May 30th 2024

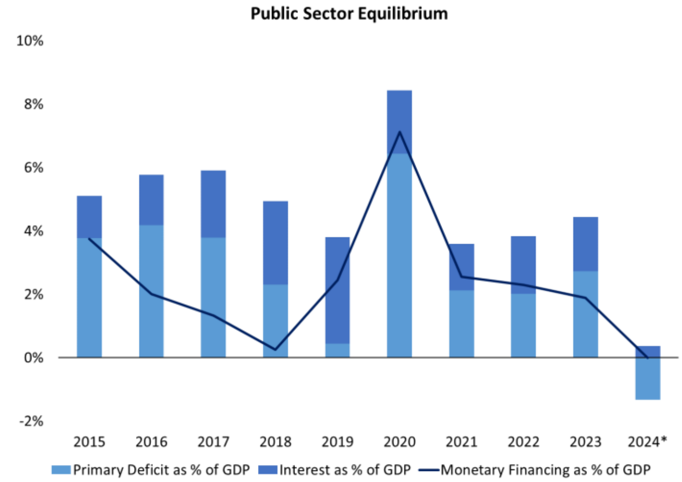
Notes on the Current Macroeconomic Framework

In just 6 months of government, the macroeconomic framework made almost a complete 180 degree turn. The "almost" is due to significant issues related to FX policy: the currency controls were maintained, and the use of an exchange rate anchor persisted. FX controls are a fundamental part of the strategy to reduce remunerated liabilities of the Central Bank, and the exchange rate anchor, with a monthly crawling peg of 2%, is one of the pillars of disinflation. When will it be possible to lift the “cepo”? Will the exchange rate float at some point? We will break it down step by step.

Fiscal Policy

The main shift in economic policy lies within the new fiscal path. During the Fernandez administration, the primary fiscal deficit averaged 3.3% of GDP. How was this imbalance financed? Essentially through the Central Bank. As seen in the graph below, the Treasury year by year financed the deficit by printing money, in an environment of deep demonetization. In other words, during the previous administration, the monetary base averaged 7% of GDP, while Central Bank issuance to finance the Treasury accumulated nearly 14% of GDP (or 10% if we exclude the circumstantial needs caused by the pandemic). Cutting off the money printing at its root completely changed the macroeconomic framework. Ending the huge fiscal dominance was a necessary (but not sufficient) condition for stability, and the current government has achieved it with surprising speed.

To put into perspective these spending cuts, this drop in primary spending was the largest in three decades for a first quarter. Revenues fell “only” 5% year-on-year thanks to the PAIS tax, while primary spending plummeted 24%, resulting in an unexpected primary surplus of 0.6% of GDP in the first 4 months of the year. In percentage terms, the biggest adjustment was in infrastructure projects and provincial budgets. However, to explain the large surplus, given its magnitude, one must also take into account the reduction in pensions and energy subsidies.



Source: Sekoia Research based on Ministry of Economy and Central Bank.

Projecting the fiscal dynamics for the rest of the year, the government could achieve the desired financial surplus. However, objectively speaking, projecting the current dynamics is not entirely accurate. The decline in the inflation rate will act contrary to the current strategy. From now, only fiscal cuts and/or the “Bases” Law remain. The “Bases” Law is welcome in terms of progressivity as it would bring the reform of the Income Tax, which would increase the revenue from this tax by 0.5% of GDP, according to the Congressional Budget Office. Nevertheless, this new law does not fundamentally change the fiscal dynamics in the short term. The capital repatriation chapter included in the new legislation could add some additional revenue, which would be welcome, but difficult to estimate.

As such, within the fiscal dynamics it's important to highlight the PAIS tax. This tax will likely account for almost 2% of GDP in terms of revenue in 2024. Without the PAIS tax, the financial surplus would disappear, but the numbers, at first glance would still remain close to primary balance. Additionally, it should be considered that a slight economic recovery would partially help to restore tax revenues associated with economic activity.

