THE WEEK AT A GLANCE

ECONVIEWS
ECONOMÍA Y FINANZAS

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Editorial: The Current Rate of Intervention Is Unsustainable

The BCRA sold more than 800 million dollars since the FX market changed from positive to negative on August 26. There are several factors behind that. There were companies that canceled debts in dollars, banks that had reduced their foreign currency position a few months ago and now recovered it, purchases at the beginning of the month from retailers and a decrease in the liquidation of exports, something totally logical considering two factors: the seasonality of the harvest imply less dollars available in the second semester and the devaluation expectations suggest that it is convenient to wait. Between August 3 and September 6, the firms canceled debt in dollars for 291 million. In July that number had been just 36 million. In the case of banks, between January and July it had reduced its holdings of dollars by 574 million.

The situation is unsustainable. These 10 days cannot be extrapolated to the rest of the year because the reserves are simply not enough. At this moment the net reserve position is 10.2 billion including the position of gold and SDRs, the currency of the IMF. Principal and interest payments to the IMF between now and the end of the year are $ 4.2 billion and gold is worth about $ 3.6 billion. In other words, there are about 2,400 million of liquidity. And getting to zero is not a very smart option. That would increase the nervousness of those who have dollars deposited (about 16,000 million, half that prior to the PASO of 2019) and would not help to close the FX Spread or reduce the country risk, all key variables for the Argentine economy to recover a certain normality.

In other words, the BCRA could continue to sell at a rate of 200/250 million per month to start 2022 with some reserves. We are talking about an average of 10/12 million dollars per day, nothing to do with the values of these days. What is clear is that the declarations of the Government officials on the intentions not to devalue after the elections are not enough. In the first place, all the ministers have said it and in most cases it was not fulfilled. Second, as much as those are the true intentions of the government, if there are no reserves, there is no other option but to depreciate the exchange rate.

So if you want to avoid an abrupt devaluation and/or run out of reserves after the elections, something should be generated so that Argentines do not seek to get out of the pesos. This is a more pronounced devaluation of the official dollar that will seduce exporters more, a rise in rates and clearer signs about the organization of the economy next year. The government between now and November prefers to avoid any of those 3. So the equation seems to be: transmit peace ahead of the elections and prepare for war after them. The paradox is that the market is moving ahead and the peace with which it is hoped to reach the mid-November elections may not be such.

Our vision is that the Central Bank, in tandem with the Secretary of Commerce, chooses to curb (even more) imports to minimize sales of reserves. But that will have effects on the level of activity and also on inflation. That is, the usual short blanket. What is gained by not depreciating the exchange rate is lost through scarcity in many goods markets. Another alternative is to introduce more regulatory measures: some creativity on the FX controls, changes in the FX positions of the financial system or something else that respects the maxim of "Popular inventiveness has no limits." In the meantime, the sale of dollar-linked bonds by the finance secretary may decompress the system somewhat, but it is difficult to achieve. At least the 46,000 million pesos obtained in this way help to ensure that there is no more issuance of pesos.

LAST WEEK IN REVIEW

✓ In July **25.2 thousand tourists left the country and 3.7 thousand entered, leaving a negative balance of 21.5 thousand.** If we consider the period from January to July, the number of people who left the country reaches 290.7 thousand, while 71.1 thousand arrived. Both inflows and outflows are still well below pre-pandemic levels.

✓ The **Treasury obtained ARS 99,608 million in the first auction of the month.** Of the total, ARS 53,880 corresponded to instruments in pesos and ARS 45,727 to instruments dollar-linked. With this amount, it managed to cover 23% of the maturities of the month.

✓ Last week the drainage of reserves continued and **so far this month sales have already reached around USD 500 million.** If we add the last days of August to this calculation, the loss of reserves is close to USD 800 million. This is the longest period and of the highest volume of sales so far this year.

✓ In the second quarter of the year, residential **internet accesses** had an increase of 5.3% year-on-year for fixed connections and 9.4% for mobile connections. On the other hand, accesses in organizations fell 10.8% and 4.8% (fixed and mobile respectively).

✓ At its last meeting, the **European Central Bank** resolved to keep its reference rate at 0% and announced a **slight cut in its monthly bond purchases,** from the current € 80 million to a range of € 60-70 million.

