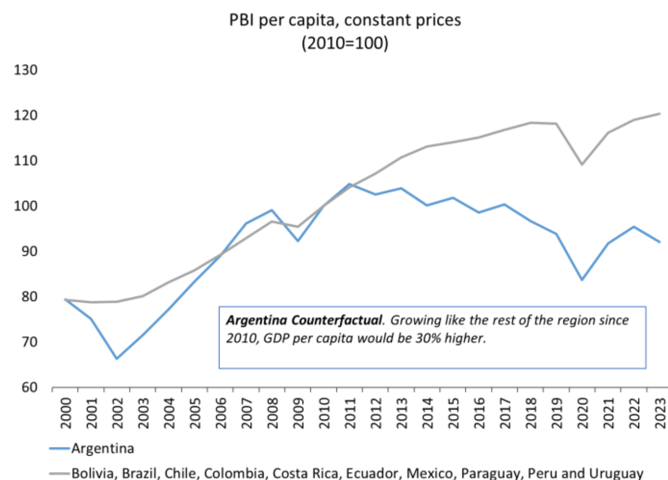
March 8th 2024

Some comments about macroeconomic policy

The Argentine macroeconomy is at a clear turning point. The economic framework in place over the past years, with an unsuccessful attempt for change during the Macri administration, is in transition. The big question is: Where is this transition heading? Before digging into the specifics, we'll provide a brief comment on the macroeconomic scheme that the country needs to leave behind and the mistakes that should not be repeated in economic policy.

Since 2010, Argentina has been a striking case of economic and social failure. Since then, per capita GDP has fallen by 8%, while the region has grown on average by 20%. To grasp the divergence, if Argentina had grown at the regional average from 2010 to the present, the country would be 30% richer per capita today, leading Latin America above Chile and Uruguay (see below). While this exercise is counterfactual, we are not extrapolating the growth rate of South Korea, China or Poland; we are simply extrapolating the regional average. Evidence of this is the similar behavior during the first decade of the 21st century between Argentina and the rest of the region.



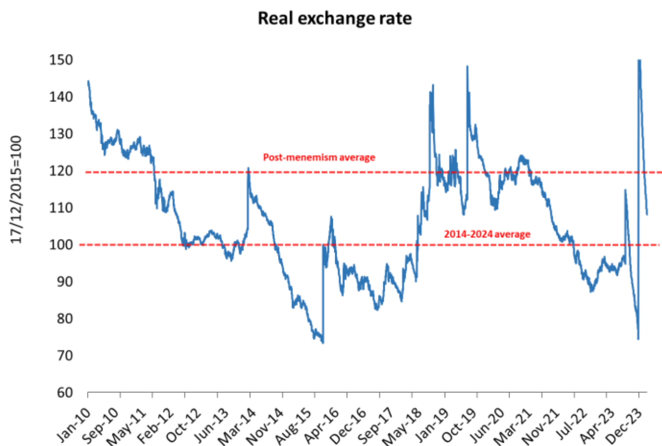
Source: Sekoia Research based on IMF data.

This is not even the worst part, the disastrous macroeconomic dynamics occurred with a simultaneous colossal wasteful of resources. The comparative evolution of international reserves is an excellent indicator of this. Like per capita GDP, the reserves of the Central Bank of Argentina (BCRA) showed a similar trend to the rest of the region between 2000 and 2010. Since then, the region (on average) managed to double its international reserves, while Argentina practically spent all its savings from the previous decade. Continuing the counterfactual exercise, extrapolating the regional behaviour from 2010 to today, the BCRA's reserves would be between 15% and 20% of GDP, levels in line with the rest of the region (excluding Bolivia and Ecuador). A potentially comfortable position in terms of dollars held by the Central Bank.

Source: Sekoia Research based on IMF data.

In summary, the Argentine economy completely decoupled from the regional average since 2010 in terms of growth and, worse still, squandered an incredible amount of resources while the rest of the region saved dollars. Argentina ran out of external credit while the vast majority of the region had and continues to have smooth access to the international capital market. An interesting fact, besides Argentina, the other two countries in the region with very high country risk and low reserves are Bolivia and Ecuador, precisely the countries with fixed exchange rates or dollarization. Fixing the exchange rate does not seem like a good idea. The countries that have done it best in the region allow their exchange rates to float.

