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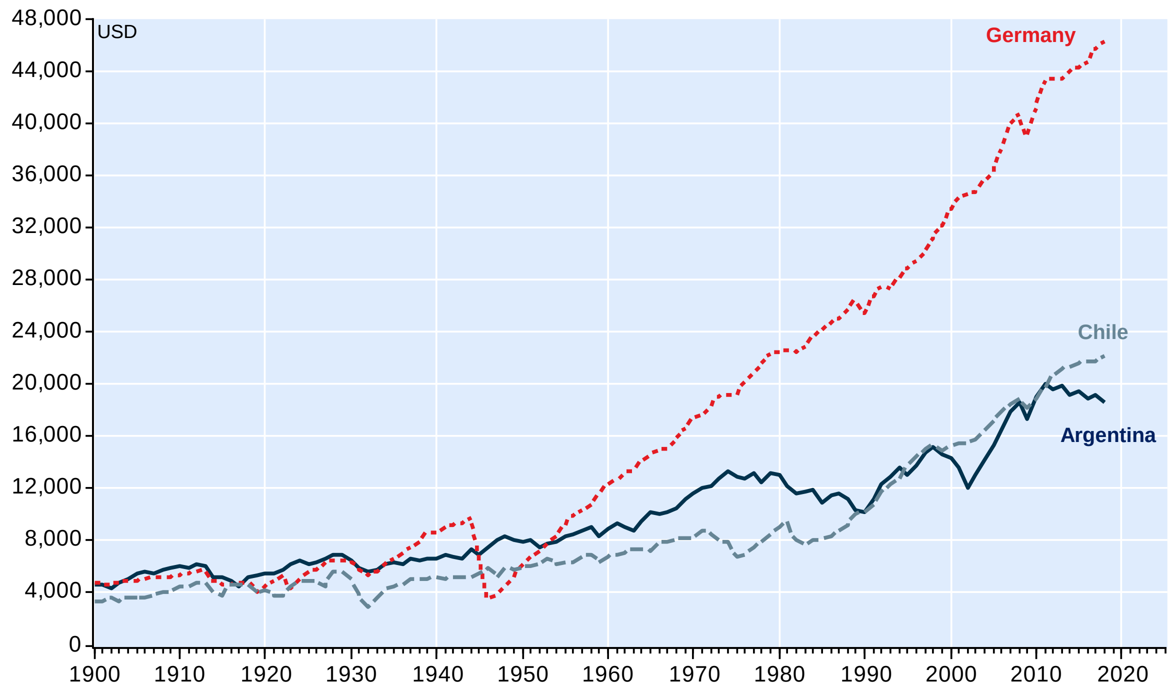
Will the latest attempt to reform Argentina's economy finally succeed?

By Angelo Katsoras

Introduction

A century ago, Argentina was among the richest countries in the world, with a per capita income that surpassed Germany's. However, its fortunes have since taken a turn for the worse. Today, Germany's GDP per capita is several times that of Argentina. Even neighbouring Chile's GDP per capita exceeds Argentina's by about a fifth (see chart below). Argentina's financial instability is highlighted by the fact that, since gaining independence from Spain in 1816, it has defaulted on its debt nine times, including three times since 2000.

Argentina's long economic losing streak
Real per capita GDP: (1900 to 2018)



NBF Economics and Strategy (data via University of Groningen)

Disillusioned by decades of financial crises, voters surprised pollsters by electing Javier Milei as president last November. He takes power at a time when Argentina is in the midst of yet another inflationary crisis fueled in large part by governments that for years have printed money to finance spending. Argentina's total debt-to-GDP ratio is expected to rise to 89.5% this year from 84.7% in 2022, according to the IMF. About 55% ($263 billion) is denominated in foreign currency.[1]

Largely due to the short-term effects of the new government's reforms, the IMF revised its 2024 economic growth projection for Argentina from +2.8% to -2.8%. The Institute of International Finance predicts that annual inflation will rise to about 300% by mid-year.[2] However, the IMF did state that, if these reforms are implemented properly, they could set the stage for more-stable, long-term growth.