✓ The IBGE reported that **Brazilian inflation reached 9.68% year-on-year in August,** the highest since 2016, driven by food and energy. The monthly variation was 0.87%.

NEXT WEEK HIGHLIGHTS

✓ On **Tuesday 14** the INDEC will publish the **CPI for August.** We expect 2.7% for last month.

✓ On **Wednesday 15** the **use of installed capacity** in the industry during July will be published.

✓ On **Wednesday 15,** important data from the **Chinese economy** such as **unemployment and industrial production** will come out.

✓ On **Thursday 16** the data of the **current account of the balance of payments** for the second quarter of the year will be published.

✓ On **Thursday 16** the **costs of the basic and food basket,** the input to determine the poverty and indigence lines, will come out.

Market dashboard

Weekly, monthly and yearly variations

	Last data	w/w	m/m	y/y	
Official exchange rate ARS/USD	98.2	0.3%	1.1%	31.1%	▲
Blue Chip Swap	170.9	0.2%	1.8%	31.3%	▲
Blue Chip Swap "SENEBI"	178.7	0.7%	0.6%	-	▲
Parallel	179.5	-0.6%	-0.3%	38.6%	▼
CB reserves (USD million)	45,778	-207	+3795	+3326	▼
Policy rate (Leliq)	38.0%	0 p.p.	0 p.p.	0 p.p.	=
Badlar rate (private banks)	34.1%	-0.06 p.p.	-0.06 p.p.	+4.56 p.p.	▼
Merval (in ARS)	80,058	5.3%	15.1%	74.6%	▲
Country Risk (spread in %)	1,490	0.2%	-4.9%	33.0%	▲
Official exchange rate BRL/USD	5.22	1.0%	-0.5%	-1.9%	▲
Soybean (USD/ton)	467.6	-0.8%	-10.7%	26.6%	▼
Oil - Brent (USD/barrel)	72.6	-1.2%	0.5%	86.4%	▼

Note: arrow depends on weekly variation

Stoplight for Economic Activity

Seasonally adjusted variations

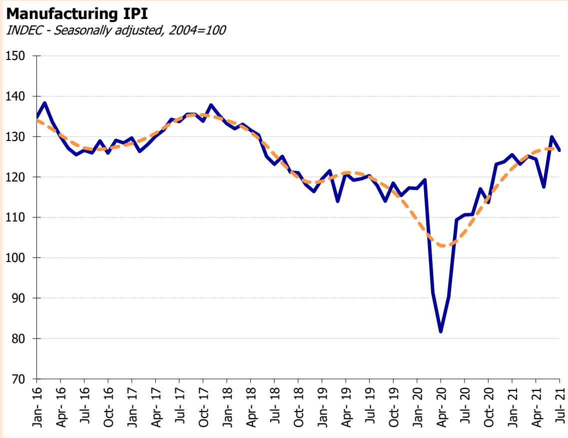
		m/m	q/q	LD vs previous Q
Industrial production	*Jul-21*	-2.6%	0.4%	2.2%
Automobile production	*Aug-21*	-10.5%	6.9%	-13.5%
Steel production	*Jul-21*	-0.7%	7.3%	5.2%
Poultry production	*Jul-21*	-5.5%	-4.9%	-2.2%
Dairy production	*Jul-21*	-0.2%	1.7%	0.4%
Beef production	*Jul-21*	-4.2%	-9.0%	-1.6%
Real Estate transactions (CABA)	*Jul-21*	-8.8%	1.3%	2.0%
Flour Production	*Jul-21*	-0.5%	-0.5%	1.7%
Oil production	*Jul-21*	0.7%	3.5%	1.8%
Gas production	*Jul-21*	1.2%	5.3%	3.6%
Cement production	*Aug-21*	-3.0%	-0.2%	-2.0%
Construction activity	*Jul-21*	2.1%	0.3%	6.1%
Retail sales	*Jul-21*	6.9%	-3.4%	6.6%
Gas sales	*Jul-21*	6.5%	-4.3%	9.1%
Motorcycle licenses	*Aug-21*	-3.1%	20.7%	4.5%
Use of electricity	*Aug-21*	-3.0%	-1.5%	-5.4%
Subway rides (CABA)	*Jul-21*	27.4%	19.3%	50.3%
Imports CIF	*Jul-21*	-2.7%	6.2%	4.0%
Exports FOB	*Jul-21*	1.7%	4.7%	11.1%
Loans in ARS to private sector	*Aug-21*	0.6%	-4.3%	-0.2%
VAT-DGI Revenues	*Aug-21*	-0.1%	-1.1%	2.4%
Formal private jobs (SIPA)	*Jun-21*	0.1%	1.0%	0.3%
Formal private jobs (EIL)	*Jul-21*	0.0%	0.0%	-0.1%
Consumer confidence	*Aug-21*	5.0%	3.0%	10.5%
Government confidence	*Aug-21*	9.0%	-3.5%	4.1%

Note: stoplight color depends on monthly variation

How Much Fuel Does the Recovery Have?

