MONTHLY REPORT

ECONVIEWS

ECONOMÍA Y FINANZAS

March 2021

Issue #201

The **efforts to avoid adjustment might work** until the elections, **and then what?**

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Life in times of the **CEPO**

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THE MONTH AT A GLANCE

RECENT DEVELOPMENTS

- With an USD 1.9 trillion relief bill and full vaccination as early as June, the US is set for a stronger than expected recovery in 2021. International markets remain bullish, but inflation anxiety is on the rise even if actual inflation rates have not shown a sharp increase so far. Brazil's problems complicate Argentina's objective of appreciating the real exchange rate. The Brazilian Real shot up to 5.8 per dollar last week as Bolsonaro clashes with top economist Guedes over reforms, fiscal adjustment, and intervention in key public companies such as Petrobras. A weaker BRL puts pressure on the ARS. Market expectations on growth have decreased in Brazil have dropped by 20 bps to 3.23% for 2021. Central Bank of Brazil raised rates from 2% to 2.75%
- The government is trying to increase the corporate income tax rate to 35% from 30% for companies making over 2.1 million pesos a year. This not only increases taxation but also unwinds the tax reform of 2017 under which income tax would have gone down to 25%. Congress recently passed a special stimulus package for construction, which includes a tax amnesty and the exemption or deferral of taxes until 2023.
- YPF rose the price of oil this week another 7% on average and has scheduled further hikes for April and May but may freeze prices afterwards in line with the electoral agenda.

FIGURE OF THE MONTH

Sovereign bonds under foreign legislation are yielding

17.2%

on average, with doubts about Argentina regaining access to credit in the medium term

TO BE ALERT

On a 7-day average new Covid cases in Argentina grew

7.8%

over the last week: a new outbreak poses the largest risk to the economic recovery

WHAT'S COMING NEXT?

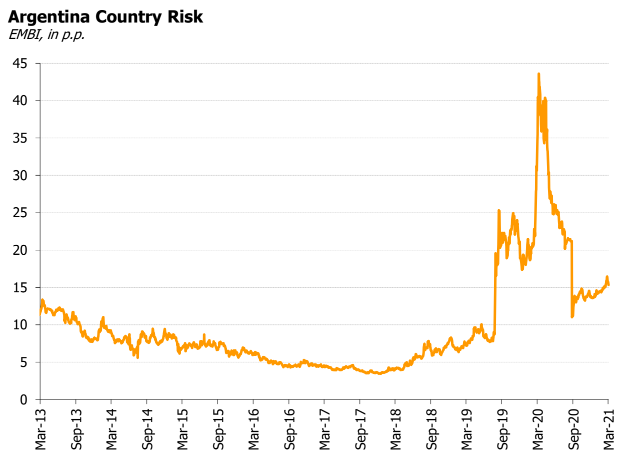
- The idea that a new arrangement with the International Monetary Fund will have to wait until after the October midterms is now widely accepted. Minister Guzmán is set to meet with IMF chair Kristalina Georgieva in late March. We also believe that the Government will not pay a USD 2.4 billion maturity with the Paris Club in May, instead choosing to renegotiate that debt towards the end of the year.
- President Fernandez was scheduled to meet in person with his Brazilian counterpart in late March, but the summit was suspended over Covid fears. This rapprochement with Brazil is exemplary of the pragmatic shift undergone by Argentine diplomacy in the last months. Fernandez will visit Beijing in May and his team is working on a bilateral with Biden.
- The lack of rainfall in February and early March could reduce the expected soy harvest from 49 to 45 million tons, although higher prices will compensate the effect on the commercial balance. Soybeans are trading around USD 520 per ton.
- The bill to reform income tax which is being debated in Congress proposes increasing charges on businesses to compensate raising the minimum taxable income for persons, a change that could hurt investment.

SUMMARY OF MAIN INDICATORS

Economic activity		**Financial variables**	
Economic Activity	↑	Inflation	→
Consumer Confidence	↓	FX spread	→
Industrial activity	↑	Country Risk	↓
External accounts		**External variables**	
Current account	↓	Soybean price	→
Reserves BCRA	↑	Brazilian GDP	→
Fiscal balance	↑	Financial conditions	→

Up arrow indicates improvement, down arrow worsening and horizontal no changes

GRAPH OF THE MONTH:



Source: Econviews based on JPMorgan

FEB	FEB	FEB	MAR	MAR	MAR	MAR
22nd	24th	25th	1st	5th	11th	19th
Econviews Monthly #200: Medium term prospects + report on the provinces' fiscal and debt situation	Government meets with unions and food industry in search of a **price and wages agreement**	Fernandez concludes official visit to **Mexico**, AMLO pledges **support in negotiations** with **IMF**	In opening speech to Congress, Fernandez centers on **judicial reform** and bashed opposition.	IMF will propose a **major SDR allocation**: Argentina could benefit by USD 3.35 billion extra in April or May	**Argentina** applies its **2,000,000th vaccine** (as of March 18, 6.4% of population has received at least one shot).	**Econviews Monthly #201**

POLITICS

Although the Government was shocked by the vaccines scandal, it is enjoying some oxygen from the calm FX market and the recovery in economic activity. President Fernandez's positive image has fallen in the last months, but it still sits above 40%, far from his peak last April but quite competitive nonetheless. The first polls show a slight advantage for the ruling coalition, but few candidates have been announced and the political climate has not entered election mode yet. While the Government is spending energy on the judicial agenda, the pace of vaccination, economic rebound and its ability to contain rising inflation will probably decide the vote.

PANDEMIC

After a slow start, the vaccination campaign gained steam in the second half of February after reaching a deal with China's Sinopharm, Sputnik and AstraZeneca's supply kicking in. In the last few days Argentina has been applying over 130,000 daily doses, inoculating 6.4% of total population as of March 18th. New cases average around 7,000 per day, an uptick of 7.8% against last week. Although the numbers remain well below the peaks in October and January, the strained sanitary situation in Paraguay and Chile and the collapse in Brazil has authorities on alert, especially after the appearance of the more aggressive variants. For this reason, travel to bordering countries was recently limited further.