President Milei is in a race against time. While he currently has a mandate for change, the longer it takes to tackle the hyperinflation crisis and turn the economy around, the greater the chances that his approval ratings will drop significantly. And thus limit his ability to advance his reform agenda.

[1] Argentina country report, International Monetary Fund, August 2023
[2] "Milei's Austerity Is Devastating Argentina," Foreign Policy, March 5, 2024

Policies enacted by President Milei so far

Just days after his inauguration on December 10, Milei used his executive authority to implement a series of radical measures. These included phasing out annual subsidies equivalent to 0.7% of GDP,[3] reducing the number of government ministries from 18 to 9, suspending all new public works contracts, and devaluing the peso by more than 50% in order to boost exports and reduce imports [4]

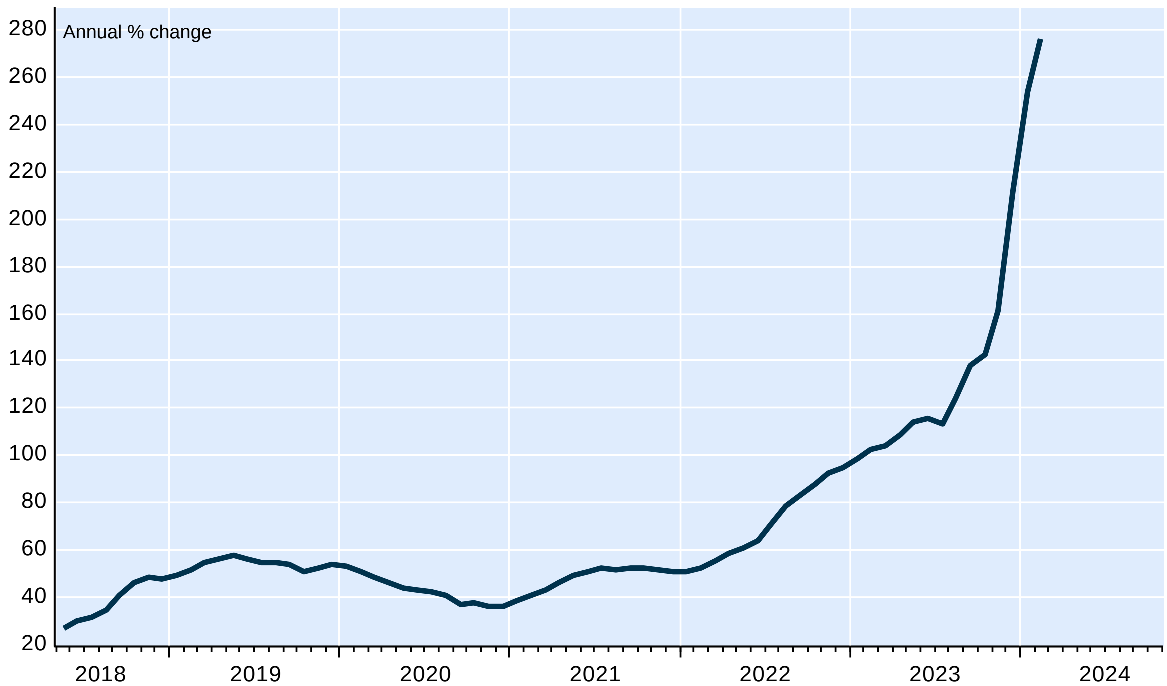
The government claims that these measures allowed Argentina to post its first monthly budget surpluses (January and February) in 12 years and to increase its foreign currency reserves from $21 billion to $27 billion.[5]

The IMF has welcomed these actions and recently approved a new $4.7-billion loan disbursement, which raised the total amount lent to Argentina to $40.6 billion.

