MONTHLY REPORT

ECONVIEWS

ECONOMÍA Y FINANZAS

December 2023
Issue #234

Milei: fast and **not so furious**

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a year to **change gears**

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THE MONTH AT A GLANCE

RECENT DEVELOPMENTS

- The Federal Reserve held rates at 5.25-5.50% again at its December meeting and the dot-plot shows FOMC members see 75 bps of cuts in 2024. However, tensions in the Red Sea may push inflation upwards.
- The ARS fell from 366 to 800 (+54% devaluation or 118% increase in the USD). It will run at a 2% monthly crawling peg. Exporters will be able to enter dollars at an 80/20 blend with the Blue Chip Swap but paying a 15% tax rate (net ARS 736). Importers will face a 17.5% tax, leaving an ARS 945 effective exchange rate. Informal and Blue Chip Swap rates lowered to ARS 947, an 18% spread.
- Minister of Finance Caputo set out a plan to reach fiscal balance in 2024, with 2.2 points of GDP in revenues increases, mainly by setting taxes on foreign trade, undoing the income tax reform, and a new tax amnesty. There are 3 points of cuts in energy and transport subsidies, social spending, CAPEX and public sector wages. However, the government is already negotiating cuts in export taxes for some agricultural sectors and the provinces want a share of the tax on credits and debits.
- The Central Bank will phase out its stock of Leliqs, which had a 133% rate, and use the 100% repo rate for monetary policy from now on, a bet to shift market financing into Treasury bills which pay 104% APR and clean its balance sheet.

FIGURE OF THE MONTH

The value of the USD has increased by

118%

on December 13th, taking it from ARS 363 to 800.

TO BE ALERT

Our high-frequency scrapper has

15.6%

weekly inflation in groceries for the third week of December.

WHAT'S COMING NEXT?

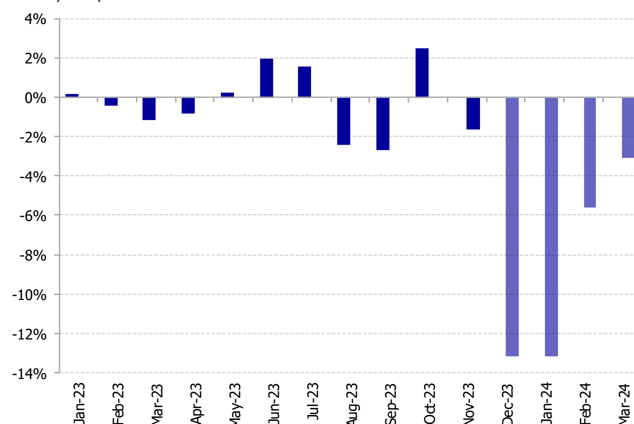
- The worst of the pass-through from the 118% devaluation will be felt over the summer. We are forecasting 25% monthly inflation in December and January and 15% in February, with two-digit figures until June. High-frequency indicators show weekly inflation is running at X%. Of course, expectations, exchange rate policy and adjustments in regulated prices will all play into the next few months' inflation, and the risk of spiraling out of control exists.
- The Central Bank bought USD 1.9 billion reserves after devaluating. Its net reserves are still negative by USD 10 billion, but fresh funds from CAF allowed to cover December's maturity with the IMF and the USD 3.5 billion maturities in January shouldn't be an issue. Net reserves are a key figure to follow over the next months.
- The market does not fully buy into the Central Bank's new 2% monthly crawling peg, with dollar futures for January priced at ARS 852 (+4.7%) and February's at 903 (+6%). However, investors are piling into the Treasury's X18E4 and S18E4 bills, which pay 8.7% monthly rates, betting on a new period of carry-trade.
- The government has announced public hearings on electricity and gas bills in January, the first step to cutting subsidies. Minister Caputo intends to cut economic subsidies (which also include transport) by 0.7 points of GDP in 2024.