ECONOMIC ACTIVITY

Preliminary data suggests the recovery showed no respite in the first two months of 2021. Manufacturing grew by 1.7% monthly s.a. in January, while construction advanced 4.4% in the same period. Retail, among the hardest hit by the pandemic, saw its sales go up 3.6% monthly s.a. in February. With an external climate that allows for FX stability in the next months and the Government avoiding a large fiscal adjustment ahead of the elections, the coming months could bring more positive figures. We have raised our 2021 growth estimate to 7%. However, the high levels of country risk complicate access to financing for the private sector, a medium-term drawback.

INFLATION

Monthly inflation kept high at 3.6% in February, after January's 4% record. The general CPI has been rising in y/y terms since November, reaching 40.7% last month. Due to the summer holidays restaurant and hotel prices led the index with 5.4% monthly growth. Food and beverage prices rose 3.8%, ending up above general inflation for the seventh consecutive month. Core inflation stood at 4.1% m/m, while regulated prices grew only 2.2% after jumping 5.1% in January due to an adjustment in telecommunications. However, this last item is still lagging if we consider its 21% y/y rise, owed to utility rates being frozen since early 2019. We estimate inflation will end the year around 50%.

MONETARY SECTOR

With a favorable external environment, the Central Bank keeps building up reserves, which are up USD 386 million YTD. At 3.1 billion, net reserves are still too low to loosen currency controls, but the monetary entity has been successful at keeping the FX spread contained: the parallel dollar is trading at ARS 142.5 (a 56% spread) while the BCS stands at ARS 149.75, (64%). The CB has considerably slowed the daily depreciation of the official exchange rate (now at ARS 91.36) as part of its anti-inflationary policy. We believe the RER could appreciate up to 3% in 2021. So far, the entity shows little intention of hiking interest rates: the policy rate remains at 38% while the private Badlar rate hovers around 34%.

FISCAL ACCOUNTS

The Government achieved a primary surplus of ARS 24.1 billion in January on a cash basis, although in February the accounts are expected turn red again. Between the tax on wealth, the IMF's SDR allocation and increased revenues from export taxes, the fiscal outlook has improved. However, we maintain our 3.5% primary deficit estimate for 2021, considering authorities will probably use the extra resources to fuel the recovery. In this scenario, the Treasury would require the CB's assistance for around 3.6% of GDP, although the figure will vary depending on the market's appetite for Peso denominated debt. As maturities add up in the second semester, this option's financial cost may rise.

I. Muddle through and adjustment in 2022

The current economic situation raises two important questions. Firstly, can the government continue to muddle through until the October elections as it did in recent months? In other words, can it keep inflation under control, avoid a new acceleration of the parallel exchange rates and maintain the current growth momentum going? **Secondly**, and if the economy gets to the elections in one piece, **the question is how will the government be able to address the imbalances that will continue to build up during these months (at least until October), and correct them to avoid a new economic crisis?**

What is at stake is the medium-term sustainability of the policy environment and the risks are a slowdown in economic activity, and a sharp increase inflation, a more severe shortage of reserves, a skyrocketing in the parallel exchange rates, and of course, a new default.

The answers to the first question depend on three themes: politics, the pandemic and economic policies.

On the political side, there are clear signals that Cristina Kirchner is gaining power and is having increasing influence on key policy decisions. **The government has shifted into election mode and made a twist towards more populist policies on the economic side:** it has tightened price controls; it is delaying once again increases in utility prices and it slowed down the nominal depreciation of the currency in its efforts to bring down inflation.

In addition, President Fernandez took a tough stance towards the opposition and the IMF during the state of the union address in Congress, in a clear departure from the conciliatory approach that he had a year ago. He sided with Cristina Kirchner regarding her legal issues and criticized the judiciary system and replaced the Minister of Justice to exert further pressure on the judges.

One message that comes loud and clear is that the government (and Cristina in particular) considers that the October elections are critical for its ambitions to increase the pressure on the judiciary and Fernandez is playing along with a radicalization of most policies, including the economic ones.

The main objective of the ruling coalition in October is to reach half plus one seat in the lower house, to gain control of both chambers of Congress, as it already controls the Senate, which is not at stake in the midterms. Now it has 119 representatives in the lower House while it needs 129 to obtain quorum to pass laws without the support of other parties**. It will not be easy, but a defeat in the elections will complicate the ability to govern in the next two years.**

On the economic front there are three issues that seem to be critical; keeping inflation under control, avoiding a steep rise in the parallel exchange rates and keep the pace of the economic recovery.

To achieve these goals the government looked into the back mirror and is mimicking the policies implemented between 2011 and 2015, when Cristina´s government avoided a full-blown crisis using widespread price

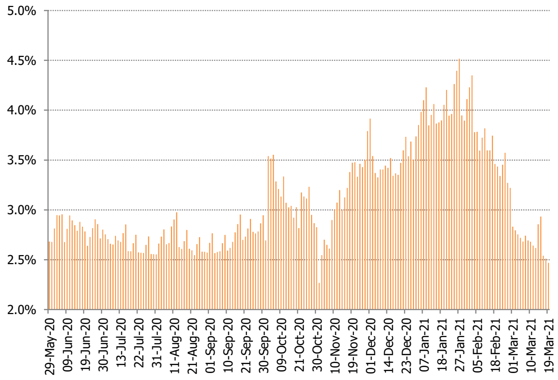
Net and Liquid International Reserves

In billion USD

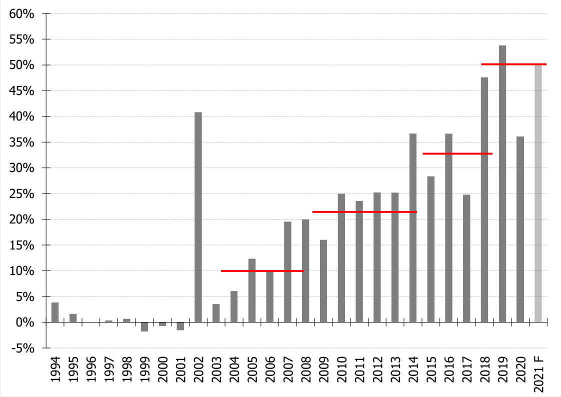
Gross reserves	**39.8**
Reserve requirements in USD	11.5
Swap with China	20.0
Treasury SDRs position	1.0
BIS & Repos	4.2
Net reserves	**3.1**
Gold	3.4
Liquid net reserves	**-0.3**