But it is important to note the painful short-term costs of these measures. These include not fully indexing pensions to inflation and cutting subsidies for public transportation and energy. Some of Argentina's regional governments have warned that bus and subway fares will rise by as much as 360% in the coming months.[6]

While monthly inflation has been slowing recently (from 25% in December to 13% in February), annual inflation still sits at over 276%, the highest in the world.[7] To put this into perspective, it only took an annual inflation in the 8% range to destabilize the politics of most industrialized countries.

Argentina's massive inflation challenge
Annual % change in CPI

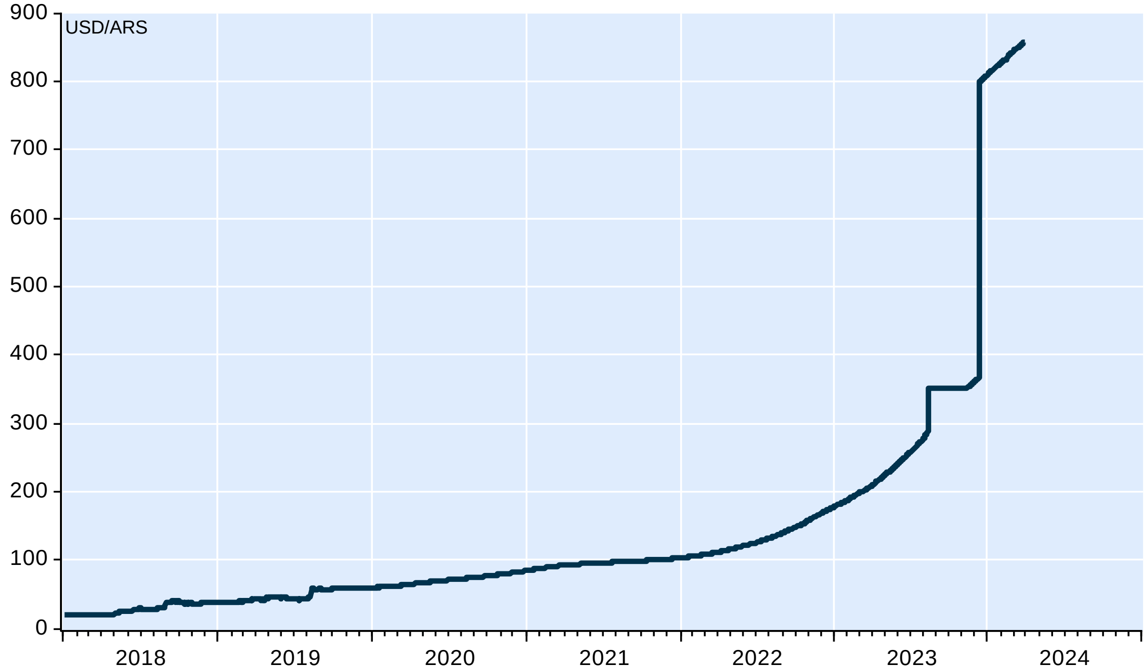


NBF Economics and Strategy (data via Refinitiv)

Inflation has been driven primarily by a significant depreciation of the currency, a trend that has been particularly pronounced since President Milei took office last November. As we've discussed previously, a significant percentage of this depreciation can be attributed to the government's decision to devalue the currency by more than 50% in an effort to reduce the budget deficit. The government's move also brought the official exchange rate closer to the lower black-market rate.

[3] "What Javier Milei could learn from Peru's economic successes," The Economist, February 22, 2024
[4] "Success and Setbacks: 100 Days of Argentina's Milei," Agence France-Presse, March 19, 2024
[5] "Argentina's Milei warns lawmakers he will make reforms 'with or without' them," Agence France-Presse, March 3, 2024
[6] "How Javier Milei is trying to curb Argentina's 250% inflation," Financial Times, February 14, 2024
[7] "Argentina's 100 days of shock treatment," The Globe and Mail, March 19, 2024

Argentina's freefalling currency
Argentinian Pesos per U.S. dollars



NBF Economics and Strategy (data via Refinitiv)

