THE WEEK AT A GLANCE

ECONVIEWS
ECONOMÍA Y FINANZAS

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Editorial: Chainsaw Challenges

Most economists (including those of us at Econviews) believe that fiscal adjustment is a necessary condition to stabilize the economy. That is to say, Javier Milei has the correct diagnosis. The chainsaw analogy he used in the campaign was somewhat explicit, but no less correct. Not that the other macroeconomic challenges are easy, but this one is especially complex given the governance issues and natural learning curve of any new team that arrives. In this chapter we put everything that will necessarily have to be negotiated with governors, unions and their social works and other interest groups that have the power to block decisions.

In addition to that, there is a problem of proportions that makes this company almost an epic. Milei talks about a spending cut of 5 points of GDP. In our opinion, cutting 4 points would be a great achievement, and if it cut 3.5 points, economists and markets would still give it the green light. A small primary deficit is statistically the same as reaching equilibrium.

The total collection of the national state is around 24 points of GDP. Of that, approximately a third goes directly to the provinces and there is nothing to do. That is to say that the Nation collects in net terms about 16 points and spends (well counted) almost 20 points. There is another third of the collection that goes directly to ANSES. There perhaps half a percentage point can be found with inflation accelerating and not compensating the loss for retirees with bonuses. The rest will have to come from general administration expenses. The problem is that there Milei should save 3 points out of 12 spent on issues that do not include retirement. In other words, she should dynamite 1 out of every 4 pesos spent. That is difficult, even if there were unrestricted parliamentary support. It is clear that "political expenses" are not enough and that we will have to put a strong hand on subsidies, public works and discretionary transfers to the provinces and perhaps try to liquefy salaries a little.

Provincial governors do not help in the process either. A few weeks ago they did not say anything when Massa defunded them to eliminate the most equitable tax that exists in the economy and that transformed Argentina into a country where there are very few people who pay income tax. Now they say that they do not have money and propose to co-participate in the tax on debits and credits that today finances ANSES. The president-elect was wrong to raise his hand to approve that move. Possibly today he regrets it. Until a few weeks ago, the provinces were surplus entities and some engineering could have been put together to finance the transition with a little less pain.

The other issue that the economic team must organize is financing. The good thing is that January is usually a fiscally benign month. But then the real game begins and not all spending cuts will be ready from day one. Milei will surely prevent monetary issuance to finance deficits. That means that money will have to be found in the local market. That is easier if exchange restrictions are not removed. But not removing FX restrictions goes against everything Milei thinks and says. Eliminating them means paying more for bonds tied to the dollar because the exit exchange rate is higher. Not eliminating them makes it very difficult for money to enter Argentina.

The challenge will then be whether to adopt pragmatism and use the issuance of money for a few more months or whether to decide to continue with the FX restrictions for a few months and use the remaining pesos to pay what remains of the deficit. What we do not see is significant financing from external markets (for now), although we are somewhat more optimistic with a new program from the Monetary Fund. The Fund will surely ask for a more monetary shock strategy, but there is room to talk and with some financing the markets would be calmer.

LAST WEEK IN REVIEW

- **Weekly inflation jumped to 3.1%** according to the Secretariat of Economic Policy. With this data, the variation of the last four weeks shows 10.8%.

- In Tuesday's auction, **banks renewed only 22.8% of the Leliqs that expired, and 2.8% on Thursday**. The stock of repos reached AR$ 14.7 billion and Leliqs was reduced to AR$ 7.5 billion.

- **Personnel in the Ministry of Health grew by 13% in October compared to the previous month**, according to the INDEC Public Administration Staffing report. Also noteworthy is the 5.3% growth in workers at INCAA, and the falls in the Institute of Scientific and Technical Research for Defense (-8.7%) and in the Joint Chiefs of Staff of the Armed Forces (-4.9%).

NEXT WEEK'S HIGHLIGHTS

- On **Wednesday 6th**, INDEC will publish the **indices of industrial fishing production and industrial mining production** corresponding to the month of October.

- On **Wednesday 6th**, the BCRA publishes its **financial stability report** corresponding to the second half of 2023.

- On **Thursday 7th**, INDEC will publish the **industrial manufacturing production index** for the month of October.

- On **Thursday 7th**, INDEC will also publish the **current indicators of construction activity** (ISAC) for October.

- On **Thursday 7th**, the BCRA publishes its **monthly monetary report**.

