Emerging Insight

Argentina – A good start

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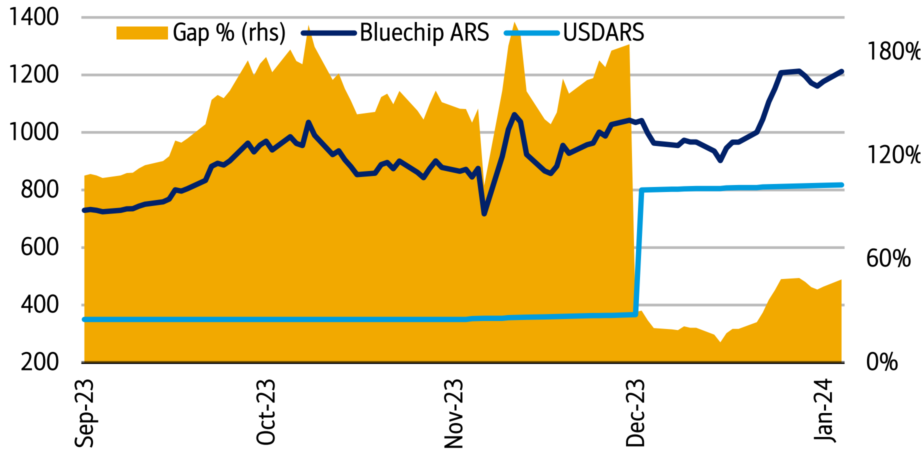
Key takeaways

- The government's positive start: large fiscal adjustment, a strong devaluation, reserves accumulation and IMF agreement.
- Risks: reforms face hurdles in the Congress and courts. Very high inflation and risks of protests to the adjustment.

By Sebastian Rondeau

Chart of the Day: Argentina – ARS, Bluechip (and % gap)
Parallel FX gap dropped to 48% from 180%.



Source: BofA Global Research, Bloomberg

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Argentina: a good start

The new government had a positive start on the macro policies front. It proposed a larger fiscal adjustment than we expected (including revenue measures), a strong devaluation, fast reserves accumulation and an IMF staff level agreement. Capital controls removal is gradual. The reforms proposals are ambitious and are facing hurdles in the Congress and the courts. Challenging inflation dynamics and protests are important risks.

A good start...

The new government had a positive start on the macro policies front. These include a larger fiscal adjustment than we expected (including revenue measures), a strong devaluation, fast reserves accumulation and an IMF staff level agreement. Capital controls removal is gradual. The structural reforms proposals are ambitious and are facing hurdles in the Congress and the courts Omnibus Bill, Mega-Deregulation Decree, FX and prices. Extremely high inflation is challenging, and the big question is the population reaction to the adjustment.

Fixing the twin deficits

The decisive announcements to correct the fiscal deficit and external accounts (FX devaluation) stabilized the financial situation. This explains a bigger bond rally than we expected initially.

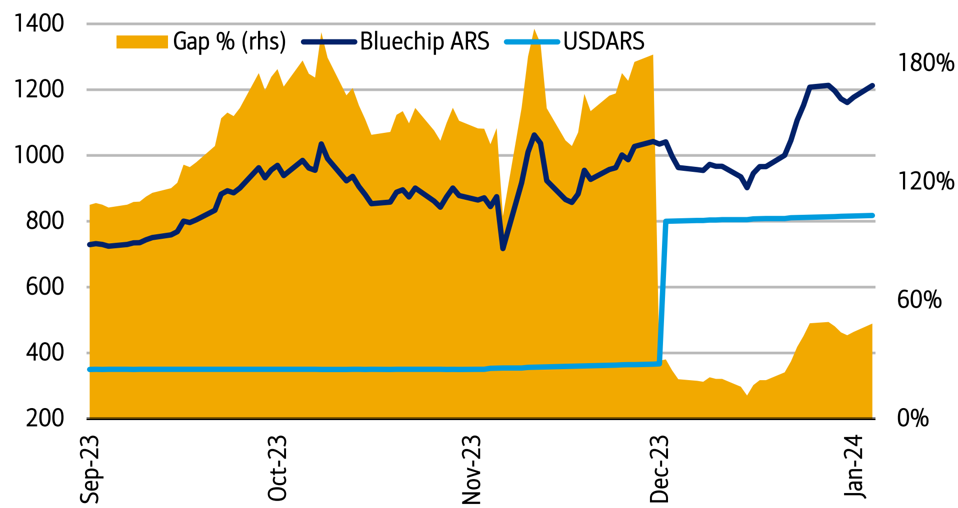
The government announced a balanced budget target involving a 5% of GDP adjustment for 2024, 3% of GDP through spending cuts, 2% revenue measures Emergency package stronger than expected. Remain OW EXD bonds. The government shows determination, and we think at least 70% of the adjustment can be done without congress. Import tax hikes are already in place (0.8% of GDP), we expect the tax amnesty to pass congress (export taxes will like be diluted), and we expect the government to present the reversion of income taxes in coming weeks.

Of course, the fiscal adjustment faces challenges. The energy subsidy cuts (to start in February) face increased energy costs due to the devaluation. And the recession will likely be deep in 1Q (sharp decline seen in early consumption indicators), affecting government revenue. A better harvest should support revenue in 2Q. We forecast a 1% of GDP primary surplus in 2024 (including the tax amnesty). In the medium term, the government should replace tax hikes by more quality spending cuts and increasing formality.