President Milei runs into congressional gridlock

Milei is caught between a rock and a hard place. On the one hand, he rose in popularity by attacking the political establishment. On the other hand, he needs the support of a significant part of this very establishment to further his legislative agenda. His Freedom Advances party controls only 40 of the 257 seats in the Chamber of Deputies and only 7 of the 72 seats in the Senate.[8]

To date, the President has lacked the savvy required to navigate this political landscape. Indeed, many people believe he has made his task even more difficult by leveling corruption accusations against certain politicians and threatening further funding cuts to provinces that resist his agenda. Some provincial governors reacted by pressuring their federal representatives to oppose his policies.

This tension played a large role in the Milei administration's failure to win congressional approval for key pieces of legislation. For starters, last December, he had to withdraw a bill with 664 articles that included such measures as allowing the privatization of numerous state-owned companies and lowering export taxes.

Then on March 14, the Senate voted against his second attempt at economic reform by presidential decree, which allows the government to bypass Congress under "exceptional circumstances". The reform package contained measures to amend or revoke over 300 laws in a broad range of areas, including rent controls, export caps, the privatization of state-run companies, and the loosening of labour laws.

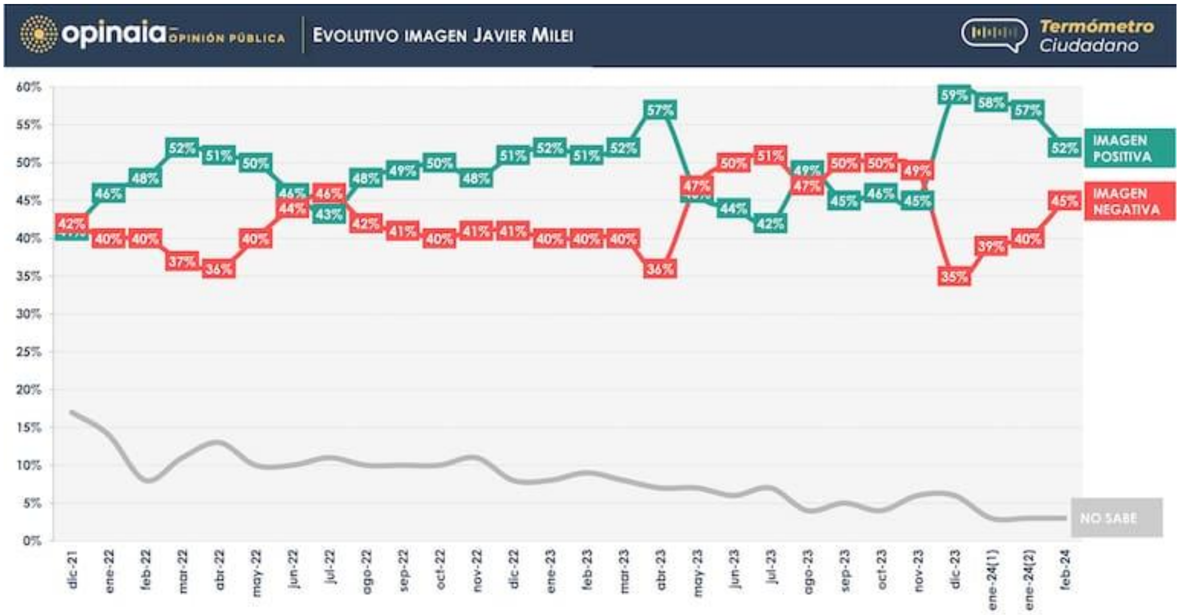
The decree package must now go to the lower house of Congress, where a simple majority can overturn it.[9] (Congress doesn't have to approve a decree for it to go into effect, but they can vote it down.) While Milei's predecessors have issued many decrees over the past 20 years, this is the first presidential edict in recent memory to be voted down by the Senate. This is indicative of the level of political tension that exists between the opposing sides.