- On **Thursday 7th, inflation in Buenos Aires City** for the month of November is announced.

- On **Sunday 10th** the presidential ceremony takes place. **Javier Milei and Victoria Villaruel will be sworn in** before the Legislative Assembly as president and vice president until December 10, 2027.

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Market dashboard

Weekly, monthly and yearly variations

	Last data	w/w	m/m	y/y	
Official exchange rate ARS/USD	361.0	1.0%	3.2%	115.3%	↑
Blue Chip Swap "SENEBI"	935.5	-4.9%	5.2%	188.7%	↓
Parallel	935.0	-4.1%	4.5%	202.6%	↓
CB reserves (USD million)	21,508	-43	-368	-16,680	↓
Policy rate (Leliq)	133.0%	0 p.p.	0 p.p.	+58.00 p.p	=
Badlar rate (private banks)	129.9%	+0.63 p.p	+0.50 p.p	+60.81 p.p	↑
Merval (in ARS)	870,169	-5.2%	41.2%	410.1%	↓
Country Risk (spread in %)	1,982	1.3%	-23.8%	-10.4%	↑
Official exchange rate BRL/USD	4.88	-0.5%	-1.5%	-5.9%	↓
Soybean (USD/tn)	486.9	-0.4%	2.6%	-7.3%	↓
Corn (USD/tn)	182.9	0.3%	-2.2%	-28.5%	↑
Wheat (USD/tn)	212.0	5.1%	2.7%	-24.0%	↑
Oil - Brent (USD/barrel)	83.7	-0.7%	-7.9%	-7.0%	↓
Oil - WTI (USD/barrel)	73.7	-1.5%	-9.1%	-9.1%	↓
Natural Gas (USD/MMBTU)	2.8	-1.4%	-19.5%	-58.2%	↓
LNG (USD/MMBTU)	15.7	-4.3%	-7.6%	-55.1%	↓
Copper (USD/lbs)	3.9	3.0%	11.9%	-42.0%	↑
Aluminum (USD/tn)	2,174.5	-1.2%	-2.7%	-12.0%	↓
Gold (USD/oz.)	2,070.1	3.4%	4.4%	14.8%	↑

