MONTHLY REPORT

ECONVIEWS
ECONOMÍA Y FINANZAS

September 2023
Issue #231

2024: from **paradise to hell, anything is possible**

Page 4

Dollarization: Ecuador, El Salvador… **Argentina**?

Page 7

THE MONTH AT A GLANCE

RECENT DEVELOPMENTS

- The Federal Reserve held rates at 5.50% in September, but the dot-plot shows 12 of 19 board members favor one last hike to 5.75% this year. The forecast for late 2024 was also raised from 4.75 to 5.25%.
- Minister of Economy Massa announced two stimulus packages, which include bonuses for formal workers and retirees, tax breaks and subsidized credit lines, at a cost of around ARS 1,300 billion or 0.7% of GDP. The permanent changes in income tax could lower revenues by 0.8% of GDP per year.
- Train and bus fares in the Buenos Aires Metropolitan Area and utilities were frozen until December. The fiscal cost is low, but this is more repressed inflation for after the elections.
- The Ministry of Economy began publishing weekly inflation data, a troubling sign. Its numbers have CPI running at 2% per week in mid-September, though some private estimates are higher.
- The Central Bank has kept the official exchange rate pegged at ARS 350 since August 14th and will keep it there until November 19th, the date of the eventual run-off election. The parallel exchange rates heated up in the last days: the parallel dollar is trading at ARS 792, an 126% spread and the BCS is at ARS 831, an 137% spread.

FIGURE OF THE MONTH

August's inflation was

12.4%

the highest monthly record since exiting hyperinflation in 1991.

TO BE ALERT

The recent stimulus measures add up to

0.7%

of GDP in Q4 and risk further fueling inflation.

WHAT'S COMING NEXT?

- WTI oil prices rose 9.1% in the last month to 90 dollars a barrel. This complicates disinflation, and markets are pricing the Fed will hold rates above 5% until 2025.
- Due to statistical carryover and inertia, September's CPI will be around 12%. With a pegged exchange rate, it could slow to 9% in October, but will accelerate to two digits in November and December. We expect 2023's inflation will close around 180%.
- The general election is scheduled for October 22nd. Javier Milei is the frontrunner, but some voters may be put off by his radical proposals such as dollarization. JxC's Patricia Bullrich is struggling to retain moderate Larreta's votes without losing her hawkish profile, competing with Minister Massa for a place in a likely run-off on November 19th.
- Milei's advisors are split on dollarization, but even the more moderate proposals such as a "bimonetary system" could lead to a run on the peso in the short run. We see an ARS 754 official exchange rate by December and the BCS could rise up to ARS 1,089 in our negative scenarios.
- Initial estimates for the 2023/24 harvest are positive, and could lead to a USD 25 billion surplus for external accounts next year. The end of the drought will also help the economy rebound, as agriculture directly represents 8% of GDP.

SUMMARY OF MAIN INDICATORS

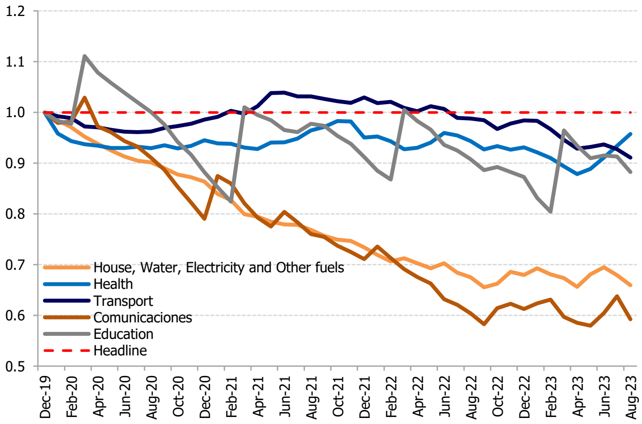
	Last	Previous		Last	Previous
Economic activity			**Financial data**		
Economic activity (MoM s.a.)	2.4%	-0.1%	Inflation (monthly)	12.4%	6.3%
Consumer confidence (MoM)	-1.6%	1.2%	FX spread (21day avg.)	116.2%	106.4%
Industrial activity (MoM s.a.)	-1.2%	-1.5%	Country risk (bps 21day avg.)	2,152	2,020
International accounts			**External data**		
Current Account (USD BN)	-6.35	-5.38	Soybean price (per ton, 21day avg.)	470.8	516.1
CB Reserves (USD BN 21day avg.)	27.67	24.33	Brazilian activity (MoM s.a.)	0.4%	0.2%
Primary balance (ARS BN)	-36.96	-334.34	Financial Conditions Index	22.3	23.3

Source: Econviews based on multiple sources - working days only

GRAPH OF THE MONTH:

Regulated prices rose less than headline inflation

Compared to the headline, Dec-19 =100



Source: Econviews based on INDEC

RECENT ECONOMIC DEVELOPMENTS

AUG 28th	AUG 30th	SEP 8th	SEP 13th	SEP 17th	SEP 28th	SEP 29th
Econviews Monthly #230: The PASO primaries' impact + special report on provincial finances.	Massa freezes transport fares, **gives bonuses for retirees, formal workers, and credit lines** at 0.3% of GDP estimated cost.	**New York court rules against Argentina in YPF nationalization trial**, orders country to pay USD 16 billion to Burford Capital.	Massa responds to August's 12% CPI with **VAT refund for formal workers and income tax cuts**, at 0.2% of GDP cost.	**JxC wins Chaco province with 46-42 vote**, in new triumph after winning Santa Fe province the previous week.	Senate votes in favour of **raising income tax floor from 6 to 15 minimum wages**, turning it into a definite law.	**Econviews Monthly #231**

POLITICS

His unexpected win in the August primaries put libertarian Javier Milei in the spotlight. Since then, he has sought to build bridges with union leaders, but still attacks the traditional political class. He is unclear on his most controversial proposal, dollarizing the Argentine economy, with some of his advisors recognizing it is impossible in the short-term, but other pushing forwards with the idea. Minister of Economy Massa has announced 0.5% of GDP in stimulus measures in a wild bet towards the October 22nd general election, at the cost of more inflation. JxC's Patricia Bullrich has moderated her discourse, as she now occupies the center spot between Milei and the government but is not a set figure in an eventual run-off.

