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TPCG ARGENTINA
STRATEGY VIEW

Argentina – Strategy
April 12, 2024

Monetary policy: a path to the promised land or another walk through the desert?

- **IN THIS PIECE.** Over the past month, the Government has started being more transparent about what its "currrency competition" framework would look like. We take a look at the monetary policy since December to find out if the policy implementation is consistent with the Government's desired destination.

- **OUR KEY TAKEAWAYS.** Since December, there has been little doubt that the current monetary framework is a transitory arrangement until the time when the Government could implement its desired "currency competition" regime. The problem was that because it wasn't clear what currency competition meant, it was very hard to gauge how long this transition would take and whether we were making relevant progress toward the desired destination. From the Government's stylized description of the regime it's shooting for, we summarize currency competition as a framework combining (i) a free-floating FX rate, (ii) legally banning the BCRA from creating high-powered money, and (iii) striking down the legal hurdles preventing other currencies from having legal tender. In other words, to lead to the promised land, the current transitory regime needs to pave the way for the BCRA to be able to release capital controls and stop printing money. Currently, there are three main sources of base money creation: (i) fiscal dominance, (ii) reserve accumulation, and (iii) BCRA remunerated liabilities interest expense, with the Central Bank compensating for these sources of base money creation by issuing new remunerated liabilities to sterilize. To achieve the second pillar, the Government needs to (i) shut down fiscal financing completely, (ii) allow the FX to float without intervention (which would mean no more reserve buildup), and (iii) either bring rates to zero or eliminate the stockpile of remunerated liabilities. We find that the Dec-Mar monetary policy execution hasn't really brought the BCRA much closer to achieving these targets. Authorities seem focused on eradicating money printing to finance the fiscal deficit and on diluting high-powered money in real terms. Still, achieving both of these is not enough to create the conditions that Mr. Milei seeks. At the start of 1Q24, the Government had a shot at getting traction in the right direction. The primary surplus, combined with the Bopreal placements, would allow the BCRA to sterilize about ARS13tn in 1Q24, creating the conditions to reduce remunerated liabilities by about two-thirds and the BCRA interest expense. That didn't materialize as most of the fiscal effort ended up diluted in monetary terms by the banks executing the puts they tagged to their holdings of Treasury paper, which resulted in an ARS1.35tn cut in monetary credit to the public sector in 1Q24, despite the Treasury making an ARS6.35tn effort. Likewise, the Bopreal issuance ended up offsetting the money printing for the reserve buildup. In this context, the contraction of the monetary base in real terms resulted not from the BCRA stopping to create high-powered money (as it should to hit the Government's target) but rather by almost doubling the remunerated liabilities stockpile relative to November's. Having failed to take advantage of the 1Q24 window to reduce remunerated liabilities, the coming months will be tough for the BCRA to create the conditions to halt high-powered money creation. Due to seasonality and the gradual normalization of social security (now that there's a new pension indexation formula in the books) and energy payments, the chances of scoring monthly primary surpluses in the ARS1tn range are going to get slimmer. Though we expect the Treasury to continue posting surpluses, the magnitude will likely get smaller as we get into 2H. On the other hand, the selling of the summer crops and the need to continue accumulating reserves is likely to keep FX dominance elevated in the coming months without the benefit of Bopreal issuances to sterilize it. With continued FX dominance, an elevated interest expense, and lower Treasury support to sterilize, the BCRA will need to introduce policy changes to return to the trajectory leading to the currency competition destination.

- **STRATEGY IMPLICATIONS.** With a REER that looks better than what most analysts give it credit for, we believe that the case for the ARS is strengthening with a longer-lived peg.

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Monetary policy: a path to the promised land or another walk through the desert?

The Government begins to flesh out its endgame for monetary policy: a promised land with a floating currency and scarce ARS.

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Over the past four months, one of the biggest questions was the monetary-external design the Government was shooting for. In recent weeks, the Government has started to articulate its vision. Whereas the Government's fiscal strategy has been crystal clear from day one (reaching an overall surplus in CY24 through discretionary program cuts, diluting social security with inflation, and higher taxes), the endgame for the monetary and FX markets has been less visible. Both regimes feel like stopgap arrangements until the Administration is ready to put a more permanent framework in place. On the monetary side, the Government has relied on diverging inflation and depreciation expectations to lower rates into deeply negative territory on inflation-adjusted terms. However, it still offers attractive carry trade opportunities that anchor money demand. At the same time, authorities have allowed real money balances to collapse as inflation eroded them, seeking to reduce the monetary overhang left behind by Messers. Fernandez and Massa. On the FX side, the objective was to shoot for a lower BCS premium and accumulate reserves. Still, these objectives were met through unsustainable policies, like allowing 20% of exports to drain on the BCS to increase supply and accumulating additional import arrears. As we enter 2Q24, the question is: how much longer could these transitory policies last? When would authorities move to a more sustainable regime? What would it look like? Well, over the past two weeks, we've started to get some answers.

On a very top-down view, the Government seems to be thinking in a framework (i) where the ARS floats freely against the USD, (ii) the BCRA stops high-powered money, making local currency scarce, and (iii) contracts can be settled on any currency, effectively giving legal tender to FX competing with the ARS.

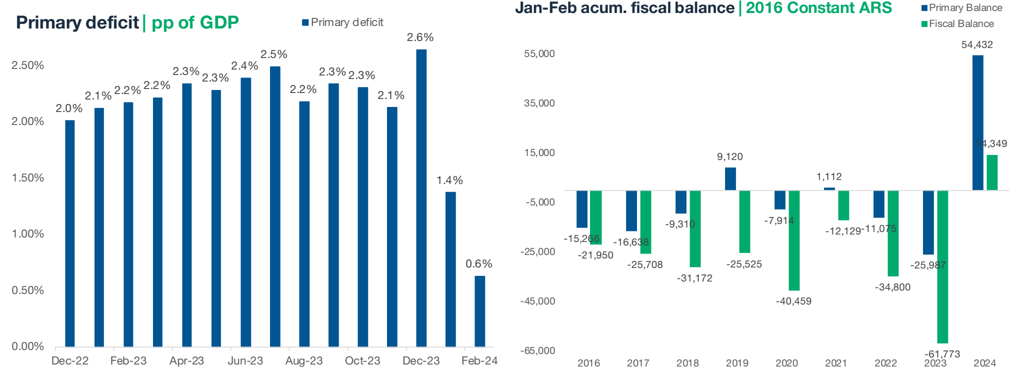
On a very top-down view, the Government seems to be thinking in a framework (i) where the ARS floats freely against the USD, (ii) the BCRA stops high-powered money, making local currency scarce, and (iii) contracts can be settled on any currency, effectively giving legal tender to FX competing with the ARS. During the campaign, Mr. Milei favored Mr. Ocampo's plan because it offered a shortcut to dollarizing the economy. Since then, dollarization has fallen out of favor in the Administration's narrative, replaced by a different promised land: currency competition. So what does that mean? At this point, the currency competition framework that Mr. Milei is shooting for seems to have three main pillars. The first is a free-floating FX rate. With the ARS starting to look richer after four months of a 2%mom crawling peg that has lagged behind inflation by 80pp, eroding one-third of the initial devaluation, the Government has signaled its intent to start unwinding capital controls in 2H and let the currency float. Doing so would require normalizing import arrears in a context where, despite the devaluation, the current account remains in the red. The second pillar is to legally ban the BCRA from creating high-powered money. Currently, there are three main sources of base money creation: (i) fiscal dominance, (ii) reserve accumulation, and (iii) BCRA remunerated liabilities interest expense. Currently, the Central Bank compensates these sources of base money creation by issuing new remunerated liabilities to sterilize. To achieve the second pillar, the Government needs to (i) shut down fiscal financing completely, (ii) allow the FX to float without intervention (which would mean no more reserve buildup), and (iii) either bring rates to zero or eliminate the stockpile of remunerated liabilities. Once all sources of dominance are eradicated, the Government would try to pass a bill that would make any new base money creation illegal, effectively freezing high-powered money in nominal terms. The expectation is that if the economy bounces back with a nominally fixed amount of high-powered money, sustaining the remonetization process would stretch the multiplier too thin, forcing agents to start transacting in FX putting their savings in play. This leads to the third pillar of the framework, striking down the legal hurdles preventing other currencies from having

legal tender. The first step for this is to strike down Article 765 of the Civil Code, which defines the ARS as legal tender for all debts, regardless of the original currency of the contract. Under the current framework, all contracts in Argentina are ARS payable if the debtor so desires. The Government is considering an amendment that would make FX contracts fully enforceable.