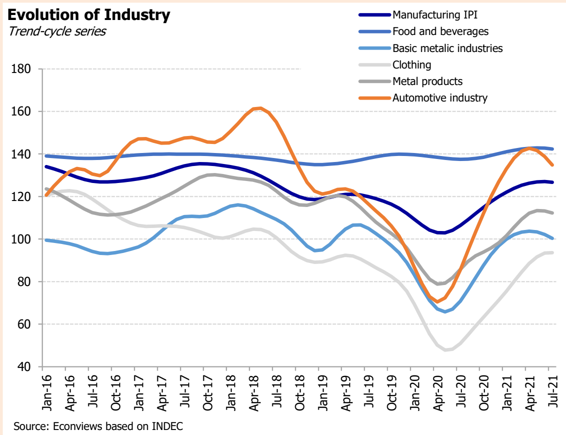
The big upset in the primaries, with opposition wins in all main districts, could impose the need for the Government to take additional measures to prop up consumption and economic activity on the road towards the general elections in November.

Economic activity has shown signs of recovery after being dealt a very hard blow by the strict lockdown in 2020. But the rebound has been very mixed. While some sectors such as Industry and Construction have registered genuine growth and already exceed the -mean- levels of 2019, in the vast majority of sectors what we have observed is just a rebound. The reactivation has not been linear, but rather in zigzags, to the rhythm of the pandemic's evolution and its successive "waves" of infections. In this context, we ask ourselves, **how much fuel does the recovery have left after the primaries and what will happen beyond November?**



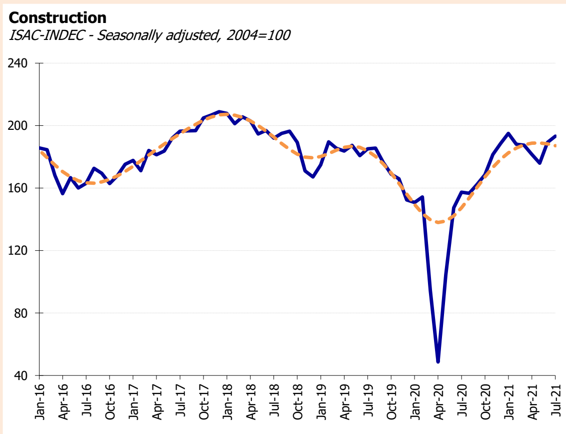
__A brake on the auto industry__

Let's start with manufacturing. On Tuesday INDEC released the industrial production index (IPI) data for July, **which showed an expected decrease of 2.6% in the series without seasonality compared to June**, a month that was underpinned by the reopening after the temporary closings in May and the recomposition of stocks, as well as a higher demand from the construction sector. Therefore, the fall in July was more of a normalization and the IPI remains at a level that is 5.6% higher than the same month of 2019.



A clear example was the auto industry. After lowering production in April and May, June marked the highest level for that month since 2017, according to ADEFA. But, mirroring what happened with the industry as a whole, production fell in the seventh month of the year (13.6% in our seasonally adjusted estimate). **And in August the downward trend continued**: despite the manufacturing of some 6,327 more units than in July, after discounting the seasonal effect a monthly drop is 10.5% observable. **The problem comes from the side of auto parts**: the subsector runs a trade deficit and the government wants to tighten FX controls even more, which could put a ceiling on the automotive industry's reactivation despite the firm demand for new cars.

In this sense, it is worth wondering if the Industry as a whole is hitting a roof or if it has more room to recover. The answer is not obvious, but the data provide some evidence in favor of the first hypothesis. Analyzing the trend-cycle series for a number of industrial sectors, which indicate their medium and long term evolution while eliminating seasonal effects and irregularities, we can observe that most sectors have already reached a certain peak in their recovery, or as in the case of the automotive industry, the trend is already negative.



