Perspectives

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ARGENTINA – Some progress but it seems reasonable to wait

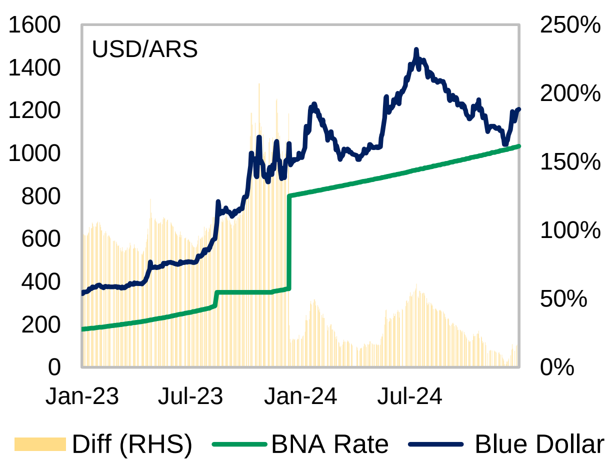
The election of Javier Milei as President who took office in December 2023 have made 2024 a year of radical change. The results of his fiscal austerity, aimed at ending monetary financing, and his management of the peso are both impressive (budget surplus, important disinflation) and mechanical (progress on the inflation and external accounts fronts can also be explained by the recession). Reducing imbalances also comes at a high social cost.

The two pillars of J. Milei's strategy

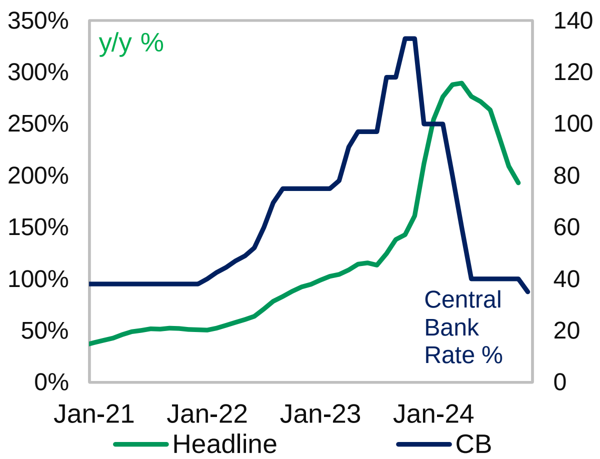
Achieving a **primary surplus** has been the cornerstone of the President's strategy (violent spending cuts, concentrated on social spending, reduction of primary spending from 20% to less than 16% of GDP, reduction of total spending by more than 20% in real terms). The primary surplus could reach 1% of GDP by 2024, for a total budget deficit of 0.5%. The government is targeting a primary surplus of 1% for 2025, i.e., a budget deficit of 0.3% despite the abolition of the "Impuesto País" (a 30% tax on dollar transactions and imports), a loss of revenue which the government plans to offset by increasing other taxes (fuel taxes, export duties and income taxes). The government's forecasts for growth (5%) and inflation (18%) seem optimistic compared to consensus forecasts (4.4% and 30%).

The second key element of Milei's economic strategy was a **significant devaluation of the peso** in December 2023 and the introduction of a crawling peg (monthly depreciation of 2% against the dollar). These measures have considerably reduced the gap between the official and parallel exchange rates: a reduction also favored by the BCRA's interventions.

Official & Blue exchange rates



Inflation and Official rate



Sources: BCRA, Crédit Agricole SA/ECO

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The exchange rate regime, however, remains under debate. Dollarization, initially envisaged by Milei as the solution to the peso's disaffection, seems to have been temporarily discarded in favor of "currency competition", which aims to strengthen the role of the dollar (implicit dollarization?). In addition, discussions have emerged on the possibility of reducing the monthly slide to 1.0-1.5% as progress is made on inflation and foreign exchange reserve accumulation (nostalgia for the peg?). However, this strategy is likely to put pressure on the peso, as the real effective exchange rate has appreciated sharply. The goal (including that of the IMF) is a floating peso, but legitimate concerns about the lack of a nominal anchor, the impact of inflation and low reserves persist. Finally, more generally, structural problems remain. It relates notably to resident disaffection towards the peso, de facto dollarization, narrow export base, limited responsiveness of exports to depreciation.