Note: arrow depends on weekly variation

Stoplight for Economic Activity

Seasonally adjusted variations

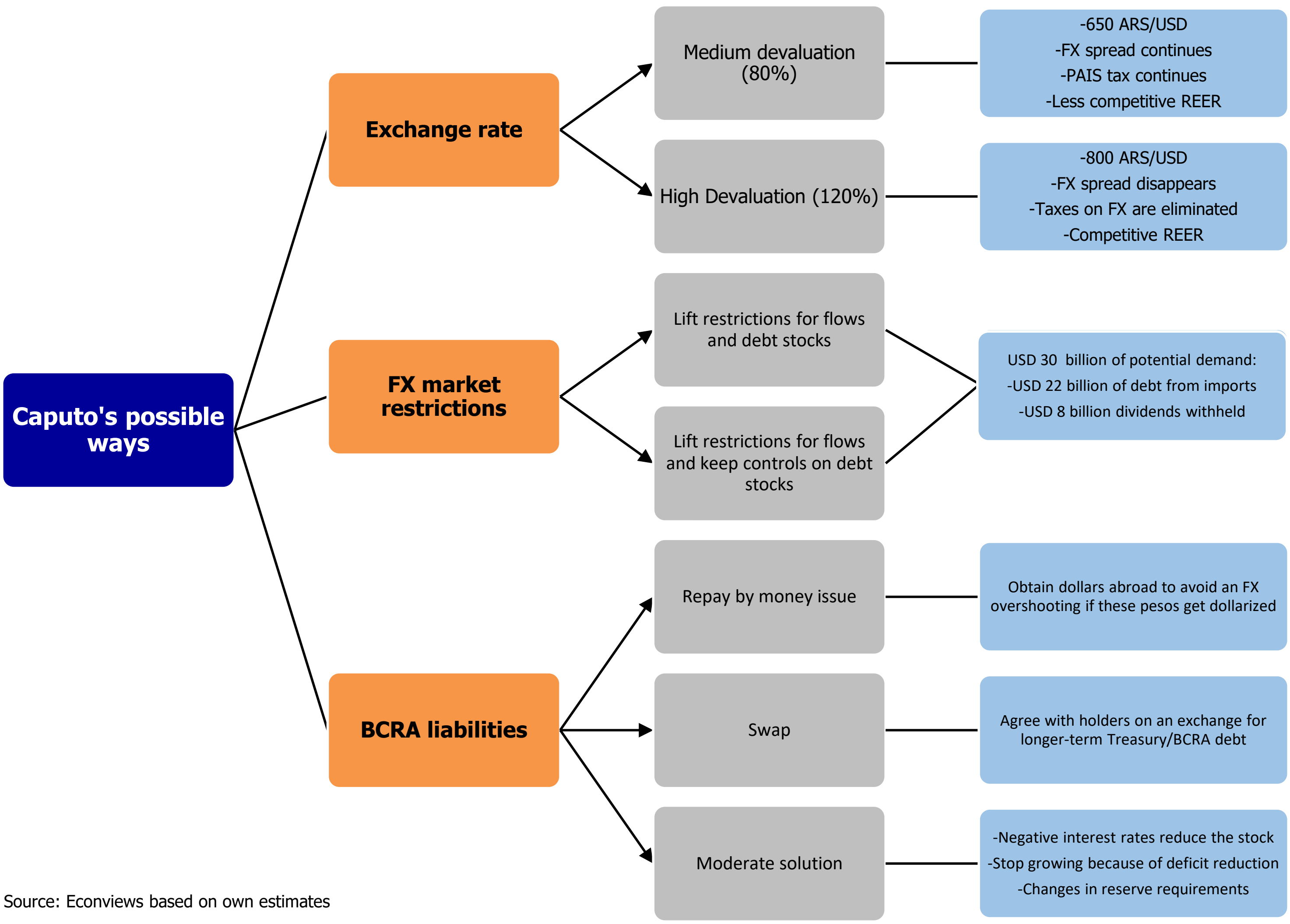
		m/m	q/q	LD vs previous Q	
Industrial production	*Sep-23*	0.2%	-1.9%	0.1%	🟡
Automobile production	*Oct-23*	-2.3%	-6.6%	-10.3%	🔴
Steel production	*Oct-23*	-3.7%	2.4%	5.5%	🟢
Poultry production	*Oct-23*	7.1%	0.1%	3.2%	🟢
Dairy production	*Oct-23*	-1.0%	-0.7%	-2.4%	🔴
Beef production	*Oct-23*	1.8%	-9.3%	-3.4%	🔴
Real Estate transactions (CABA)	*Oct-23*	14.5%	5.6%	11.2%	🟢
Flour Production	*Oct-23*	-2.9%	-1.3%	-2.3%	🔴
Oil production	*Oct-23*	1.3%	1.8%	2.6%	🟢
Gas production	*Oct-23*	-10.6%	-0.3%	-8.4%	🔴
Cement production	*Oct-23*	1.5%	-5.4%	-2.0%	🔴
Construction activity	*Sep-23*	-0.1%	-1.5%	-0.4%	🟡
Gas sales	*Sep-23*	-3.3%	-4.7%	-5.2%	🔴
Motorcycle licenses	*Oct-23*	16.8%	-1.5%	5.7%	🟢
Use of electricity	*Oct-23*	-0.5%	1.3%	1.9%	🟢
Subway rides (CABA)	*Oct-23*	-5.9%	-12.5%	-12.9%	🔴
Imports CIF	*Oct-23*	-3.6%	-6.8%	-3.8%	🔴
Exports FOB	*Oct-23*	-5.5%	-0.8%	-6.6%	🔴
Loans in ARS to private sector	*Oct-23*	4.1%	-7.1%	0.2%	🟡
VAT-DGI Revenues	*Oct-23*	-10.0%	-5.6%	-10.8%	🔴
Formal private jobs (SIPA)	*Aug-23*	0.3%	1.1%	0.6%	🟡
Formal private jobs (EIL)	*Sep-23*	0.0%	0.5%	0.2%	🟡
Consumer confidence	*Nov-23*	5.3%	5.1%	7.5%	🟢
Government confidence	*Nov-23*	15.6%	1.9%	20.2%	🟢

Note: stoplight color depends on last month vs previous quarter variation

Caputo's Possible Ways

- *There are three issues where Luis Caputo will have several action plans: devaluation, FX restrictions, and BCRA liabilities.*
- *Rumors speak of a devaluation that would not be as high as expected and that FX restrictions would continue. We think that a shock plan would be better.*
- *We think that too much importance was given to the liabilities of the Central Bank. If the fiscal deficit is reduced, it is a problem that should be solved.*

In 6 days, Milei will take office. Last week he confirmed that Luis Caputo will be his economy minister, but there are still no details about the plan beyond leaks that have been published in newspapers. **In this context, we see that there are several fronts where the government will have more than one path to choose from.** We have our preferences, but that does not mean that they necessarily end up being the chosen option or that there is only one way to do things.