__With a hand from the Government__

Construction's results for July were better than the Industry's. The ISAC series, seasonally adjusted, advanced 2.1% after the 7.6% rebound in June. And although it is still below last January's peak, construction activity far exceeds its levels from 2019. **Watch out! This time the impulse came mainly from the side of public works**: the demand for asphalt shot up 47.3% monthly and explained 0.9 of the 2.1 percentage points of monthly growth, despite its very low weight in the index. On the other hand, inputs related to private work had mixed results, which nevertheless remained at good levels. **Now, the preliminary data for August is not very auspicious: the *Construya* Index contracted 7.3% per month in our seasonal adjustment.**

What will happen in the next few months? In the short term, the situation in both sectors will remain relatively positive, although we do not expect much growth. With the increase in the exchange rate spread and a more moderate inflation, there is still some scope to take advantage of a relatively low construction cost measured in parallel dollars, although the trend reversed in August. In addition, financing in up to 24 installments at a subsidized rate for the purchase of materials also gives oxygen to the sector in the run up to the elections. In this sense, a greater number of private works companies believe that Construction will remain stable in the coming months.

And the industrial sectors that are closely related to Construction will indirectly benefit. On the other hand, the producers of durable goods will also have the boost of subsidized financing and the improvement of the population's income in the coming months: after revised wage negotiations, the real salary will probably end this year at the same level as inflation after a significant drop in the first semester. To that we must add the "helicopter money" the Government will pour into the streets from here to November. **The main threat to the recovery of production in the short term is that the government will tighten import controls to limit the very strong outflow of dollars registered in the last days.**

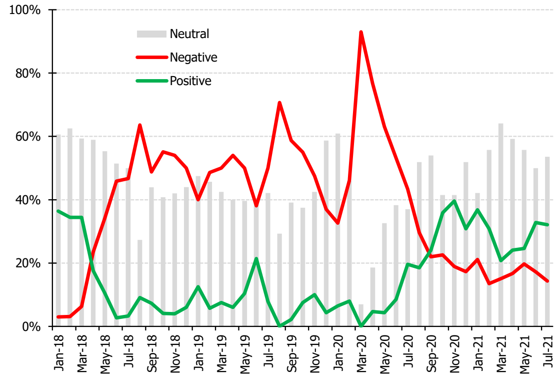
But in the medium term, Construction faces the same challenges as Industry. In the analysis of the trend-cycle series, a flattening and even a fall is seen for hollow bricks, an input closely related to private work. On the contrary, asphalt demand is in the middle of an upward cycle: **the boost to public works is a staple of election years.**

<u>A high bid on Consumption</u>

Any measure taken between now and November cannot significantly alter the dynamics of the sectors that produce goods. Instead, the focus will be on putting money in people's pockets and keeping inflation under control by any means necessary, stepping on the exchange rate and maintaining utilities frozen. And, on the other hand, sanitary restrictions will continue to be lifted as the contagion curve falls. **The recovery between now and November will center on the service economy.**

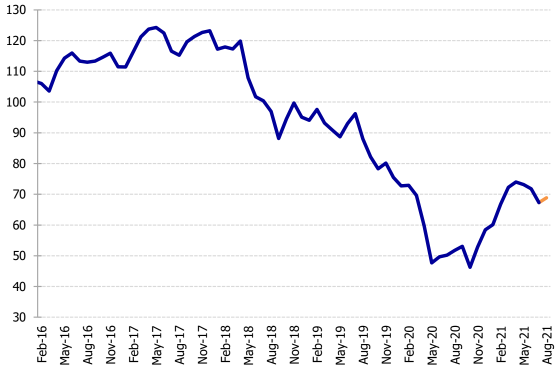
In August, population mobility reached its highest level since the start of the pandemic, according to Google data, as the authorities further loosened the current restrictions. In the City of Buenos Aires, the capacity for theaters and music venues was increased, the closing hour for cinemas, bars and restaurants was extended, and the province of Buenos Aires authorized outdoor events for up to 1,000 people. The greater flexibility was also

Expectations for private activity in the next 3 months
Survey of main construction companies



