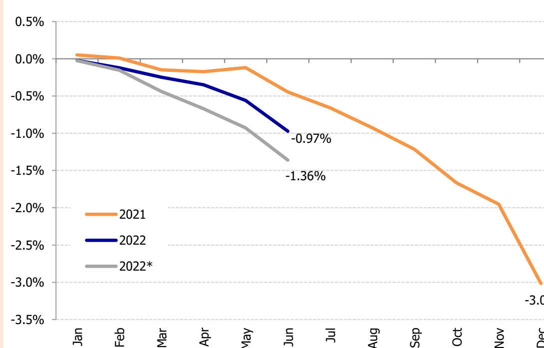
Gross reserves	**39.7**
Reserve requirements in USD	12.0
Swaps (incl. China)	21.0
SDRs	1.3
BIS	3.0
Net reserves	**2.4**
Gold	3.5
Liquid net reserves	**-1.0**

Source: Own estimates based on BCRA and IMF

Up to Jul-20

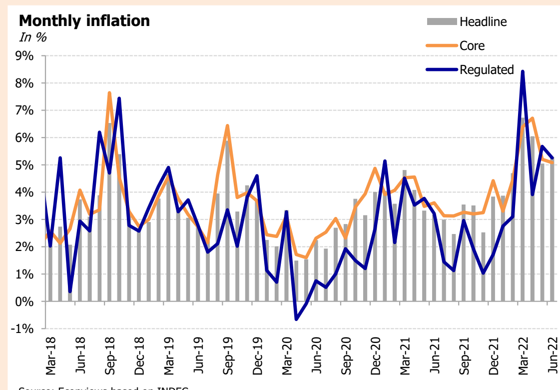






pressure, and it is unthinkable that the Treasury can obtain financing for the deficit in the market. **Once again, the burden falls on the Central Bank, which will be forced to print more money and domestic debt.**

Batakis is conveying the need for a strong fiscal adjustment, though the difficulties are in the implementation. To achieve the necessary reduction in the fiscal deficit the Minister will face strong resistance within the government coalition, starting with Cristina Kirchner who is opposed to a reduction in subsidies, as well as governors that will resist a reduction in transfers to the provinces and ministers who are not ready to see cuts in their budgets.



Another difficult front is inflation, where there was a small increase to 5.3% in June while we expect a larger increase in July to the range of 7 to 8 percent. This jump is largely explained by the new tighter "*cepo*" that restricted imports even more, creating shortages and leading to a rise in some prices, and to the new requirement to obtain six-month financing for many imports, which creates great uncertainty as importers do not have a clue what will be the exchange rate six months from now, nor if the Central Bank will have reserves at that time to make the payments.

In summary, Batakis took over the ministry at a very difficult time, and she inherited large imbalances everywhere. The situation is critical and requires major actions. **So far, the government has not taken strong measures and seems to be betting on a miracle. The outlook is gloomy, and the crisis seems to be with us.**

II. Facts and Myths about Public Debt

The prices of Argentine bonds have collapsed and are trading at levels not seen since the Lehman crisis, when there was high probability of default. Now, like then, market players are extremely bearish, and perhaps once more they overstate Argentina's debt problems. The problems have extended to domestic peso debt, where the concerns about a new restructuring are widespread.

These low prices (and high yields of foreign debt) reflect more Argentina's history of little concern to restructure and the tendency to impose harsh terms on the creditors than Argentine debt fundamentals. True, the economy still runs a large fiscal deficit and has very low reserves, though these are issues that with a solid macro plan and a comprehensive IMF program can be reversed. History might tend longer to turn around a history of defaults. The failure of the Macri administration that started with high hopes is another factor that adds to the skepticism of investors.

There are three issues that are worth discussing. First, as in 2008 there is a large divergence between the actual and the perceived Argentina's debt burden. **Second, Argentina does have a liquidity problem**, that it needs to solve by 2025, otherwise there will be no alternative to another debt restructuring (it will need time to pay though not a haircut, it could

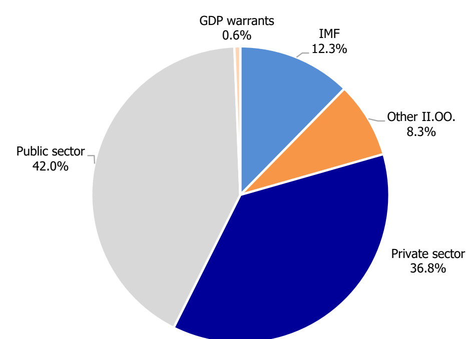
be a restructuring *a la* Uruguay). **Third, domestic (peso denominated) debt is now under pressure**, and there are concerns of new reprofiling along the lines of the one done in 2019 and about the growth central Bank debt.