With the endgame better fleshed out, the questions shift to the sequencing and the path leading to this promised land. The first step in the sequence was securing a primary surplus and an overall balance. By the end of 1Q24, this initial step seems mostly covered.

With the endgame better fleshed out, the questions shift to the sequencing and the path leading to this promised land. The first step in the sequence was securing a primary surplus and an overall balance. By the end of 1Q24, this initial step seems mostly covered. The Treasury posted in February an ARS1.2tn primary surplus and an ARS338bn overall surplus, rounding up the first two months of the year and accumulating ARS3.2tn in primary savings. After adjusting for inflation, we find that, since 2016, the Treasury has only ended the first two months of the year with a primary surplus in 2019 and 2021, but the Jan-Feb 2024 primary surplus is 54X that of 2021 and over 5X that of 2019. More importantly, this is the first time in over 15 years that the Treasury posted an overall surplus in Jan-Feb. The Government estimated that the ARS3.2tn primary surplus amounts to 0.5pp of GDP, but that factors in a two-month primary surplus against an annualized GDP. Normalizing a two-month period for both surplus and GDP yields almost 5pp of GDP in primary savings. In this context, the twelve-month-rolling primary balance has improved from a 2.6% of GDP deficit in December to a 0.6pp deficit in February and could become balanced by March. In other words, the primary surplus accumulated in 1Q24 will likely prove larger than the deficit Mr. Massa racked up between April and December 2023.

Figure 1: The Government posted a primary surplus in February, accumulating ARS3.3tn in primary savings in Jan-Feb.



Source: TPCG Research based on the Treasury

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The Government deepened the January strategy, cutting spending by -40%yoy in real terms for a second month in a row, on the back of diluting social security and personnel spending with inflation, deep cuts to transfers to provinces and capex, and accumulating subsidy arrears. The Government's consolidation strategy remains based on two anchors: (i) revenue dropping by less than the recession and (ii) severe spending cuts using inflation, discretionary cuts, and arrears to reduce every outlay. Fuel sales tax and export taxes remain critical to keeping the tax intake from collapsing during a recession, which we estimate could run as deep as -5/-6% SAAR in 1Q24. On the spending side, the Government doubled down on the January strategy despite the market's misgivings about its sustainability. Social security and personnel spending continued to drop in real terms at paces between -30%yoy and -20%yoy as the Government continued to adjust benefits and wages well below inflation, racking gains in the two largest outlays of the Federal Government's balance sheets. We estimate that inflation has shaved almost 0.5pp of GDP from the combined personnel and social security bill in just two months. Discretionary cuts deepened on transfers to provinces (-76.7%yoy in real terms) and in capex (-86.9%yoy) as the Government escalated the conflict with governors and Congress. Finally, while the Government stepped up some subsidy payments in February (ARS254bn in January vs. ARS402bn in February), we estimate that it's still accumulating arrears against GenCos, PlanGas providers, and transportation companies.

Figure 2: Primary spending continues to drop at a pace of almost -40%yoy in real terms, led by social security.

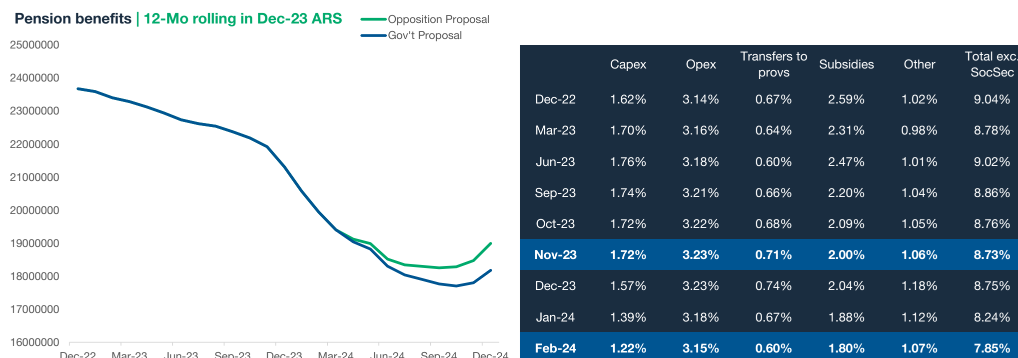
	4Q23				Jan-Feb 2024			
	ARStn	%yoy nominal	%yoy real	pp of GDP	ARStn	%yoy nominal	%yoy real	pp of GDP
Revenues	**11.6**	**152%**	**-6.7%**	**16.5%**	**11.7**	**255%**	**-2.5%**	**17.2%**
Tax revenues	6.9	140%	-11.0%	9.7%	7.4	308%	12.3%	10.4%
Social security contributions	3.1	142%	-10.4%	4.9%	3.3	177%	-23.9%	5.0%
Income from Treasury property	0.8	262%	34.0%	1.0%	0.6	312%	12.7%	1.0%
Non-tax revenues	0.8	237%	27.6%	0.9%	0.4	181%	-22.3%	0.9%
Primary spending	**14.1**	**163%**	**-4.3%**	**19.2%**	**8.4**	**127%**	**-38.0%**	**17.8%**
Personnel spending	2.0	204%	9.1%	2.6%	1.5	194%	-19.7%	2.5%
Social Security	7.6	149%	-8.4%	10.4%	5.3	157%	-29.6%	10.0%
Subsidies	1.3	150%	-12.6%	2.0%	0.7	70%	-54.1%	1.8%
Energy	0.9	144%	-16.4%	1.5%	0.4	44%	-61.6%	1.3%
Transportation	0.3	132%	-14.2%	0.5%	0.3	157%	-29.0%	0.5%
Other	0.1	927%	279.8%	0.1%	0.0	-37%	-83.3%	0.0%
Transfers to Provinces	0.6	261%	30.2%	0.7%	0.1	-17%	-76.7%	0.6%
Capex	1.0	116%	-19.1%	1.6%	0.2	-52%	-86.9%	1.2%
Other	1.5	218%	13.5%	1.8%	0.7	123%	-38.6%	1.7%
Primary balance	**-2.5**	**228%**	**10.1%**	**-2.6%**	**3.2**	**-851%**	**-309.5%**	**-0.6%**
Interest payments	1.1	71%	-37.6%	1.7%	2.4	304%	12.0%	2.1%
Overall balance excl SDRs	**-3.6**	**158%**	**-11.4%**	**-4.3%**	**0.9**	**-184%**	**-123.2%**	**-2.8%**

Source: TPCG Research based on the Treasury

The change in the social security indexation mechanism allowed the Government to flex the subsidy cut schedule without compromising the fiscal targets.