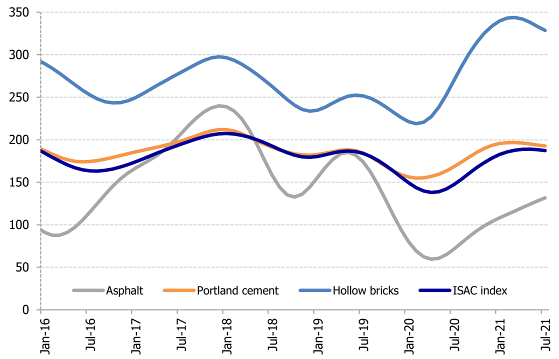
Source: Econviews based on INDEC's Cualitative Construction Survey

Exchange rate and cost of materials for construction*
Cost of materials/parallel dollar, Dec-15=100



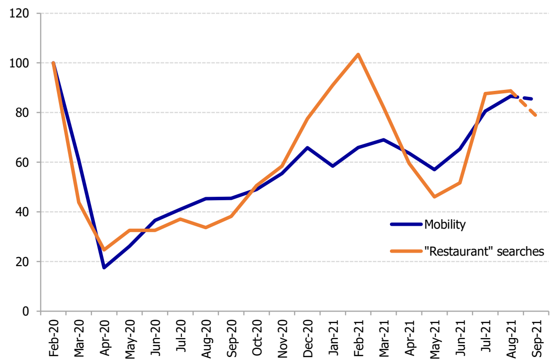
*Estimate for last month
Source: Econviews based on INDEC

Construction activity & supplies: medium-term evolution
Trend-cycle series



Source: Econviews based on INDEC

Mobility and Google searches of "Restaurant"
Non-seasonally adjusted indexes, mobility to shops, Feb-20=100



Source: Econviews based on Google

observed in transport: suburban train tickets reached their highest level since the start of the pandemic in July and the data for August will surely continue in the same direction.

We do not have hard data for August yet, but some high-frequency indicators show that activity in retail sectors continued to increase, although slowing down compared to July. Electricity consumption in Shops and Services increased 14.2% monthly in July and another 1.6% in August, seasonally adjusted. In turn, Google searches for "Restaurant", a good indicator of real-time sales - albeit with greater volatility - reached their highest level since the start of the pandemic after discounting seasonal effects. The first data for September, still very incomplete, would indicate a fall, but this can turn around.

Cheap financing programs are part of the battery of measures to prop up consumption. The expanded *"Ahora 12"* installment program for the purchase of all types of goods is mainly aimed at sustaining sales of durables. And the extension of "*Pre-viaje*", which reimburses 50% of tourist expenses for those who sign up, will seek to give a feeling of relief to a sector that was hit very hard by the pandemic.

With all this, the government wants the economy to close the year with a rebound of 8%. In our baseline scenario, GDP will close at 7.4%. June left a carryover of 6.86%, so from here to the end of the year the growth we will see is rather testimonial and will be led by the services sector. **Our nowcast model showed a year-on-year growth of 9.1% for July and a seasonally adjusted monthly growth of just 0.6%.**

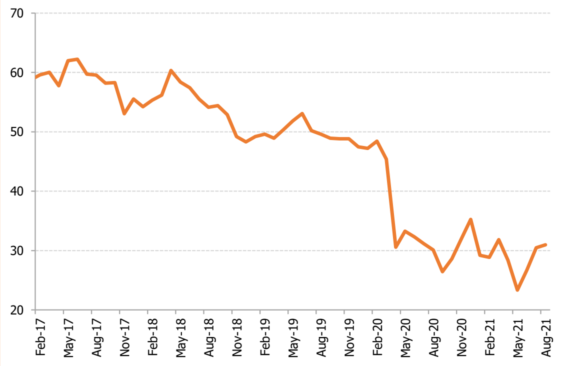
The day after the elections

The recovery has lost momentum, there is no doubt, although it will continue moderately. The problem is that the reactivation has been very dissimilar between sectors and some of them continue to operate well below pre-pandemic levels. This reflects clearly in private employment.