SUMMARY OF MAIN INDICATORS

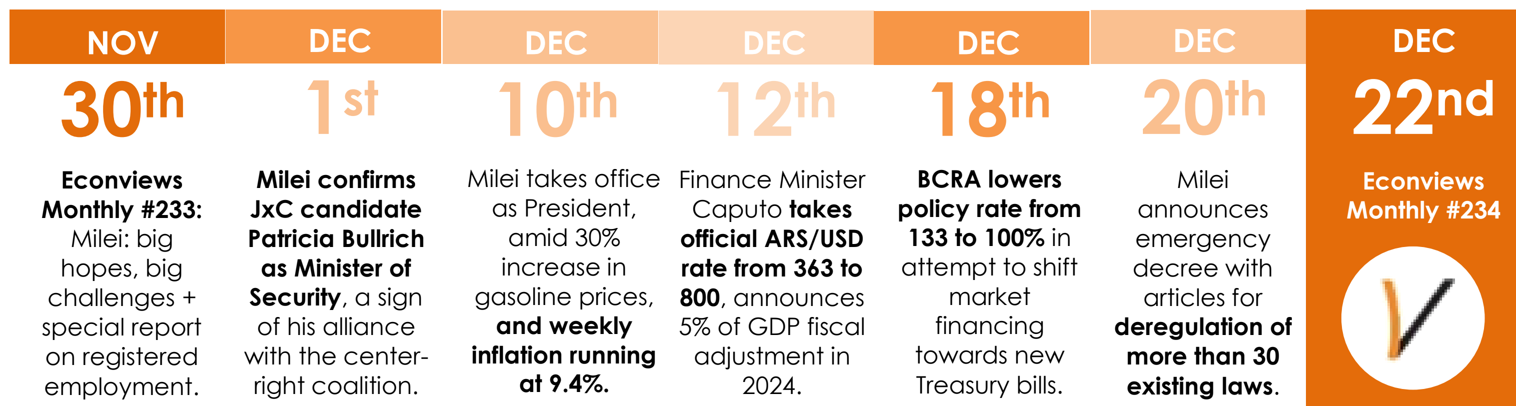
	Last	Previous		Last	Previous
Economic activity			**Financial data**		
Economic activity (MoM s.a.)	-0.1%	-0.1%	Inflation (monthly)	12.8%	8.3%
Consumer confidence (MoM)	5.3%	4.0%	FX spread (21day avg.)	105.4%	150.9%
Industrial activity (MoM s.a.)	-0.3%	0.4%	Country risk (bps 21day avg.)	1,928	2,474
International accounts			**External data**		
Current Account (USD BN)	-6.35	-5.38	Soybean price (per ton, 21day avg.)	484.5	490.8
CB Reserves (USD BN 21day avg.)	21.40	22.93	Brazilian activity (MoM s.a.)	-0.1%	-0.1%
Primary balance (ARS BN)	-210.48	-330.34	Financial Conditions Index	21.3	21.0

Source: Econviews based on multiple sources - working days only

GRAPH OF THE MONTH:



RECENT ECONOMIC DEVELOPMENTS



POLITICS

Javier Milei took office as President of Argentina on December 10th. While he has shown a high degree of improvisation and struggled to fill important cabinet posts, it is clear this is a much more pragmatical version of Milei than the campaign's libertarian outsider. High profile figures from the Macri administration such as Luis Caputo, Patricia Bullrich or Santiago Bausili are in charge of the Ministries of Finance, Security and the Central Bank, respectively. However, Milei has also kept officials from the Massa era in Mining or Customs. His first real test will be passing his "omnibus" fiscal reform and deregulation bill in Congress, which will require support from JxC legislators and opposition governors to reach a majority.

IMF

The Milei administration obtained fresh financing from CAF to cover December's USD 912 million maturity with the Fund, and we believe chances of entering arrears over the 1.9 billion maturity in January are very low, considering the new government has shown a positive dialogue with the IMF. Fund authorities lauded the December 12th devaluation and fiscal adjustment package, considering the measures were "a good foundation to further discussions to bring the existing Fund-supported program back on track". However, if Milei insists on dollarization, this could be cause for new tensions with the IMF.

ECONOMIC ACTIVITY

Activity contracted 0.1% between September and October, although it grew 0.6% in year-on-year terms. The economy has proved remarkably resilient despite the drought and even with a 3% slump in the last two months of the year, the recession will only be about 1% for all of 2023. Manufacturing (-0.3%) did badly in October, but construction (+0.2%) recovered after a two-month fall. Early indicators for November such as steel output (-5.5%) or cement production (-7.5%) show activity worsened. Social security contributions fell 5% year-on-year, showing formal employment's boom may be coming to an end. We expect 2023 to close with a 0.9% GDP contraction, with activity falling another 2% in 2024 due to the fiscal adjustment.