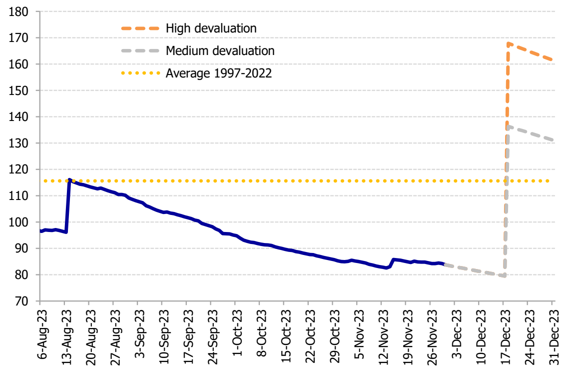
Source: Econviews based on own estimates

As we said last week, we think that the first important measure will be related to the exchange rate. In addition to the urgency that this issue poses, it is also true that at this point it will be easier for the new government to make decisions, given that it does not require approvals from Congress, but rather it is simply the BCRA that decides. **In this issue, there are two possible paths in sight (doing nothing is not an option): a high exchange rate devaluation or a smaller one.**

The first option is to let the exchange rate float and the market would take it to a value of around 800 pesos. Starting from the 360.5 pesos at it ended in November, this implies a jump of just over 120%. With this devaluation, the FX spread could be eliminated quickly and all taxes on the dollar (PAIS + Advances on Income Tax) would be eliminated. Furthermore, the real exchange rate would become competitive enough for reserves to grow again. **This would be a shock strategy and, based on our criteria, the most appropriate.**

However, we do not marry this scenario. According to recent news, there are chances that Toto Caputo will go for the second option. **That is, the initial devaluation would not be so high, and the PAIS tax would remain in place.** A dollar at 650 pesos implies an exchange rate jump of 80%. In this case, the FX spread is likely to remain somewhat higher and will not disappear at least until the PAIS tax is eliminated. The gain in competitiveness would be lower, so the incentive for exports to be settled would also be lower.

Real Effective Exchange Rate
Base 100 = 17/12/2015



Source: Econviews based on BCRA & own estimates

We believe that by following this line of action the current situation can be decompressed, but there are chances that the devaluation will fall short considering that inflation can quickly erode the improvement. According to our price survey, in the last week of November, all the items we measured rose at least 5% compared to the previous week. The average of all categories reaches 6.9%. **This means that the real exchange rate appreciation when it comes time to devalue may be even greater than expected.**

Price survey - November

Weekly price variation in large GBA supermarkets

Category	5th week
Cleaning products	6.5%
Perfumery	5.9%
Dairy	6.0%
Meat and meat products	8.7%
Greengrocery	8.5%
Drinks	5.2%
Store	7.4%
Average var. foods	7.2%
Average var. total	**6.9%**

Source: Econviews based on own estimates

We understand that the justification for a not-so-high exchange rate correction comes from the fact that the restrictions will not be removed anyway, although here we think that there are also several options, and it is not all black or white. Milei's analysis is correct when he says that all restrictions cannot be lifted without first resolving the issue of Leliqs/Repos. If all those pesos seek to be dollarized, the demand for dollars would be so high that the exchange rate would rise a lot, which would translate into more inflation and the situation could become complicated.

What we think is that not all restrictions necessarily have to be lifted, but that with an exchange rate of 800 pesos per dollar, controls on new flows of imports or debt payments could be removed as long as the obligation to settle exports is maintained. The accumulated stocks (debt from imports and withheld dividend payments) can begin to be paid gradually once the Central Bank accumulates reserves.