Source: Own estimates based on BCRA and IMF
Up to Mar-18

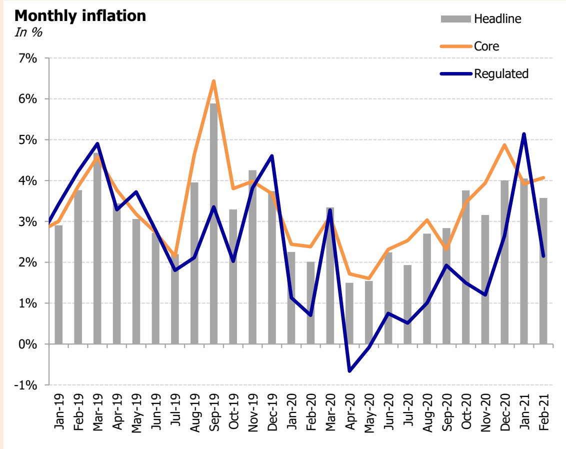
Rate of depreciation
Accum. 30 days - Official exchange rate, Com. "A" 3500



Inflation
Annual variations - End of period

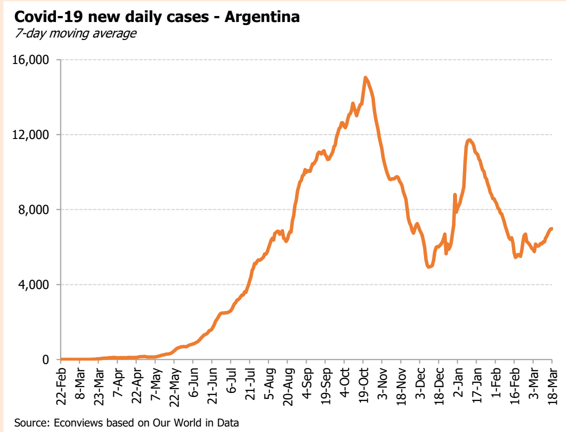


controls and regulations and imposing restrictions on the access to the foreign exchange market. In the end, they avoided the adjustment, though along the way they created big imbalances in relative prices (exchange rate, regulated prices), generated large fiscal deficits due to the mounting subsidies, there were shortages of many goods and they depleted the stock of net reserves, which became negative at the end of their term. **Controls and regulations are once again the name of the game.**



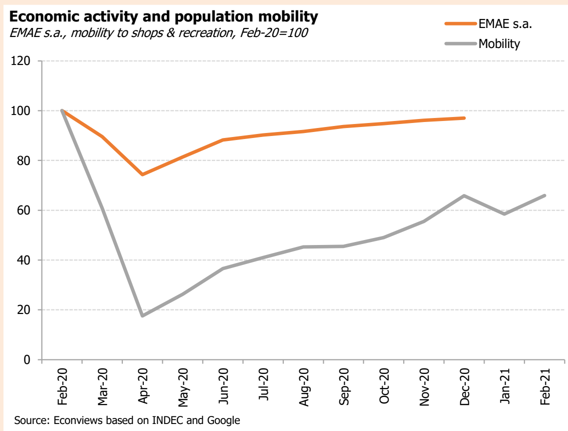
The policies have a good chance of working for a few more months thanks to the improvement in soybean and other commodity prices that are expected to provide eight billion dollars in additional exports and roughly 0.7% of GDP in additional tax revenues compared to 2020. **In addition, the capitalization of the IMF implies that Argentina will get a windfall of 3.5 billion dollars** that it can use to meet the bulk of the payments to the IMF that are due this year. **This gift from heaven allows the government to postpone till after the elections an agreement with the IMF** which would have required some politically costly policy decisions.

In the new environment in which Argentina will get more dollars it can postpone the adjustment and put a lid on the exchange rate and regulated prices to soothe the inflation pressures. However, it is not a costless option, because **the imbalances in relative prices and in the external front will worsen and the eventual correction will be more painful.**



The third issue, which is the pace of the economic recovery, seems to depend more heavily on the evolution of the pandemic and the speed of vaccination than on any economic stimulus. Covid-19 cases have dropped during the summer and have allowed the removal of many of the restrictions that the government imposed during the strict lockdowns last year. This improvement has helped the recovery of the economy. **The main problem is that there are difficulties to secure enough vaccines are increasing the risks of a second wave and new lockdowns.** This situation is a concern for the government and represents a threat for the elections.

The government seems to have a clear agenda regarding what to do in the economic front until October. It looks like the old recipe of pork and barrel, populist policies, which in this case it means large fiscal imbalances, deepening problems in relative prices and using the windfall in reserves to postpone adjustments will be used again.



As always, Murphy's law can come into action and a few things can go wrong. We expect smooth sailing until June or July, while soybean exports are at their peak. The risks of a black swan start in August or September when the navigation could be rough if there are concerns about the elections and people massively run away from pesos putting pressures on the parallel exchange rates and inflation.

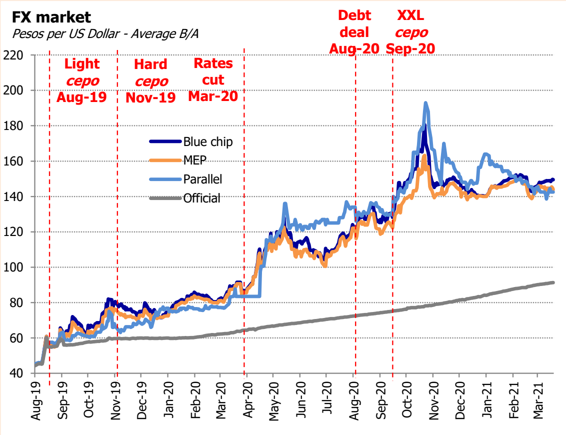
The most likely scenario is that the time of reckoning will come after the elections, when baring a miracle, the government will be forced to confront the medium terms problems as there will be little room to postpone solutions.