The change in the social security indexation mechanism allowed the Government to flex the subsidy cut schedule without compromising the fiscal targets. With social security leading the YTD spending cuts, the indexation formula became a contentious issue. The Government ended the conflict by issuing a decree that settled on (i) moving from a formula governed by a mix of wages and social security contributions growth to one indexed by monthly inflation starting in April (because of the lag in inflation prints, April benefits must be indexed by the February print, as the March CPI won't be published until mid-April), (ii) capping the reflationary risk that the current framework suffers from if inflation descends rapidly, and (iii) the need for a transition from the current formula to the new formula. The transition was fixed as a 12.5% kicker on top of the initial adjustment of the baseline benefit in April (which should dilute to an 8% increase in outlays as the supplemental payment isn't getting indexed). In this context, the Government decided that the March indexation (+27.8%) should take care of the December inflation (relieving the Government from contemplating the December print in the transition) and that the transition should fully acknowledge the February print. The January inflation (20%) is only partially accounted for in the transition calculation, as the Government capped the pension indexation resulting from January inflation to 12.5%. We estimate that, under the Government's proposal, pension benefit payments would drop by -12%yoy in real terms during CY2024. Extending these cuts to the rest of the social security spending (either governed by the pension indexation formula or by minimum wage, which is likely to drop by even more) would result in savings of about 1.3pp of GDP. Adding the cuts to capex, discretionary transfers, and fiduciary funds payments (which we estimate could amount to over 2pp of GDP), the dilution of personnel wages along inflation and redundancies (about 0.5pp of GDP), the return of personal income tax, and the boost to export taxes from grain, it adds up to over 6.5pp of GDP in discretionary savings. While the recession is likely to shave some of that, the Government now estimates that it won't need to cut subsidies as deeply, as fast as planned in CY2024, to hit its fiscal targets. Under the original schedule, the Government planned to cut almost the entirety of subsidies over three months between February and April. The plan was to cut subsidies by nearly three-quarters of the 2pp of GDP, leaving just a vestigial amount to support the basic consumption of the most vulnerable families. Going ahead with the original schedule meant having most households receive a 7X increase in their electricity and natural gas bills, which risked tipping social sentiment against the Government. The additional discretionary savings, especially in social security, relieve the Government from needing to pick between its fiscal targets and upsetting social sentiment. With enough discretionary savings to hit the 2024 targets, the Government seems to be considering spreading the subsidy cuts over three years rather than three months. The new schedule would allow the Government to net about 0.7pp of savings from subsidy cuts per year, minimizing the risk to approval ratings.

Figure 3: The discretionary savings, especially the cuts in social security spending, are giving the Government some breathing room to spread out the pain of the subsidy cuts.



	Capex	Opex	Transfers to provs	Subsidies	Other	Total exc. SocSec
Dec-22	1.62%	3.14%	0.67%	2.59%	1.02%	9.04%
Mar-23	1.70%	3.16%	0.64%	2.31%	0.98%	8.78%
Jun-23	1.76%	3.18%	0.60%	2.47%	1.01%	9.02%
Sep-23	1.74%	3.21%	0.66%	2.20%	1.04%	8.86%
Oct-23	1.72%	3.22%	0.68%	2.09%	1.05%	8.76%
Nov-23	**1.72%**	**3.23%**	**0.71%**	**2.00%**	**1.06%**	**8.73%**
Dec-23	1.57%	3.23%	0.74%	2.04%	1.18%	8.75%
Jan-24	1.39%	3.18%	0.67%	1.88%	1.12%	8.24%
Feb-24	**1.22%**	**3.15%**	**0.60%**	**1.80%**	**1.07%**	**7.85%**

Source: TPCG Research based on the Treasury

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The second part of the sequencing is creating the conditions to float the currency after the harvest. The stabilization program's initial priority was to reach a fiscal surplus ASAP. Putting fiscal figures in the black would help eradicate fiscal dominance and weaken aggregate income, helping to curb inflation and the current account deficit. With the initial target on track, the next step is preparing the currency to float. The biggest hurdle is that the current account remains in deficit when adjusting for import arrears. Between December and February, the BCRA accumulated USD5.2bn in reserves as the result of a USD6.9bn current account surplus and a USD1.6bn financial account deficit, mostly driven by net Treasury and private sector debt payments. In the current account, a USD10.3bn trade surplus compensated for USD3.4bn net payments from the services and the income balances. The problem is that the robust trade balance results from not paying for imports. Between December and February, import payments accumulated USD3.5bn, about one-quarter of the USD13bn in merchandise shipments that Indec accounted were nationalized through Argy points of entry. Without the BCRA restrictions forcing importers into splitting the payments for their shipments into four, the trade balance would have dropped over 90%, to USD838mn, and the current account would have posted a USD2.6bn deficit, costing the BCRA a USD4.3bn loss in reserves during the quarter. Floating the currency requires dealing with those arrears and ensuring that the current account moves back into a surplus.

Figure 4: The FX market of Dec-Feb suggests that the BCRA still has a long way to go before it can float the currency.

	2023		Dec-23 - Feb24	
	CY	Jan-Nov	Official	Adjusted for import arrears
Current Account	**-3,581**	**-6,544**	**6,883**	**-1,894**
Trade Balance	12,486	9,104	10,319	1,542
Exports	61,663	57,559	13,799	13,799
Agri-flows	21,265	19,742	4,268	4,268
Energy exports (Indec)	7,911	7,192	2,081	2,081
Rest	32,488	30,625	7,450	7,450
Imports	-49,178	-48,455	-3,480	-12,257
Energy imports (Indec)	-7,924	-7,610	-762	-762
Rest	-41,254	-40,845	-2,718	-2,718
Services Balance	-6,195	-6,176	-168	-168
Income Balance and rest	-9,872	-9,472	-3,268	-3,268
Capital & Financial account	**-18,105**	**-16,580**	**-1,643**	**-1,643**
Retail dollarization	-725	-1,055	404	404
Non-residents net lending	-4,454	-4,070	-616	-616
FDI	913	823	194	194
Portfolio	6	6	5	5
Financial loans	-5,373	-4,899	-815	-815
Treasury Net indebtness	-4,809	-4,122	-227	-227
IFIs	1,134	917	-2,010	-2,010
Public sector dollarization	189	174	24	24
Net payments	-1,054	-1,053	-32	-32
IMF	-5,078	-4,159	1,791	1,791
Rest (incl. BCS sales)	-8,117	-7,334	-1,204	-1,204
Valuation effects	**162**	**40**	**-63**	**-63**
Change in reserves	**-21,524**	**-23,084**	**5,177**	**-3,600**

Source: TPCG Research based on the BCRA

After adjusting for import arrears, the NIR position has barely improved at all, meaning that the BCRA would still need to print a substantial amount of ARS to rebuild reserves. At almost ARS6.5tn, the biggest source of high-powered money creation since the Milei Administration was inaugurated was FX dominance, as the BCRA printed ARS to purchase USD from the FX market and rebuild reserves. In other words, aligning net reserves with the IMF targets is critical for the Government to move towards its new framework in which the BCRA is barred from creating high-powered money. Once reserves are out of negative territory and on adequate levels, the BCRA will be able to effectively stop intervening in the FX market, release controls for the market to clear on itself, let the currency float, and cease to print ARS to purchase dollars. The snag is that, after adjusting for import arrears, net reserves remain at a dangerously negative level. With data up to March 14th, we estimate that using the Government's and the IMF's definition of net reserves, which doesn't account for import arrears, net reserves have improved by USD9.1bn since December 10th, from -USD11bn to -USD2bn. In other words, by end-March, the Government will likely have accumulated enough net reserves to hit the NIR targets through end-September. Suppose we adjust for import arrears, on the other hand. In that case, net reserves show no improvement, remaining at -USD11bn in a context where reserve accumulation and USD purchases in the FX market roughly match the magnitude of the additional import arrears. With net reserves close to zero, the BCRA could remove itself from the FX market equation, allowing the currency to float. With net reserves dwelling close to -USD11bn, the margin to begin easing capital controls and allowing the market to clear on its own, without the BCRA forcing the private sector into the selling side (and printing ARS to buy the private sector's FX surplus), looks more remote.

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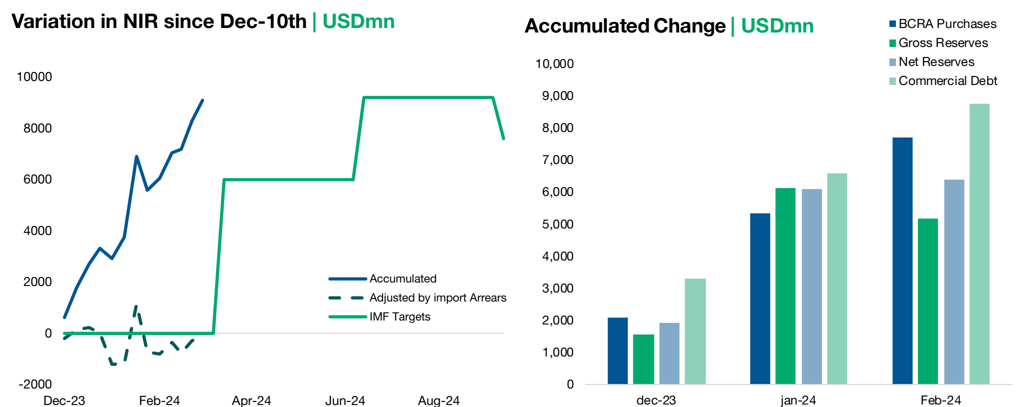
Figure 5: Adjusting for import arrears, net reserves remain unchanged from December, at around -USD10bn.