On external debt a new restructuring is possible, though avoidable.

On the domestic debt, the Central Bank has been intervening and maintaining liquidity on the short-term Treasury instruments. The problem is that the Central Bank is issuing its own debt to sterilize the pesos. In effect it is substituting Treasury debt for Central bank debt, which is of course easier to rollover while the market for Treasury, longer term debt dries-up. **In this sense we ask, what is the risks of snowballing of Leliqs?**

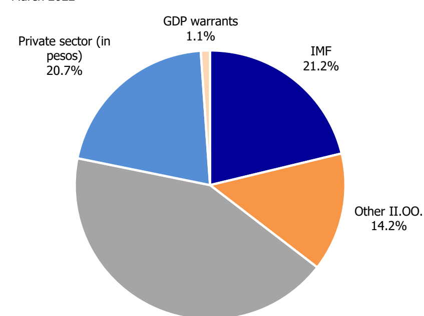
What you need to know about Argentina's debt

Despite the concern about Argentina's public debt, the stock is not particularly high, and under the right circumstances **it should be manageable**. Total gross debt as of June 2022, including GDP warrants, reached USD 378 billion dollars. In the last year it represented 66% of GDP, while **net debt**, i.e. excluding intra public sector debt, drops to **USD 219.8 billion which is just 38% of GDP.**



There are two issues to keep in mind, because these figures underestimate the debt burden. First, there is evidence that the peso is overvalued, and 80% of debt is in foreign currency, which means that the **actual debt burden could be at least 20 or 30% higher (though it still won't be a large number).** The figure, using some measure of long-run equilibrium exchange rate will remain well below 50% of GDP.

Second, one should probably add some Central Bank debt to the equation, namely the stock of Leliqs and reverse repos ("pases"), which today represent roughly 9% of GDP. But even in we include them, the size of the debt does not appear to be particularly burdensome by international standards.

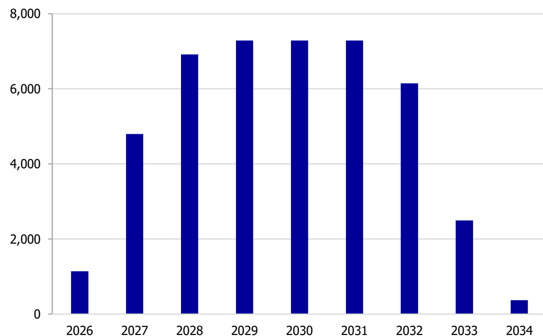


Perhaps the main weakness in the debt structure is that most of the net debt is denominated in foreign currency, a common feature for developing economies, though in Argentina might be more worrisome. Only 20.7% of net debt, or some USD 45 billion, is denominated in pesos - of which over three quarters is either indexed by inflation (66%) or pegged to the evolution of the dollar (9.6%). Conversely, 79.3% of net debt is denominated in foreign currency, of which more than half is in the hands of the private sector (roughly 15% of GDP).

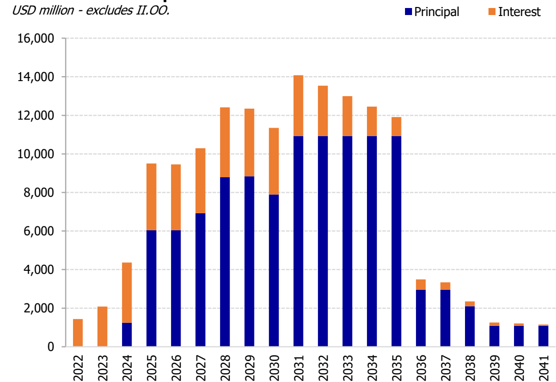
The positive side is that there are no significant maturities in foreign currency with the private sector until 2025, when they amount to 6 billion dollars. And interest payments are a non-issue as the rate has been set at very low levels in the restructuring of 2020. In 2023 interest payments will be roughly 2 billion dollars.

