ARGENTINA

MAKE OR BREAK

The *Ley Bases* (a set of measures designed to liberalise the economy and, more generally, society) presented by Javier Milei after his inauguration last December was finally adopted at the end of June. As the President's party has no majority in either the Chamber of Deputies or the Senate, the final version was watered down. However, it is a victory for Milei, who is racing against time between an economy sinking into deep recession and the first signs of disinflation. For the government, the fight against inflation justifies the drastic cuts in public spending and the maintenance of a strategy of real exchange rate appreciation. Beyond the spectacular recovery in the public accounts and the trade balance since the start of the year, the question is whether this shock treatment, however useful it may be in controlling inflation, will not weaken the economy more than necessary.

After a six-month battle between the executive and members of parliament, punctuated by demonstrations and riots, Javier Milei's government succeeded in pushing through its reform package (originally 600 articles, since reduced to 238). The government had to make concessions, but emblematic tax measures were passed at third and final reading in the Chamber of Deputies.[1] The outcome of this confrontation was unexpected given the lack of a majority for the presidential party in both houses. Tensions in financial markets have abated somewhat.

However, the calm remains precarious. Argentina's economy is sinking into recession and, although the extreme fiscal restrictions succeeded in reducing the surge in inflation at the end of 2023/ beginning of 2024, the inflationary hydra is far from being defeated. The central bank's foreign exchange reserves, which had recovered in the first few months after Javier Milei's election, have plateaued. Fortunately, the country still enjoys the support of the IMF and China's central bank.

DRASTIC REMEDY

In Q1 2024, GDP contracted by 2.6% q/q after -2.5% in Q4 2023. Year-on-year, the decline was already 5.1%. Activity in the construction sector collapsed at a rate comparable to that seen during the Covid-19 crisis, testifying to the severity of the downturn (see chart 1). Industrial production has fared little better, falling by more than 10% compared with its average level in 2023. With consumer prices soaring (up 115% in cumulative terms between November and April for the official CPI), real wages in Q1 2024 were down 20% year-on-year in the private sector and 30% in the public sector, and the unemployment rate rose to 7.7% from 5.7% in Q4 2023. Without the fall in the household savings rate (retail sales fell by just 2% year-on-year in real terms in Q1 2024) and the very positive contribution of foreign trade in terms of the change in the trade balance, the fall in GDP would have been even more marked.

The deepening recession is the consequence of the contraction in private demand, but also of the drastic cuts in public spending, in line with the promises made by Milei before he was elected. Thus, over the January-April period compared with the same period in 2023, central government primary spending (i.e. spending excluding interest) was cut by 19% in real terms, including -13% for the wage bill and other current expenditure, -20% for social transfers, -47% for transfers to non-central government bodies and -80% for capital expenditure. Only certain transfers to the most deprived were maintained (in real terms).

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	10.4	5.2	-1.6	-4.0	2.5
Inflation, CPI, year average, %	48.4	72.4	133.5	220.0	50.0
General gov. balance / GDP, %	-4.5	-4.3	-4.6	-2.8	-1.0
General gov. debt / GDP, %	80.0	85.5	153.7	55.0	40.0
Current account balance / GDP, %	1.4	-0.7	-3.5	1.4	2.0
External debt / GDP, %	55.0	58.8	113.7	55.0	57.0
Forex reserves, USD bn	39.7	44.6	23.1	30.0	35.0
Forex reserves, in months of imports	6.6	5.5	3.1	3.8	4.2

TABLE 1 e: ESTIMATES & FORECASTS SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ARGENTINA: ACTIVITY INDICATORS (Q4 2019=100)

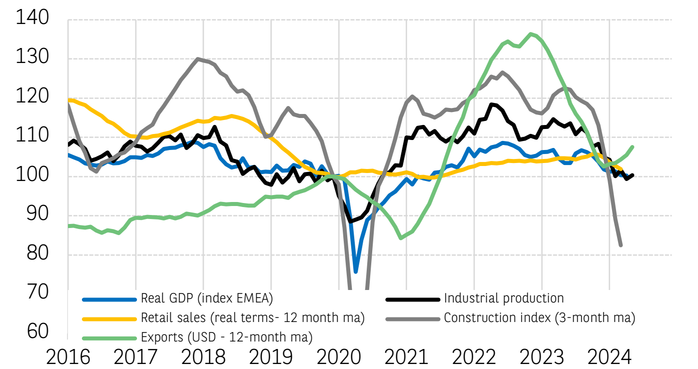

CHART 1 SOURCE: INDEC, ISAC, BNP PARIBAS

PERSISTENTLY LOW FOREIGN EXCHANGE RESERVES

This shock treatment made it possible i) to slow inflation from a double-digit rate of increase from November to March (17% per month on average) to 4.2% in April; ii) to generate a surplus in the central government budget (+1.3% of GDP over the January-April

1 The number of privatisations announced has fallen from around forty to less than a dozen. On the other hand, the lower limit of personal income tax has been lowered to tax monthly salaries from ARS 1.8 m (USD 1,936 at the current official exchange rate) and, conversely, the tax base for wealth tax has been raised from ARS 27 to 100 m (i.e. just over USD 1 million at the current official exchange rate).

period for the primary balance, +0.1% for the total balance) and in the balance of current payments (USD 7.6 bn over January-April compared with a deficit of 4.8 bn over the same period in 2023).