Employment in the Industry not only recovered quickly, but already exceeds February 2020's levels, with data up to June. In Construction it is still depressed but the upward trend continues. **This contrasts with employment in the service sectors:** in Commerce and Transport it went stagnant a few months ago, and in Restaurants and Hotels the trend continues to decline, although we will probably see some improvement in the data for the coming months. **But the reality is that some 88,500 formal private jobs have been lost since the pandemic began. In the same period, the public sector added some 66,300 employees. A difficult dynamic to sustain.**

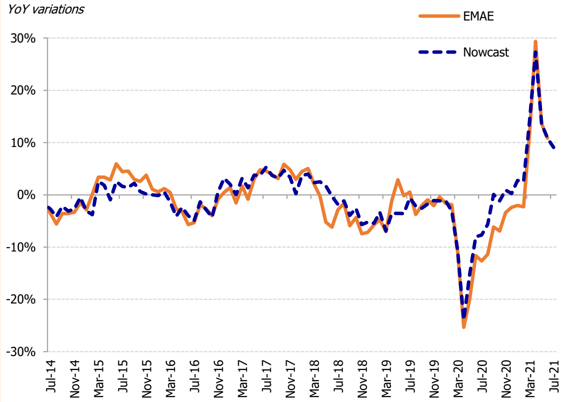
The situation beyond November leaves more doubts than certainties: the recovery appears to be running out of gas. By 2022 we expect wages to fall again in real terms: in our baseline scenario next year's inflation will close at 48% if utilities and the FX rate are recalibrated, which is very likely within the framework of an agreement with the IMF. On the other hand, the adjustment of fiscal accounts -in a non-electoral year- will mean a fall in public works. And

Electricity consumption in Shops and Services
In MW, seasonally adjusted



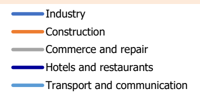
Source: Econviews based on CAMMESA

EMAE vs Nowcast
YoY variations



Source: Econviews based on INDEC

Formal wage-employment
Feb-20=100 - Seasonally adjusted



Source: Econviews based on Ministry of Labor

without proper incentives, investment will remain at extremely low levels - the ban on beef exports is a clear example of what not to do.

It's the macro, stupid. Reversing the stagnation trend is not impossible, but it is difficult: without a defined and predictable economic direction, companies cannot think much beyond the short term, and soaring inflation distorts the decisions of both consumers and producers. There are no magic recipes here, but if we want to return to a sustained growth cycle, a clear and defined program is a necessary condition. **The best hope is that a program with the IMF will help align expectations and that the economy will slowly normalize.**

The Secrets That Leliqs Hide

The Ministry of Economy, Martin Guzman, described last week the AR$ 4 trillion that the Central Bank holds in interest-bearing liabilities (Repo + Leliqs) as a "situation that is dysfunctional for the economic system." What he wanted to say? And, even more, if it is dysfunctional as it maint ains, why is any progress being made to lower this "mountain" of short-term securities that many point out as a "time bomb".

We must start by remembering that both the Leliqs and Pases (repo), as well as the ancient LEBAC bills, are part of the monetary policy instruments that the CB has at its disposal, and that it uses to control de money base. Through tenders directed to financial institutions, and to people when the Lebac Bills were operated, it offers titles that have a duration of 1 to 7 days in the case of Pases and 28 days in the case of Leliqs, which today give a nominal interest rate of 32%, 36.5% and 38%, respectively.

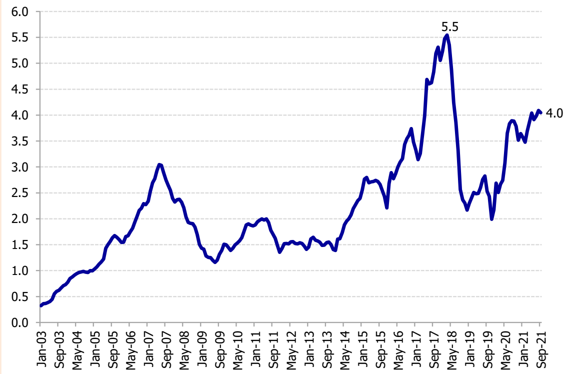
It should be noted that if the government needs to sterilize, that is, to remove money from circulation, it means that there is an oversupply that is being generated in another way. In 2020 and so far in 2021, the mismatch in the monetary balance was generated by the monetary financing of a record primary fiscal deficit, which forced the CB to go out and mop up the surplus through the Passes and the Leliq. In numbers, during the last pandemic year the CB transferred to the Treasury just over AR$ 150 billion per month, while from January to August of this year it did so for another AR$ 100 billion.