Principal payments from the SBA loan with the IMF are not a problem either, so long as inflows from the EFF agreement continue to arrive, which are subject to the fulfilment of the program targets, but the IMF has

taken a rather lenient stance on this matter**.** And rates from the IMF loan are extremely low compared to what market rates would be -which the government doesn't have access to anyway. **But soaring global rates will increase interest payments to the IMF. Yet significant net capital payments only start in 2027.**

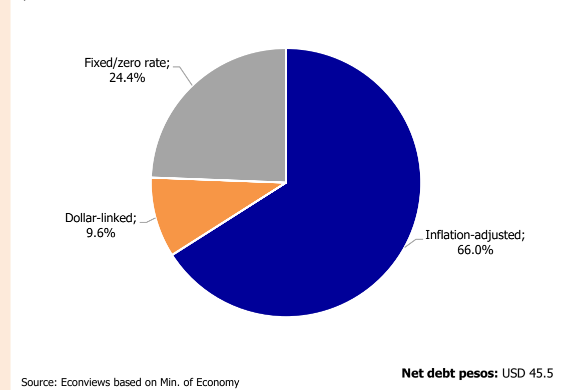


Source: Econviews based on Min. of Economy and IMF



Source: Econviews based on Min. of Economy

Peso-debt dynamics are trickier. While the stock of peso-debt is not unmanageable, its composition and duration are unsettling the market.

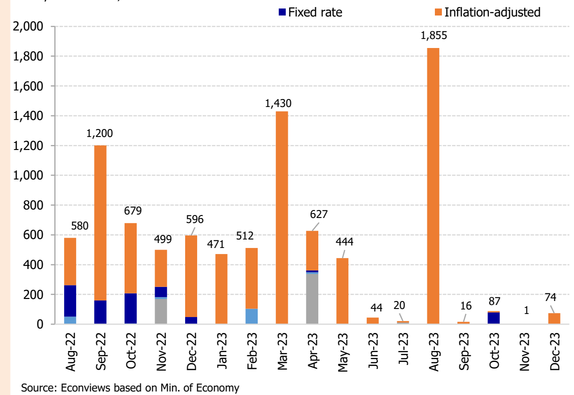


Source: Econviews based on Min. of Economy

Most of the stock is inflation-adjusted, and therefore cannot be eroded through inflation, but as tax revenues grow with inflation -provided there is no recession- there is an automatic hedge. The fact that most of the debt is indexed is not a problem *per se*, as the issue of indexed debt instruments could help to develop the local debt market.

The problem is the lack of credibility in the government's economic policies. As confidence drops, so does the average duration of peso debt. The government now seems incapable of issuing securities with an average life of over a year. Instead, in recent months it has been relying more and more on inflation-adjusted bills (CER bills) with a duration of few months and discount bills that pay a growing interest rate. Investors do not seem interested in purchasing debt that matures beyond the elections in 2023, and there is a massive CER-bill maturity in August 2023 that could be very difficult to rollover.

And worries have extended to the next few months, particularly for September, when maturities in pesos reach some at ARS 1.2 trillion. This led to a drop in the price of "linkers" and rumors of a possible reprofiling mushroomed. Central Bank responded by purchasing Treasury bills and bonds to sustain their prices. It then institutionalized it through creating a put option on them to reduce volatility.



Source: Econviews based on Min. of Economy

We do not believe peso debt will be reprofiled, and the government has been loud and clear about doing whatever it takes to avoid such thing. That means the Central Bank could continue to purchase bonds at the cost of printing like hell and then sterilize.

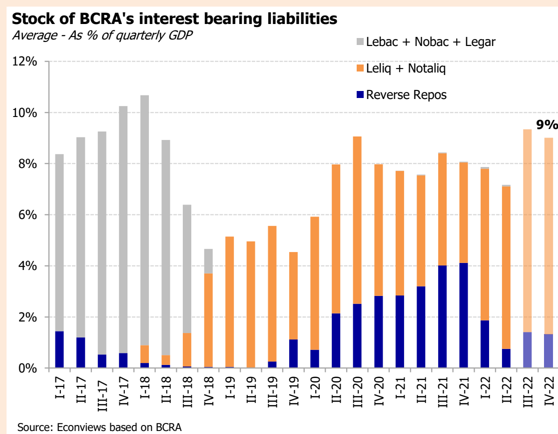
But the debt of the Central Bank itself is now making alarms go off, though markets overestimate the size of the problem