INFLATION

Monthly inflation accelerated again from 8.3% in October to 12.8% in November. Fears of a devaluation outweighed the pegged exchange rate and no adjustments in energy or transport utilities. Healthcare (+15.9%) and food and beverage prices (+15.7%) rose the most, and core inflation is running at 13.4% monthly. Year-on-year, the CPI increased 161%. The combination of a 118% devaluation, phasing out price controls and adjustments in utilities and gasoline will take monthly inflation to 25% in December and January and stay in double-digits until at least June. We are forecasting 225% inflation in 2024, assuming a deceleration after July if the adjustment plan is successful.

MONETARY SECTOR

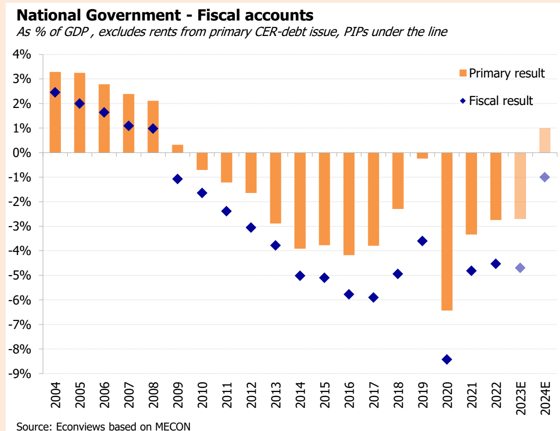
The Central Bank is phasing out Leliqs and will use the repo rate for monetary policy, effectively cutting its policy rate from 133 to 100%. The fixed-term deposit rate was also cut from 133 to 110%. This is a bet to get investors to pile into the Treasury's new Discount Bills, which pay 104% APR or 8.7% monthly, still negative in real terms, but above other available instruments. Importers have been offered 4-year dollar-link bonds at a 5% annual rate, in order to normalize the USD 25 billion excess commercial debt. The strategy appears to be cleaning the BCRA balance sheet, sterilizing pesos through Treasury bills and betting the carry trade will ease pressure on the parallel exchange rates, which are trading at ARS 947, an 18% spread.

FISCAL ACCOUNTS

November's primary deficit stood at ARS 210 billion, accumulating 1.7% of GDP in eleven months of 2023. However, ARS 300 billion in extraordinary incomes came from the tender for the 5G network in Argentina, equal to 0.3% of GDP. Income tax revenues (-32%) are collapsing in year-on-year terms after the reform, while primary spending fell 4.9% thanks to cuts in energy subsidies. The new government's fiscal program aims at a 2-point primary surplus in 2024, but negotiations with governors over the tax on credits and debits and exemptions from export taxes for some agricultural sectors could put a dent in this figure. Overall, we believe the government has chances of reaching a 0.5 to 1-point primary surplus, no small feat.

I. Milei: fast and not so furious

Milei has started his presidential mandate with policy measures that generate some hope. True, he confronts huge challenges, as he received an economy in intensive care with negative international reserves, a grossly overvalued currency, rampant inflation, a large fiscal deficit, and no access to international credit. He is taking steps to correct it.



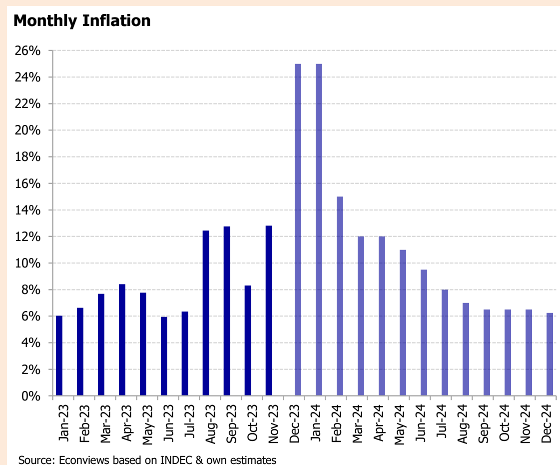
The response has been a stabilization which aims to restore the basic macroeconomic balances. This includes drastically reduce the fiscal imbalance, a devaluation aimed at restoring external competitiveness to increase international reserves, and a gradual elimination of the FX restrictions to improve the supply of basic inputs and favor economic activity.