Considering this last point, let's move on to the current situation. We see the dynamics of the real exchange rate as the Achilles' heel of the new government's economic program. Although at today's levels, the official exchange rate does not appear undervalued, as seen in the graph until February, it is somewhat below the post-convertibility average and slightly above the average of the last 10 years; but this dynamic raises some questions.



Source: Sekoia Research based on BCRA data.

The abrupt devaluation, as we well know, entails significant social costs. Therefore, a currency jump is usually the last resort. When President Javier Milei took office, a discrete exchange rate jump was entirely inevitable. The new economic team opted for a substantial devaluation to establish a high real exchange rate, setting up a cushion for the future appreciation. We believe this measure was appropriate because in order to deflate the monthly devaluation rate (crawling) must be lower than the inflation rate. At the same time, the crawling rate must be lower than the interest rate to bring in foreign currency. Finally, the new government had to pursue a negative real interest rate to reduce the monetary liabilities resulting from the fiscal mismanagement of the previous administration. How can these three things be achieved simultaneously? With a high initial exchange rate jump. Our humble criticism is not directed at the initial devaluation but rather at the 2% crawling rate thereafter. Given the inflationary inertia, the real exchange rate appreciates very quickly. In our view, the precious and costly cushion is evaporating too rapidly.

Here, inflationary inertia plays a key role. High inflation regimes are complicated. If the country had experienced hyperinflation, the option of reducing liabilities in real terms and fixing the exchange rate might have allowed a rapid reduction of inflation. Fortunately, and thanks to the new government for implementing significant fiscal adjustments, Argentina did not reach this scenario which is the worst in terms of social impact. Therefore, the current scenario involves moving away from a high inflation regime. As empirical evidence shows, and there is plenty in our region, patience is required. The indexing of a significant part of the economy causes past inflation to be the main component of future inflation, and while fiscal adjustment and a change in expectations help reduce inflation, inertia does not disappear. Hence, the exchange rate cannot be fixed because inertia inevitably lags behind. We must be patient and, in that wait, avoid letting the exchange rate lag too quickly.

A current account deficit implies that a country spends more than it produces, thus relying on external savings to finance the excess domestic expenditure. By implementing a significant fiscal adjustment, the excess spending of the public sector disappears thus allowing for a lower real exchange rate compared to a deficit-prone public sector since the external deficit will be lower. However, there is also the private sector. A rapid appreciation of the exchange rate can lead to a balance of payments crisis, even without fiscal problems. In these scenarios, the exchange rate becomes the adjusting variable. An example of this is the final stage of the 90s in Argentina. Due to a significant exchange rate appreciation, brought by the fixation to an increasingly strong dollar worldwide, Argentina experienced a major crisis. This crisis did not occur due to fiscal indiscipline; in fact, in the final stage of the convertibility plan, the public sector showed a primary fiscal balance.

Let's return to the notion of patience. The Decree of Necessity and Urgency (DNU) and other measures promoted by the new government from a micro perspective aim to increase productivity. We find this path more than welcome. However, productivity does not change overnight. As an example, to close the fiscal hole the economic team even had to raise taxes punishing the productivity of the private sector. Therefore, companies cannot be expected to compete with the rest of the world overnight if the exchange rate appreciates. If the chosen path is greater trade openness, much needed after the absurd commercial isolation of the last decade, it cannot occur in an environment of exchange rate appreciation.