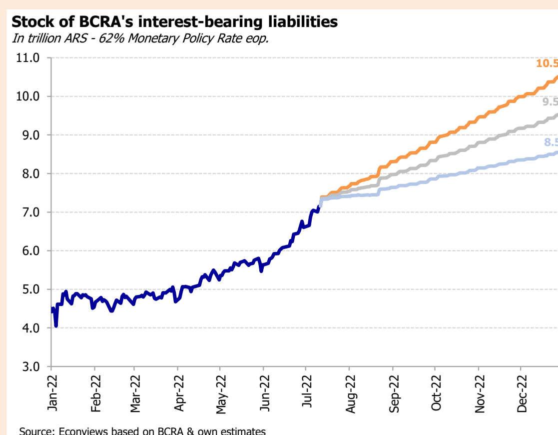
As the Central Bank now has to print more money to assist the Treasury (through Transitory Advances and by purchasing securities), it also has to sterilize that issue. It absorbs this money excess by issuing Leliqs or reverse Repos, **but the consequence of this is an increase in its debt.**

Assuming that the monetary base grows 70% by year's end (that is 20 p.p. below inflation), we estimate that **the stock of the Central Bank's interest-bearing liabilities could end in 2022 at 9% of GDP** (fourth quarter average and quarterly GDP). **In a worse scenario, where the CB has to print even more money, this figure could grow to 9.7% but if the situation improves and the money issue is lower, it would go to 8.3%. One caveat: with high inflation using annual GDP significantly overestimates the debt/GDP ratio**

Measured in pesos, these scenarios imply a BCRA's debt stock of ARS 8.5 trillion, ARS 9.5 trillion, or ARS 10.5 trillion depending on the assumption of money printing.

For the moment, this stock of debt does not seem to be unmanageable. Two factors help. The first one is that the monetary base is growing at around 47% y/y, so it will have to increase to reach our 70% forecast for the end of the year and that implies lower sterilization. The second is inflation. **With an estimated interest rate of 62% in December (83% effective) and inflation at 90%, as the CB bills are not indexed to inflation, this debt is constantly being diluted.**





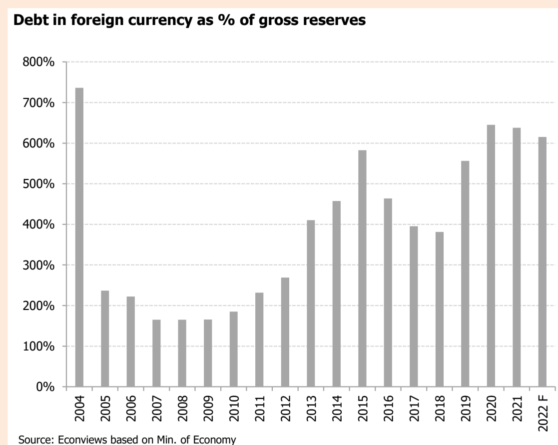
Is Argentina solvent?

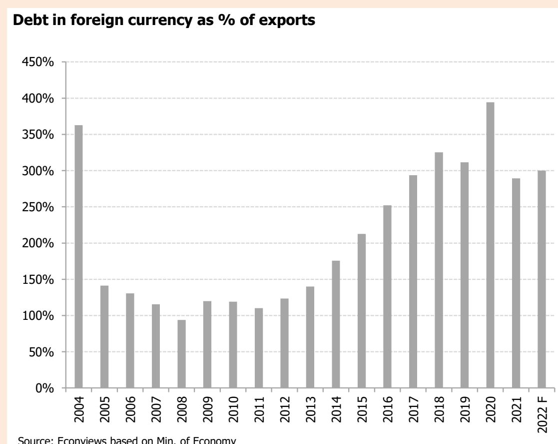
Sovereign debt solvency is measured using different indicators. The most important are the exchange rate and its volatility, interest rates, the level of reserves and international inflation.

International inflation, local inflation and the nominal exchange rate determine the real effective exchange rate (REER) level. An appreciated REER reduces the burden of debt measured as share of GDP. A strong peso increases GDP measured in dollars, while higher international inflation dilutes the debt. But FX volatility can make this ratio vary significantly from one year to the other, as demonstrated after the devaluation 2019 and many times in Argentina's recent history when GDP fluctuated between 300 and 640 billion dollars.