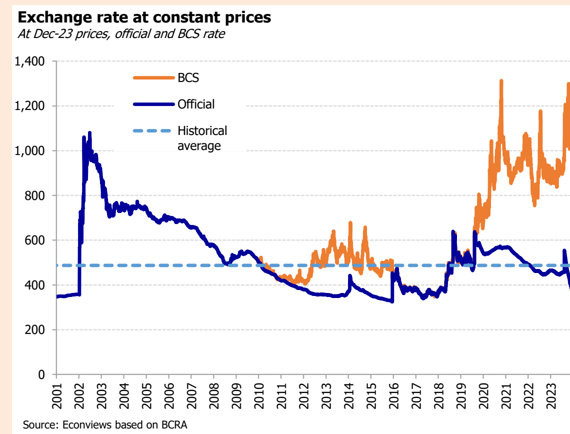
These stabilization policies have been complemented by an emergency decree, whose aim is to introduce some structural reforms to deregulate the economy, and to foster competition and efficiency. It deals with some sacred cows such as the commercial airline business (directly affecting Aerolineas Argentinas), with some aspects of the labor regime and with the health insurance system among others. It goes against crony capitalism, political related business and more. The overarching idea is to reduce costs for consumers and businesses and boost productivity.

The ambitious fiscal adjustment is intended to be the anchor of the overall macroeconomic program, one that will allow at a later stage to reduce inflation and improve the balance of payments. The target is to eliminate the overall fiscal deficit through a reduction in expenditures of around 3.0% of GDP and increases in tax revenues amounting to 2.0% of GDP. It will be a difficult goal to reach, but even if he misses the target by some margin, it will mean a major reduction in the fiscal deficit that can open the door to new access to external lending and for a large reduction in inflation.

On the external front the government started with a bold devaluation, a level that looks reasonable in terms of providing the right incentives to generate a balance of payments surplus. On the other hand, it has been prudent in lifting the FX restrictions and has advanced at a slow pace (too low for some), perhaps because it preferred to err on the prudent side, in its efforts to minimize mistakes that could lead to a loss in reserves.

These policy measures represent the first step of the stabilization/structural reforms of Milei's program, which aims to deal with the emergency. However, these policies will inevitably lead to a temporary increase in inflation, the devaluation and the adjustment in utility rates and other controlled prices will have a one-off effect on the overall price level that will be reflected in very high rates of inflation in December and January (probably in the range of 25 to 30 percent per month). The main question is whether these decisions will lead simply to a one-time effect on the price level followed by a gradual drop in inflation between February and April or if instead the one-time increase will permanent effects as it happened in August after the 20% devaluation when inflation increased from the 6 to 7 percent range to almost 12 percent thereafter.





The government was also aggressive on external front, as it devalued the currency to 800 pesos, in what it seems a clear overshooting, a decision that might imply a little more inflation but will help the go lower interest rates. The idea is to initially maintain a devaluation of 2% per month, though it can only sustain it for a short while. Otherwise, inflation will erode competitiveness and will require a new step devaluation, a risky exercise, given the pain that inflicts through inflation. We thus expect that sooner rather than later the Central Bank will adopt a more aggressive crawling peg, probably at around 8 or 9 percent per month. In the meantime, it has taken a risky and controversial decision: to lower the policy interest rates. The reasons underlying this decision remain unclear, though at this stage it seems related to erode the real value of the debt in times of high inflation.

Milei has surprised most of us. He has been tough on fiscal and exchange rate policies and prudent on the monetary side, correcting some of the mistakes that Macri made in 2015. But there are big challenges ahead. He needs Congress to pass the necessary laws, especially taxation issues, and to maintain popular support during the initial difficult parts of the adjustment process.

Milei has started much better than many of had expected. During the campaign he built a reputation of being tempestuous, aggressive, and intolerant, and of taking extreme position in international relations and regarding the traditional political leaders (what he called “la casta”). However, he displayed a very different attitude since he was elected. He has been listening instead of shouting, he has shown moderation in many of his decisions, and even changed some of the appointments he made at the outset in order to gain political allies or to get people with more experience and expertise. In spite of the moderation, he is moving forward at a rapid pace on many fronts, and challenging some sacred cows which he is trying to get rid of.