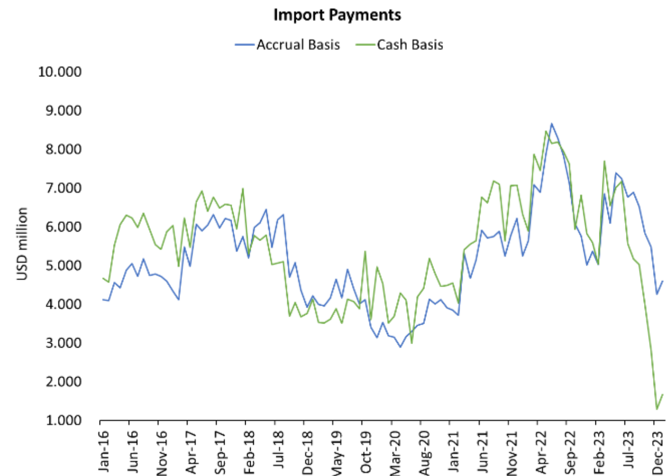
At the end of the day, the current account determines the real exchange rate that an economy can sustain. Countries can have a current account deficit for a long time, as long as it is financed sustainably, namely with Foreign Direct Investment (FDI). These investments take time and are a long-term process. A significant mistake of the Macri government was to think that a flood of money would come to cover the external deficit. During the 2015-2019 period, FDI increased very slightly and did not even finance half of the external deficit. One year, it did not rain enough, and the country ended up with a brutal correction of the real exchange rate and a

recession that led to the government losing the 2019 elections. In recent years, FDI in Argentina has been very low, but due to capital controls, the external deficit to be financed is also low. However, if the intention is to normalize the economy, the current account deficit to be naturally financed will be higher, and FDI will not respond so quickly. Therefore, the real exchange rate should not lag behind.

In other words, from the perspective of foreign investors investing in the real economy in volatile Argentina for the long term is an excessively risky bet. If the current project fails, it is likely that a populist government will return to power in 2027. Therefore, although some new investment projects will surely emerge with the change of government, it is unlikely that Argentina can have a large current account deficit financed with FDI in the short or medium term for all these reasons. Hence, we consider it a mistake not to safeguard the exchange rate cushion. As mentioned, the real exchange rate does not appear overvalued today, but the dynamics of a 2% monthly crawling with strong inflationary inertia is a point of concern.

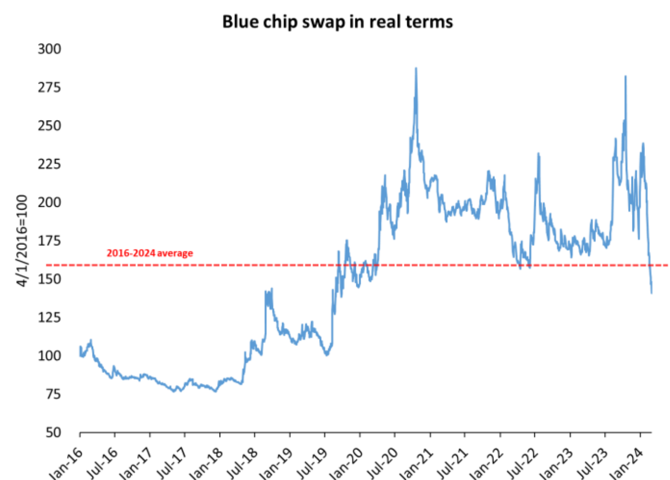
The significant accumulation of reserves since December 2023 has nothing to do with the real exchange rate. It is related to the severe recession we are going through and the import payment scheme established by the government upon taking office. To assess this behavior, approximately USD 7.5 billion were auctioned among the three BOPREAL series, providing relief to the problem of import debt from the previous administration. The registry and the drastic reduction in phantom debt were another significant achievement of the government. However, a communication from the Central Bank in December outlined a payment schedule for new imports depending on the sector. The structure for the payment of most goods after customs clearance was composed of four installments at 30, 60, 90, and 120 days. Thus, if we compare what was accrued and what was paid, the new importers' debt during December and February would be around USD 7 billion, leaving an ambiguous result.

Paying imports in installments was a good measure since the Central Bank was absolutely bankrupt when the new government took office. With the new schedule, time is gained until the harvest. However, as mentioned, this accumulation of reserves says absolutely nothing about the level of the real exchange rate.



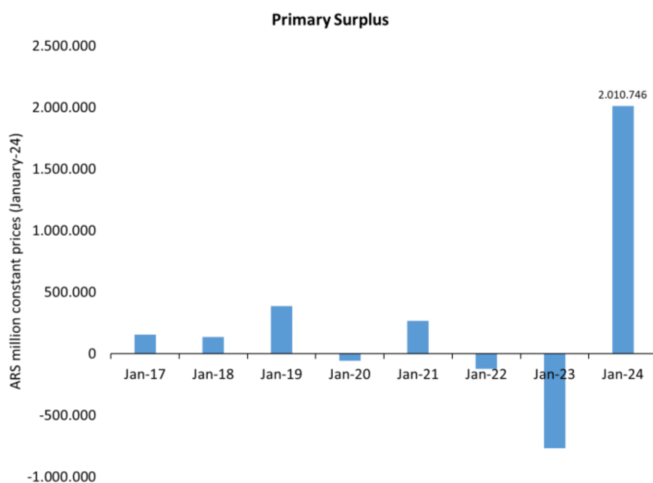
Source: Sekoia Research based on BCRA and INDEC data.