Source: TPCG Research based on the BCRA

Over the next three months, the harvest will put about USD30bn in play. The Central Bank will need to decide whether it wants to use them to (i) unify the FX rates, (ii) repay import arrears, or (iii) continue adding reserves. The latest summer crops harvest puts output at about 107mn combined tons of soybean and corn, up from 56mn tons last year. Even factoring in the -16%yoy drop in average prices for the 2023-24 harvest, we expect the summer crops to fetch USD31.2bn, a USD12bn increase relative to the 2022-23 harvest. Adding the winter crops, the entire harvest's value would increase to USD35.7bn, up from USD23.7bn last year. The Government expects these additional monies to help normalize the FX market. With 20% of exports draining into the BCS via the blended FX mechanism, we estimate that the summer crops could add about USD7bn to the BCS supply in the coming months, strengthening the parallel FX closer to the official fixing. In other words, the regulation slipping current account flows into the financial account is likely to bring FX rates very close to reunification in the coming months, at a cost of about 60% of the incremental yearly revenue from the harvest (USD7bn out of USD12bn). The Government would then need to decide how to allocate the remaining USD5bn to reduce import arrears and continue to add international reserves. With the NIR targets for the year almost locked in, the Government should pivot to reducing the USD10bn in imports arrears that it accumulated since December. The easiest way to do so is to shift in 2Q from paying imports in a 120-day window to paying them in a shorter span, eventually moving back to allowing spot payments. That would create a situation where import payments exceed shipments for a few months as the BCRA deleverages. Still, the decompression pace could be managed to be consistent with maintaining net reserves aligned with the IMF targets.

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Figure 6: The summer crops could add about USD12bn relative to 2023. A large chunk of it would go to the blended FX.

	Total Value (USDmn)	Value of harvest Production Total (mn tn)	Sowed area (mn ha)	Yield (qq/ha)	Price (May future avg YTD)	Initial stocks (USDA Estimate)
Soybean						
2019-20	15,945	50.7	17.2	30.5	314.5	28.9
2020-21	23,846	45.0	16.9	27.7	529.9	26.7
2021-22	25,742	42.2	16.1	27.7	610.0	25.1
2022-23	10,748	20.0	16.0	16.3	537.4	23.9
2023-24e	21,590	50.0	17.3	30.2	431.8	17.2
Corn						
2019-20	6,736	51.5	7.26	82.4	130.8	2.4
2020-21	12,126	52.0	7.3	83.2	233.2	3.9
2021-22	12,388	51.0	8.64	68.8	242.9	1.2
2022-23	9,007	36.0	8.9	51.7	250.2	1.8
2023-24e	9,585	57.0	8.6	76.9	168.2	1.1
Wheat						
2019-20	3,881	19.5	6.8	29.9	199.0	1.7
2020-21	3,919	17.0	6.5	28.6	230.5	1.7
2021-22	7,360	23.0	6.9	35	320.0	2.3
2022-23	3,910	11.5	5.9	23.3	340.0	1.9
2023-24e	4,495	14.5	5.5	28.3	310.0	4.1
Total						
2019-20	**26,561**	**121.7**	**31.3**	**-**	**218.3**	**33.0**
2020-21	**39,891**	**114.0**	**30.7**	**-**	**349.9**	**32.3**
2021-22	**45,490**	**116.2**	**31.6**	**-**	**391.5**	**28.6**
2022-23	**23,665**	**67.5**	**30.8**	**-**	**350.6**	**27.6**
2023-24e	**35,670**	**121.5**	**31.4**	**-**	**293.6**	**22.4**

Source: TPCG Research based on CBT and TPCG Trading Desk

Ultimately, the problem is that the inflows from the summer crops won't suffice to bail out the BCRA and allow for the introduction of a capital-control-free unified FX market. We expect the Government to maintain two segmented FX markets, albeit operating at unified FX rates.

Ultimately, the problem is that the inflows from the summer crops won't suffice to bail out the BCRA and allow for the introduction of a capital-control-free unified FX market. We expect the Government to maintain two segmented FX markets, albeit operating at unified FX rates. Mr. Milei's promised land includes a free-floating ARS in a capital-control-free FX market allowing for widespread circulation of FX for domestic contracts and transactions. We estimate that the BCRA would need to recap the BCRA between USD10bn and USD15bn to release capital controls and implement a regime like the one the Administration is targeting. Unfortunately, after factoring in the cost of the blend, the harvest will only provide a USD5bn additional influx. In this context, we expect the Government to move to the second best: maintain some capital controls which would keep the official FX market and the BCS segmented and gradually ease current account restrictions, especially on new import payments while allowing the blend and other drainages to keep the FX rates of both segmented markets aligned. In other words, we expect the "brecha" to collapse faster than the release of capital controls. Managing a framework like this one requires (i) drainage from the official market to the BCS to keep FX rates aligned and (ii) a current account surplus (or external borrowing) to feed those drainages, which could be accomplished by either a weaker REER (which the Government rejects) or a tighter monetary policy stance.

The YTD MonPol stance: eradicating fiscal financing was not enough

While the Government has made substantial inroads in attaining a fiscal surplus and eradicating monetary financing, we believe that authorities have only made moderate gains in the direction of their target monetary framework.

While the Government has made substantial inroads in attaining a fiscal surplus and eradicating monetary financing, we believe that authorities have only made moderate gains in the direction of their target monetary framework. There are two parts to the monetary and external frameworks that we discussed in the last section: the destination and the path to it. Most of the previous section was dedicated to describing the destination. Consider what you might think about the Government's endgame (and we really think that legally banning high-powered creation is a bad idea); we believe it's much more interesting to focus on how the Administration plans to get there. For starters, a Government that campaigned openly about its endgame and got 56% of voters to back its proposals has a mandate to seek these transformations. On the other hand, even if we do not dwell on whether the destination is right, the trajectory is relevant, as the wrong set of policies might make the endgame unattainable. This section will concentrate on whether the current monetary policy stance is consistent with the path leading to the Government's intended destination. Unfortunately, we believe that the current trajectory already deviates from the one leading to Mr. Milei's promised land.

The trajectory consistent with the Government's destination includes a fiscal ARS financing surplus, which the Treasury hands over to the BCRA to sterilize the remaining sources of high-powered money creation.

The trajectory consistent with the Government's destination includes a fiscal ARS financing surplus, which the Treasury hands over to the BCRA to sterilize the remaining sources of high-powered money creation. The critical component of the Government's endgame is freezing high-powered money in nominal terms to make the ARS scarce. Freezing base money nominally requires either shuttering all three dominances (fiscal, FX, and financial / quasi-fiscal) or at least having them compensate each other. Shuttering all three dominances would require (i) the Treasury being self-sufficient (doable), (ii) the BCRA letting the FX float and renouncing to adding reserves (dangerous given how negative net reserves remain), and (iii) reducing to zero the BCRA's remunerated liabilities stockpile (unfeasible in the short run). The second best would be to run an ARS primary surplus large enough, which, combined with the net roll-over of ARS Treasury paper in the market, allowed for the Government to recapitalize the BCRA every month so that the net contraction of base money resulting from negative public sector domestic credit offsets the money printing to purchase reserves, to cover the BCRA's interest expense, and to repay remunerated liabilities gradually. The problem is that given the magnitude of the ever-growing remunerated liabilities stockpile and the monthly quasi-fiscal deficit, the Treasury would need to reduce public sector credit by about 7pp of GDP in 2024 to keep base money constant (and that's assuming that the BCRA stops buying reserves).