IMF

After disbursing USD 7.5 billion in late August, which allowed the government to cover maturities until the end of the year, the IMF appears to be waiting out the elections. Massa's stimulus plan includes a freeze on gas and electricity rates, something the Fund had explicitly counseled against. Staff are also likely to frown upon the permanent changes in income tax, which weaken the next government's fiscal position. We expect the remaining USD 3.3 billion disbursement will be delayed until December, probably after the new president is sworn in on December 10th, to give time for the IMF staff to begin drafting a new plan with the economic team.

ECONOMIC ACTIVITY

Activity rebounded 2.4% between June and July, thanks to 42% monthly growth in the agriculture sector as it leaves the worst of the drought behind. The economy was 1.3% below July 2022 levels, accumulating a 1.8% contraction in seven months of 2023. This led us to revise our GDP forecast for the full year upwards from -3.5 to -2.5%. However, 10 out of 16 economic sectors slumped between June and July, including very important ones like manufacturing (-1.4%), construction (-2.4%) or retail (-0.8%). With the shock from the post-primary devaluation, we expect activity to rebound 0.5% quarter-on-quarter in Q3-2023, thanks to agriculture, but fall 3% in Q4 amidst higher inflation and political uncertainty.

INFLATION

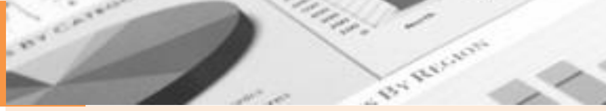
August's CPI confirmed expectations that the 22% devaluation after the primaries has a high pass-through to prices. Monthly inflation leapt from 6.3 to 12.4%, the highest in over 30 years. Food and beverages rose nearly 16%. Wholesale prices increased 19% in August, meaning second-round effects will still be felt this month. The Ministry of Economy began publishing weekly inflation, presenting a decrease from 4.8% the week after the primaries to 2% in the third week of September as good news. But due to strong inertia and statistical carryover, we expect another 12% print. Year-on-year inflation is running at 124% and could reach 180% or higher by December. In a best case scenario, it will remain in three-digits next year.

MONETARY SECTOR

Having devaluated the exchange rate 22% to ARS 350 and hiked its Leliq policy rate from 97 to 118% after the primaries, the Central Bank's new strategy is a hard peg until October 22nd, and probably November 19th if there is a run-off election. Yet 12% monthly inflation means the 10% effective monthly rate is *ex-ante* negative. We expect a new hike in the Leliq rate to 130% around that period and believe the official exchange rate will finish the year around ARS 754, although a lot depends on the outcome of the elections. The new fiscal measures will have to be at least partly financed through money issue, further pressuring on inflation and the parallel exchange rates.

FISCAL ACCOUNTS

The primary deficit shrunk from ARS 334 billion in July to 37 billion in August, accumulating 1.2% of GDP in eight months of 2023. However, August's relatively small deficit reflects ARS 146 billion extra revenues due to the increase in the tax on dollar purchases for imports of services, goods, and freight. VAT and other taxes linked to the level of activity are also doing well. Fiscal accounts will worsen in September (and even more in October) as the ARS 1,300 billion (0.7% of GDP) in stimulus measures start to add up. With Congress ratifying the changes in income tax, the fiscal incongruence will drag on into 2024 unless the law is revoked by the new government. We believe the primary deficit will close 2023 around 2.8% of GDP.



I. 2024: from paradise to hell, anything is possible

The economic situation continues to deteriorate, and it is now clear that whoever wins the general elections will have a colossal challenge in December. He or she will have to deal with an extremely fragile situation including a high and probably rising rate of inflation, the need to devalue to reduce the FX spread, reduce the fiscal deficit, increase utility rates, remove the FX controls, and design a strategy to quickly increase reserves to avoid a new default on external debt.

The economy is now dysfunctional and is moving along an unsustainable path where the outcome is clear: **devaluation, and a new rise in inflation**. The government, which has an eye on the elections, is doing everything that it can to postpone the inevitable, and it can probably achieve its goal by increasing the size of the imbalances. In other words, it will manage to keep a lid on the exchange rate at the cost of losing reserves, a tighter *cepo*, and more appreciation of the real exchange rate. The legacy that they will leave does not appear to be a concern for them. If they succeed, the dreaded adjustment will be left for December and the next government will have the have the unpleasant task of doing it.

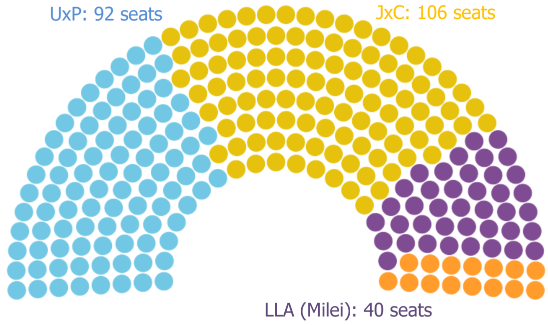
This situation raises at least two questions. First, does it matter which of the three candidates makes the adjustment? Second, what are the risks of a full blown economic and financial crisis, and will it resemble any of the ones that Argentina suffered in recent history, like 1981, 1989 or 2001?