Between 2011 and 2015 Cristina's government, facing similar dilemmas, managed to avoid the inevitable adjustment depleting the stock of international reserves, financing the fiscal deficit with Central Bank debt, and pushing relative prices to the limit. They knew that time was running out, but they managed to reach the edge of the cliff without having to take the last step forward. The Macri administration was forced to do the adjustment, with the consequences that everybody knows.

The difference this time around is that if the administration gets to October in one piece, it won't be able to pass on the adjustment to another administration. Pr esident Fernandez will need to address the imbalances and he will have to choose between an adjustment with a program, preferably supported by the IMF, or a completely disorderly one.

The options will be clear, but they will not be pleasant. Non-election years are the ones when governments take the unpleasant policy measures, and 2022 is not likely to be an exception. At that time, the IMF program will take center stage and policies will dance at its rhythm. The government will have few options to accepting a reduction in the fiscal deficit, bringing down the spread between the official and the parallel exchange rates, adopting a monetary stance that supports lower inflation and implementing sector policies that favor investment and long-term growth. There is an alternative, of course, but it is a scary one.

We continue to expect that there will be an IMF program, that the agreement will be reached towards the end of the year or in early 2022, and that the agreement can represent a turning point that is needed for Argentina to return to growth. If a socialist Greek government did the adjustment when it had no options, Argentina will probably do it as well.



ECONVIEWS
ECONOMÍA Y FINANZAS

II. Life in times of the CEPO

The Argentine economy is going through its second period of foreign exchange restrictions (the *cepo*) in the last decade. Argentines have been living with FX controls during 6 of the last 10 years. Far from being flexible, the restrictions have been increasing and the Argentines had to forcibly adapt to do business, travel and save under these restrictions, which generate several negative side effects for the economy. Moreover, as the market always finds a way around them, the government constantly upgrades and updates the restrictions and spends time and energy covering loopholes.

In this report we analyze the evolution of relevant macro-finance variables to understand what the FX controls mean for the day-to-day of the economy, the business climate, and the markets.

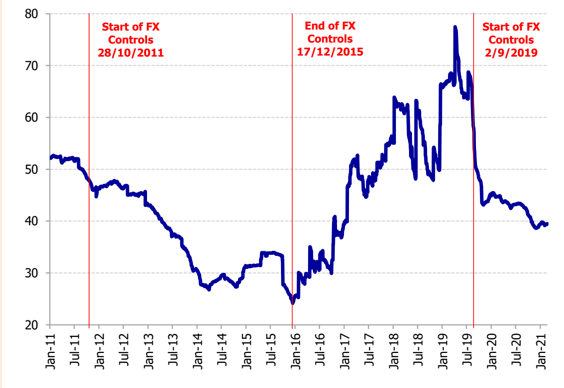
i) The many stages of the FX controls: Addiction, rehab, and addiction again

Exchange rate policy has been a critical issue for recent administrations. The story is well-known: persistent capital outflows, a large drainage of international reserves, lack of confidence in the government and the absence of a clear macroeconomic plan that led to tight foreign exchange controls to deal with a run on the currency. **And once the controls are introduced, they become addictive. More is needed every time and the marginal effectiveness keeps on getting smaller and the side effects larger**.

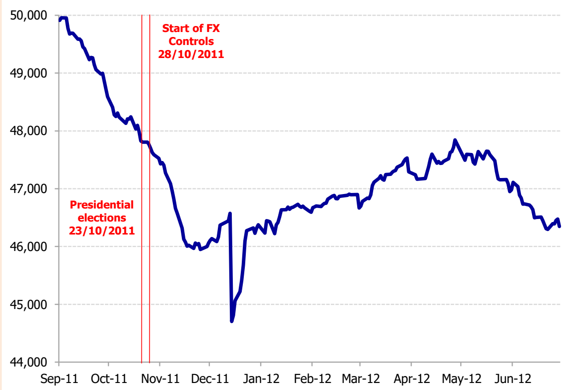
To make a long story short: in 2011 the persistence of capital outflows posed problems to Cristina Kirchner's administration, as it was eroding reserves. It was not obvious that Argentina needed a significant adjustment in the exchange rate to restore overall competitiveness, but the high credit spreads, the drop in soybean prices and the depreciation of the Brazilian Real increased devaluation expectations and intensified the dollarization of domestic portfolios. As a result, **the private sector gross dollar purchases amounted to around USD 3.5 billion per month. Between August and October 2011, international reserves fell by USD 4,400 million.**

The initial measures to address the turbulence were to force the mining and oil sectors to surrender all the exports proceeds in Argentina, while insurance companies were required to bring back to Argentina the funds that they were holding abroad. Individuals needed an authorization from AFIP to buy (a small amount of) dollars for hoarding, which was difficult to obtain. But **as the situation continued to deteriorate and international reserves dropped another USD 1,461 million in November 2011, the government resorted to FX controls generally known as the CEPO.** Access to the official exchange market for hoarding purposes and to transfer dividends abroad was suspended, and purchases with credit and debit cards in foreign currency had to pay a new tax. The government also introduced very tight import controls.