Figure 7: Some unpleasant high-powered money arithmetics.

$$\Delta Base Money = \underbrace{\Delta Net\ External\ Credit}_{NIR} + \underbrace{\Delta Net\ Domestic Credit}_{NDA}$$

$$\Delta BM = FX\ Purchases + \Delta Private\ Sector\ Credit + \Delta Public\ Sector\ Credit$$

$$\Delta BM = FX\ Purchases + BCRA\ Interest\ Expense + \Delta\ in\ Remunerated\ Liabilities + \Delta Public\ Sector\ Credit$$

$$\text{If } \Delta BM = 0 \rightarrow$$

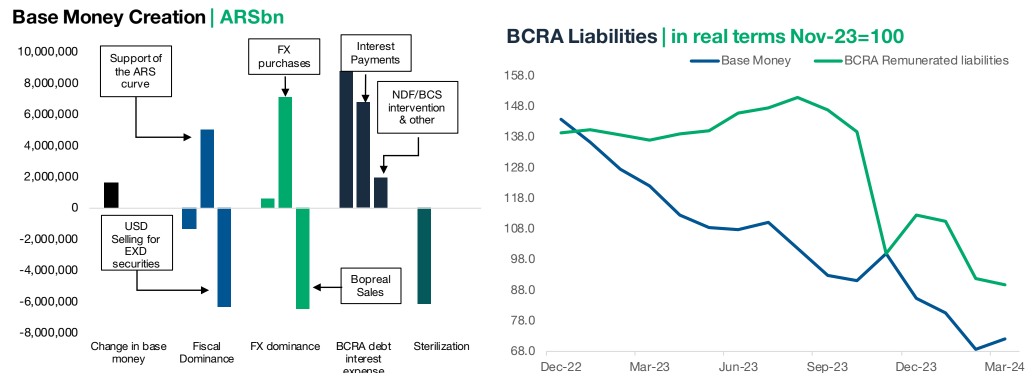
$$-\Delta Public\ Sector\ Credit = FX\ Purchases + BCRA\ Interest\ Expense + \Delta\ in\ Remunerated\ Liabilities$$

Source: TPCG Research

YTD, the Government has managed to bring base money growth almost to a standstill. Still, it required a substantial increase in remunerated liabilities, as the primary surplus was not enough to offset FX purchases and the interest expense.

YTD, the Government has managed to bring base money growth almost to a standstill. Still, it required a substantial increase in remunerated liabilities, as the primary surplus was not enough to offset FX purchases and the interest expense. The Government points to base money growing well below inflation as a signal that monetary policy is on the right trajectory to meet the Administration's designs. Still, a deeper look reveals a less rosy reading of the past three months. In effect, base money has increased by 38.9% in Dec-Mar, or about -28% in real terms, assuming a 12% CPI print in March. Most of it results from a 72.7% increase in BCRA remunerated liabilities, which picked up from ARS17.8tn by the end of November to ARS30.8tn currently, just 10pp slower than inflation. The increased remunerated liabilities were necessary despite the BCRA almost zeroing fiscal and FX dominances. The problem is that zero fiscal and FX dominances are insufficient to put the BCRA on the right trajectory. If external credit and public sector credit are zero, then base money would grow at a tune of about ARS2tn per month (or about 16%mom, way faster than inflation) on the back of the CenBank's interest expense. As long as the BCRA needs to increase remunerated liabilities to sterilize its quasi-fiscal deficit, we believe the Government won't get closer to its desired regime. Overcoming this hurdle would require either (i) increasing the primary surplus considerably, (ii) stopping rebuilding reserves, or (iii) lowering the interest expense considerably. With the primary surplus of the first quarter of the year running close to 7pp of GDP annualized, increasing it looks challenging. With the selling of summer crops and negative net reserves dominating the coming months, we don't expect the BCRA to stop buying USD in the FX market in 2Q24. In the short run, we expect the BCRA to keep lowering the reference rate aggressively to curb interest expense growth. Still, the problem is that the outstanding remunerated liabilities grow faster than the BCRA cuts rates. In that context, over 1Q24, the interest expense has continued to grow despite the BCRA offering deeply negative interest rates. The risk is that the monetary framework runs out of traction.

Figure 8: Base money growing slower than inflation, only because the BCRA keeps sterilizing, maintaining remunerated liabilities constant in real terms.



Source: TPCG Research based on the BCRA

A large part of the problem is that endogenous high-powered money creation needs derailed the one chance that the BCRA had to reduce remunerated liabilities considerably.

A large part of the problem is that endogenous high-powered money creation needs derailed the one chance that the BCRA had to reduce remunerated liabilities considerably. When the current framework was put in place in December, we anticipated that the BCRA would be able to tap two large sources of ARS (the contraction in monetary credit to the public sector and the issuance of the Bopreal) to sterilize a reduction in remunerated liabilities. The Treasury combined its primary surplus with the excess financing it secured in the ARS market during 1Q24, handing the BCRA ARS6.4tn to either buy dollars for EXD maturities or to repurchase Government-issued securities held by the BCRA. On the other hand, the market purchased about ARS6.5tn in Bopreal from the BCRA. Combined, these two sources totaled ARS13tn, meaning that authorities could have used these ARS to reduce remunerated liabilities by 52% (relative to the end-December outstanding). Doing so would have created a positive feedback loop where the combined effect of a lower remunerated liability stockpile and negative interest rates would have put the BCRA leverage ratio on a downward trajectory relative to inflation and real money balances. The problem was that the BCRA was unable to use these sources of sterilization to repay remunerated liabilities. Most of the ARS contraction generated by the fiscal effort ended up allocated to sterilizing the issuance of ARS4.7tn from banks' hitting the BCRA with puts on their holdings of Treasury debt. In this context, net of the issuance to repurchase Treasury debt from banks, the contraction in monetary credit to the public sector in 1Q24 dropped to -ARS1.7tn, despite the ARS6.4tn fiscal effort. On the FX side, the Bopreal monies sterilized most of the ARS7.1tn in FX purchases to rebuild the NIR position, leaving net FX-related issuance at +ARS490bn. All in all, the net effect of the ARS13tn in the two critical sources of ARS absorption that the BCRA had in 1Q24 was just ARS1.2bn, just over 10% of the ARS9.2tn of the remunerated liabilities' interest expense plus the NDF losses. In other words, rather than taking advantage of a massive primary surplus and the Bopreal issuance to curb base money growth, net of the increase in remunerated liabilities, high-powered money creation in 1Q24 totaled ARS8tn, an 83% nominal increase relative to end-December, or a 10pp real increase.

Figure 9: Net of sterilization via increased remunerated liabilities, high-powered money is more persistent to inflation than expected.