	Bullrich (JxC)	Milei (LLA)	Massa (UxP)
Diagnosis			
Economic teams			
Execution capacity			
Political capacity			
Social containment capacity			

It seems clear that the three candidates will approach the challenges differently. Patricia Bullrich seems to be in a better position. She has a strong economic team that has been working on a blueprint to deal with it using a comprehensive approach that would attack heads on the need to correct the macroeconomic fundamentals (namely a drastic reduction in the fiscal deficit and in the FX spread and the adoption of a sound monetary policy) combined with a set of structural reforms that would include de-regulation, a modernization of the labor regime and the independence of the central bank among others. There is no guarantee that the policies will succeed, but at least she has a coherent and comprehensive approach that with some tail wind has a good chance of

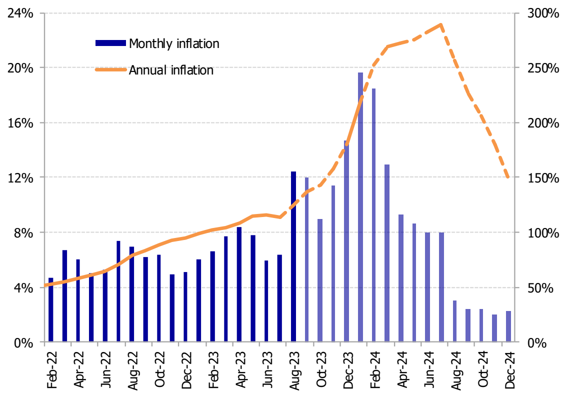
Post-election composition of Lower House

If August 13th primary results are repeated in general election



Source: Econviews

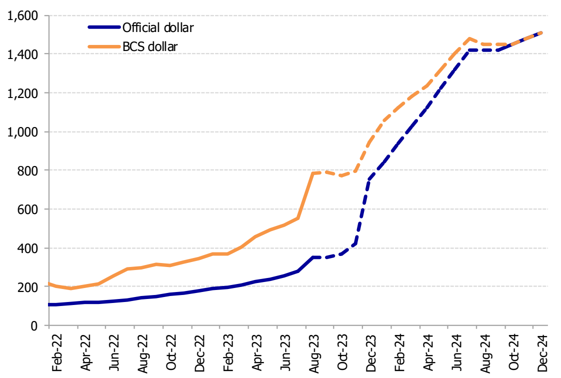
Bullrich: monthly and annual inflation



Source: Econviews based on INDEC and own estimates

Bullrich: official and parallel exchange rate

Pesos per dollar



Source: Econviews based on BCRA and own estimates avoiding runaway inflation. The risks of a full blown crisis are the smallest of the three.

Patricia would be politically strong and it the sense that she would be in a good position to pass laws in Congress as Juntos por el Cambio will be the largest minority in the Lower House with the ability to receive support from Milei's legislators and independents. The situation will be more difficult in the Senate, though with the support of some provincial senators she could manage to obtain majorities. In addition, Juntos por el Cambio plus some potential allies (which should be easy to entice if she wins) will govern more than half of the provinces, a huge change relative to recent history when the Peronists were in that position.

At the other end of the spectrum is Javier Milei, who seems to be the frontrunner in the polls. At the at the moment, he does not have an economic team (just a few economists working in isolation) and his main proposal that is the dollarization of the economy, which could be a long-term project, is non-viable in the near future simply because the Central Bank does not have dollars and does not have the possibility to borrow in the markets. This immediately raises the question of what Milei would do if he were to take over in December, and the answer is that nobody knows. He does not have a plan B and given that fragility of the economic situation there is clear risk that prices and the exchange rate would quickly enter into a worrisome spiral. Under that scenario there is also a risk that the country would enter in default due to lack of dollars at the Central Bank and the lack of expertise of his team.

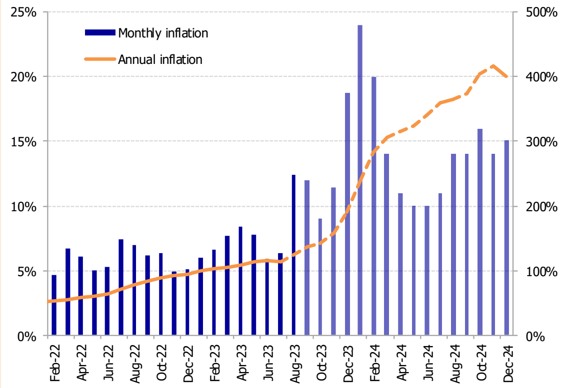
One worrisome aspect of Milei is that if he wins, in the best possible case he will have no governors, only 8 senators out of a total of 72, and 40 out of 258 congressmen. He will not have the ability to approve laws in Congress, and he would not be able to block or veto any decision made by two thirds of the members of the Chambers. In other words, Milei would be a very weak and vulnerable president that could even powerlessly face an impeachment if the opposition perceives that his policies are falling apart, and the population at large is disappointed. The risks will be high.

Finally, in the case of Massa we can imagine an intermediate scenario, in which initially he does not turn around the economy, but where the economy does not fall apart. Massa probably will adopt a gradual approach. Perhaps he will curse himself for inheriting an economy with large imbalances and in need of urgent repairs, though it was all his making in the effort to win the election.

Most likely, he will not adopt a shock approach as in the other cases, and instead look for low dose medicines. There will be a devaluation but not large enough to solve the overvaluation of the currency and hence there would still be a large spread between the official and the parallel exchange rates, the FX controls on imports and the *cepo* would not be dismantled, even for new operations. There could be an effort to bring down the fiscal deficit and to move towards a primary balance in the accounts, though not immediately and we don't expect that there would be significant structural reforms.

While Massa might not have a comprehensive program to deal with the macro- imbalances and is not expected to implement far-reaching structural reforms, he is clearly a shrewd politician and he is well known

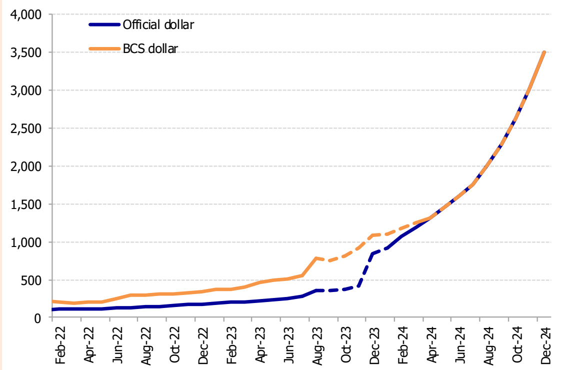
Milei: monthly and annual inflation



Source: Econviews based on INDEC and own estimates

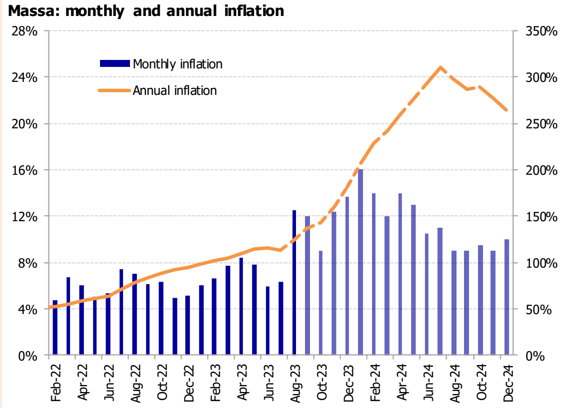
Milei: official and parallel exchange rate