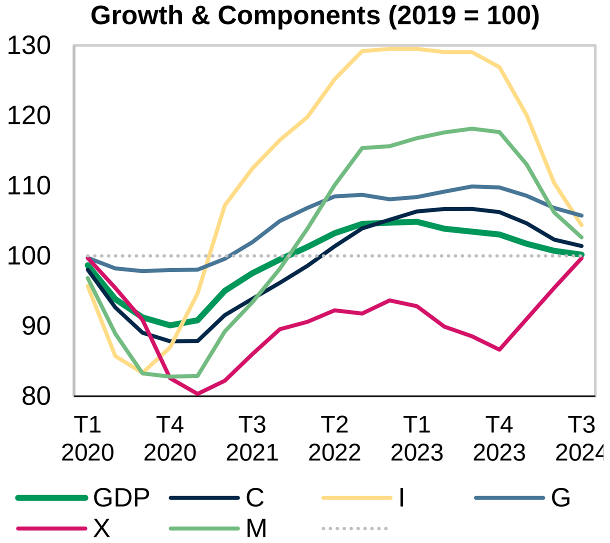
Falling inflation: estimable progress, partly mechanical

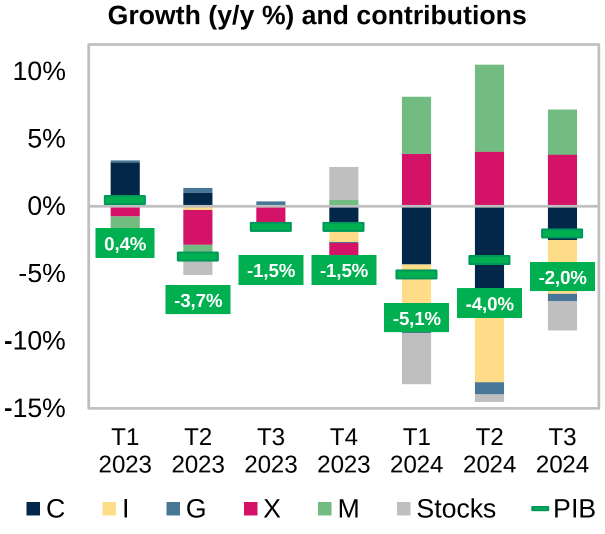
The Milei administration has made significant progress in the fight against inflation. Annual inflation has fallen from a peak of almost 290% (April 2024) to 193% (October 2024). Monthly inflation rates have fallen below 2.5%, and projections for year-end 2025 range from 18.3% (government estimate) to 45% (IMF forecast).

This improvement is the result of a drastic fiscal adjustment, the end of monetary financing, a clearer exchange rate policy and, ultimately, a fall in domestic demand. This has enabled the central bank to lower interest rates and reduce its balance sheet. Real interest rates remain negative.

After a severe recession, the economy is showing some signs of recovery, mainly thanks to the primary sector (mining exports) and a sharp drop in imports. The primary sector has rebounded after a drought-stricken 2023. Industrial production is recovering slowly. Services are slow to recover. Domestic demand remains weak, due to a decline in consumption (loss of purchasing power of wages and pensions) and investment (lack of visibility, lack of demand, capital restrictions). The effects of lower interest rates and the resumption of credit (due to the increase in dollar-denominated bank liquidity following the amnesty) are unconclusive (limited impact due to low credit penetration in Argentina).

The situation is still precarious, but the economy should recover by 2025. Growth could exceed 4%, thanks mainly to a mechanical recovery in private consumption. Sales of durable goods and supermarkets have stabilized; after falling, real wages are slowly recovering, suggesting that the worst may be over. One of the major risks is an increase in imports as demand recovers, a risk all the greater given the peso's appreciation in real terms. While stimulating imports, an overvalued peso could damage the competitiveness of companies, particularly in tradable services, and small manufacturing firms. The abolition of the PAIS import tax in 2025 will add further pressure on their competitiveness. Finally, capital controls are likely to continue to limit investment.