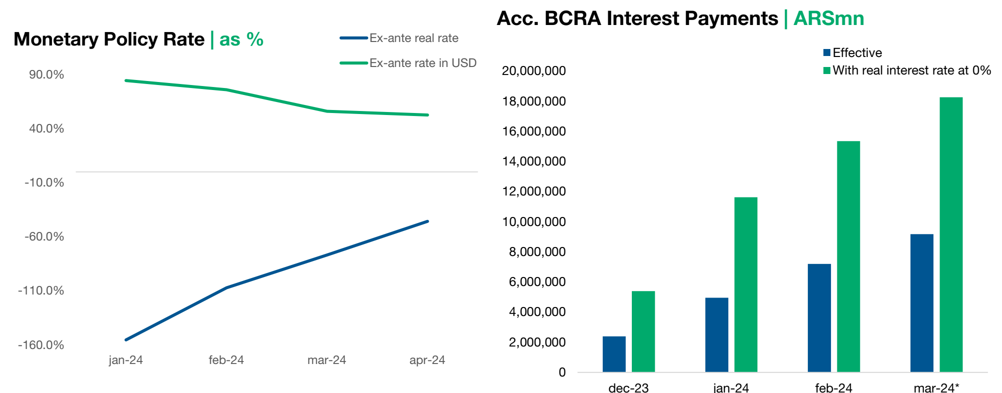
	2022		2023		Jan-Nov		Dec		Jan-Mar 2024	
	Nominal	pp of Gdp	Nominal	pp of Gdp	Nominal	pp of Gdp	Nominal	pp of Gdp	Nominal	pp of Gdp
Total High-power money creation uses	6,616,447	8.0%	20,388,395	10.7%	15,651,386	8.2%	4,737,009	1.7%	8,010,527	1.8%
As a pp of Base Money	*181.1%*		*391.8%*		*300.8%*		*52.8%*		*83.4%*	
Fiscal dominance	1,363,029	1.7%	4,233,364	2.2%	5,645,249	3.0%	-1,411,885	-0.5%	-1,350,470	-0.3%
Direct monetary financing	620,051	0.8%	1,698,000	0.9%	1,698,000	0.9%	0	0.0%	0	0.0%
Short term loans	620,051	0.8%	1,298,000	0.7%	1,298,000	0.7%	0	0.0%	0	0.0%
Dividend transfers	0	0.0%	400,000	0.2%	400,000	0.2%	0	0.0%	0	0.0%
Support of the ARS curve	1,260,501	1.5%	7,800,000	4.1%	7,100,000	3.7%	700,000	0.2%	5,000,000	1.1%
USD selling for EXD maturities	-517,524	-0.6%	-5,264,636	-2.8%	-3,152,751	-1.7%	-2,111,885	-0.8%	-6,350,470	-1.4%
FX dominance	1,479,274	1.8%	2,466,311	1.3%	448,438	0.2%	2,017,873	0.7%	590,035	0.1%
Issuance to purchase FX	1,479,274	1.8%	2,466,311	1.3%	448,438	0.2%	2,017,873	0.7%	7,090,035	1.6%
Bopreal sales	0	0.0%	0	0.0%	0	0.0%	0	0.0%	-6,500,000	-1.5%
Financial dominance	3,774,145	4.6%	13,688,719	7.2%	9,557,699	5.0%	4,131,020	1.5%	8,770,962	2.0%
Interest payments	3,386,279	4.1%	16,327,458	8.6%	13,938,814	7.3%	2,388,644	0.9%	6,790,803	1.5%
NDF/BCS intervention & other	387,865	0.5%	-2,638,739	-1.4%	-4,381,115	-2.3%	1,742,376	0.6%	1,980,159	0.4%

Source: TPCG Research based on the BCRA

In the short run, the Government is likely to continue relying on negative interest rates. Still, these are unlikely to sort out the remunerated liabilities problem, especially with Bopreal placements tapering and the primary surplus leveling in nominal terms.

In the short run, the Government is likely to continue relying on negative interest rates. Still, these are unlikely to sort out the remunerated liabilities problem, especially with Bopreal placements tapering and the primary surplus leveling in nominal terms. Unable to reduce the stockpile of remunerated liabilities, the BCRA took a page from the Treasury's playbook and opted to dilute them via inflation. This was possible thanks to the initial devaluation in December and the 2%mom crawling peg, which dissociated inflation expectations from depreciation expectations. Following the REER correction, the consensus expected the FX to lag substantially behind inflation over the following months. The BCRA rightly bet that it didn't need to offer positive real rates and that an attractive depreciation expectations adjusted interest rate would be enough to anchor money demand. In this context, despite offering real rates ranging between -160% and -40% annual, the prospect of 50% annual FX-adjusted rates has kept demand for BCRA remunerated liabilities primed, allowing the BCRA to mop up liquidity excesses. The negative rates shaved about nine trillion ARS from the BCRA's interest expense between December and March (relative to a zero real interest rate), or about 78% of base money over 1Q24. We expect the BCRA to cut rates aggressively again after the March inflation print, especially if it comes closer to 10%mom, pushing real rates deeply into negative territory again. Even then, the BCRA's interest expense will likely continue hovering around ARS2tn monthly. From now on, however, the primary savings are unlikely to continue accumulating at an ARS1.6tn a month pace. Given the 2pp of GDP primary surplus target, we estimate that if the Treasury commits it entirely to the BCRA, it could sterilize about 1tn per month. In other words, the fiscal contribution to monetary policy could drop below the pace at which banks have been executing puts recently, resulting in a return of fiscal dominance. On the FX side, with most of the summer crops still ahead of us and most of the sterilization from Bopreal placements behind us, FX dominance is likely to make a comeback.

Figure 10: The BCRA has taken advantage of the dissociation between inflation and depreciation expectations to bring real rates deeply into negative territory and reduce the interest expense.



Source: TPCG Research based on the BCRA

One alternative would be to maintain capital controls, stop buying reserves, and phase out the puts on the Treasury debt. Combined with negative interest rates, it would give the contraction in monetary credit to the public sector a shot at sterilizing the BCRA's interest expense without the need to grow remunerated liabilities.

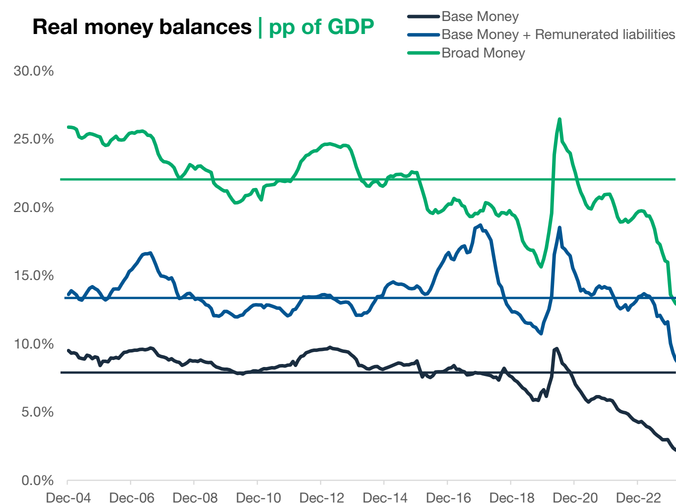
One alternative would be to maintain capital controls, stop buying reserves, and phase out the puts on the Treasury debt. Combined with negative interest rates, it would give the contraction in monetary credit to the public sector a shot at sterilizing the BCRA's interest expense without the need to grow remunerated liabilities. We set up to see if the path that the Government was walking led to Mr. Milei's desired destination. It doesn't seem so. The remunerated liabilities and the quasi-fiscal deficit remain a destabilizing factor, forcing the BCRA into a continued sterilization effort to keep a hawkish monetary bias, preventing the Government from implementing its desired regime. The risk of a comeback of fiscal and FX dominances in 2Q24 only worsens matters, suggesting that the Government would need to introduce corrections to its policy mix to set the trajectory back toward the desired destination. One alternative would be to maintain capital controls well into late 2024, allowing to maintain deeply negative interest rates. The limit to this alternative is that the Government would still need to decelerate high-powered money creation or risk widening the "brecha." That would require being less aggressive about reserve accumulation (which would, in turn, allow for some normalization of import arrears) to reduce FX dominance and, more importantly, do something about the puts. Increasingly, it seems as if the puts sold on Treasury debt are not working as intended. Rather than having the BCRA as a liquidity backstop if the Treasury securities' market seized, banks are using the BCRA as a trading counterparty to unwind at better-than-market prices bad bets like USD-L paper as

depreciation expectations collapsed and source the liquidity to change horses and deploy monies in CPI linkers. There's an argument that the BCRA subsidized the swap to ensure the success of the Treasury's debt placements throughout 1Q24. We believe that the argument is exaggerated, considering that banks have almost no alternative application to public debt considering the reserve requirement regime (the alternative is posting zero-interest-bearing cash reserves) and the effect of the recession on private loan demand.

A different alternative, allowing for a faster release of capital controls, would require the BCRA to accelerate high-powered money creation (potentially compensated by increasing cash bank reserves), risking a slower inflation deceleration and higher FX volatility.