Milei faces major challenges. He is now taking advantage of the support from the popular vote and the honeymoon period to move forward with many of the policy measures. The strategy is different from Macri’s one as Milei has depicted a gloomy situation from the outset in order to pave the way for far reaching policy measures and move quickly on the fiscal and the structural reforms, while he is moving more gradually on the monetary front. He is still very vulnerable in Congress as he is far from having a majority in the lower house and in the Senate, which means that he could face uphill challenges in there.

The challenges remain huge, and it is unclear whether he will be able to deliver on his promises and maintain the momentum. The real test will come when he starts to face difficulties and we will need to see how he deals with it. On the whole, however, we are still hopeful that his mandate could mark a turning point in which Argentina can finally move away from populist policies.

II. Economic outlook for 2024: a year to change gears

The year is ending, and with it, a government that has left more harm than good. At Econviews, we have repeatedly examined Alberto Fernández's macroeconomic legacy, now it's time to focus on our expectations for the next year. For this reason, we've organized the following report into six key areas. We'll explore them to gain a deeper understanding of the policies announced during the first two weeks of Milei's government, while also analyzing the potential trajectory of the economy in the coming months.

Fiscal shock

Milei's economic team recognizes fiscal imbalances as the primary cause of many macroeconomic issues, particularly the high inflation rate. So, the fiscal retrenchment was the chief policy announcement and is for the time being the main credibility anchor.

Starting with a 3% primary deficit (excluding the Income Tax reform, prepaid taxes in 2023, and the overcoming drought), the government aims to increase revenues by 2.2 percentage points and cut spending by 3 p.p. (although the table mentions 2.9 points, the sum of different items is 3.2). This is intended to achieve a 2.1% GDP primary surplus. Subtracting 2 points for interest payments would lead to a return to fiscal balance after 16 years. Econviews projects a surplus just above 1%, which is a good outcome, nonetheless.

Chainsaw effect. While the government plans to reduce transfers to provinces by 0.5 points, we believe they overestimate their political capital to carry out this adjustment. A cut of 0.1% seems more reasonable. Regarding adjustments in pensions, we also think that a reduction of 0.4 is overly optimistic, and a more logical approach would be to cut it by 10 basis points. Another crucial aspect involves social assistance programs, with an estimated cut of 0.4%. Given the current poverty rate in children (56%), an increase in the amount of the 'Child allowance' program has already been implemented. This has a fiscal cost of 0.2 points. For capital expenditures and energy subsidies, we anticipate cuts of 0.7% of GDP in both cases, in line with the Ministry of Economy's projections.

Increased tax pressure. We believe the potential revenue of the new PAIS tax on dollar purchases and export duties is much more than 1.3 points of GDP. With a 25% higher real exchange rate, the tax burden on foreign trade in relation to GDP could rise by about 2 points, enough to address over two-thirds of the primary deficit. There will also probably be a reversion in the last income tax modification, leading to a revenue increase of 0.4% of GDP. This will be an instrument of the national government to negotiate with governors in exchange for their support in Congress.

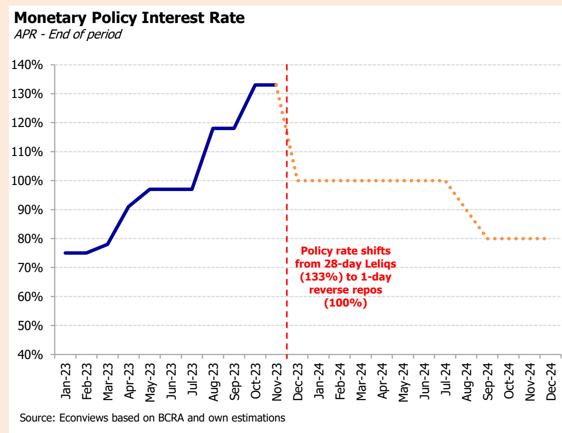
2024 Fiscal program
Changes in revenues and spending as a % of GDP