Evolution of International Reserves
In billion USD

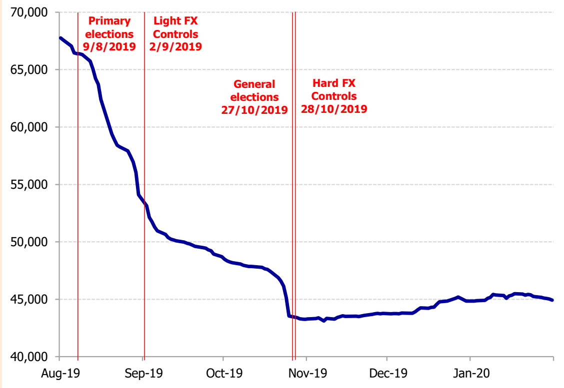


International Reserves
In million USD



FX restrictions were finally lifted in December 2015, followed by a strong one-step jump of 50% in the official exchange rate, at the beginning of Macri's administration. The foreign exchange market functioned without restrictions, for both individuals and companies, for almost four years. But **when Mauricio Macri lost primary elections against Alberto Fernández by an unexpected difference of 15 percentage points, the markets reacted negatively, and the financial turbulence returned. In just one day, the peso slumped 16%.** The currency continued to be under pressure during the following days and **the Central Bank had to intervene by selling international reserves for the first time since September 2018.** Only **in August, international reserves fell USD 13.8 billion and dollar deposits dropped USD 5.7 billion.** The primaries clearly marked a turning point for financial stability and economic performance. **Confidence was the name of the game again.** The expected policy response was the immediate imposition of foreign exchange controls. But the government instead took initially a controversial decision and forcefully reprofiled the short-term dollar and peso debt, on the hope that with this policy measure could sidestep the imposition of foreign exchange controls. However, this was a miscalculation, as three days later the Central Bank was forced to introduce them anyway.

International Reserves
In million USD



The imposition of foreign exchange controls has at least allowed the Central Bank to slow down the drain in reserves, as it is more difficult to buy dollars at the official exchange rate due to the controls. **However, the outflow has not been completely stopped and reserves continued falling.** After losing USD 24.6 billion during the three previous months, in November 2019 international reserves increased by USD 512 million, and rose another USD 1,076 million in December and USD 68 million in January. But here the good news ended there. Reserves fell again in February and lost USD 5,462 million in 2020. Of course, the speed of the losses of reserves has diminished dramatically, as it is more difficult to buy official dollars, but the trend did not change direction.

Main Economic Variables Under Fx Controls
In million USD

	International Reserves	Reserves Purchases	Deposits in USD
FX Controls 28/10/2011 - 16/12/2015	-23,463	3,521	-5,791
2 months before	-2,363	-3,374	330
2 months after	-1,251	2,321	-2,623
No FX Controls 17/12/2015 - 30/8/2019	29,937	-13,385	19,204
FX Controls 2/9/2019 - ...	-14,277	-4,535	-29,488
2 months before	-10,178	-2,038	-4,685
2 months after	-10,840	-5,445	-8,028
2 months after "200 USD restriction"	1,298	3,473	-387
2 months after "XXL restrictions"	-3,386	-1,815	-2,793

Something similar had occurred in 2011. The FX controls significantly reduced the Central Bank sales of dollars and in November it was able to buy USD 61 million, while in October the sales reached USD 2.1 billion. Nevertheless, reserves continued to fall and lost USD 1.46 billion in November. The outflows of USD deposits reached 20% of the stock. Reserves took a breather in the first months of 2012, but then resumed their decline and fell USD 3.1 billion in 2012 and USD 12.7 billion in 2013.

In 2020, as months went by the Central Bank made some successive tightening of the restrictions, closing loopholes. The package of measures was not enough to stop the drainage of reserves, which fell by another USD 5.4 billion in September 2020 and USD 5.4 billion more in October. Restrictions were strongly tightened. With the new extra-large "cepo" established in late September, firms that could have refinanced their debts voluntarily in the market were forced to restructure. This decision removed in one stroke one of the main advantages of the recent sovereign debt restructuring, namely that corporates could regain access to the international capital markets to finance private investments in critical sectors to spur growth. The restriction to repay debt was the death sentence to issuing new debt. It is difficult to attract funds to come into the country when there is no way out.

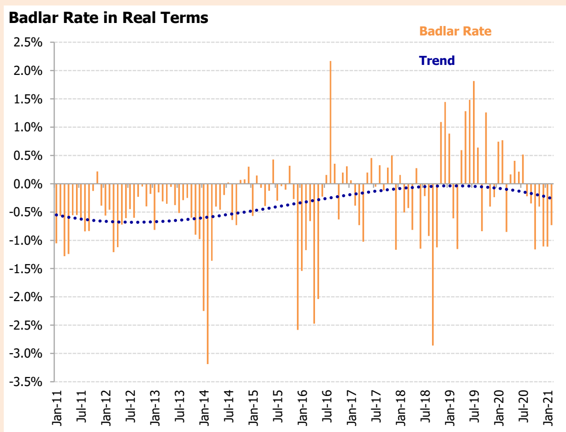
We detail below the chronology of the main exchange restrictions as of August 2019:

Chronology of the *cepo*

	List of measures
28-Aug-19	The Government unilaterally extends the maturity of all short-term Treasury bills held by institutional investors, including peso and dollar-denominated as well as dollar-linked ones
30-Aug-19	Banks are barred from distributing profits abroad without previous authorization from the BCRA
1-Sep-19	Companies are barred from distributing profits abroad without previous authorization from the BCRA
	Companies are barred from purchasing dollars for hoarding and must be authorized by the BCRA to make payments in advance of debt in dollars
	Exporters of goods and services must settle FX proceeds within a specified time frame
	Individual purchases of dollars for hoarding is limited to USD 10,000 per month
28-Oct-19	Individual purchases of dollars for hoarding is limited to USD 200 per month
26-Dec-19	The new Administration applies a 30% surcharge (PAIS tax) for dollar purchases and expenditures in dollars with credit or debit cards
15-Sep-20	Companies with financial debt maturities of over USD 1 million per month are to be allowed to pay only 40% of them at the official FX rate and have to seek new terms for the remainder of the debt with an average life of at least 2 years
	An additional surcharge of 35% is applied, as advance payment of the Profits Tax and/or the Personal Goods Tax, on purchases of dollars for hoarding and expenditures in dollars with credit or debit cards
	Expenditures in dollars are included in the USD 200 limit set on purchases for hoarding. Excess expenditures are to be discounted from the following months' limits
	Individuals on government subsidies are barred from buying dollars for hoarding

ii) What are the implications of the FX controls on the functioning of the economy?