The level of reserves is also used as an indicator, and in general gross reserves are used to measure solvency -while net reserves are better for assessing liquidity appropriateness. The ratio of foreign currency debt to exports is also a popular (but controversial) indicator.

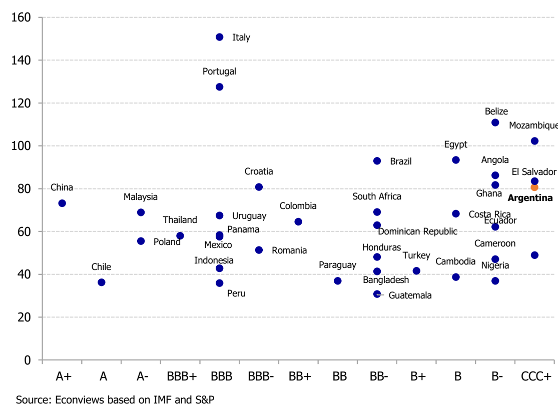
In terms of both indicators, the stock of debt denominated in foreign currency is larger than the average of the past two decades, but it is not in unseen or unsustainable levels, and it does not display a worrisome dynamic. Measured as share of gross reserves, USD debt stands at nearly 600%, which may seem like a high number but is indicative of the low level of reserves rather than the high level of debt. Measured as share of

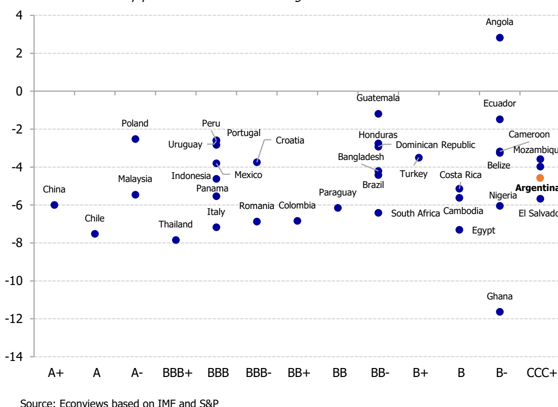




exports, we estimate that through 2022 it will be 300%. There is a methodological issue here, as we are comparing a stock with a flow, so one must bear in mind that foreign-currency debt has a much larger duration than peso-debt. What we can observe, though, is that this ratio is stable and even lower than 2017-2019's average.

Gross debt to GDP and the current fiscal deficit may point to the health of the level of debt, but the international comparison shows that is not the case. Rating agencies assess sovereign debt risk based on outlook - but take past performance into account as well. And as a result, looking at the current picture could be misleading.





The charts above show the level of gross debt and 2021's fiscal balance for a number of developing and developed economies. Argentina is rated CCC+ by Standard & Poor's, which means that debt is deemed vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the country to service it. As can be observed, there are several countries with a higher ratio of debt to GDP with a much better rating. Even low-income countries perform better than Argentina, like Angola or Egypt. Regarding fiscal balance, Argentina is far from an outlier if you look at the picture. **But it has a long history of fiscal mismanagement and is a serial defaulter. In its short history, Argentina has defaulted 9 times on its sovereign debt.**

Argentina must therefore muster confidence that it is willing to service its commitments, and a necessary condition for that is that its macroeconomy is stabilized. If market access is regained by 2025, maturities in foreign currency could be rolled over and a default could be averted.

Under different scenarios, provided market access is regained, debt issued in foreign currency could continue to fall measured as share of GDP.

Let's assume 3 different scenarios. All share the common assumption of market access and payment of interests.

Scenario 1): Our base case. Argentina corrects its relative prices - particularly the FX rate and utility rates- so GDP temporarily stagnates in local currency, but falls measured in dollars. Growth resumes and there is no need to appreciate the peso, so the REER with base Dec-01=100 stands