	Change vs. 2023	
	Ministry of Economy	Econviews
2023 primary result	**-3.0%**	**-3.4%**
Income tax reform	-0.4%	-0.4%
Export duty advances	-0.3%	-0.3%
Post-drought recovery	0.7%	1.3%
2024 primary result starting point	**-3.0%**	**-2.8%**
Increase in revenues	2.2%	2.3%
PAIS tax on dollar purchases (17.5%)	0.8%	1.2%
Increase in export duties (15%)	0.5%	0.9%
Reverting income tax reform	0.4%	0.4%
Personal assets tax + tax amnesty	0.5%	0.5%
Less revenues due to recession		-0.8%
Cuts in spending	2.9%	1.6%
Pensions	0.4%	0.1%
Transfers to provinces	0.5%	0.1%
Economic subsidies (energy + transport	0.7%	0.7%
CAPEX	0.7%	0.7%
Social programs	0.4%	-0.2%
OPEX	0.5%	0.2%
Unspecified increase in expenses	-0.3%	
2024E primary result	2.1%	1.1%

Source: Econviews based on Min. of Economy

Risky monetary approach

The new monetary scheme shows several changes compared to the previous one. First, there is a decision to eliminate the leliqs and replace them with Ledes, which means shifting the burden of debt from the Central Bank to the Treasury. This a controversial decision, mainly because it is easier to rollover the Central Bank debt which is only held by banks than the Ledes which are widely held by investors at large. The auctions are going to be more challenging from now on.



The second problem is that the leliqs were an instrument to manage liquidity while the LEDES are designed to finance the Treasury. As a result, the Central Bank loses a key instrument to sterilize a potential excess of money supply. This creates a confusing situation in which it remains unclear who will run monetary policy. It is a clear blow to Central Bank independence, especially if the Central Bank does not set the policy rate (the rate on reverse repos) independently of the Treasury.

This operation involves a shift in the ownership of debt. What were previously liabilities of the Central Bank (Leliqs) will now be debt of the Treasury (Ledes). As long as the pesos received by the Treasury return to the BCRA (either through deposits or debt repurchases as announced), this movement is not expansionary in monetary terms. All of this implies that the Central Bank largely loses control of liquidity, which now falls into the hands of the Treasury.

Of course, the Central Bank can resort to the one-day reverse repos as the new policy instrument. If it wants to do that, the reasonable thing to do was to replace the leliqs issuing reverse repos, which was clearly an option, and use the rate on reverse repos as the policy rate. However, replacing the leliqs with Ledes means that to a large extent the control of money supply has been shifted to the Treasury.

The initial signals are worrisome, especially regarding the control of inflation. The Central Bank lowered the Overnight Repo rate from 126% to 100% (8.55% effective monthly), establishing it as the new monetary policy rate in a context in which inflation is likely to rise to around 25% per month. This is a risky move because one of the objectives should have been to try to avoid that this episode is simply a jump in inflation and that 25% does not become the new norm.

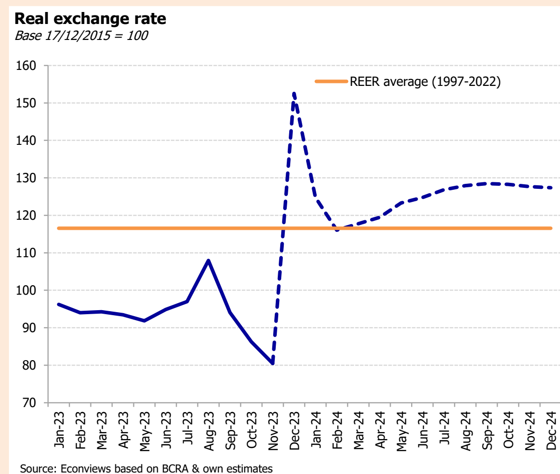
So far, the drop in interest rates has not led to a depreciation of the currency, and the exchange rate has remained stable or even decreased measured in ARS, though this is understandable in December, when the demand for money is seasonally high. The problem is that it starts to decline in January and February. That's where we will see how much this financial repression scheme can withstand.

Foreign exchange regime

On December 13, the Central Bank raised the official exchange rate to ARS 800, resulting in a devaluation of 54% or an increase of 118% in the local price of the USD. This devaluation left the FX 53% above the historical average in real terms. In the coming weeks, we expect this effect to

gradually dissipate, closing December and January at 36% and 11% above the average, respectively.