A different alternative, allowing for a faster release of capital controls, would require the BCRA to accelerate high-powered money creation (potentially compensated by increasing cash bank reserves), risking a slower inflation deceleration and higher FX volatility. If the Government wanted to release capital controls faster, it would need to rapidly convert remunerated liabilities into zero-interest-bearing liabilities. In other words, swap repos for base money. That's problematic, especially in a context where demand for real money balances is only stabilizing on the prospect of limited high-powered money creation. The expectation of a sudden monetization of remunerated liabilities, if the Government decided to release capital controls faster, could abort the recovery of real money balances. At worst, it could result in a new episode of FX volatility and more-persistent-than-expected inflation if high-powered money creation to monetize remunerated liabilities hits against dropping demand for real money balances. At best, the remonetization would coincide with a rebound in money demand. This scenario would allow a monetary equilibrium where remunerated liabilities are digested without an inflationary acceleration. By late November, base money plus remunerated liabilities stood at ARS26tn, or 3X base money. Since then, the figure has increased to ARS43tn or 3.5X base money. In other words, remunerated liabilities have increased by 50pp of base money, even factoring in the base. Swapping remunerated liabilities for high-powered money would mean increasing the monetary base from 2.2pp of GDP to 9pp of GDP. Excluding periods with capital controls, base money has only been that high at the height of the 2004-06 remonetization, as the economy came out of the 2001 crisis but hadn't started generating inflation (that happened after 2007). Factoring in the multiplier, a 9pp of GDP high-powered money would be consistent with real broad money balances around 25pp of GDP. The figure below is illuminating. High-powered money is about one-fourth of its historical levels in real terms; broad money is about half; BCRA monetary liabilities are two-thirds of what they've averaged over the past 20 years. In other words, the BCRA remunerated liabilities are staggering relative to the economy's puny real money balances. Remonetizing the remunerated liabilities would require demand for real broad money balances to double their current 12pp of GDP level. Besides looking far-fetched, such a recovery in money demand would come at the expense of the Government accepting a path leading to a different destination than its "currency competition" target. If most of the remonetization is financed with the creation of high-powered money (to rescue remunerated liabilities), then there would be little need for the private sector to put its hard currency liquidity into circulation, as the ARS would not be scarce.

Figure 11: The BCRA remunerated liabilities remain oversized relative to the economy's diluted real money balances.



Source: TPCG Research based on the BCRA

The only path we see where the current trajectory would lead to Mr. Milei's desired destination is the one in which the Government manages to borrow USD10-15bn.

The only path we see where the current trajectory would lead to Mr. Milei's desired destination is the one in which the Government manages to borrow USD10-15bn. In our view, this is the alternative that the Government hopes to traverse. Door number one would allow the Government to stabilize the economy rapidly at the cost of maintaining capital controls. Door number two allows for a rapid release of capital controls at the cost of either delaying the stabilization or the Government renouncing its currency competition destination. Neither door looks very enticing. Fortunately for Mr. Milei, there's a third door leading to the Government's promised land (a stable economy with a floating FX rate, scarce ARS, and freely circulating FX to fuel the economy's recovery) without painful sacrifices. Unlocking door number three, however, requires borrowing USD10-15bn to rescue the BCRA's remunerated liabilities not with high-powered money but with FX. In our view, this is the path the Government is trying to unlock in the coming months. Securing the funding would allow the BCRA to do away with its remunerated liabilities by converting CenBank creditors' holdings into USD, leaving real money balances at historically low levels for a stabilized economy. With no dominances pushing the BCRA to create high-powered money (the primary surplus would take care of the fiscal dominance, a floating FX would moot FX dominance, and the rescue of the remunerated liabilities would eliminate the quasi-fiscal deficit), the Government could create the ARS scarcity it seeks, setting the stage for its proposed "currency competition" regime. Wait. If it were this simple, why did you write twelve pages hammering us with the challenges besieging monetary policy? Well, because Messrs. Milei and Caputo still need to find a samaritan willing to part with USD15bn and hand them over to the Argy Government. We believe that raising such an amount from private creditors is far-fetched, as the issuance would be subordinating ARGENT creditors to ARS holders. The Republic would need to increase its EXD burden considerably, stretching its sustainability figures, to rescue ARS holders (which are trapped by capital controls) at par. This option rapidly hits the same brick wall as Mr. Ocampo's original proposal to dollarize the economy. In our view, the Government hopes that the IMF will play the role of the Samaritan. It remains to be seen if (i) the IMF is willing to sink another USD15bn into Argentina and (ii) whether it would agree to do so to dollarize the economy, a plan that DC is not, according to media reports, keen on.

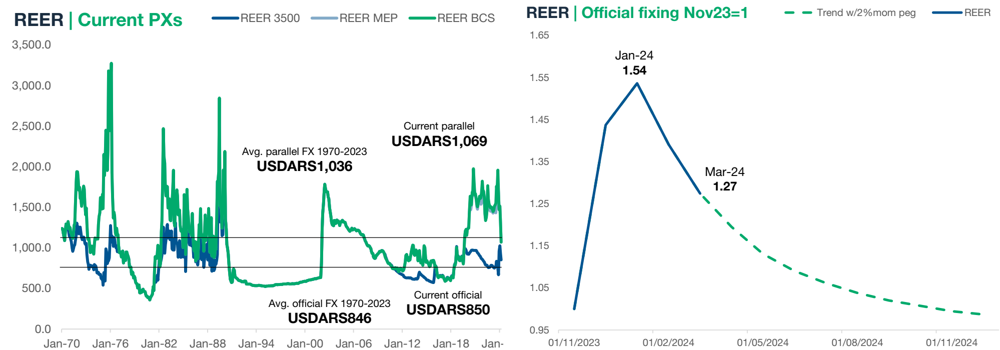
Is the REER adequate, weak, or rich? With unit labor costs at 20-year lows, it's hard to argue that the currency is overvalued.

A critical discussion related to the Government's proposed "currency competition" regime is the implicit REER at which the economy would operate. We find that many local players and international creditors are concerned that the currency has gotten rich since December.

A critical discussion related to the Government's proposed "currency competition" regime is the implicit REER at which the economy would operate. We find that many local players and international creditors are concerned that the currency has gotten rich since December. The Government is adamant that its destination regime includes a freely floating FX rate, which should moot the concerns about currency overvaluation. Still, the concept of the free float gets almost immediately distorted by the assertion that the Government plans to freeze base money creation nominally, making the FX rate irrelevant due to the ARS scarcity. In this context, the alignment of the FX going into a nominally rigid framework as Mr. Milei's proposed currency competition becomes a relevant issue. By historical comparisons, the REER doesn't seem overvalued. The economy has supported a richer ARS than the current level, both in periods with and without capital controls. However, periods with a stronger currency and no FX restrictions usually result from current account deficits covered by non-resident financial inflows. Since 1973, the official fixing REER averaged, at current prices, USDARS846, not far from March's USDARS850. Moreover, even the BCS looks roughly aligned with the historical average and is way tighter than the average excluding periods with a unified FX, suggesting that the regulated official fixing is not that far from the floating BCS. Still, creditors' concerns are justified. For starters, with the FX at levels aligned with the historical average, there isn't any more breathing space. The Government argues that the REER for the current regime should be stronger than the historical average, but at this point, we see little evidence to support the claim. On the flows side, the current account remained in the red over the first quarter after adjusting for import arrears, and financial inflows did not pick up as in 2016. From a stocks point of view, net reserves remain deeply negative if we factor in the import arrears that the BCRA has stacked up since December. On the other hand, while inflation is coming down rapidly, monthly CPI prints are likely to exceed the pace of the crawling peg consistently throughout the rest of 2024, putting additional pressure on the REER. With the March CPI at around 12%, according to the market consensus (final data due today), the REER ended 1Q24 -21.5% depreciated relative to November. If inflation averages 7.5%mom in 2Q24, 4.5% in 3Q24, and 3.3%mom in 4Q24 along our baseline, the REER will be at pre-devaluation levels by October. It's a better prospect than under the market's original expectations

(which had the REER at pre-deval levels by March). However, it still means that by the time the ARS begins to float, the real official fixing rate would be at Massa levels of overvaluation.