Sources : IMF, BCRA, Crédit Agricole SA/ECO

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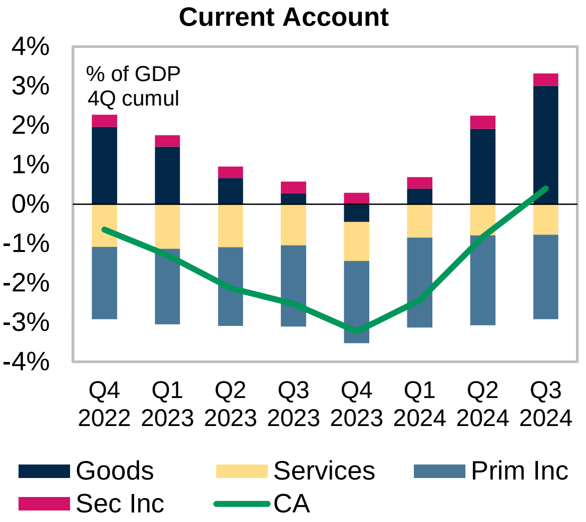
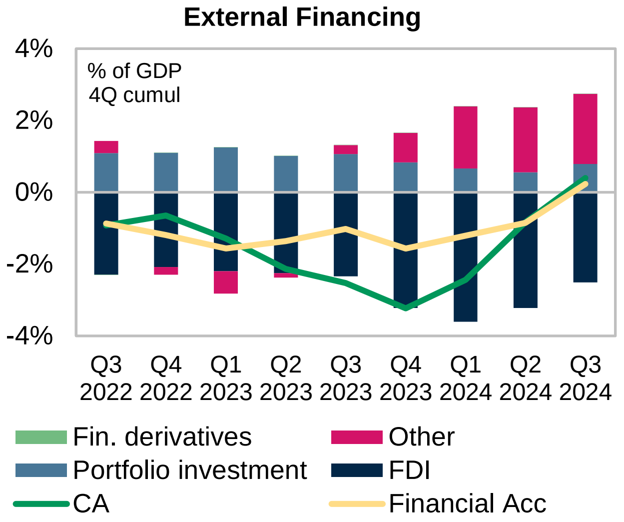
External accounts: a largely mechanical recovery

The nominal depreciation of the peso, the adjustment of public finances and the recession led to an improvement in the external accounts. The current account showed a surplus of 0.4%, mainly due to strong exports (agriculture and energy) and a sharp drop in imports. Aided by the amnesty program, external financing has improved, but reserves remain insufficient, particularly in net terms (excluding the PBOC FX swap lines) and regarding external payments in 2025.





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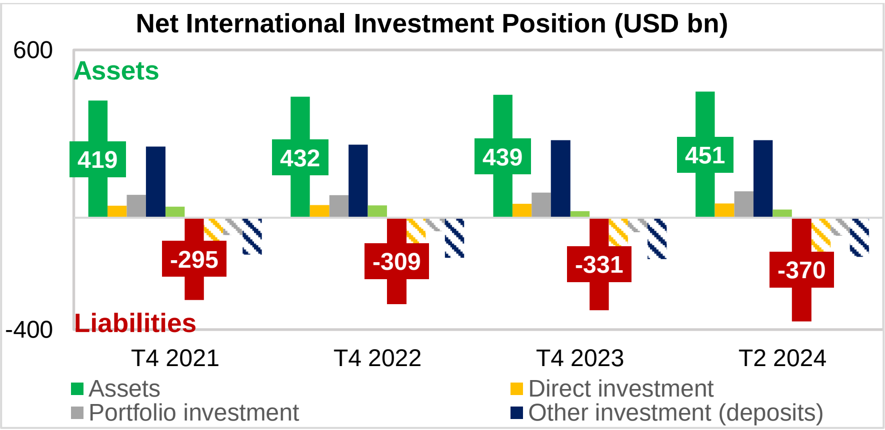
By 2025, the current account should show a slight deficit as imports recover. Foreign direct investment is likely to remain moderate until capital controls are lifted, and the foreign exchange regime is definitively stabilized.

External financing difficulties persist. While the prospects of a new agreement with the IMF are encouraging, the implications should not be overestimated. The IMF is due to review the current program ($44 billion) in the very near future; this program has been widely criticized by the IMF's own internal control bodies (lack of coherence, conditionality, etc.). In terms of austerity, Argentina, the IMF's biggest debtor, has gone well beyond what the IMF could ask for, but has not reached the target in terms of reserves. The IMF should continue to insist on the (floating) exchange rate regime and the accumulation of net foreign exchange reserves (outside China's swap lines). It may limit its assistance to renewing its commitment with little or no new money.

Despite uncertainties, the markets have reacted positively; however, a return to the markets could be premature and could prove dangerous (cf. the increase in foreign debt under Macri's presidency, much appreciated by the markets). Finally, the question of Argentines' disaffection with the peso (cf. accumulation of assets abroad and positive net external position) remains key.



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