Pesos per dollar



Source: Econviews based on BCRA and own estimates

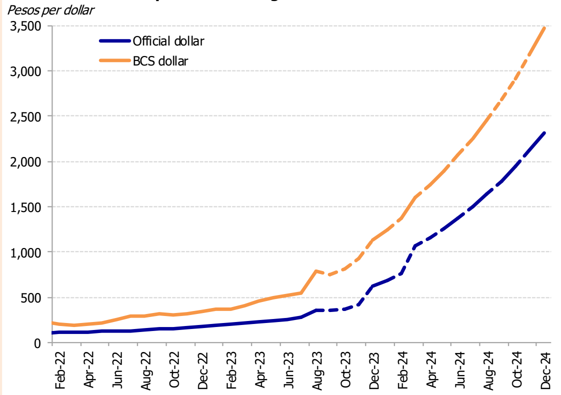
Massa: monthly and annual inflation



Source: Econviews based on INDEC and own estimates

Massa: official and parallel exchange rate

Pesos per dollar



Source: Econviews based on BCRA and own estimates for his ability to change policies if necessary. This means that even if he faces a rough beginning, he has the capacity to change in the future and eventually to adopt sounder policies.

In the graphs we show the possible evolution of the inflation, the exchange rate and the FX spread in the three scenarios. In the case of Bullrich there could be a rough beginning, but the situation does not get out of control and later next year there could be an anti-inflation program that drastically brings it down. In the case of Milei the FX spread is removed quickly and there is a sharp devaluation, but inflation is never brought under control. Finally, Massa is an adjustment in two steps, it starts in a gradual way and later, when he realizes that that things don't work, he would take another step to reduce the FX spread and improve the external accounts.

In the three scenarios we expect that the IMF will play a critical role, as we don't anticipate that the Fund will once again be willing to support a light program of the type agreed with Guzman and Massa. It seems that there was enough time for complacency and that now it will not be willing to accept Argentina going into arrears in order to regain part of its lost reputation. A reasonable agreement should be relatively easy to reach in the cases of Bullrich and Milei, as they are willing to undertake many of the policies that the IMF recommends. In the case of Massa it will probably be more difficult, not only because he appears to be less willing to implement a comprehensive program at the outset, but also because during the last year he failed to keep his promises and there is widespread distrust in Washington. We expect that he will be asked to take numerous prior actions and it is an open question whether he will be able to deliver.

Everything indicates that we should be prepared for a turbulent summer, but the medium-term outlook appears to be much better. The main reason is that next year we anticipate a 25-billion-dollar surplus assuming that there will not be another drought that will provide significant relief on the external front and will allow the removal of the *cepo*. The other reason is that after so much pain due to inflation and the large increase in poverty, the population is looking for alternatives, namely a move to market friendly policies, less regulation and a reduction in taxes and in government intervention.

II. Dollarization: Ecuador, El Salvador… Argentina?

Javier Milei wants to dollarize the Argentine economy. This has been the backbone of his campaign. For voters weary of inflation, it is an attractive promise, and one that is very easy to understand. For economists and business leaders, it is the most controversial point. His advisors tell a different story every day: a swift dollarization or a gradual one, with or without capital controls, etc. In this special report, we will analyze how dollarization played out in the few countries that actually implemented it, and how much sense there is to Milei's proposals.

For starters, aside from the US only 3 countries with more than a million inhabitants use the dollar as legal tender: Ecuador, El Salvador and Panamá. We will focus on Ecuador, the largest economy of those three. Other relevant cases are Venezuela, where after hyperinflation, 48% of local market transactions are carried out in dollars, and Uruguay, who's "bimonetary" system is often mentioned as an alternative to dollarization.

i. The case of Ecuador

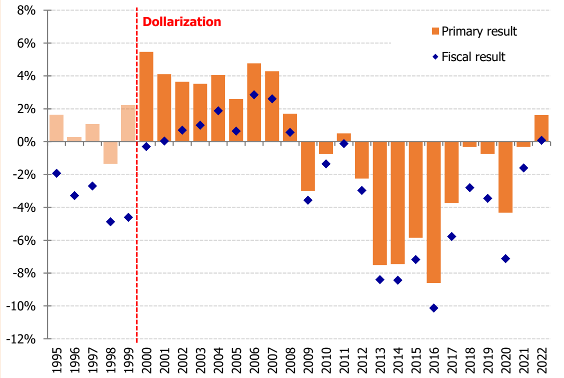
Unlike many of its neighbors, Ecuador was unable to stabilize its economy in the 90s and suffered 40% inflation on average through the decade. In 1998, the triple shock of El Niño floods, lower oil prices and financial crises in other emerging markets sent Ecuador into a deep recession. GDP fell 4.7% in 1999 and inflation soared to 61%. Ecuador's currency, the sucre, lost 76% of its value in two years.

Loss of oil revenues and emergency spending weakened fiscal accounts, **but at the heart of the crisis was the banking sector**. The system had been deregulated in 1994, leading to a poorly supervised credit boom. Between 1994 and 1998, dollar deposits rose from 16 to 37% of the total, while dollar loans tripled from 20 to 60%, often to clients with incomes in local currency. This amplified the negative balance sheet effects of a devaluation. Once external conditions turned sour, the delinquency rate shot up from 10 to 50%. Policy mistakes such as a tax on credits and debits spurred deposit outflows, making things worse.

Before formal dollarization, Ecuador's financial system was larger and more dollarized than ours is today. By 1999, 67% of loans and 54% of deposits were in foreign currency, compared to 10% of loans and 15% of deposits in Argentina. Total credit to GDP was 25% in Ecuador then and less than 6% in Argentina today.

