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Argentina: on the verge of another crisis?

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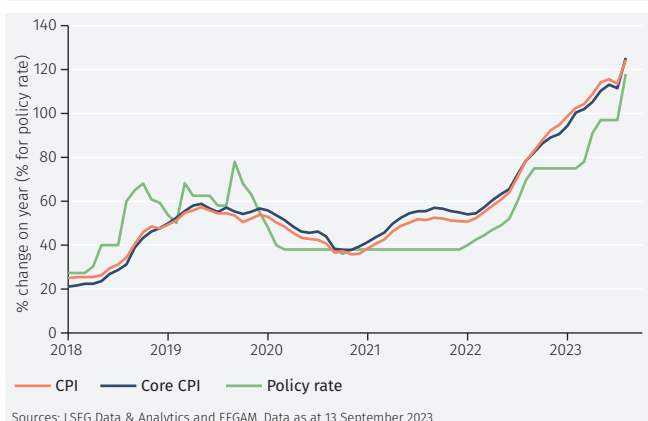
 REGIONAL PORTFOLIO CONSTRUCTION

ARGENTINA: ON THE VERGE OF ANOTHER CRISIS?

Argentina is again in a deep economic crisis. Annual inflation is over 120%, the consolidated fiscal deficit is likely to surpass 10% of GDP and activity is expected to contract by 3% in 2023. The candidates in the coming Presidential election propose very different economic plans. In this edition of *Infocus*, economist Joaquin Thul looks at the roots of Argentina's crisis and the risk of yet another default.

It is no surprise that Argentina is in a deep crisis. Inflation has surpassed 120% year-on-year (see Figure 1) and the consolidated fiscal deficit will exceed 10% of GDP in 2023. A severe drought risks causing a 30% decline in the agricultural crop in the 2022/2023 period, resulting in lower agricultural exports, which represent more than one third of Argentina's total exports. Markets expect Argentina's GDP to contract between 2.5% and 3% in 2023, the weakest among South American economies.

1. Inflation and policy rate



Additionally, Argentina will hold Presidential elections on 22 October. A potential second round between the two first round candidates with the most votes could take place on 19 November.¹ Three candidates will compete for the Presidency: (i) the current Finance Minister Sergio Massa for the incumbent Peronist party (ii) leader of the opposition and former Security Minister Patricia Bullrich, and (iii) Javier Milei, a libertarian economist. The success of the latter in the August primaries came as a surprise given his lack of political background and unorthodox proposals to dollarise the economy and close the central bank. Milei benefited from the general discontent the

population has with the political system and won a third of total votes. According to polls on voting intentions, he is the favourite to win the election.

Regardless of who is elected, the new President will face a difficult economic situation with two main hurdles. Problems with inflation are not new and have as their origin poor fiscal management and lack of central bank independence. Additionally, capital controls have led to the creation of multiple exchange rates and the loss of international reserves, making it difficult to limit the depreciation of the Argentinean peso.

Problem #1: A history of fiscal mismanagement

Argentina ran a primary deficit in every year between 1960 and 1990 and in more than half of the last 30 years.² Given its history of debt defaults, it has been unable to access international debt markets at reasonable conditions to finance spending. Therefore, without resorting to higher taxes, the government reverted to the central bank (BCRA) to finance spending. The BCRA has financed fiscal deficits by printing money or by using international reserves.

These operations would normally be sterilized by issuing domestic debt or increasing banks' reserve requirements to reduce the circulation of additional pesos. The interest paid on these short-term liabilities, called LELIQ, issued by the central bank are part of the government's quasi-fiscal spending and in Argentina represent a large part of the consolidated fiscal deficit (see Figure 2).³

The need to sterilize quasi-fiscal spending has led to a rapid increase in the stock of LELIQ notes since their creation in 2018 to USD 54 billion. This is equivalent to 8% of GDP and more than 70% of all BCRA's current remunerated liabilities. The interest rate on these has increased from 60% in 2018 to close to 120%

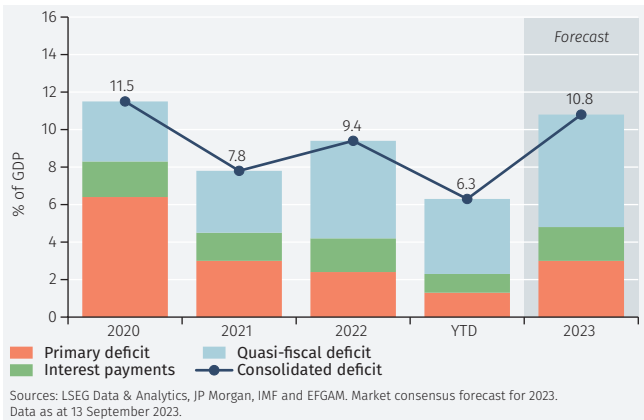
¹ To win in the first round any candidate must receive more than 45% of the votes or receive more than 40% of votes with a 10% lead over the second most voted candidate.

² *Quasi-fiscal deficits: Latin American lessons for South Asia*, Rodriguez, C. (1993).

³ Quasi-fiscal spending refers to operations that result in a net transfer of public resources to the private sector through nonbudget channels (*Manual of Fiscal Transparency*, IMF 2001).