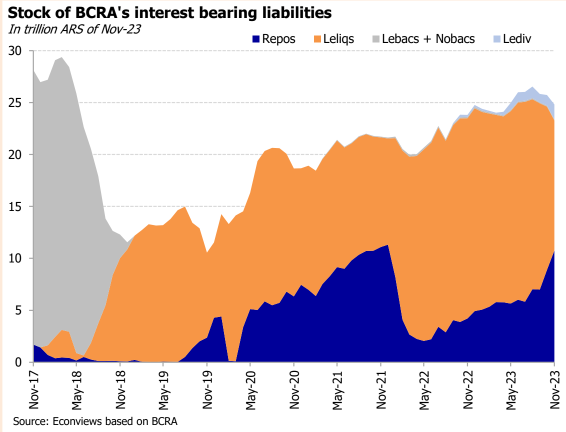
Regarding the issue of Leliqs or Passes, there are also several ways to address it. Our view is that it is a problem to have on the radar, but not of the magnitude that Milei gave it. If the primary deficit is eliminated, the Central

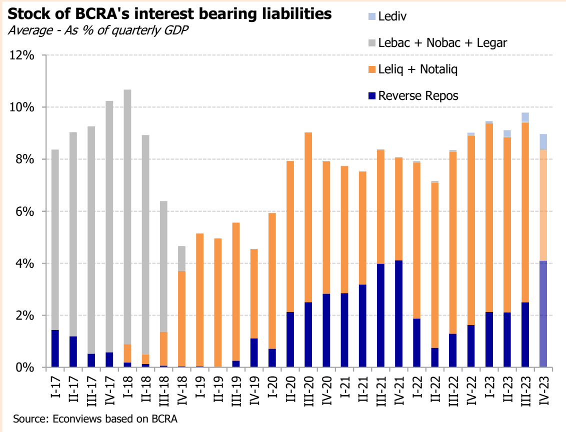
Bank will not have to issue more money to finance the Treasury. With this, there will be fewer excess pesos and therefore less need for sterilization. This ensures that this liabilities stock does not keep growing. Furthermore, the devaluation and the consequent acceleration of inflation will cause negative interest rates, so the amount of this debt (both in real terms or as a percentage of GDP) will be reduced. Finally, by making changes to the regulation on reserve requirements, a rotation of remunerated liabilities (Leliqs/Repos) to not-remunerated liabilities (monetary base) can also be achieved.

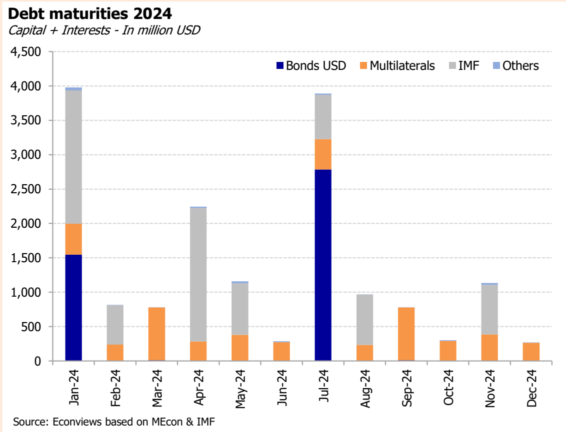
The government's proposal seems to go another way. One option is to propose a swap of these BCRA liabilities for a longer bond from the Treasury or the Central Bank itself. A priori this option is not bad as long as the maturities are extended. Another point that should be taken into account is that the Leliqs or the Repos are backing deposits, so if they are exchanged for a very long bond, we will have to think about giving the banks a liquidity window in case those deposits are not renewed. Possibly the best thing would be to swap only a percentage, so as not to affect the system.

Another alternative for this debt is to be repaid by the Central Bank. That would imply that many pesos would have to be issued, which, as we said, could run against the dollar. **The government would obtain dollars that would be used to avoid sudden movements in the exchange rate.** Our vision is that if financing is obtained from abroad (something to which we assign few chances in the short term) it would be better to use it to guarantee that debt payments can be made or to improve the situation left by Massa and Pesce in the BCRA. By the way, in January the country must pay interest to bondholders for USD 1.5 billion and USD 1.9 billion of principal amortization to the IMF. In this sense, the new authorities will likely negotiate a loan or a minimum of settlements with the oilseed and cereal export sector for the first months. For this reason, we also think that a high real exchange rate would make things easier.

One last point where the new administration will face a dilemma is how it will finance the December deficit, which will be the highest of the year. Possibly the current ruling party leaves some money available given that in the last bond auction, it obtained almost a trillion pesos above what was due. However, that will not be enough. From a communication standpoint, it would not be good to start the mandate by asking the BCRA to issue money, so the only alternative left is to get some aid from the market.