It is true that the shortage of international reserves is a critical constraint for economic activity that needs to be solved. But the tight FX controls bring unwanted effects for individuals and firms. Markets are severely distorted jeopardizing the normal functioning of the economy. Although they can be useful to buy time, they are not efficient in curbing the loss of reserves in the long term and tend to generate even greater macroeconomic imbalances.



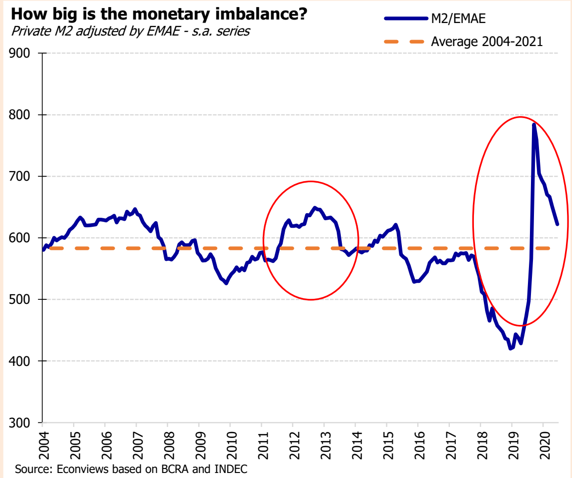
The implications on macroeconomic performance:

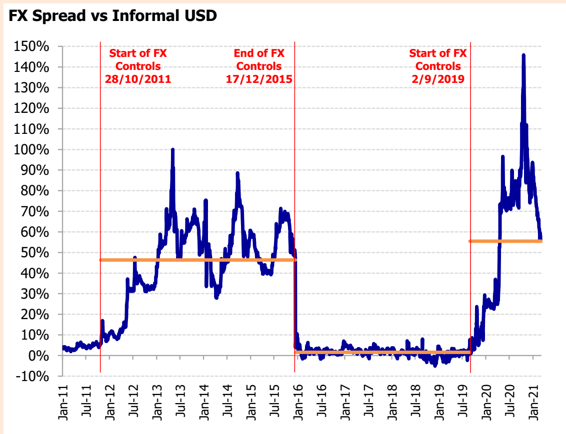
One of the most direct consequences of the FX restrictions is financial repression. Without controls, the increases in the money supply imply that there is an excess supply of liquidity in pesos that firms and individuals can use them to buy dollars. But controls limit the ability of residents to buy dollars, and at the same time they restore the ability of the Central Bank to manage the money supply and hence, to maintain lower interest rates. Pesos get trapped in Argentina. If we look at ex-post real interest rates in recent years, they only approached zero in the years without controls. In financial repression times, interest rates have been negative in real terms.

In a context of ample liquidity and much lower interest rates, individuals and firms should decide among two options: maintain pesos in the banking system at negative real interest rates or instead, try to fly out of pesos. As they are not able to buy dollars at the official exchange rate, they will either buy them in the parallel market putting pressure on the parallel exchange rate, or instead they will spend more on goods which could put pressure on domestic prices. Or perhaps they will do a little bit of both. **Here, the main unwanted effect is the growth of the FX spread, which tends to be a function of the degree of tightening of FX controls. The main distortion of having different FX rates is that it creates incentives to delay or** under-invoice exports on the one hand and to speed up or over-invoice imports. Likewise, this prevents the inflow of capital, which must come at the official FX rate, with the obvious impact on investment.

With the implementation of 2011 restrictions, the spread doubled in just one week and jumped from 6% to 33% during the first year. It reached a peak of 100% in May 2013 and averaged 46% while the restrictions were in place. This time, due to the decision of reprofiling debt in pesos in September 2019, the economy did not have safe and liquid financial instruments in pesos which can be used to place any excesses of funds. Time deposits, which had a minimum maturity of 30 days, did not pay attractive interest rates. The main alternative was to dollarize portfolios by buying bonds, a decision that put more pressure on the market-based dollars. Thus, the spread between the official exchange rate and the blue-chip swap rose from 7.7% in early September to 25% at year-end. In 2020, the large monetary overhang due to the pandemic and the negative real interest rates, together with the further tightening of the controls, led the FX spread to reach its peak of 92% in October. In the comparison with the informal dollar the spread rose to 146%, well above the previous peak of 100% of 2013.

Financial restrictions allow the government to live with an appreciated currency for longer, as the pressure on the financial account can be stopped and the limitation on imports could somewhat delay the problems of the current account. This has the political advantage that strong currencies have: a fake sense of well-being for the middle class, the one that define elections. This comes in the form of cheap home appliance, travelling capacity and other examples. In 2015 the peso was at its strongest point since Argentina left the currency board. The current situation is different, as the peso is not strong in historical terms. Now the confidence is the one that is low, so it is not about boosting the well-being, but preventing a sudden loss of it. In truth, the middle class can enjoy home appliance at the official rate, but with the restrictions, saving is very expensive and travelling (Covid permitting) will be expensive too, as there are two taxes for as much as 65% when buying air tickets and spending abroad with the credit card.