The imbalance between the amount of money and the amount of goods and services produced, which we measure through the deviation between the observed value and the historical value of the ratio between M2 (currency and coins held by the non-bank public plus savings deposits) and the EMAE, **had a peak of 35% during 2020**. And although it was corrected as economic activity picked up, as well as the inflation, in the meantime the CB was forced to increase the stock of interest-bearing liabilities in a dizzying way.

The cost of having doubled the number of Passes + Leliq in real terms compared to the end of 2019 is the size of the interests (more than AR$ 100

CB's remunerated liabilities (Leliq + Pases + Lebac)

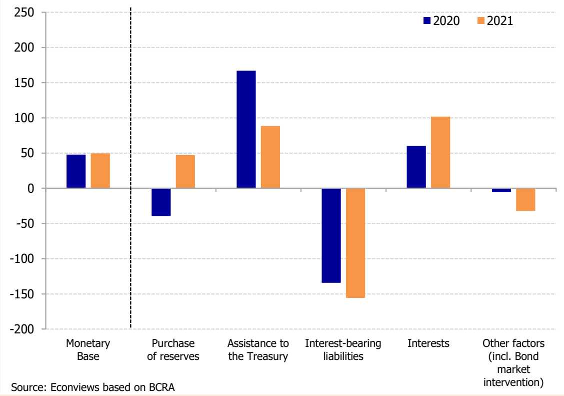
In AR$ billions, real terms as of sep-21



Source: Econviews based on BCRA

Monetary Base expansion/contraction factors

In AR$ billions - monthly average, up to aug-31



Source: Econviews based on BCRA

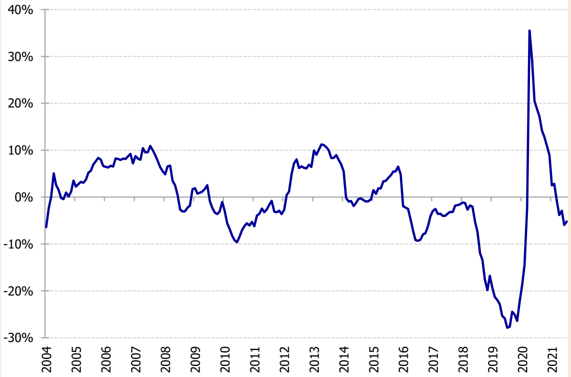
billion every month), which makes very difficult the handling of the monetary policy of the CB. We had mentioned that so far this year, the monetary financing was almost AR$ 100 billion per month, the same amount that the instituion led by Miguel Pesce had to pay for the interests of the remunerated liabilities. Thus, the monetary imbalances now comes from both the fiscal deficit and the quasi-fiscal deficit, that is, from the interests that the CB must pay for the securities it issues.

This problem is aggravated if we note that the interest rate, which determines the amount of interest to be paid month by month for the Passes and Leliq is below the inflation expectation, that is, it is negative in real terms. Part of the pressure that we have seen in the last few days in the FX market (the CB had to interviene up to US$ 500 million so far this month) is due to the fact that the money demand in local currency is falling. And it will continue to be so as long as the real interest rate remains negative. This puts the economic team at a crossroads, a "dysfunctional situation" in the words of the minister. With each porcentaje point of increase in the monetary policy rate, the interest burden of the liabilities paid today would increase by AR$ 3 billion per month. That is, if it wanted to equate it with inflation (+10 percentage points), the CB would go from paying the current AR$ 125 billion to AR$ 155 billion.

What options are in the menu to reduce the stock of remunerated liabilities, allowing raising rates without being crushed by the interests? The painful option is the one we saw during 2018, in which the stock was reduced, but with it, also the international reserves. Without trust, the money automatically go from Leliqs and Pases to seek foreign currency. Thus, from 2017 to 2018 the stock was reduced by a third, and international reserves were maintained only thanks to the loan that came with the program signed with the IMF. Today the situation is drastically different, with a projection of net reserves for the end of the year of US $ 2,500 million, there are no dollars available to "give away".