In late 1998, authorities announced a blanket guarantee on deposits and took over one of the largest private banks. Not only did the measure fail to restore confidence, but the Central Bank was forced to expand the money supply to support banks. Monetary issue grew 152% over the following year. In February 1999, the currency was allowed to float, depreciating 30%. In March 1999, the government froze deposits for 12 months to stem the outflow, accelerating the crisis. By late 1999, 60% of banks' assets were in public hands. After a 50% devaluation in the last quarter left the country on the brink of hyperinflation, **in January 2000 the government decided to dollarize the economy**.

Ecuador's fiscal accounts
As a % of GDP



Source: Econviews based on IMF

Different starting points

	Ecuador 1999	Argentina 2023E
Inflation (Dec.)	61%	181%
Monetary base (%, Dec/Dec.)	136%	90%
Currency in circulation (%, Dec/Dec.)	160%	75%
Dollar deposits as a % of total	54%	15%
Dollar loans as a % of total	67%	10%
Delinquency rate, all loans	53%	3%
Credit/GDP (average)	25%	6%
Primary result (as a % of GDP)	2.2%	-2.8%
Fiscal result (as a % of GDP)	-4.6%	-4.8%
Net int. reserves (in million USD, Dec.)	872	-4,000

Source: Econviews based on CBE and own forecasts

Ecuador's crisis had many idiosyncratic elements, but the transition issues and its post-dollarization economic performance are both relevant to the debate in Argentina today.

- **Aspects of the transition**

By the end of 1999, the Central Bank of Ecuador held USD 872 million net international reserves. The IMF and other multilaterals committed 2 billion in April 2000 to strengthen the plan. **As part of the reform, the CBE's balance sheet was split into four separate systems.** Systems 1 and 2 encompass low nomination sucre coins, bank deposits and other financial entity deposits, which are fully backed by foreign exchange as in a **classic currency board**. At the onset of dollarization, the CBE's liquidity instruments (BEMs, similar to Argentina's Leliqs) were also included in system 2, Systems 3 and 4 have looser requirements and match the CBE's liabilities with the IMF, the government, and the private sector to foreign exchange, but also repos and public and private bonds. This part was designed to allow the CBE to (partly) act as a **lender of last resort to commercial banks**. But it also left space for the CBE to finance the Treasury, as then occurred between 2014-17 (as can be seen in Box 1).

To minimize the amount of FX necessary to fully back systems 1 and 2, authorities overshot the exchange rate. With 872 million net reserves, total currency and deposits could have been rescued at a 20,000 per dollar exchange rate. Yet including other liabilities such as BEMs raised the rate of conversion to 32,000 per dollar. Dollarization took place at 25,000, an intermediate rate based on authorities' estimates of how which liabilities had a "high chance of being swapped" for dollars. Thus, **the plan started out with a 54% real devaluation**, against 1999's average RER.

This meant that in March 2000, real wages were 30% below 1999's average. Readjustment of nominal wages, non-tradable prices and regulated prices like fuel and gas pushed inflation to 91% in 2000 and 22% in 2001, **only converging to US inflation by 2004**. By that year, the RER had returned to pre-crisis levels, meaning dollarization brought about no gains in competitiveness.

One technicality was how to convert contracts in sucres into dollars. De-indexation (*desagio*) set all deposit rates at 9% and loan rates at 17%. Afterwards, a maximum rate equal to LIBOR + EMBI + 4 percentage points, or 1.5 times the average rate, was set for all loans. Ex-post, **real interest rates were negative until 2002**.

Initially, depositors could only withdraw up to USD 4,000 from banks. Time deposits were gradually unfrozen from March 2000 onwards, but despite fears of a new bank run, total deposits in the system grew 38% over the rest of the year, signaling confidence in the new monetary scheme.

- **Post-dollarization economic performance**

Critics of dollarization often point out it hinders economies' ability to adapt to shocks. If terms of trade deteriorate, the RER can only depreciate through internal deflation. But nominal wages tend to be downwards rigid, so the result is higher unemployment and less growth. Dollarization in Ecuador coincided with the early 2000s commodity boom, so this was not a problem early on.

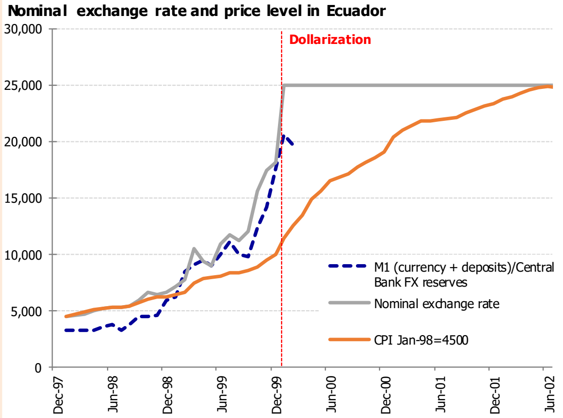
CBE's four balance sheets

Tier	Assets	Liabilities
1	FX	Currency (sucres) and bank deposits
2	FX	Other financial entities' deposits, BEMs*
3	FX, repos, public debt instruments	CBE external debt (IMF and others), public and private sector deposits
4	Other assets and credit lines	Other liabilities and equity

**Bono de Estabilización Monetaria*, CBE's pre-crisis liquidity instruments

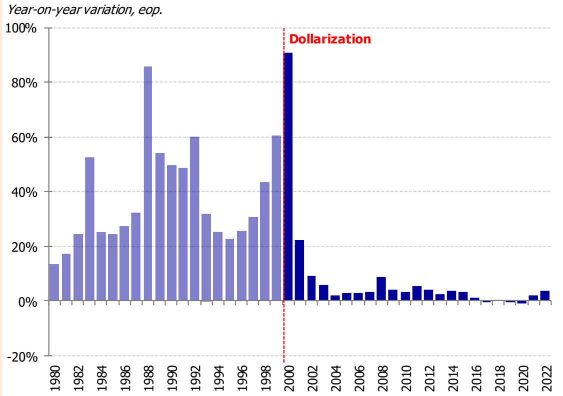
Source: Econviews based on CBE

Nominal exchange rate and price level in Ecuador

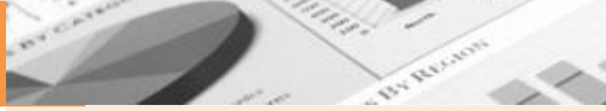


Source: Econviews based on CBE

Inflation in Ecuador
Year-on-year variation, eop.