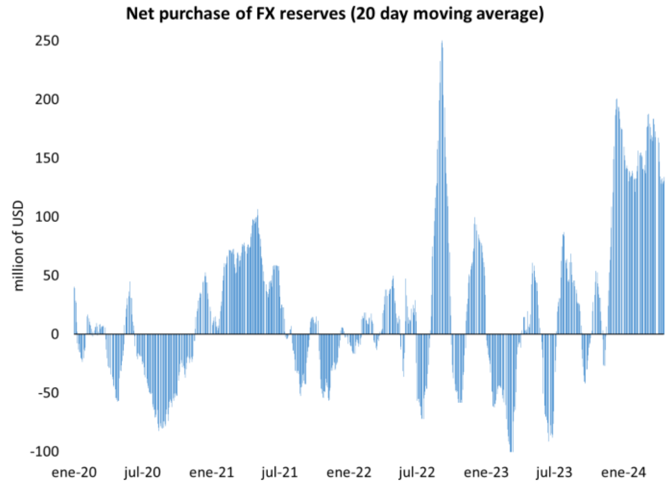
The spending cuts have direct implications for the balance sheet health of the Central Bank. When the monetization of the deficit stopped, the Central Bank stopped issuing unbacked monetary liabilities. This is the main and sustainable path to restore the monetary authority and, consequently, the currency's stability. The government, taking advantage of the FX controls, was able to dilute the Central Bank's liabilities with negative real rates, especially in the early months. But clearly, this has its own limits.

On the other hand, the Central Bank has also reduced its interest-bearing liabilities, but at the expense of increasing Treasury liabilities. Essentially, part of the government's strategy was to exchange Central Bank debt for Treasury debt. We do not see a significant problem with this, the relevant issue for the Central Bank's recovery is to end fiscal dominance.

In summary, the government implemented a somewhat rough fiscal adjustment, but it didn't have many other tools. Even considering the weight of the PAIS tax and the effect of inflationary dilution, the fiscal job was noteworthy. What was the alternative to the severe adjustment? Adjusting slightly less and financing part of the transition with monetary issuance? Looking at the inflationary dynamics of November and December 2023 (see PriceStats graph), it's not at all clear that this path would have been less painful in social terms.

The Exchange Rate and the External Sector

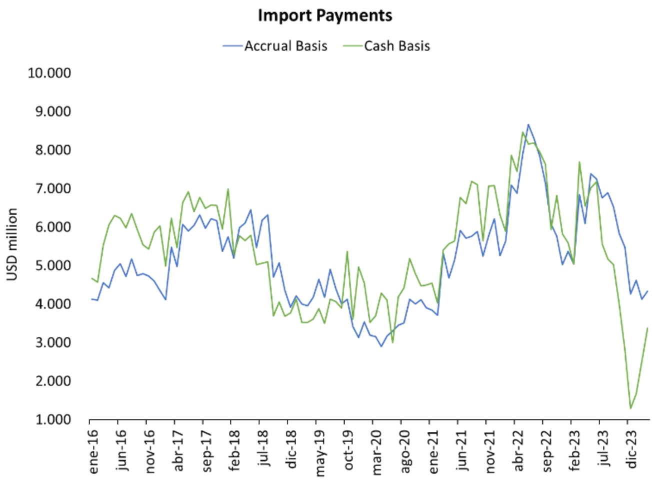
Regarding the Central Bank, the most noteworthy aspect undoubtedly has been the accumulation of reserves. Purchases have reached USD 14 billion so far this year. This positive data hides some shades. Firstly, the recession helped greatly to contain imports demand. Similarly, as a result of the brutal exchange rate gap during 2023, many importers accumulated stocks, reducing import needs for the beginning of 2024. Secondly, the Central Bank was able to solve the importers' debt problem with the issuance of BOPREAL bonds, which in turn helped sterilize pesos and increase revenue (part of these subscriptions were subject to the PAIS tax). Finally, the accumulation of reserves also occurred due to a very successful measure by the government: postponing import payments by 30, 60, 90, and 120 days due to the lack of reserves upon assuming office (negative USD 11 billion).



Source: Sekoia Research based on Central Bank.

However, as seen in the graph below, the differences between accrued imports and payments made are narrowing as installment payments have expired. Likewise, as activity recovers, imports will grow again. It should be noted that the elasticity of imports is very high in Argentina, and the current administration has taken some measures to normalize and slightly reopen international trade. The big question is: How many reserves will the Central Bank be able to accumulate in the coming months of high export sales, considering the aforementioned facts? We do not have an answer to this question. The harvest, both in price and quantity is good, but not outstanding. Therefore, at the end of the day, the accumulation of reserves will depend on one hand on the pace of activity and import growth, and on the other hand on the dynamics of the exchange rate scheme defined by the government.

A brief observation regarding the agricultural sector: We do not see the sector holding onto stocks. At the moment, the government's exchange rate anchor appears credible, and the agricultural sector is selling stocks. The brief delay of these weeks was mainly due to climatic factors that delayed harvesting.