Figure 12: Despite the 2%mom crawling peg, the REER remains 21% weaker than pre-devaluation levels and looks adequate in historical comparison.

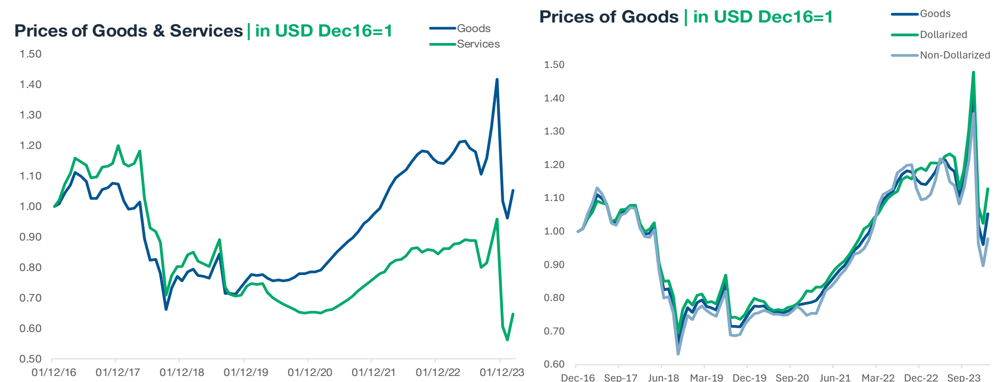


Source: TPCG Research based on Indec, BCRA, and TPCG Trading Desk

Many local analysts have raised concerns about the REER and how expensive some tradable goods have become. In our view, the market is confusing unaffordable tradable goods due to import controls with a strong REER.

Many local analysts have raised concerns about the REER and how expensive some tradable goods have become. In our view, the market is confusing unaffordable tradable goods due to import controls with a strong REER. Lately, whenever you listen to a local analyst, market participant, or reporter talk about currency overvaluation, they'll usually pick a tradable imported good as an example of how expensive things have become locally. With import restrictions still binding, it's hardly a surprise that some imported goods are offered domestically multiple times more costly than import-parity cost. Importers are still not allowed to pay for their shipments in cash, as the BCRA forces them to finance payments between 30 and 180 days. In a country that has abused trade financing and stacked up a substantial amount of import arrears, additional funding is costly and gets fully passed through into final prices domestically. In our view, local analysts mistake an elevated cost of living and unaffordable tradables with REER overvaluation. Effectively, good prices measured in USD seem expensive in the light of the deep recession. In a comparison since 2016, goods prices in USD are higher than they've ever been during the Macri Administration, and, more importantly, though they are below the levels of the Fernandez Administration, they seem to be bouncing back rapidly as the CPI outstrips the crawling peg. A closer look at the composition of goods shows that imported goods are almost 20% more expensive in dollar terms than purely domestic goods (with the base set in December 2016) due to import restrictions. Ultimately, while goods seem expensive, it's very hard to argue that there's REER overvaluation when services in USD terms stand at their lowest level since 2006-07. In dollar terms, service prices are about 35% lower than in 2016, 46% lower than during the first two years of the Macri Administration, and about 30% lower than in the Fernandez Administration. In fact, services are currently priced like they were at the worst point of the COVID shock when everything was shuttered. If the REER is defined as the ratio between tradeables and non-tradeables, expensive tradeables and ludicrously cheap non-tradables mean a depreciated real FX rate.

Figure 13: With services' prices in USD at 15-year lows, it's very hard to argue that there's REER overvaluation.



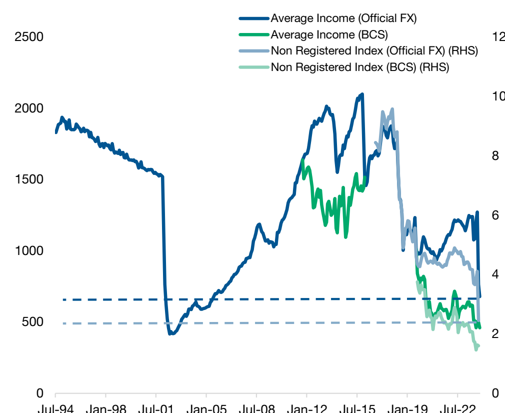
Source: TPCG Research based on Indec, Alphacast and BCRA

Ultimately, the anchor of the external regime is low unit labor costs. Wages in USD are at their lowest since 2007, limiting concerns that the economy could face competitiveness problems as it normalizes.

Ultimately, the anchor of the external regime is low unit labor costs. Wages in USD are at their lowest since 2007, limiting concerns that the economy could face competitiveness problems as it normalizes. As with every aggregate figure, comparing the headline REERs for two different configurations of the economy without accounting for the underlying differences could lead to the wrong conclusions. While the REER is stronger than in periods of robust current account surpluses, wages are the lowest since 2005, at USD700 per month on average (USD460 at the BCS). With unit labor costs as low as they are currently, Argentina has consistently pulled current account surpluses between 2 and 3pp of GDP in the past. By contrast, during the Macri Administration, the average wage was twice as high as currently, at USD1,500 per month. An interesting benchmark is 2010-11, at the end of the CFK-1 term and just before the introduction of FX controls, when the REER was similar to the current level. Back then, with the economy coming out of the 2008-09 recession, the average wage was USD1,400 per month. Over the past 30 years, the Argy economy has averaged wages of USD1,350 a month at the official fixing, a level that we believe is at the core of the country's macro problems. Those elevated unit labor costs have pushed the economy to systematically slide into current account deficits, which either had to be financed with financial inflows (leading to leverage problems), net international reserves selling (leading to the BCRA balance sheet deterioration), or FX controls (culminating with the Fernandez-Guzman-Massa mess). Low wages present the opportunity for a different economic configuration, where the external equilibrium is not derived from a depreciated nominal FX but rather from competitive unit labor costs.

Figure 14: With wages at 20-year lows, unit labor costs look competitive, creating a window for nominal stabilization without FX volatility.

Average Private Sector Wage | Jan-24 USD



Source: TPCG Research based on Indec and Human Capital Ministry

While this configuration of the economy could (i) support the Government's currency competition framework and (ii) result in consistent nominal stability, it remains to be seen if it is politically consistent.

While this configuration of the economy could (i) support the Government's currency competition framework and (ii) result in consistent nominal stability, it remains to be seen if it is politically consistent. Though Mr. Milei has repeatedly argued that the fiscal deficit and money printing are at the core of the Argy economy's secular problems, the truth is that these are just manifestations of the actual problem: Argentina's persistent desire for an inconsistent income level. Society has regularly supported politicians and regimes running large primary deficits, overvalued FXs with capital controls, raiding the CenBank or the pension system, depleting reserves, and printed money provided that it led to higher incomes. Voters have tolerated ever-higher inflation levels if it meant keeping the illusion of higher real incomes. In other words, rather than inflation targeting, Argentina has spent the last three decades in an "income targeting" regime. Initially, in the 90s, unemployment was the adjustment variable. Since the 2001 Crisis, when society decided it wanted elevated income levels and low unemployment, policies became less consistent, the economy turned into a pressure cooker, and the FX (and the BCS during periods of FX controls) was the only pressure release valve left. This configuration resulted in persistent FX pressure and nominal volatility. The first four months of the Milei Administration seem like a reset of the economy and a fresh start. Unit labor costs at the current levels allow for a more reasonable economic policy mix. A more sustainable level of real income would moot the need for secular fiscal and monetary impulse, reducing the risks of an FX volatility spike to correct the accumulation of inconsistencies. With lower FX volatility risks, a more rigid system like the Government's currency competition seems viable, and, more importantly, nominal stability could

be attainable. The only snag is that the Government needs society to accept a lower income level than it sought to maintain over the past three decades. We estimate that with lower import and FX restrictions lowering working capital costs, unit labor costs would still be competitive, with average wages between USD900 and 1,000. While that would allow for a 30% increase in dollar wages relative to the current level, it would also require society to accept a real income level at least 30% below the average of the past 30 years.

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