Source: Econviews based on IMF



Between 2004 and 2014, GDP per capita grew at a 3.1% annual rate, in line with an economy with a similar export profile such as Colombia (3.6%) and above LATAM's average (2.5%). This was also an improvement against Ecuador's 1.3% annual rate between 1990 and 1998.

Real exchange rate and commodity prices

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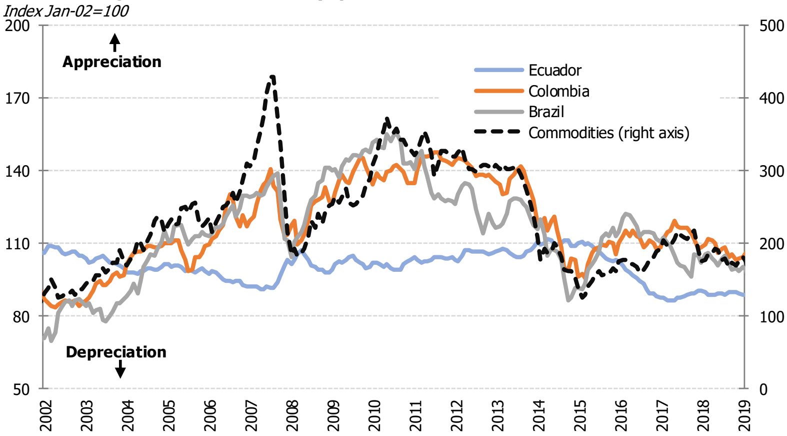


Source: Econviews based on several sources

GDP per capita growth

Average annual rate, 2017 PPP dollars

	1990-98	2004-14	2015-19	2020-23E
Chile	4.9%	3.4%	0.5%	0.5%
Colombia	1.9%	3.6%	0.9%	1.7%
Ecuador	**1.3%**	**3.1%**	**-1.0%**	**-0.8%**
Perú	1.5%	4.8%	1.7%	0.9%
LATAM	1.3%	2.5%	-0.7%	0.5%

Source: Econviews based on IMF

The first real test came in 2014-15 when commodity prices slumped 57%, and oil (which was then half of Ecuador's exports) fell 68%. Between Q1-2014 and Q1-2016, Brazil and Colombia responded to the shock devaluating their RER 21% and 26%, respectively. In the same period, Ecuador's RER appreciated 2%.

Between 2015 and 2019, Ecuador's GDP per capita contracted at a 1% annual rate, faring much worse than Colombia (0.9%) or even LATAM's average (-0.7%). The RER eventually devaluated 21% between Q1-2016 and Q1-2018. This was achieved through 0.2% deflation in 2017, and some luck as the US dollar weakened significantly that year. Unemployment rose from 3.1% in 2013 to a peak of 4.6% in 2016, although by 2019 it had fallen to 3.8%.

GDP per capita

In 2017 PPP dollars

	2000	2019	Accum. variation	2023E
Chile	14,915	23,906	60%	24,157
Colombia	9,279	15,000	62%	15,875
Ecuador	**8,274**	**11,440**	**38%**	**11,023**
Perú	6,686	12,886	93%	13,159
LATAM	12,568	15,604	24%	15,817

Source: Econviews based on IMF

Before the pandemic, Ecuador's GDP per capita, adjusted for purchasing power parity, was 11,400 dollars. Compared to the year 2000, it had grown 38%, much less than other Pacific economies like Chile (60%), Colombia (62%) or Peru (93%). It was above the LATAM average for that period (24%), but this is due to Argentina, Brazil, and Mexico's weakness in the 2010s. **The IMF estimates Ecuador's GDP per capita will close 2023 around 11,020 dollars, 3.6% below 2019**. This sets it apart as one of the few LATAM economies that has not fully recovered from the pandemic.

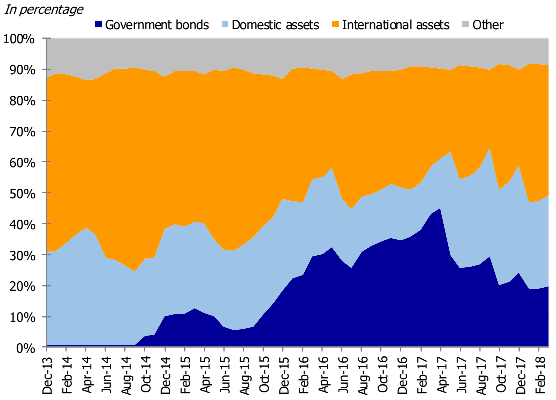
Box 1: A loophole to finance the Treasury.

A 2022 IMF paper pointed out that **the Central Bank of Ecuador indirectly financed the Treasury's deficit between 2014 and 2017**, after a 2009 reform which allowed it to purchase government bonds from public banks. On the CBE's balance sheet, a new liability (higher public bank deposits) was balanced out by a new asset (the bonds), but the ratio covered by international reserves fell. Since Ecuador also ran current account deficits between 2011 and 2015, private bank deposits fell, turning the CBE's balance sheet even more illiquid.

Government bonds went from 0% of the CBE's assets in 2013 to a peak of 45% in 2017, with the CBE holding USD 5.9 billion. The IMF calculates net international reserves fell from 3 billion in 2015 to negative 2 billion in 2017. After the change of government that year, new authorities set out to clean the CBE's balance sheet. But the episode highlights that **dollarization is not a safeguard against the Central Bank funding government deficits for prolonged periods**.