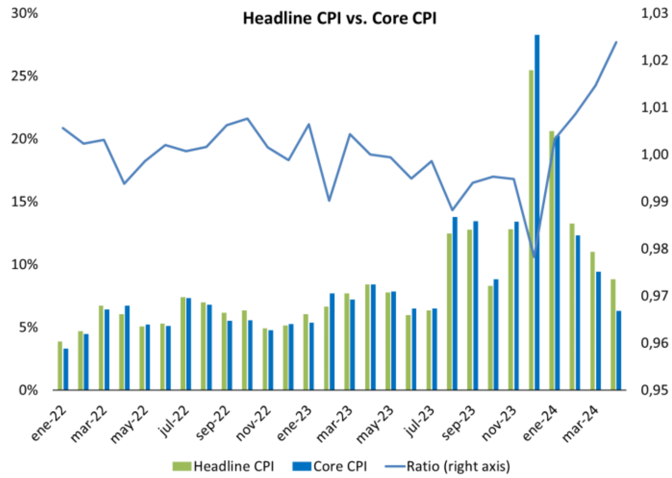


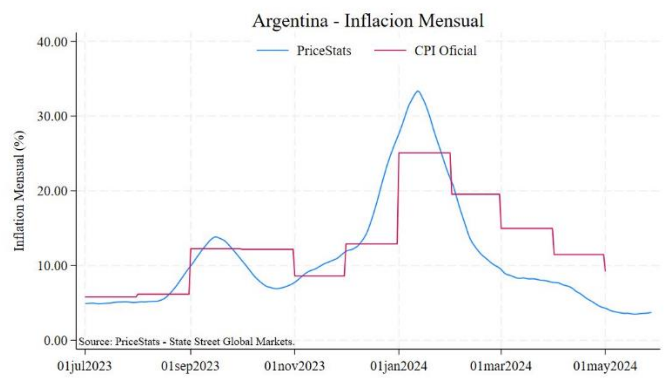
Source: Sekoia Research based on INDEC and Central Bank.

At this point, the government will face a crossroads. With this real exchange rate, it may not be able to repurchase enough reserves to lift the cepo. Furthermore, as past experience makes clear, it is complex to accumulate reserves with FX controls. This can only be solved with financing from abroad and the only potential candidate would be the IMF. Currently, the government is in the midst of negotiations with the entity.

Inflation and the Real Exchange Rate

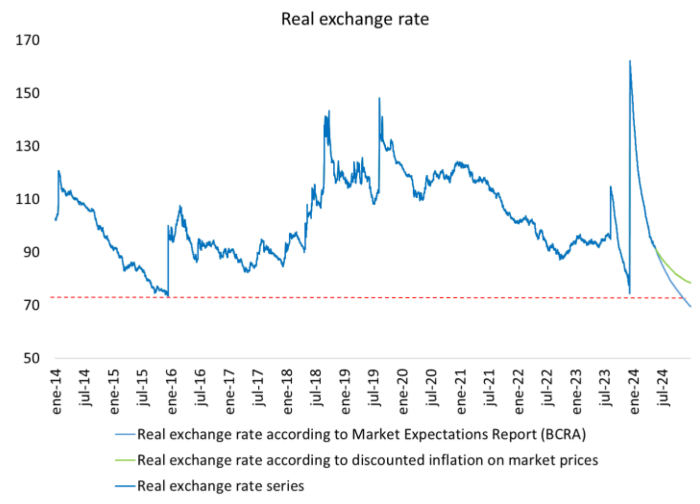
The decrease in inflation is noteworthy, especially because this process occurs in an environment of changes in relative prices. As can be seen in the first graph, core inflation is lower than regulated price inflation because adjustments in tariffs have been made very quickly. Similarly, as shown in the second graph, high-frequency inflation has been decreasing and will likely be around 5% in May, a significant drop. However, achieving a marginal decrease in the inflation rate will become increasingly complex; each point of decline is more difficult to achieve than the previous one. Inflation inertia hampers the process. Additionally, activity indicators for April would indicate that it bottomed out in March, and real wages are gradually recovering. Pensions and allowance (AUH) payments will also begin to recover from next month. Naturally, this complicates the task of disinflation.





Source: Sekoia Research based on INDEC and Price Stats.