Argentina's defaults through the years

9 episodes of sovereign default

1-	1827	It occured after a lending boom, in which Argentina was able to issue bonds in London to finance their wars of independence against Spain.
2-	1890	Argentina was heavily indebted for the construction of railways and Buenos Aires's modernization.
3-	1951	Perón was not able to avoid a debt crisis at the end of his first term, after several years of fiscal mismanagement.
4-	1956	After the military coup against Perón in 1955, an economic crisis and default broke out, although they agreed with the Paris Club in order to avoid a bigger default.
5-	1982	It arose from the regional crisis due to the rise in interest rates in the United States during the government of Ronald Reagan.
6-	1989	A series of failed attempts at the end of the 1980s -after the failure of the Austral Plan and the Primavera Plan- to curb inflation, which rose beyond 3,000%, caused another default in 1989.
7-	2001	In the midst of one of the worst economic crises in its history, the then President Rodríguez Sáa announced in December 2021 that Argentina would not pay its foreign debt maturities.
8-	2014	After two swaps with the bondholders affected by the 2001 default, Argentina had achieved the acceptance of 93% of its creditors. But the country went into default, for not agreeing to pay the remaining litigating creditors.
9-	2020	The government of Alberto Fernández failed to pay a maturity of USD 503 million that fell on May that year, in the middle of negotiation with private bondholders.

below 170 in 2027. Under that scenario, the debt ratio grows by 2024 ends up below its current level in 2027.

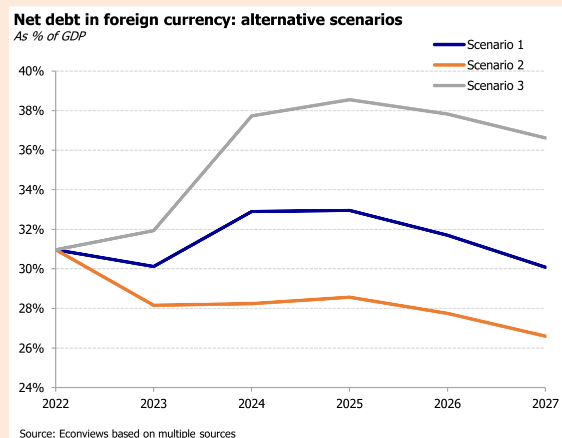
Scenario 2) Authorities maintain an appreciated peso and growth slows down as exports lose steam, but remains positive, while fiscal accounts are improved. This is the less likely scenario.

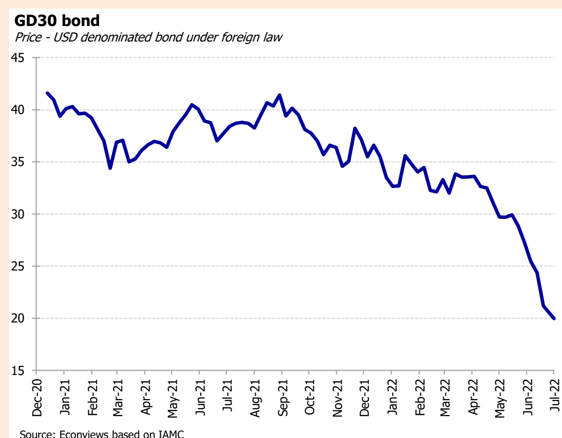
Scenario 3) After a devaluation the REER is kept at a high level and it has a contractionary effect on the economy, and growth does not resume fast due to depression of internal demand. The ratio goes up but later stabilizes, aided by international inflation.

These scenarios are optimistic in the sense that, despite some different approaches to economic policy, fiscal and monetary responsibility is displayed by a future government, while access to international capital markets is regained and the government can service interest payments. **But the conclusion that we draw from here is that the level of foreign-currency debt is not the problem. The main issue is liquidity, and if Argentina can not regain credibility the likelihood of a default will remain elevated.**

The price of USD-denominated debt shows that credibility is non-existent. Despite historically high terms of trade, the Central Bank does not accumulate reserves and that stems from an extremely high FX spread.

But to reduce the spread, the government must first set a consistent plan and commit to eliminating the fiscal deficit, fix the distortions in relative prices while the Central Bank must also commit to lowering inflation with a responsible monetary policy. **That the price of USD sovereign bonds trades at 20 cents per dollar indicates that the market does not believe the government can or is willing to fix the current disbalances, and as a result it overstates Argentina's debt problems.**