FX devaluation and reserves accumulation.

The ARS devaluation (+120% ARS increase in December) combined with persistent capital controls allowed a strong FX reserves accumulation ($3bn since President Javier Milei took office to $24bn), with $4b FX purchases from BCRA (and a payment out-of-pocket of $1.5bn in USD bonds). This was also allowed by slow allocation of USD to pay

Exhibit 1: ARS, Bluechip (and % GAP)
Parallel FX gap dropped to 48% from 180%.



Source: BofA Global Research, BLoomberg

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old import debts and gradual allocation of USD to new imports (in four monthly installments for most goods).

The fast pace of FX reserves accumulation has a negative side effect: the public sector is increasing peso debt outstanding with the private sector as a result. This and slow ARS depreciation are putting pressure on the parallel FX (gap vs official ARS jumped to 48% from a 12% low, though still down from the 170% in November).

Crawling peg should accelerate by February

FX reserve accumulation should slow down as import payments are relaxed (the first installment of the new import system is due this week) and as the currency appreciates in real terms (still we see another $2bn in BCRA purchases next 30 days). BCRA has depreciated the currency only 2% monthly after the jump despite inflation is running above 20%.

We think BCRA will have to accelerate the depreciation in coming weeks and no later than in February. At this pace, in a month the real exchange rate would go back to the August 2023 peak, which looks like a lower bound for the IMF program in our view. On the flipside, the starting of the soy harvest in April and the IMF disbursements will bring some calm to the FX. BCRA is also offering USD bonds to importers "BOPREAL" (it allocated $1.2bn so far) which also helps sterilizing pesos.

We see the ARS at 1,573 in June and 2,330 in December (and the parallel FX gap dropping to 20% after the harvest). We expect a current account surplus of 1% of GDP this year (from a 4.4% deficit in 2023).

Inflation challenging, but some positive signals

Inflation was 25.5% mom in December, jumping from 12.8% in Nov, the highest since February 1991 (core was 28.3%, food 30%), following the devaluation and price deregulation. In 2023, headline inflation was 211% (core 229%).

We see the Inflation jump partly as a one-off relative price correction following the devaluation and de-regulation. But there is also a persistent component form previous expansionary policies and wide-spread indexation. Relative price corrections pending (e.g. in electricity, natural gas, fuels, transportation, health, education) will weigh on inflation in January-April.

The government is fighting inflation with a large fiscal adjustment and reduction of money printing (the recession will help), but with loose monetary policy (widely negative real interest rates, likely to inflate away the money overhang). There are encouraging signs on core inflation in early January. We forecast inflation at 210% this year (from 205% before). The de-indexation proposal sent to Congress is a necessary condition for a more aggressive disinflation program in our view.

IMF staff level agreement: $4.7bn disbursement and verbal support

Argentina reached a Staff-Level Agreement (SLA) with the IMF and will have access to $4.7bn disbursement (if IMF Board approves it), which exceeds the $3.3bn pending disbursement from November. IMF praised the government ambitious stabilization program including a "large and credible" upfront fiscal adjustment, actions to rebuild reserves, to correct relative prices, and to move to a market-oriented economy.

Fiscal and Reserves Targets.

The government intends to achieve a 2% of GDP primary fiscal surplus in 2024. FX reserves accumulation target is $10bn by end 2024, including the $2.7bn accumulated in December (so a +$7.3bn in 2024). The government is committed to eliminate the multiple FX regime. Authorities seek to end central bank credit to the government and to reduce the peso overhang. FX policy aims at accumulating reserves.

IMF argued that the price and FX corrections will have an inflationary impact and deepen the GDP contraction. But that actions have been successful to limit the crisis, with $3.6bn central bank FX purchases. Disinflation will come gradually.

A new IMF program is possible?

Minister of Economy, Luis Caputo said that they revived the current program given the financial emergency. But that the IMF is open to explore a new program (including the possibility of fresh money) if Argentina is willing to discuss it. He said that Argentina needs to solve its structural problems by itself first (starting with the fiscal deficit addiction).

He added that if the Omnibus bill does not pass congress, they will still seek the fiscal balance, but with tougher measures. The reforms proposals are ambitious but are facing hurdles in the Congress and the courts. The mega de-regulation decree is also suffering some set-backs (a court suspended the labor reform). Also, the national labor union (CGT) announced a national strike against these initiatives for January 24. Milei maintains relatively high popularity, generally above 50% according to polls, despite the devaluation and inflation jump.

News and Views

Brazil: Services Volume increased 0.4% momsa in November

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Brazil Volume of Services increased 0.4% momsa in November, from -0.6% in October. That increase happened after three consecutive negative results. The print was in line with market expectations, though below our forecast of 0.7% momsa. Compared to November 2022, services volume remains at -0.3% yoy. Three out of the five categories registered marginal gains, with Household' Services being the main positive highlight both in annual (5.4% yoy) and in monthly terms (2.2% momsa). While Transportation (-1% momsa) continues to pressure down.

- **To follow:** We expect deceleration in activity throughout the end of 2023. Our preliminary forecast for November´s IBC-Br (Brazilian Central Bank monthly GDP proxy) is a 0.7% momsa decline.

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