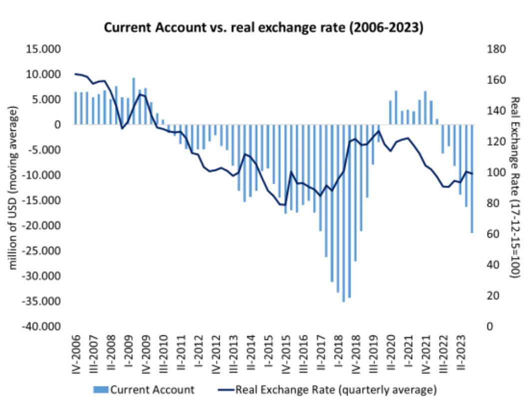
A monthly inflation rate above 2% appreciates the real exchange rate. If this peg rate continues, using the inflation projections from the REM (the implied projections in the CER bonds are slightly more optimistic, but the point still stands), the exchange rate would be at the minimum left by CFK in 2015 by the end of the year, and at the average level of the 1999/2000 period. Those levels could only be sustained for very brief periods. In other words, thinking that Argentina can maintain the same real exchange rate as in the late nineties with 50% more tax pressure than back then (+10% of GDP) seems unlikely to us.



Source: Sekoia Research based on BBG and Central Bank.

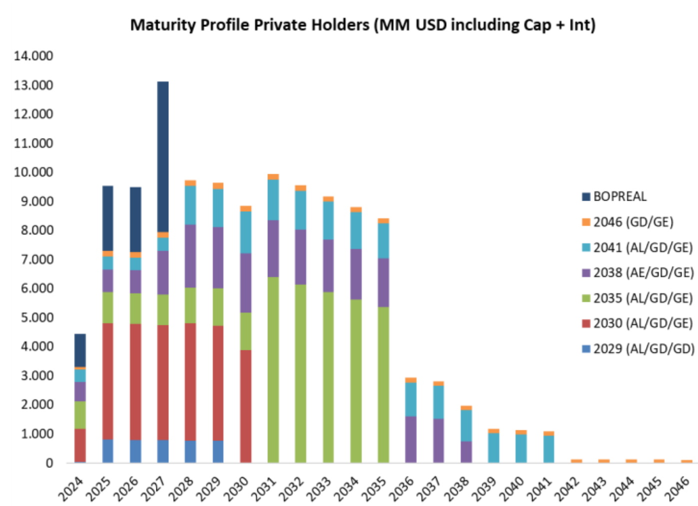
One cannot ask too much of the private sector in regards to exports with an appreciated exchange rate. The last time the country had large current account deficits, it always ended badly. In 2017, the Cambiemos government made the mistake of believing it could finance a current account deficit of 4% to 5% of GDP.

Nevertheless, a country can carry on with a stronger currency if it manages to finance the current account deficit. Argentina cannot finance those levels, because it requires foreign direct investment, which is very low in the country. Mexico, Brazil, Chile, Peru, and Colombia have current account deficits, but they largely finance them with FDI. Until Argentina can attract consistent FDI like its neighbors, it cannot have a high current account deficit and, therefore, should not appreciate the exchange rate too much. Along this line, the government seems interested in attracting capitals from abroad but convincing large investors will be a great challenge after Macri's failed experiment.



Source: Sekoia Research based on INDEC and Central Bank.

Let's look at the upcoming payments of external debt to the private sector. The graph below details the payments of dollar-denominated bonds (including BOPREAL bonds) held by private investors, excluding International Organizations. In 2025 and 2026, the country shall face maturities close to USD 9 billion for each year. It's difficult for the country to meet these payments in cash, regardless of the level of the real exchange rate. However, the level of the real exchange rate, along with fiscal discipline and governance, are the main pillars of the cost of credit. Therefore, these will demonstrate the government's capacity for voluntary rollover in the debt markets.



Source: Sekoia Research based on INDEC and Central Bank.

In summary, we view favorably the chosen fiscal path. It's very tough, but we believe it's almost inevitable. The government's firmness in fiscal discipline is commendable, a necessary condition for the long-awaited economic stability. The monetary path is clearly a transition, diluting the Central Bank's liabilities while the currency controls allow it. Our greatest concern lies in the exchange rate policy.

Thus, two paths open up. The first one is that the economic team believes the country can have a real exchange rate similar to the late 90s or late 2015; we view this with much concern. The second is that the economic team seeks to accumulate more reserves to exit the currency controls and, upon exit, unify and float to a higher real exchange rate at some point in the second half of the year. Perhaps they are thinking that the pass-through of devaluation could be more containable with a lower monthly inflation rate and with more reserves as insurance. Although devaluations come at a high political and social cost, this second path worries us much less than the first for medium-term sustainability.

Kind regards,

Sekoia Research.

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