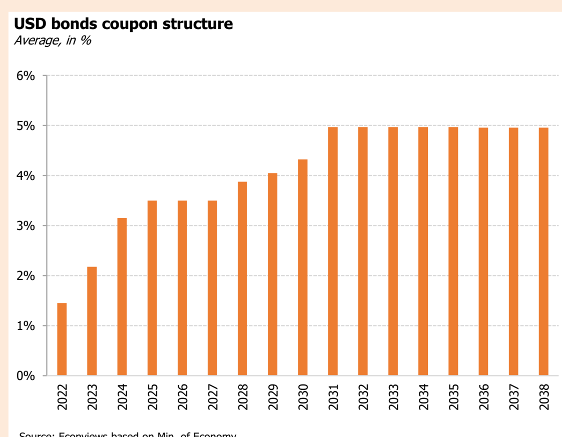


Rising interest rates: a new challenge ahead

We have focused so far on the level of debt and observed that capital payments in foreign currency are not a problem in the short run. **But we have assumed that interest maturities can be serviced, and this could prove challenging as interest rates are rising fast due to high international inflation. But as local inflation also ramps up, so will local rates and the burden of peso-debt interests.**

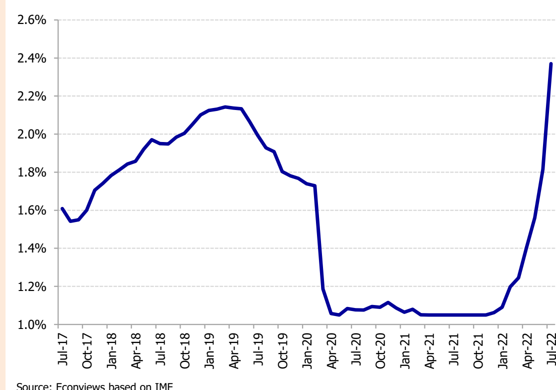
Interest services of USD debt to private bondholders is currently fixed as interest rates were determined in the agreement reached in 2020. This means that the largest portion of debt denominated in foreign currency is not vulnerable to rises in global rates in the short run. These rates do increase with time, but they reach a maximum of 5% only by 2031. **Even with access to market to rollover capital maturities and with a sharp drop of country risks these rates would be unattainable.**

The problem in the foreign-currency denominated debt lies mainly with the IMF loan. For the past years, the IMF basic interest rate stood flat (0.05 + 1%) but in the last few months it has quickly accelerated and will continue to do so through 2023. This variable rate depends largely on the



rate of US 3-moth Treasury bills, with Eurobonds' rate coming in second place (which, for the moment, remains negative but not for long).

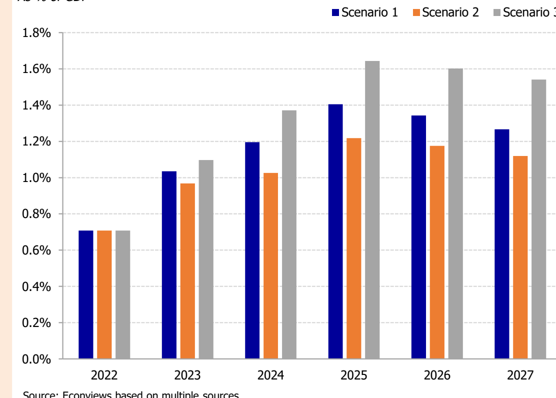
The SBA loan that is being repaid with inflows from the later EFF loan carries a rate equal to the IMF basic rate (variable + 100 bps) plus a surcharge of 200 bps due to excess borrowing over Argentina's quota - nearly USD 4.5 billion- and another 100 basis points due to prolonged excess borrowing (the outstanding loan has represented more than the benchmark 187% excess on the quota for more than three years).



The new EFF loan's rate will be subject to the 200-bps surcharge but only after 51 months of excess borrowing does it add the extra 100 bps, a longer period than the former SBA loan's. So, provided the agreement holds, by early 2024 the 100-bps surcharge should be dropped until 2026.

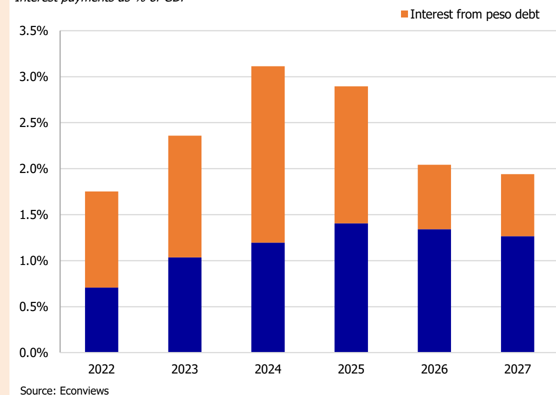
International organizations -like the World Bank- typically charge LIBOR or SOFR rate (the new benchmark rate) + 200 basis points, and the latter moves very closely to the FED funds rate. As a result, it will rise but not as much as the IMF's total rate.

