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ARGENTINA: INTENSIFIED PRESSURES ON THE ECONOMIC MODEL

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BCRA allows sharper peso devaluation aimed at stopping reserve loss

Argentina's Central Bank (BCRA) finally allowed a sharper peso devaluation last week amid the steady decline of its stock of international reserves and the widening FX gap between the official ARS:USD1 and the unofficial parallel market (*dolár blue)* rates. (Figure 1.) The nominal exchange rate weakened 17% last week to ARS8:USD1 as officials announced that the value of the peso would be determined by the market through supply and demand. The government had been defending the crawling-peg FX regime to provide an anchor for inflation but, ultimately, allowed peso weakening with the aim to stop the loss of reserves.

Authorities have not made clear if the move marks a one-step devaluation to a fairer value (perhaps the ARS8:USD1 ceiling where the BCRA intervened on Friday and where the peso closed on Monday), or a formal change towards a managed-float FX regime. The choice—and how it is implemented—will send a key message to the market about the government's commitment to either stay on its same course or deliver needed adjustments to the policy framework.

To anchor the nominal exchange rate and the elevated inflation rate (which is, by private estimates, two to three times higher than the official rate of 10.9% p.a.), the weakening of the peso will require accompanying adjustments to tighten fiscal and monetary policies.

Fiscal spending and reserve loss pose threats to sustainability of economic model

Argentina's unorthodox economic policy framework has been increasingly difficult to sustain. (See *Argentina: Pressures on the Economic Model*, February 2013.) At the heart of the unsustainable economic model is loose fiscal spending, which is unconventionally financed with the BCRA's peso transfers to the Treasury; the ANSES pension fund; and the BCRA's international reserves.

GDP growth is underpinned by highly expansionary fiscal policy, especially since 2009. (Figure 2.) Primary fiscal expenditures grew close to an average of 40% yoy in the months of September-November. With loose spending on subsidies and government programs, the cash-strapped government has increasingly turned to unorthodox funding sources. In the last 12-months, one-third of the end-2012 monetary base has been transferred from the BCRA to the Treasury. Even with the transfers from the BCRA and funds from the nationalized pension fund agency (ANSES), the fiscal deficit has widened to around 3% of GDP from a surplus of 1% at the start of 2009.

Argentina relies on the trade balance to supply USD and bolster the reserves stock since the country is locked out of global capital markets. The economy is, thus, increasingly dependent on agricultural exports (of soy, corn, and wheat) to support loose economic policy. Yet, with lower commodity prices and a larger import bill attributed to rising energy imports, the trade balance has steadily eroded to 2% of GDP from 6% of GDP before the 2008/09 global financial crisis. (Figure 3.) This combination of less favorable commodity prices, growing energy imports, FX intervention, and expansionary fiscal policy has drawn down the reserves stock. Reserves now total USD29bn, having declined by USD1bn since the start of 2014 and by USD13bn since January 2013. (Figure 1.) Reserves cover roughly six months of imports, down from eight in 2012 and 12 in 2010.

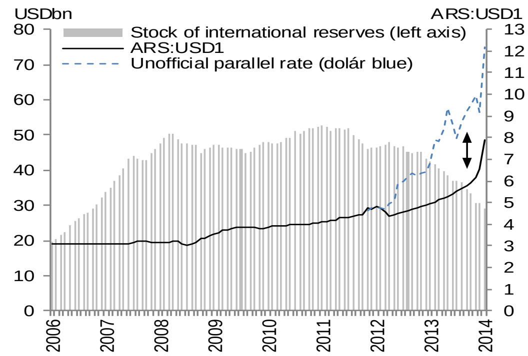
Tighter fiscal and monetary policies are needed to anchor peso and inflation

Allowing the peso to weaken is a needed step towards correcting the overvaluation of the peso in real terms. (Figure 4.) Nominal peso devaluation will need to be followed, in our view, by tighter fiscal and monetary policies to anchor the currency and inflation, and to secure competitive gains.

The government has not yet announced a comprehensive change to its economic model and it is unclear if they intend to do so. It declared some easing of capital controls and higher interest rates. However, these measures are likely to be insufficient. The BCRA signaled a 600bp increase on its short-term peso notes (LEBACS) raising the nominal rate to 26%; however, the real BADLAR rate (the average interest rate paid by private and public banks on peso deposits) remains negative.

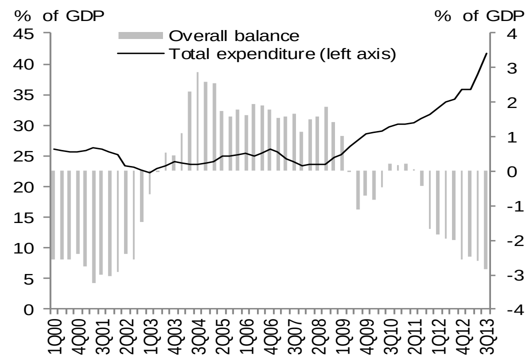
In the absence of a coordinated plan to improve macro-economic fundamentals with tighter fiscal and monetary policies, there are risks of a disorderly peso weakening, higher inflation, reserve losses, and economic instability. Argentina's high inflation–low growth dynamic, declining reserves stock, and wide gap between the official and parallel FX rates position the country as an outlier in the Latin America region. Still, the trade channel could pose spillover effects, though the impact may be cushioned if the government eases trade controls once the peso reaches a fairer value. Direct spillover via the financial channel is less likely; however, sentiment towards EMs may be negatively impacted as the timing of the peso devaluation coincides with global market volatility.

Figure 1: Argentine peso vs. USD1



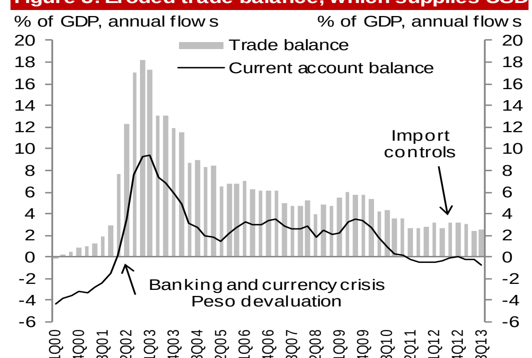
Source: BCRA; Thompson Reuters; BTMU Economic Research.

Figure 2: Widening fiscal deficit



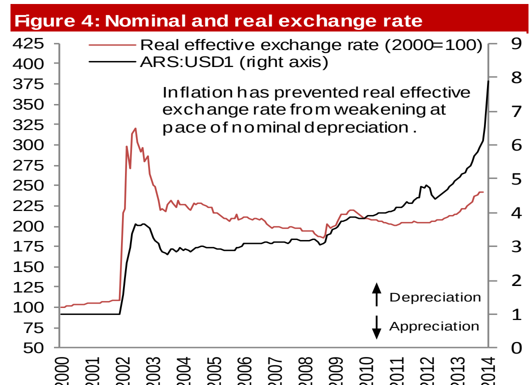
Source: MECON; Thompson Reuters; BTMU Economic Research.

Figure 3: Eroded trade balance, which supplies USD



Source: MECON; BTMU Economic Research.

Figure 4: Nominal and real exchange rate



Source: BCRA; Thompson Reuters; BTMU Economic Research.

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