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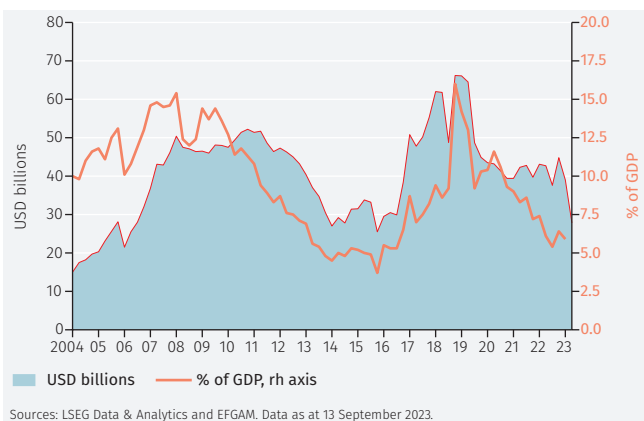
2. Consolidated fiscal deficit



annualised in 2023. Therefore, the large stock of LELIQ in the market, and the high interest rate paid on these, has fuelled expectations of future higher financing needs and additional money printing, further increasing inflation expectations.

An alternative way of financing the quasi-fiscal deficit would be to use international reserves. However, these have declined by 58% since 2018 to less than USD 28 billion, used by the government to prevent a deeper depreciation of the peso (see Figure 3). Net international reserves, which are defined by the IMF as gross reserves minus short-term foreign currency liabilities, fell by over USD 14 billion to minus USD 5.4 billion as at June 2023.⁴

3. Gross international reserves



Problem #2: A weak currency with multiple exchange rates

The use of capital controls and international reserves to limit the depreciation of the currency has not been successful. A parallel unofficial exchange rate has developed, called the *blue dollar*, which has depreciated at a faster rate and currently trades at double the official rate (see Figure 4). In recent years, government initiatives to deter the use of the *blue dollar* and promote exports resulted in the creation of multiple exchange rates to be used by different sectors. At the time of writing this report, Argentina has 16 different exchange rates versus the dollar.

Following the primary elections, Finance Minister Massa announced a devaluation of the peso of 22%, which still fell short of the 60% devaluation included as one of the conditions stipulated in the IMF loan review. Argentina has consistently missed the target goals of that program.

4. Argentinian pesos per US dollar



For many years successive Argentinian governments have implemented export restrictions to control domestic food prices and limit inflation. Additionally, after the economic crisis in 2001 the government adopted a series of subsidies for electricity, gas and water bills, equivalent to 2.3% of GDP. These were introduced as a temporary measure to offset the effects of the sudden devaluation of the peso after abandoning the peg with the US dollar but became permanent since then. All these measures were aimed at limiting the depreciation of the currency and controlling inflation, rather than attempting to tackle its causes.

⁴ Fitch ratings, June 2023.

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Policy options

Javier Milei, the frontrunner in the electoral polls, proposes a full dollarisation of the economy to bring down inflation. While dollarising the economy would theoretically allow for domestic inflation to converge towards that of the US and improve the standing of the country as a destination for foreign investment, it is probably neither necessary nor sufficient to solve Argentina's fiscal problem.

Milei's proposal to dollarise fails to address the reasons behind elevated government spending. Over two-thirds of Argentina's total public spending is attributed to social spending, including social assistance to lower income households, spending in education and healthcare. This non-discretionary spending is difficult to change for any government without large majorities in Congress. Additionally, it also fails to explain how an economy with a shortage of dollars and limited trade links with the US can successfully dollarise.⁵

An alternative solution would involve a stabilisation plan that aims to reduce fiscal spending and bring inflation down without the loss of monetary autonomy that would follow a full dollarisation of the economy.⁶

A stabilisation plan should involve consolidating public finances, harmonising the exchange rate regime, removing subsidies on utilities and export tariffs and limiting BCRA interventions. This would prevent the central bank from financing government deficits while also helping to strengthen the central bank's balance sheet and enhance its independence. This would take time to implement but would send a strong signal to external investors that Argentina is committed to solving its economic problems. All elements of the plan could be implemented without the need to dollarise. The plan could also seek to raise taxes, although that could prove unpopular from a political point of view.

A similar plan was implemented successfully in Israel in 1985, during the government of Shimon Peres, which managed to bring inflation down from 450% to under 20% in less than two years. One of the keys to that plan was an agreement between political parties, the central bank and labour unions on the long-term benefits of following such an approach, something that today in Argentina looks difficult to achieve.

An alternative solution would probably be more damaging both socially and economically. The unsustainable balance between low reserves, controlled exchanged rates, high inflation and high government deficits is likely to end with another default of at least part of its existing obligations and an accelerated devaluation of the currency that will worsen the inflation situation.

Conclusion

Argentina is again facing a serious economic crisis. Years of poor economic management and political disputes mean the country is back on the verge of hyperinflation. Such problems are not new and have their roots in elevated government spending and lack of central bank independence. The preferred solution would see implementation of a stabilisation plan that would reverse some of the existing policies and promote growth. However, ahead of the Presidential elections in October, none of the candidates have offered a credible plan to solve the crisis. The economic scenario is therefore likely to get worse before it starts to improve and, as a result, asset prices in Argentina will remain volatile ahead of the election. Unless there is a clear shift in attitude towards a negotiated solution between parties, a deep crisis remains the most likely outcome.

⁵ US purchases less than 7% of Argentina's total exports, the fourth largest destination after Brazil, China and the EU. As a comparison, when Ecuador dollarised its economy in 2000, exports to the US represented almost 40% of total exports.

⁶ It is beyond the scope of this report to make a full analysis of the costs and benefits of a full dollarisation of an economy. However, the loss of monetary independence can become a hindrance for a country when the economy of the issuing country is at a different point in the cycle than the dollarised economy. Additionally, flexible exchange rates can also help absorb negative external shocks.

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