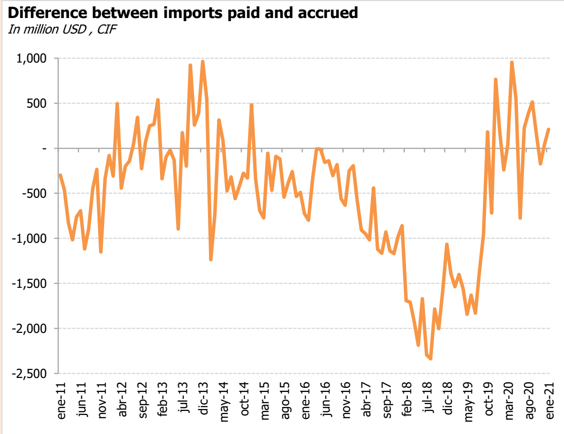


FX Spread vs Informal USD

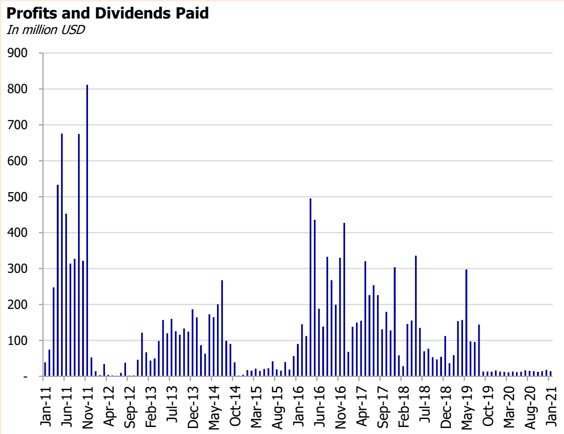
	Average	Max.
FX Controls 28/10/2011 - 16/12/2015	46%	100%
No FX Controls 17/12/2015 - 30/8/2019	2%	11%
FX Controls 2/9/2019 - ...	55%	146%

The implications for the firms:

Doing business is a nightmare for everyone under FX restrictions, but more so for international companies operating in Argentina. First and foremost, the purpose of the firm is to make money and out of the blue, remitting dividends becomes a non-starter. A few numbers shed light on this matter: during 2020 dividend remittances abroad were only USD 166 million. The average outflow in dividends between 2016 and 2018, when no restrictions were in place, was USD 2.2 billion per year. In 2010 and 2011, before Cristina Kirchner set up the restrictions for the first time, dividends surpassed the USD 4 billion each year. Then dividends were insignificant in 2012 and again in 2015, but apparently some political decisions opened the taps in 2013 and 2014 with over USD 1 billion in dividends remitted. There is no other explanation than discretionary decisions for these trends.



This leaves companies with a structural excess of pesos. This creates an awkward situation in which savers are companies rather than people. There is a big stock of bank deposits or investment in mutual funds that are in fact money waiting either to pay dividends, imports, services, or royalties, all of which face severe limitations. Often companies ended up investing in local "dollarized assets". For instance, in the first wave of financial restrictions of 2012 many firms ended up buying real estate, so at least they could justify it as saving on the rent, although we know that this is not always an optimal financial strategy. This is apparently not happening this time around, more so when after Covid-19 many firms realized that they could live with less office space.



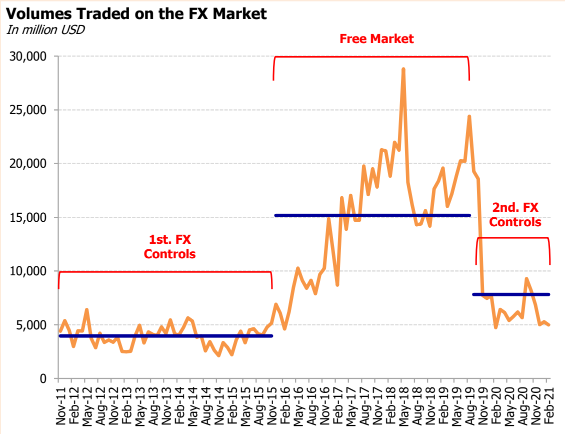
The excess of pesos can easily be seen in money aggregates. The peaks of private M2 in real terms using a 3-month moving average indicator were in March and October 2013. For M3 the peak was at the end of 2015. Not even the Covid-19 managed to surpass previous peaks of money supply, despite heavy printing.

Another important aspect of the difficulties of living under FX restrictions is on payments abroad. The Central Bank simply does not authorize the sale of dollars for certain payments. Up until 2020, well documented debt through bonds or with foreign financial institutions could be paid and commercial banks would get the green light from authorities to sell the dollars to honor commitments. One of the innovations of the tightening of FX restrictions last year was forcing companies to default. Under new Central Bank rules debtors had to renegotiate new terms in such way that terms of the debt were lengthened by 2 years and only 40% could be paid as the original contract was stipulated. This creates a tremendous reputation cost for debtors, but the pain goes beyond. Today it looks unthinkable that new money comes into Argentina for these set of companies or anyone else, if the terms of the bond are a matter of discussion with Central Bank officials.

This is for well documented debt with third parties. Inter-company payments are far more difficult to channel. These include borrowing, royalty, shared services, and other categories that will always look suspicious to the Central Bank. These kinds of transfer have suffered difficulties from 2012 onwards with the hiatus of 2016 to September 2019 when Argentina's FX market operated normally. The idea that headquarters will always roll over your debt may look true at the beginning, but eventually trade credit stops, as Argentina is not always such an important market. On the other hand, the Central Bank has reasons beyond dollar scarcity to be picky when authorizing payments. For the very moment that there is a big spread between official and market dollars, companies have all the incentives to be over invoiced while importing services. With goods this is more difficult given that market prices are more transparent, but it does happen as well.

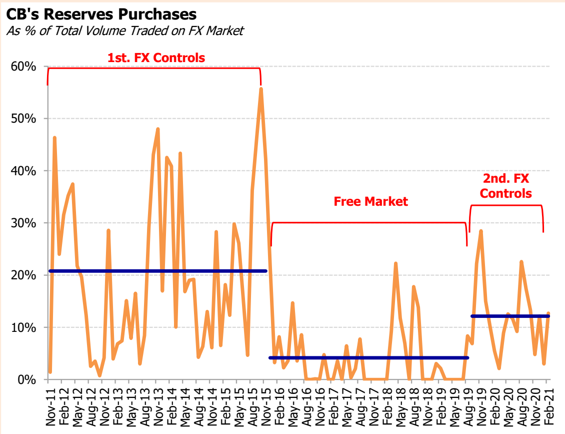
Import payments are another hurdle. In Argentina, the import of a huge number of goods requires prior authorization from the Industry Secretariat (the jargon is non-automatic import licenses). But, often, even after receiving the green light from the Secretariat, payments are blocked at the Central Bank level. Monetary authorities often limit the supply of dollars to an unknown quantity. Again, this is a revolving door (ironically President Alberto Fernandez used this analogy when he was not in office): if money cannot flow out, it will never flow in. Numbers show that trade credit was almost inexistent at times of the first wave of restrictions (2012-2015), it ballooned in times of Macri and now not only there is no new trade credit, but also everyone is trying to pay off debt. We estimate that under Macri the stock of trade credit expanded by USD 37 billion, almost 10% of GDP. **In the two periods of FX restrictions companies paid off trade credit, but much less than companies would have wanted.**