Central Bank of Ecuador's assets

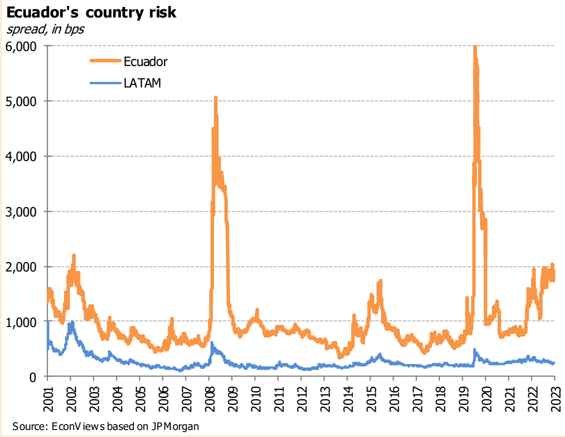
In percentage



Source: Econviews based on CBE

In short, dollarization helped stabilize Ecuador's economy during the 1999 crisis. However, it amplified the negative shock from the fall in commodity prices after 2014, leading to growth rates below the regional average, and which took longer to recover.

Another point is that dollarization has not guaranteed Ecuador access to capital markets. Since 2001, **country risk has been over 1,000 bps 32% of the time**. In that period, Ecuador underwent two new debt restructurings, one in 2009 and a more recent one in 2020. As of late September 2023, its country risk kept above 1,700 bps, although part of the recent increase is due to uncertainty surrounding the presidential elections, which will be defined in a run-off on October 15th.

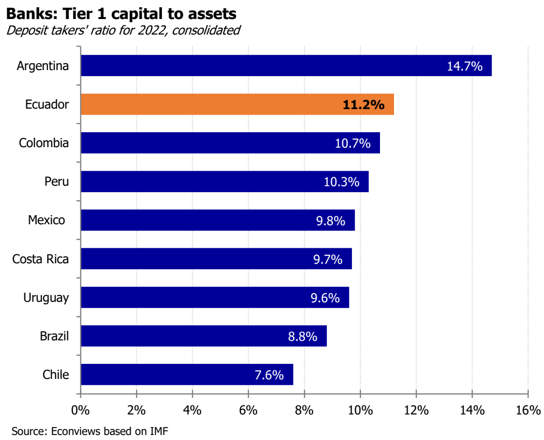


Box 2: The banking system under dollarization.

The IMF's Financial Development Index ranked Ecuador 138 out of 194 countries in 2019, only above Nicaragua in LATAM. In the Fund's assessment, dollarization is an "anchor" for Ecuador, but it also means **higher liquidity risk**. Ecuadorian banks hold a **Tier 1 capital-to-assets ratio of 11.2%, one of the region's highest**. Back in 2000, Chilean economist Andres Velasco pointed out that without Central Bank credit, it becomes necessary to increase either international reserves or bank reserves, but both options entail significant opportunity costs.

The system is also affected by some degree of financial repression. Institutions are required to keep 60% of their liquid assets in Ecuador. **Capital outflows are subject to a 3.50% rate tax** (set to lower gradually to 2%), although non-residents' profits and investments of longer than 360 days are exempt. Government and corporate bonds sold through private placements with an underdeveloped secondary market. **Few international banks operate in Ecuador, and 46% of financial system assets are in public hands**.

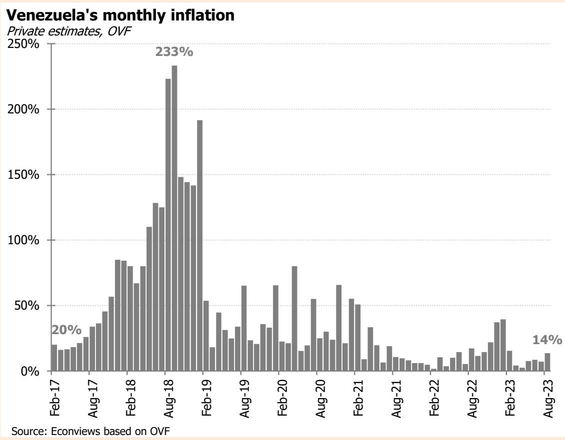
On the positive side, **more stability helped Ecuador's credit to GDP grow from 25% in 1999 to 53% in 2022**, a ratio in line with Peru (48%) or Colombia (44%). Other metrics such as deposit-taking sector assets to GDP (80%) also show the financial system's size is in line with the region.



ii. Venezuela: dollarization without dollars

An obvious critique to those who would dollarize Argentina is that the Central Bank has no dollars to exchange for currency, deposits, and other liabilities (net reserves are negative by USD 4.8 billion according to our calculations). Venezuela offers an example of *de facto* dollarization, where after years of hyperinflation, **citizens carry out 48% of daily transactions in dollars**, according to the Venezuelan Finance Observatory's estimates.

The Venezuelan crisis is well known, and its causes too complex to analyse here. Inflation spiralled out of control from 20% monthly in Q1-2017 to a peak of 200% monthly in Q3-2018. During this period, the spread between official and parallel exchange rates reached up to 10,000%.



The government relaxed currency controls in February 2019 after a 400% depreciation of the official rate. In an attempt to stop inflation, it also rose reserve requirements for operations in local currency to 93% in 2020, but “only” 31% for operations in foreign currency. This contributed to boost credit in dollars (over half of deposits were already in dollars).

With these reforms, inflation decreased to 19% monthly in 2021 and 13% monthly in 2022. The balance is a highly divided economy, where 44% of prices are set in dollars, and 87% of wages are paid in such. GDP grew 28% between 2019 and 2022 (measured in dollars, IMF calculations) but is still 75% below 2012 levels.

Dollarization in Venezuela
Percentage of operations in foreign currency

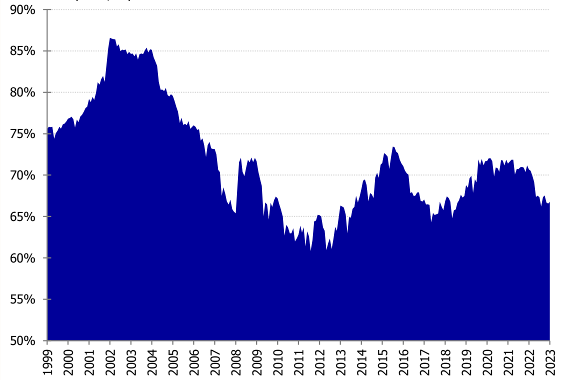
	Jun-21	Dec-21	Jun-22	Dec-22	Jun-23
Price fixing	-	34%	44%	43%	44%
Transactions	-	48%	46%	46%	48%
Private wages	69%	72%	68%	83%	87%
Commercial bank deposits	-	66%	55%	66%	58%

Source: Econviews based on OVF

iii. Uruguay’s “bimonetary” system

Up into the early 2000s, Uruguay’s monetary history is a loose parallel of Argentina’s, with a turbulent 70s and 80s, reform and stabilization in the 90s and a huge banking crisis in 2002. This left Uruguay with a high degree of financial dollarization: deposits in foreign currency reached 90% of the total and the ratio is still around 74% for private banks. **Dollar deposits in the hands of residents are 67% of M3** (against 14% for Argentina).