What to Expect in the FX Market in 2024

- *Gradually loosening FX controls, instead of a shock approach, could lower the Central Bank's reserve purchases by USD 8 billion next year.*
- *The Central Bank lost USD 4.6 billion in reserves in October, with a current account deficit of 313 million and a loss of 4.3 billion in the capital and financial accounts.*
- *Only half of the imports accrued in October have been paid. Another debt for the next government...*

With a paralyzed foreign exchange market, the BCRA still managed to lose USD 4.6 billion in reserves in October and half of that in November. It tightened import controls so much that the difference between accrued imports and those actually paid rose to 3 billion in October. However, exports fell to a minimum since the pandemic. In addition, there were net payments to the IMF and the Central Bank intervened in bond markets by a record amount.

As we said in the previous note, the economic team led by Luis Caputo discusses between two possible paths for the exchange rate. Each one has different implications for the FX market in 2024. **After losing USD 20.6 billion in reserves in 2023, it could recover between 11 and 18 billion next year,** depending on the magnitude of the devaluation and how much FX controls loosen, among other factors.

Without a drought, exports could increase by USD 30 billion. Although in the short term exports are less flexible to the exchange rate, the shock scenario gives an additional incentive to liquidate. Furthermore, with the precedent of the preferential exchange rate that allowed exporters to change 30% of their dollars at the Blue Chip Swap rate (now 50%), if the new economic team chooses to keep FX controls, a part of the flow of exports will keep flowing through this market.

Regarding imports, there will be an increase in payments, but not necessarily in quantities. The difference is that in 2024 imports will be paid for. At the margin, Argentina should reduce its commercial debt a little, but that will not be the priority of the incoming government. Rather, the focus will be on normalizing flows. With a higher exchange rate and (at least initially) with a PAIS tax on dollar purchases the import frenzy of the last years should not be an issue. Economic activity will also cool down. The stagflation that Milei announced is our base case as well.

Services will continue to run a deficit, especially on the tourism side. Especially if the exchange rate is not unified and inbound tourism continues to go to the MEP dollar. On the other hand, with a lower exchange rate, outbound tourism will also be cheaper, although we will have to see what happens with the PAIS tax and all the withholdings that today put the "tourist" dollar at par with the parallel rates.

Balance of Payments

In million USD - Cash basis

	2023E	2024E	
		Shock (more depreciated RER)	Gradualism (less depreciated RER/FX controls)
Current Account	**-6,436**	**9,127**	**6,127**
Balance of goods	9,946	23,900	21,900
Exports of goods	63,790	92,150	91,150
Imports of goods	53,844	68,250	69,250
Balance of services	-6,446	-5,750	-6,750
Interests	-9,598	-8,023	-8,023
Profits	-312	-1,000	-1,000
Transfers	-25	0	0
Financial Account	**-14,223**	**9,100**	**4,600**
Foreign Investment	953	3,000	1,500
Portfolio	30	2,100	600
Net Loans	-5,145	2,500	500
IMF	-1,787	3,000	3,000
Multilaterals	907	500	500
Hoarding	-1,260	-2,000	-1,500
Others	-7,920	0	0
erves accumulation	**-20,638**	**18,227**	**10,727**

Source: Econviews based on BCRA & own estimates

On the financial account side, the difference is substantial. If FX controls are loosened quickly and therefore the exchange rate depreciates sharply, it is much more likely that the flow of direct and portfolio investment will increase. There will also be more incentives for the private sector to seek financing abroad as dollars enter at a higher exchange rate. In both scenarios we see the IMF signing a new program and we risk that there could be some 3 billion in fresh funds.

<u>The figures for 2023</u>

The commercial debt continues to grow. In the last twelve months, imports of goods amounted to USD 74.8 billion, but only 59.2 billion were paid. Of this difference of 15.6 billion between the accrued and cash records, half (8.3 billion) corresponds to August, September and October 2023. Specifically for October, accrued imports amount to USD 5.8 billion, but on a cash basis only 2.7 billion were paid for.

A broader measure of access to the FX market that also includes dollars used to pay debts, interest or service imports, the spot traded volume, shows that in November only 258 million were traded per day, 24% below the average of the last three years and close to months of little activity such as January or February.