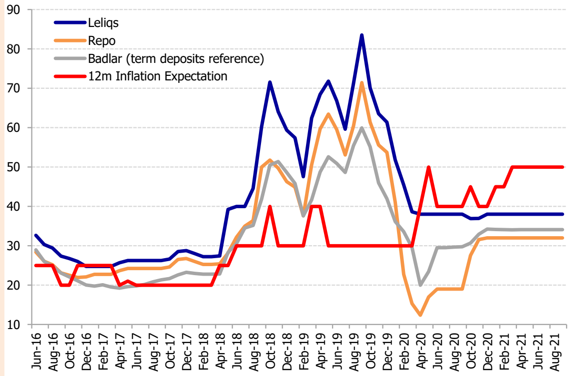
A possible solution, in our opinion, is a combination of putting to rest the fiscal dominance and economic growth, to "genuinely" absorb the monetary imbalances through credit to the private sector. This is crucial if we add to the analysis that Argentina needs to accumulate international reserves and that with every dollar that comes in there is a peso that needs to be issued. We believe that the country should strengthen its international reserve position by at least US$ 5 billion during 2022. That means a little more than 700 billion pesos of monetary expansion. Our baseline scenario contemplates a 2.5% primary deficit for next year. If the CB issues 6 out of every 10 pesos to finance it as in 2021, we are talking about 1 trillion pesos more. And we are still not counting the expansion of the interests of a stock that in December would be around AR$ 4.5 billion. They are another AR$ 1.7 billion of interest with a rate of 38%, which we consider low. **The other side of the coin is that, if dominance is not cut off, inflation becomes a necessity, since it reduces the stock of remunerated liabilities in real terms. In other words, inflation is what ends up avoiding the “snowball” effect.**

How big is the monetary imbalance?
Private M2 adjusted by EMAE - in % of deviation from the long term trend



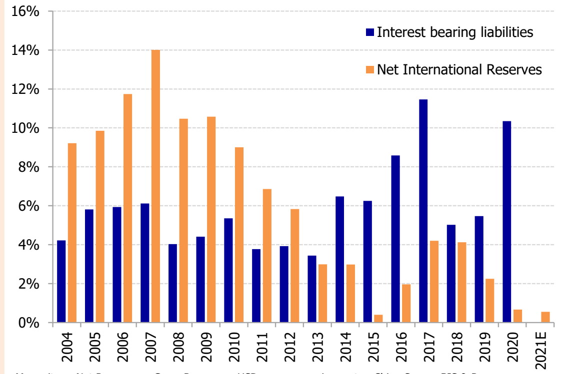
Source: Econviews based on BCRA and INDEC

Nominal Interest Rate and Inflation Expectations
In percentage points



Source: Econviews based on BCRA and UTDT

Interest bearing liabilities & Net International Reserves
As % of GDP

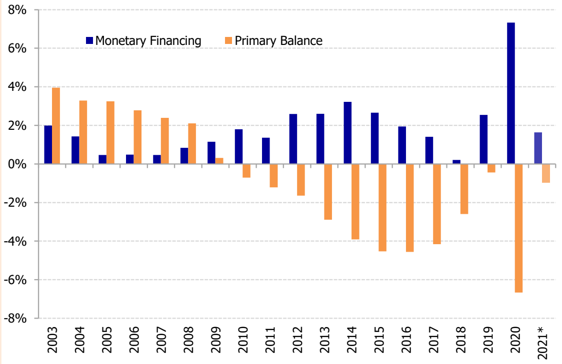


Memo item: Net Reserves = Gross Reserves - USD reserve requirements - China Swap - BIS & Repos
Source: Econviews based on BCRA and INDEC

What we want to emphasize is that to raise the rate and strengthen the money demand it is necessary to reduce the stock of Passes and Leliqs, otherwise it could lead to an explosive dynamic, and to do so it is essential that the monetary financing spigot is reduced. In any case, the only source of expansion that should be maintained is that produced by the inflow of foreign currency to increase the international reserves. It is the secret that the Leliqs hide: the inability of our Welfare State to finance public spending that leads us to issue pesos that have a diminishing purchasing power. Since no one would voluntarily stay in pesos, the Leliqs go out to look for them and capture them, helped by the cepo, at a rate that does not even compensate for the expectation of inflation.

Today, with such unrestricted control of capital movements, there is no risk of a disorderly disarming of remunerated liabilities. However, the counterpart of the Passes and the Leliqs are the deposits of the citizens. This ultimately means that they are the ones who, faced with a situation of growing mistrust, can turn to buying dollars, at the limit, at any price.

A long relationship: monetary financing and fiscal deficit
As % of GDP



*Cummulated until aug-21
Source: Econviews based on BCRA and INDEC