Uruguay: dollar deposits/M3
Residents' deposits, eop.



Source: Econviews based on BCU

The Central Bank of Uruguay switched to inflation targeting (IT) in 2002. Annual inflation has averaged 8% since then, stable, but above the CBU’s target range in 14 out of 20 years. Indexed Units (UI), modelled on Chile’s inflation-linked UFs, were also introduced in 2002, as an alternative to the financial system’s dollarization. **This helped reduce loans in dollars from 88% of the total in 2003 to 48% twenty years later**, though the figure goes above 75% for firms, which undergo significant currency risk.

Coupled with its extremely lax capital controls and the fact that **residents are allowed to carry out transactions in foreign currency freely**, this has led many to describe Uruguay as a “bimonetary” economy. The process, however, was not part of a stabilization plan like Ecuador’s, but rather the by-product of a more liberalized financial system and decades of inflation.

iv. Lessons for Argentina

Terms like “dollarization” or “bimonetarism” have been thrown around in the campaign with little precision, reflecting voters’ aversion to the peso, but not realistic economic plans.

Emilio Ocampo is Milei’s candidate for the Central Bank. In his view, it is not necessary to convert all of the circulating currency. As of August 2023, the monetary base was equal to USD 9.3 billion, and the BCRA’s liabilities are USD 28.5 billion, taking the BCS rate. Ocampo believes the monetary base can be converted using the Central Bank’s reserves in gold and SDRs, plus BIS loans and its deposits in SEDESA, an entity created in 1995 to help guarantee bank deposits. As for the BCRA’s liabilities, he proposes a fund capitalized through new debt emission, YPF stock, the social security fund (FGS) and 20% of export duties.

BCRA estimated balance sheet
In million USD - up to 15-Sep-23

Assets		Liabilities	
Gold	3,818	Reserves requirements	9,479
Dollars	7,200	Swap China (Used)	4,300
SDRs	2,940	BIS	3,149
		Sedesa	1,832
Total (1)	**13,958**	**Total (2)**	**18,760**
		Net Reserves	
		(3) = (1) - (2)	**-4,802**
Potential		Potential	
Swap 1st tranch	500	Swap 1st tranch	500
Swap not allowed	13,057	Swap not allowed	13,057

Source: Econviews based on BCRA & own estimates

The first part is faulty accounting. The BCRA holds 27.2 billion in reserves. Subtracting SDRs, which must be repaid to the IMF by December, private bank reserves and the swap with China, liquid assets are 3.8 billion in gold. Neither SEDESA deposits nor BIS loans are easily convertible. This is less than half of the monetary base’s 9.3 billion.

The second part is even less realistic. Considering Argentine bonds trade at 33 cents on the dollar, raising 28.5 billion would require issuing around 90 billion at nominal value. This would take the debt to GDP ratio from 39 to 55%, a level many would consider unsustainable for Argentina. It is also unlikely there is market demand for that much Argentine debt, at those rates and considering the experience of 2016-17.

The numbers simply do not add up for an Ecuador-style dollarization. Out of control inflation leading to a *de facto* dollarization cannot be ruled out. Carlos Rodriguez, another of Milei's advisors, proposes overshooting the exchange rate and lowering the policy rate. This amounts to a self-inflicted hyperinflation and would certainly encourage dollar adoption.

In our opinion, these proposals confuse means with ends. The desirable aspects of Uruguay's bimonetarism could be replicated in Argentina by removing FX controls, but they are not a solution in themselves. Neither is dollarization. In order to work, these schemes need a primary balance, building up international reserves and Central Bank credibility, otherwise they risk creating a new run on the peso. And if those three objectives are achieved, it is possible to lower inflation without renouncing the sovereign currency.

Base Scenario

	2019	2020	2021	2022	2023 E	2024 E
Inflation (eop)	53.8%	36.1%	50.9%	94.8%	181.0%	150.0%
Exchange rate ARS/USD (eop)	59.9	84.1	102.8	177.1	754.1	1,508.3
Exchange rate ARS/USD (eop, YoY)	58.4%	40.5%	22.1%	72.4%	325.8%	100.0%
Real exchange rate ARS/USD (eop, Dec-01=100)	151.5	158.3	137.1	129.4	211.2	174.0
Paralell exchange rate ARS/USD (eop)	74.6	140.3	203.1	340.8	942.7	1,508.3
Spread with official exchange rate (eop)	24.6%	66.8%	97.7%	92.4%	25.0%	0.0%
Gross reserves (USD billion, eop)	44.8	39.4	39.7	44.9	29.0	36.5
Net international reserves (USD billion, eop)	12.6	3.8	2.3	7.7	-4.0	4.0
Policy rate (eop)	55.0%	38.0%	38.0%	75.0%	130.0%	40.0%
GDP (YoY)	-2.0%	-9.9%	10.7%	5.0%	-2.5%	-0.5%
Formal wages in real terms (aop, YoY)	-6.0%	-1.9%	0.4%	0.3%	-3.0%	-2.5%
Primary result (% GDP)*	-0.2%	-6.4%	-3.3%	-2.7%	-2.8%	0.0%
Fiscal result (% GDP)*	-3.6%	-8.4%	-4.8%	-4.1%	-4.8%	-2.0%
EMBI Argentina (spread in bps, eop)	1,770	1,372	1,703	2,196	1,500	800
Public net debt (% GDP)	43.6%	52.7%	42.1%	35.2%	38.8%	44.4%
Current account (% GDP)	-0.8%	0.8%	1.4%	-0.6%	-3.1%	3.1%

Source: EconViews

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