Starting from December 14, a crawling peg system of 2% per month came into effect. At Econviews, we estimate that this pace can be maintained until the end of January, or at the latest, until mid-February. Subsequently, it will be necessary to devalue at a rate higher than the inflation rate to prevent continued appreciation. Argentina needs a competitive exchange rate to accumulate international reserves. Currently, the PAIS tax (17.5% over import payments) and the 80/20 scheme for exports favor a high exchange rate for imports and exports, currently trading at ARS 945 (imports) and ARS 738 (exports). However, we believe these arrangements may disappear, possibly by the end of next year when exchange rates are unified. This wedge is an important distortion that adds to the fact that firms still cannot pay for imports, new or old ones. The new imports will have to be paid in up to 120 days, resulting in a cash basis surplus these days, enabling the Central Bank to recover some of the reserves lost. In the first two weeks, the government has bought USD 1.9 billion reserves.

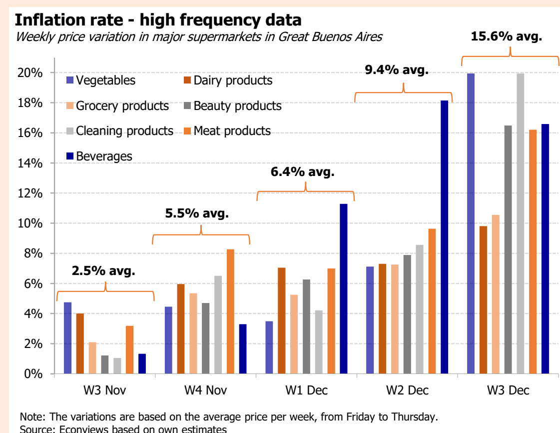


Source: Econviews based on BCRA & own estimates

To reduce a potential demand in the foreign exchange market from import's debt, the BCRA announced the launch of the 'Bond for the Reconstruction of a Free Argentina' (BOPREAL by its Spanish acronym.). Its purpose is to allow importers, with a commercial debt of USD 60,000 M, to purchase a bond in pesos with interest and principal payments in dollars. They also have the option to trade it in the secondary market if they need liquidity before the established maturity. It would be impossible to lift all market restrictions without solving this problem previously, as all this demand would take the exchange rate to very high levels.

Anti-inflationary stabilization program

Since the exchange rate jumped post-PASO, inflation took a significant step up, hovering around 10% monthly. November data, with general inflation at 12.8% and core inflation at 13.4%, appears relatively low compared to our expectations for the coming months. As we've been predicting, the summer is expected to be heated. Our price survey at Econviews reveals rates of 7% and 9% for each the first two weeks of December and even more in the third week (+15%). The FX overshooting will primarily impact the food and beverage category, which has a substantial pass-through effect as well as fuel.



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

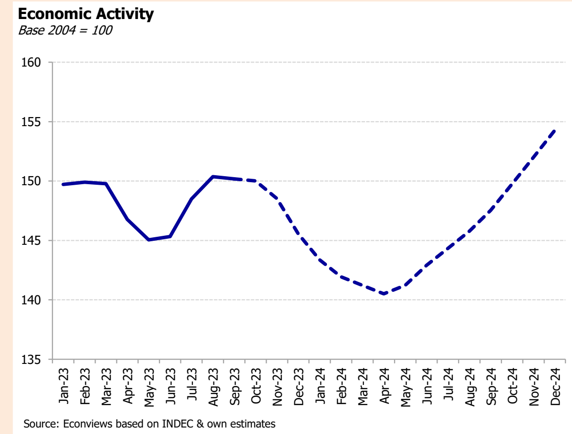
In the upcoming months, inflation will remain high. Added to the pass-through of the devaluation, starting in January or February we will have increases in regulated prices such as utilities, transportation, communications, and healthcare. Once all these effects end and relative prices are re-aligned, we think that inflation could enter a downward path. In the last months of the year, it is possible to reach monthly figures of about 6%.