However, this rebalancing has not led to a rebuilding of official foreign exchange reserves, which have plateaued at just over USD 29 bn despite i) the contraction in imports, ii) continued direct investment, and iii) net capital repatriation by non-financial residents (including in the form of conversion of dollars into pesos). The explanation is essentially twofold: i) 20% of export revenues were authorised to be exchanged on the foreign exchange market instead of being converted directly with the central bank (BCRA) ii) the Argentinian authorities repaid, in net terms, USD 4 bn to international financial institutions (other than the IMF) and official bilateral creditors.

As a result, the gap between the main parallel exchange rate (the blue chip swap rate) and the official exchange rate against the US dollar, which had narrowed to 10% at the beginning of April (from 200% at the end of November), has widened to 50%. However, the narrowing of this gap was a key factor in the sharp deceleration in monthly inflation between December and April. When the gap exceeds 50%, the sensitivity of price rises to changes in the exchange rate increases twofold. We could therefore expect inflation to pick up again in the coming months, unless the BCRA decides to completely change its strategy and tighten monetary policy. And that is precisely what it is about to do.

A CONSISTENT MONETARY AND EXCHANGE RATE STRATEGY

Over the last six months, monetary policy had been dictated by the need to put an end to the exponential cost of sterilisation by the BCRA, i.e. the interest paid on notes issued by the latter (LELIQs) to cover the monetary financing of the budget deficit (15.5% of GDP in cumulative terms between 2019 and 2023). Last year, with the yield on LELIQs soaring well above 100%, this burden had reached, according to our estimates, 9% of GDP (compared with 5.1% in 2022 and 2.8% in 2021). It was therefore urgent for the BCRA to ease this constraint, which it did by lowering its main refinancing rate from 133% in mid-December to 40% at present. At the same time, Treasury bills (used for repo transactions) have replaced sterilisation notes on its balance sheet. In total, the cost of sterilisation was reduced to 3.5% of GDP over the first five months of the year.

The monetary authorities have announced that real interest rates will return to positive territory from June, which, all other things being equal, can only increase the cost of sterilisation. However, the sources of money creation for the budget deficit (temporary advances and transfers from the central bank to the Treasury) have completely dried up, and the other Treasury operations that affect changes in the monetary base are now making a negative contribution.

The monetary factors behind inflation are therefore likely to disappear. However, in Argentina, monetary-based inflation is so endemic that controlling the monetary base alone is not enough, even if it is necessary.

ARGENTINA: FOREIGN EXCHANGE RESERVES AND EXCHANGE RATE GAP

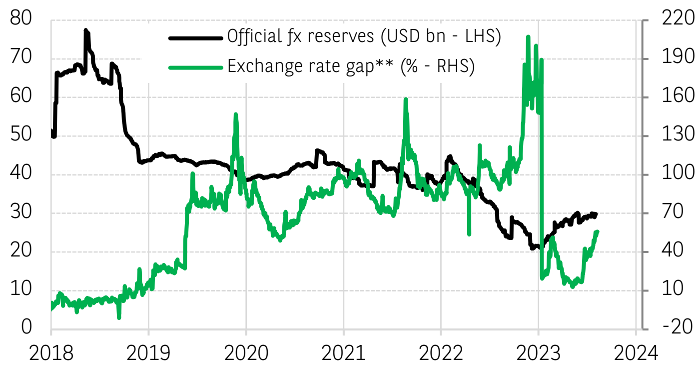

CHART 2

(**) GAP BETWEEN THE BLUE CHIP SWAP RATE AND OFFICIAL USD/ARS
SOURCE: BLOOMBERG, BCRA, BNP PARIBAS

The fight against inflation requires the central bank to keep the rate of depreciation of the official exchange rate as low as possible (the authorities have set it, in agreement with the IMF, at 2% per month against the dollar) in order to make parallel exchange rates converge towards the official exchange rate.

Indeed, the real appreciation of the exchange rate as a means of credibly and sustainably anchoring disinflation expectations is an essential strategy for any commodity-exporting country faced with hyperinflation. Administrative price controls are generally ineffective in balancing external accounts (a "forced" depreciation of the real exchange rate improves the current account balance only marginally) and, above all, are counterproductive for investment and hence growth in the medium term.

The objective of anchoring the real exchange rate accelerates the disinflation process. Over time, however, it needs to be complemented and reinforced by structural reforms to combat monopolies and, more generally, barriers to entry to the goods and services markets. This is the task of Federico Sturzenegger, a former governor of the BCRA (under Mauricio Macri) and current principal economic adviser to Javier Milei, who has been charged with bringing these reforms to fruition. Whether they will be accepted by the population remains to be seen.

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