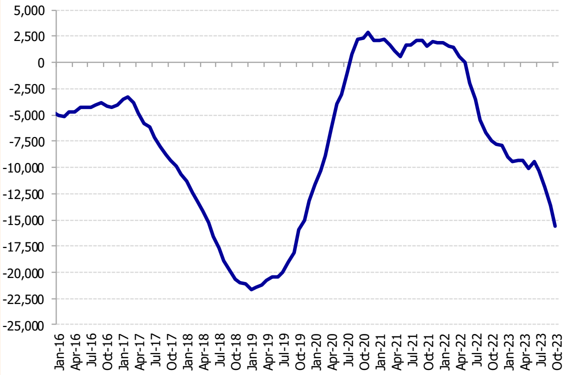
Goods exports on a cash basis amounted to USD 3.6 billion in October. Even adjusting for the 25% that some sectors changed at the Blue Chip Swap rate (30% as of October 23), it was among the worst records in recent years. **The "soybean dollar" had diminishing returns.** Oilseed and cereal exports fell from USD 2.1 billion in September to 821 million in October. According to CIARA data, between November 1 and 17, agricultural exporters liquidated 753 million. After the runoff, the Central Bank improved the BCS/official dollar mix for exporters from 30/70 to 50/50, but with expectations of 100/0 soon, only 182 million were settled in the last two weeks of the month.

Adding the deficit of US$ 753 million in the services account – the tourism deficit jumped from 575 to 870 million, for seasonal reasons, but also with many taking advantage of the cheaper tourist rate– and net interest payments of 356 million, plus other factors, **there was current account deficit of USD 313 million in October and 5.5 billion in the last year.**

The capital and financial accounts racked up a USD 4.3 billion deficit. Net loans amounted to a negative 628 million –there is no positive financing outside of multilaterals since March 2019 – and there was a 1.8 billion maturity with the IMF – 2.6 billion were due, but the payment was made between October 31st and November 1st, so the full amount was not listed. In November, another 1.7 billion were paid to the IMF between capital and interest, but in December the flow should be positive at 2.4 billion, unless the planned disbursement is delayed.

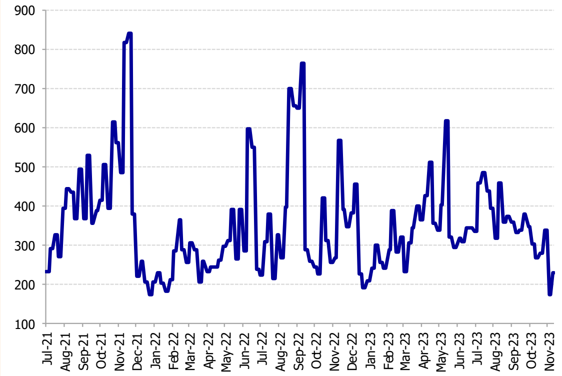
In addition, the BCRA spent USD 1.3 billion to contain the exchange rate spread through the purchase of securities in dollars, a record amount for the Pesce administration. The 4.1 billion that it spent on this cause between April and October far exceed the 2.5 billion of intervention during 2021, before the

Difference between imports paid and accrued
In million USD, CIF - Accum. 12 months



Source: Econviews based on BCRA & INDEC

FX market volume is very low
Weekly average, in million USD



Source: Econveiws based on MAE

Projected cash flow with the IMF
In million USD

	Disbursements	Repurchases	Charges
Oct-23		-1,793	
Nov-23		-848	-857
Dec-23	3,316	-912	
Jan-24		-1,940	
Feb-24			-572
Mar-24	1,061		
Apr-24		-1,940	
May-24			-750
Jun-24	1,061		
Jul-24		-647	
Aug-24			-733
Sep-24	1,080		
Oct-24			
Nov-24			-722
Dec-24			
Total 2024	3,202	-4,526	-2,778

Source: Econviews based on IMF

agreement with the IMF prohibited this type of operation. In this way, **the Central Bank's gross reserves fell by USD 4.6 billion during October,** the second worst month of the Pesce era after June of this year.

In conclusion, the data from October and those from previous months show that obtaining reserves with FX controls is a high-risk mission. In 2024 international reserves could grow by almost 11 billion with controls, but we are considering two important priors: in any case, there would be a devaluation (we assume initially at ARS 650 and then adjusted monthly) and on the other hand the 2024 controls should be much looser than the 2023 “soviet” model.