If as expected inertia will make it difficult to reduce inflation below some underlying rate (say around 8% per month), at one point it will be necessary to put in place a stabilization program. There are several alternatives which could be based on the Austral or the Israeli Plan (both

1985). Brazil's Plano Real of 1984 or the 1991 convertibility plan in Argentina. And of course, one cannot rule out dollarization.

Economic contraction

We expect the real economy to suffer in the first half of the year due to rising inflation, leading to a decline in real wages. We estimate an average drop in consumption and in investment although we expect a considerable recovery of exports. After overcoming the 2023 drought, agriculture will work in favor, but it won't be sufficient for economic expansion. Negative statistical carryover is also a drawback, so we anticipate a 2% contraction in GDP in 2024.



Employment will feel the slowdown. Considering that private employment remains stagnant, and, at best, public employment will not grow, but may decrease. The economic contraction will translate into an increase in low-quality and informal jobs until the economy shows signs of recovery, possibly in the last quarter of the year. We also anticipate an increase in the unemployment rate, reaching nearly 8.5% by the end of the year.

Social assistance programs

Social assistance programs are under scrutiny. Although one of the initial measures was to increase funds transferred to families in vulnerable situations, as we've already mentioned. Child Allowance (AUH) and family allowance, the most important programs, directly impact 9 million children, according to the latest data published by ANSES. The government has initiated an audit of all existing plans, which will be conducted not only regarding beneficiaries but also concerning the social organizations that typically act as intermediaries. This way, the government aims to break away from old patterns of populist policies.

Social assistance programs

December-2023

	Beneficiaries (qty)	Income (AR$)
Child Allowance*	4,224,805	20,661
Pregnancy Allowance	65,889	20,661
Family Allowance	4,780,635	20,661
Food stamps*	2,400,625	51,750
Back to work	1,273,424	78,000
Continous education	1,721,470	20,000

Note: * families with two children

Source: Econviews based on ANSES

In summary, the upcoming year appears to be a period of intense reforms spanning various sectors, from the legal domain to key areas such as labor, foreign trade, mining, the energy sector, and bioeconomy. The newly inaugurated president has outlined his approach through an Executive Decree titled "Foundations for the Reconstruction of the Argentine Economy," signaling his intent to amend laws to promote economic openness and limit state intervention in the private sector. Considering this outlook, 2024 emerges as a year filled with changes and new directions for the country. We remain hopeful, but not naively hopeful. The road will be tough in both political and economic grounds.

Base Scenario

	2019	2020	2021	2022 E	2023 E	2024 E
Inflation (eop)	53.8%	36.1%	50.9%	94.8%	210.3%	225.0%
Exchange rate ARS/USD (eop)	59.9	84.1	102.8	177.1	809.4	2,226.0
Exchange rate ARS/USD (eop, YoY)	58.4%	40.5%	22.1%	72.4%	356.9%	175.0%
Real exchange rate ARS/USD (eop, Dec-01=100)	151.7	158.6	137.5	129.8	198.2	172.7
Paralell exchange rate ARS/USD (eop)	74.6	140.3	203.1	340.8	1,052.2	2,226.0
Spread with official exchange rate (eop)	24.6%	66.8%	97.7%	92.4%	30.0%	0.0%
Gross reserves (USD billion, eop)	44.8	39.4	39.7	44.9	24.3	36.3
Net international reserves (USD billion, eop)	12.6	3.8	2.3	7.7	-10.0	2.0
Policy rate (eop)	55.0%	38.0%	38.0%	75.0%	100.0%	80.0%
GDP (YoY)	-2.0%	-9.9%	10.7%	5.0%	-0.9%	-2.0%
Formal wages in real terms (aop, YoY)	-6.0%	-1.9%	0.4%	0.3%	-2.0%	-4.0%
Primary result (% GDP)*	-0.2%	-6.4%	-3.3%	-2.7%	-2.6%	1.3%
Fiscal result (% GDP)*	-3.6%	-8.4%	-4.8%	-4.1%	-4.6%	-0.7%
EMBI Argentina (spread in bps, eop)	1,770	1,372	1,703	2,196	1,800	1,200
Public net debt (% GDP)	43.6%	52.7%	45.5%	46.1%	47.2%	48.2%
Current account (% GDP)	-0.8%	0.7%	1.4%	-0.7%	-2.8%	1.5%

Source: EconViews

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

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