In a nutshell, the problems of these restrictions are that momentarily the government covers the hole and stops the drainage of dollars, but in the end, it completely blocks the inflow of dollars. In the process there are institutional and reputational costs and more importantly the restrictions incentivize companies to find ways around the measures, some of which may not be fully compliant with regulations. Then, the government closes loopholes, companies learn again and lots of energy, paperwork, lawyers' fees, and time are wasted in the process.



The implications for the markets:

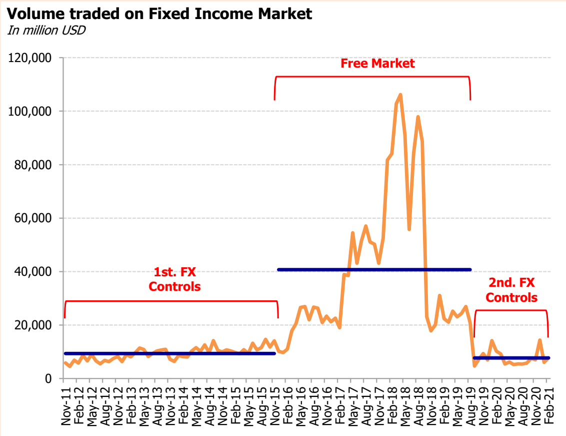
The restrictions have had a tremendous effect on markets, but not just prices. During the first wave of financial restrictions, transactions of FX in the electronic wholesale market averaged USD 3.9 billion a month. In the free market era, the volume jumped almost fourfold to USD 15.2 billion. In the last 18 months with the new restrictions, they halved to 7.8 billion dollars a month. But in a way these figures can be misleading. The Central Bank's participation has risen significantly. In 2011-2015 the participation of the bank was 20.8%. Then it fell to just 4.1% between December 2015 and August 2019 to increase again to 12.1% in the range September 2019-February 2021. The evidence of these days is that Central Bank has represented over 36% of the volume so far in March.



A similar trend can be found in bonds. In the absence of restrictions monthly volume was USD 40.8 billion in the local market, while these values dropped to 7.7 billion since September 2019 and were USD 9.3 billion in the previous era of restrictions (2012-2015). This trend happens even when bonds are the vehicle to buy and sell dollars, as FX buyers purchase a dollarized bond onshore and sell it offshore and vice-versa. For the seller it is a non-starter, as it profits from the spread, today around 60% over the official market. For the buyers is the only way of accessing the FX market, be it an individual saver a company that wants to keep its liquidity at bay or a headquarter that prefers to receive fewer dollars as dividends rather than having to buy real estate in Argentina to find a use for its excess of pesos.

iii) Conclusions

It seems clear that while in the short run FX restrictions are effective to stop the bleeding of international reserves, they only succeed in slowing down the speed of the outflows, buy they cannot be expected to generate a reversal of the outflows. They are a very imperfect substitute of credibility. But the controls are not only about capital flight. They affect investments through dividend payments, lack of imports, dollar payments, royalties, and future markets, among many other hurdles. The severe foreign exchange controls on imports negatively affect economic activity, both because they deprive producers from inputs and capital goods, and they discourage new investments in sectors that critically depend on imports. **The controls restrict capital outflows, but also inflows.** One of the problems is that going back to normal is quite difficult, because lifting the restrictions create almost by definition a one-off depreciation, which has a knock-on effect on inflation and on negative image for the government, something that politicians are almost never prepared to take. So, this labyrinth needs either a different leadership style or a positive shock that enables a gradual lifting. The boom in soybean prices could be an opportunity, more so when the USD is not appreciated in historical terms, but it seems that the government would accumulate reserves rather than trying a partial lifting of the restrictions, thus narrowing the FX spread. We may to wait until there is an IMF program for that.



ECONVIEWS
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Base Scenario

	2019	2020 E	2021 F	2022 F	2023 F
Inflation (eop)	53.8%	36.1%	50.0%	40.0%	35.0%
Exchange rate ARS/USD (eop)	59.9	84.1	120.8	172.8	228.0
Real exchange rate ARS/USD (eop, Dec-01=100)	151.6	158.8	155.0	161.5	161.1
Paralell exchange rate ARS/USD (eop)	74.6	140.3	193.2	259.1	342.1
Spread with official exchange rate (eop)	24.6%	66.8%	60.0%	50.0%	50.0%
Gross reserves (USD billion, eop)	44.8	39.4	41.9	44.4	46.5
Policy rate (eop)	55.0%	38.0%	43.0%	35.0%	28.0%
GDP (YoY)	-2.1%	-10.0%	7.0%	1.5%	3.0%
Private consumption (YoY)	-6.6%	-13.5%	8.0%	2.0%	2.9%
Primary surplus (% GDP)	-0.2%	-6.5%	-3.5%	-2.0%	-1.0%
EMBI Argentina (spread in bps, eop)	1,744	1,350	1,000	850	750
Public net debt (% GDP)	43.6%	53.1%	47.3%	49.4%	49.1%
Soybean price in USD per ton (annual average)	327	350	515	420	420
Exports of goods (USD billion)	65.1	54.9	62.4	65.8	69.4
Imports of goods (USD billion)	49.1	42.4	48.5	50.0	54.1
Trade balance (USD billion)	16.0	12.5	13.8	15.8	15.3
Current account (% GDP)	-0.8%	1.1%	0.9%	0.7%	0.2%

Source: EconViews

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