This effect comes into play in the exchange rate gap. Part of the decline in the blue chip swap is due to the fact that 20% of exports are a constant supply in that market, which pulls down the price of all free-market dollars. On the other hand, the drop in the dollar could be understood as a kind of income effect; the decline in activity is so significant that many highly dollarized businesses and households had to sell dollars in these months to cope with the decline in income. In the case of companies, this is also due to the difficulty in selling inventories. Finally, the significant fiscal signal and the favorable change in expectations also contribute to the decline, which was coming from very high levels in real terms due to coverage against a fear of hyperinflation (see chart). It is difficult to weigh the explanatory factors in the decline, like most people, such a marked drop takes us by surprise.



Source: Sekoia Research based on BCRA data.

Where we don't see much room for criticism is in fiscal policy. The government has a clear direction in this regard: to get public finances in order in any way possible. The shift in fiscal direction, as seen in the following historical chart for inflation-adjusted January figures, is decisive. The "Impuesto País" (Country Tax) is a very bad tax, there is no doubt about it. But, in our view, it is better to have a bad tax than to continue financing the treasury through monetary printing in a high inflation regime. The government will now need to work to reach agreements with the Governors and Congress and restore the fiscal chapter, especially the changes to the income tax. Remember that it is the tax with the highest degree of revenue sharing. In terms of fiscal resources, undoubtedly the power balance is favor of the Nation. The Provinces face a lethal combination. The recession disproportionately affects gross income, and inflation directly impacts salary expenses, considering that many provinces increased this spending last year for electoral reasons. More than anyone, the provinces need to reinstate the income tax. The announcement of the pact in May in the President's speech was great news for building bridges with the provinces.



Source: Sekoia research based on MECON data.

We view many aspects of the new economic policy favorably. From a micro perspective, reducing excess regulations and absurd bureaucracy seems like a significant step forward. Removing obstacles and discretionary approvals for imports, a gross source of cruel corruption and economic inefficiency, is a positive move. Prioritizing fiscal correction as the first point of the economic program appears to be a wise decision, even if it involves implementing suboptimal taxes along the way. Only through political agreement with the governors will we transition to a more efficient and progressive tax system. Hence, the resumption of dialogue from last week is great news. While other forms of dialogue would be welcome, we believe the focus should be on the underlying issue. In this regard, we consider Guillermo Franco's role in the government as fundamental to strengthen governance and drive reforms that require broad consensus. Lastly, a significant development that we find excellent is the decision to stop insisting on dollarization. As shown in the first part of the summary, fixing the exchange rate is a bad idea for economies in our region.

However, for the reasons already described, we believe that the real exchange rate is a key variable in this transitional stage. Continuing with the policy of a 2% monthly adjustment by the Central Bank (BCRA) seems to us a major mistake. Inflation will persist, even with adherence to the fiscal program, so patience is required. In this path, abusing the exchange rate lag would be a mistake. We will observe in the coming weeks the path chosen by the BCRA.

We did not mention in this summary the severe recession affecting the economy. We believe that the recession was inevitable at this stage, whether through the chosen path of fiscal adjustment and devaluation or, alternatively, through the nominal chaos in an alternative scenario. Until real wages recover (perhaps by mid-year), we will see a contraction in activity. Therefore, we also consider accelerating the crawling as necessary because it reduces the probability of another exchange rate jump, which would be costly in economic and social terms, significantly impacting governance.

Juan José Battaglia
juan@sekoia.com.uy

Ian Weber
ian@sekoia.com.uy

Manuel Carvalho Ochoa
manuel@sekoia.com.uy

Tomas Mangino
tomasmangino@sekoia.com.uy