If Milei wants any part of the package to survive, he will have to reach an agreement with Congress. The success of these negotiations will not only determine the fate of these measures, it will largely define his ability to advance other parts of his agenda.

[8] "Gauging the Outlook for Energy Reforms in Argentina," Stratfor, March 18, 2024
[9] "Argentina Senate rejects economic 'mega decree' in blow for Milei," Reuters, March 14, 2024

Milei's fate likely to rest on public opinion

While Milei's approval ratings remain fairly high, there is reason for concern. A poll released at the end of February put his rating at 52%, higher than any other national politician. However, this was down from 57% in January.[10]



The big question is whether Milei can continue to maintain this level of approval over the long term. For that to happen, people need to understand that there may be significant immediate economic costs to setting Argentina back on the path to long-term prosperity. The more his support falters, the harder it will be to pass reforms.

Agriculture and energy sectors to play key role in success or failure of reforms

Agriculture

Argentina is hoping that agriculture, which accounts for more than half of its exports, will help pull the country out of its economic doldrums. It is one of the world's leading exporters of soybeans and corn, and a major supplier of wheat and meat. Argentina is endowed with very fertile soil, relatively limited fertilizer needs, a good climate and has low transportation costs.[11]

However, this sector has long been held back by caps and taxes on agricultural exports. Milei has vowed to reduce and eventually eliminate these barriers.

A 50% devaluation of the peso has already made it more attractive for farmers to export their produce as they get more pesos for overseas sales, which are denominated mostly in dollars.

Oil and gas sectors

Argentina is also blessed with significant energy resources, including having the world's second-largest reserves of shale gas and fourth-largest of shale oil.[12] However, much like agriculture, the energy sector has been held back by exports controls and a chaotic business landscape.

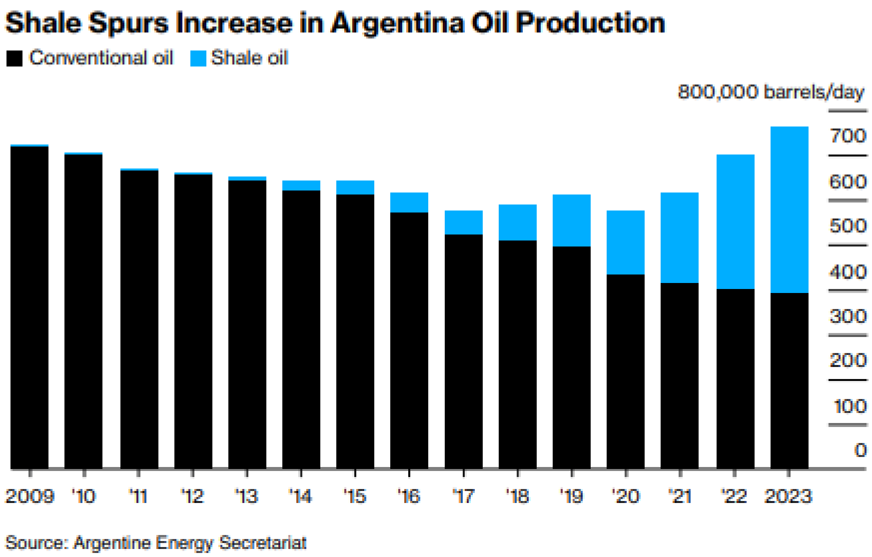
Efforts to lower caps and taxes on energy and agricultural exports were stalled when the Senate rejected the presidential decree package encompassing these reforms. The energy and agriculture sectors hope that any revised decree package to emerge from the lower house will still include these measures.