If we also asume that access to financial markets is regained by 2025 and principal amortizations with the private sector at rolled over with an interest rate of of 9-10% (a reasonable assumption), the load of interests from USD-debt measured as share of GDP is very likely to increase in coming years. From a current estimate of 0.7% of GDP, under the three different scenarios described above, **they are likely to double by 2025 and should increase by at least 0.3 percentual points of GDP next year due to rising interest rates.**



The burden of peso debt is also raising alarms as the government will need to increase interest rates if it wants to roll over maturities, and most new debt is indexed to inflation. And the real interest rate that the market will demand is likely to rise to a range of 4 to 5%. **We expect that the real primary deficit this year will be 3.5% of GDP (net of accounting rents from CER bond issue) and could continue to be 3% in 2023. A fiscal effort will have to be made in 2024 by the new government to achieve and maintain a primary fiscal balance.**

Under these assumptions and also assumming that the Central Bank will continue to finance part of the deficit in 2023, beyond the limit agreed upon with the IMF, and using our base scenario for inflation, GDP projections and USD-debt interests, **our estimates point to a strong increase in the burden of interests.**



The load of interest in pesos is likely to increase from 1% of GDP per annum to 1.3% in 2023 and reach a top of 1.9% in 2024 (assuming a great portion of new debt issue in 2023 matures in 2024). This could take the total interests to 3.1% of GDP in 2024. The future government not only will have to achieve primary balance but should strive towards reaching a primary surplus, so the stock of debt does not continue to grow. It is easier said than done, but putting fiscal accounts in order is a necessary condition in a plan that stabilizes the economy.

Can Argentina avoid a Default or a Restructuring?

In view of the previous analysis, we discard the idea of a reprofiling of the debt in peso in the short term, but we do not rule out a significant deterioration of the Central Bank's balance, which could lead to greater inflation and instability. Our base case is already an inflation in the three digits for 2023.

The rising load of USD-debt interest will demand that the Central Bank accumulate reserves and for that a further appreciation can not be sustained. But this rise is far from impossible of handling.

The real challenge starts in 2025 when capital maturities with the private sector become significant, and if access to capital markets is not regained, a new restructuring will be on the menu. And investors and rating agencies alike are betting on it, as shown by the extremely low prices of USD bonds.

We do not believe that the debt situation is impossible to handle, but the economic and political context, as well as the international conditions, are taking a turn for the worse and any misstep could impact significantly on the prospects of the economy.

Base Scenario

	2019	2020	2021	2022 E	2023 E
Inflation (eop)	53.8%	36.1%	50.9%	90.0%	105.0%
Exchange rate ARS/USD (eop)	46.4	65.1	79.5	139.2	271.4
Exchange rate ARS/USD (eop, YoY)	58.4%	40.5%	22.1%	75.0%	95.0%
Real exchange rate ARS/USD (eop, Dec-01=100)	151.5	158.3	137.1	136.6	135.9
Paralell exchange rate ARS/USD (eop)	74.6	140.3	203.1	323.6	631.2
Spread with official exchange rate (eop)	61.0%	115.5%	155.4%	132.6%	132.6%
Gross reserves (USD billion, eop)	44.8	39.4	39.5	41.7	40.5
Net international reserves (eop, in thousands of M USD)	12.6	3.8	2.3	5.2	5.2
Policy rate (eop)	55.0%	38.0%	38.0%	62.0%	70.0%
GDP (YoY)	-2.0%	-9.9%	10.4%	3.5%	1.5%
Formal wages in real terms (aop, YoY)	-6.0%	-1.9%	0.4%	-0.5%	0.5%
Primary surplus (% GDP)*	-0.2%	-6.4%	-3.3%	-3.5%	-3.0%
Public net debt (% GDP)	43.6%	52.7%	41.7%	39.6%	41.8%
Current account (% GDP)	-0.8%	0.6%	1.2%	-0.1%	0.6%

Source: EconViews

*Excludes rents from primary debt issuance in 2022

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