[10] "Milei pierde imagen positiva y aprobación de gestión, aunque se mantiene como el dirigente más valorado," LA NACION, February 27, 2024
[11] "Global markets watch Argentina's export taxes," The Western Produce, December 18, 2023
[12] International Energy Agency

Some good news for oil and gas

Last July, the government finally managed to complete a long-promised pipeline connecting a massive shale gas deposit in central-western Argentina to the province of Buenos Aires. The government reports that the new pipeline saved Argentina $1.7 billion last year and anticipates a further $4 billion in savings in 2024 by eliminating the need to import liquefied natural gas and piped gas from Bolivia.[13]

Another positive development is that Argentina's oil production, which had been declining for many years, has reversed course thanks to an increase in shale output. Rystad Energy, a consultancy firm, recently said that with the right policy measures in place, Argentina could potentially triple its current shale oil production to over 1 million barrels per day by 2030.[14]



Source: "Milei's Plan to Free Argentina's Oil Market Slows in Congress," Bloomberg, January 26, 2024

According to reports from the Argentine press, the country recorded an energy trade deficit of $4.4 billion in 2022 (i.e., difference between total exports and total imports). In 2023, Argentina's energy trade was roughly balanced. For the current year, projections indicate that Argentina is on track to have an energy trade surplus of $3.5 billion. If these projections come to fruition, it would mark the first time in over a decade that the energy sector has posted a trade surplus. The sector would therefore no longer be a drain on the country's foreign exchange.[15]

Argentina's lithium sector

Argentina currently ranks as the world's fourth-largest producer of lithium and second-largest in terms of proven reserves.[16] It has three active lithium mines with an additional 38 at various stages of development. Government data show lithium exports reached $369 million from January to May, up 84% from the same period a year earlier.[17]

What dollarization entails and whether Milei will pursue it

To dollarize, the government would have to convert all legal contracts, bank accounts, and corporate and government assets and liabilities into dollars. This would require establishing the market value of the peso, which would mean floating the currency and lifting capital controls prior to conversion.

Transitioning to a dollarized economy offers the potential to reduce borrowing costs and enforce fiscal responsibility by giving up the ability to print more money. However, there are significant challenges involved in choosing this path. This includes the central bank having to hold sufficient dollar reserves not only to purchase all the local currency in circulation but also to

[13] "Argentina hits milestone on path to gas export bonanza," Financial Times, July 18, 2023
[14] Argentina's Vaca Muerta shale patch could produce 1 million bpd in 2030, but hurdles remain," Rystad Energy, May 31, 2023
[15] "Argentine energy sector expected to be major contributor of foreign currency in 2024," Buenos Aires Herald, November 14, 2023
[16] "Argentina could be epicenter of new stage of lithium supply," S&P Global, August 14, 2023
[17] "Argentina's growing lithium industry hits export records," Bloomberg, June 17, 2023

protect banks from a run on deposits. Dollarization would also force the country to adopt the monetary policy of the United States, regardless of whether their cycles are synchronized.

While Milei has long supported dollarization, he seems to have backed away from this position since his election victory. However, he maintains that that it could still be an option one day.

Conclusion: Argentina's narrow path to success

- The massive challenges facing Argentina, underscored by hyperinflation and significant currency devaluation, cast a shadow of doubt over the president's ability to steer the economy towards sustained growth and stability. This skepticism also stems from the failures of many of his predecessors. The question is whether Milei can overcome the odds stacked against him. His narrow path to success will depend on his ability to achieve the following objectives.
- Successfully passing a revised decree package would mark a significant victory and speak to Milei's ability to learn from past mistakes in his approach to negotiating with the opposition.
- Reforms included in the new decree package would make it easier for the agriculture, energy and lithium sectors to increase production and exports, and thereby bring more foreign currency into the country.
- Swinging from an energy trade deficit to an energy trade surplus would mean less outflows of foreign currency. This, in turn, would help stabilize the peso and make it easier for the government to service its foreign dollar-dominated debt.
- Reducing inflation and stabilizing the currency would go a long way towards helping the economy heal and maintaining public support for Milei.
- Milei's approval ratings continue to hover at around 50%, which suggests that he still enjoys substantial public support. This level of popularity would make the opposition more inclined to negotiate and compromise.

Bottomline: While we remain very cautious about Milei's ability to turn the economy around, the above goals provide a clear framework by which to assess his progress.

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