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Aurora Macro Strategies – Argentina Report, Mileinnial Angst, August 1August 1, 2024

The Tearsheet

Aug 14	July CPI
Aug 21 & 28	Senate hearings for Supreme Court nominees
Aug 21	June economic activity estimator
Q4 2024	Plausible new IMF program
Oct 2025	Midterm elections
Q4 2027	Presidential elections

- Milei's approval of the Bases Bill and fiscal package in Congress demonstrated his ability to navigate the legislative branch.
- Now comes a new phase which has brought market turbulence and IMF tensions.
- For this second stage, Milei aims to eliminate money printing, setting up a third stage where he aims to lift capital controls and introduce currency competition, allowing Argentinians the ability to freely choose which currency to use for their daily transactions.
- We expect capital controls will be lifted by the end of 2024. The key complicating factor to this is a lack of reserves and a slow economic recovery that may put pressure on the official dollar rate and potentially lead to unplanned, if small, peso devaluations.
- A new IMF program by 4Q24 would help Milei to reach this third stage of his plan.

1. Milei's Minibus past the finish line

- As we predicted in our most recent Argentina report, the Bases bill (the "minibus") and fiscal package each passed the Senate by a razor-thin margin, with Vice-President Victoria Villarruel casting the tie-breaking vote.
- The main points of the final Minibus version include:
    - Delegation of powers to the executive branch:
        - One-year-long public emergency in administrative, financial, economic, and energy matters.
        - Delegation of powers to the executive branch to implement state reforms.
    - Privatizations:
        - Energía Argentina S.A.
        - Intercargo S.A.U.
        - Aguas y Saneamientos Argentinos S.A.
        - Belgrano Cargas y Logística S.A.
        - Sociedad Operadora Ferroviaria S.E. (SOFSE)
        - Corredores Viales S.A.,
        - Nucleoeléctrica Argentina S.A., and the Coal, Railway, Port, and Energy Complex managed by Yacimiento Carboníferos Río Turbio can incorporate private capital, but the state will retain control or a majority stake in the companies' capital stock.
    - Labor Reform:
        - Institute penalties for blockades and other forms of union protest.
        - Extend the employee probation period.
        - More flexible employment contracts that allow employees to become contractors.

- Public Works, Infrastructure, and Public Utilities Concessions:
  - Legislation was reformed to encourage private investment and ensure legal security, including mechanisms for review and technological adaptation.
- Energy:
  - The law introduces reforms to promote free international trade of hydrocarbons and private participation in the sector.
- Incentive Regime for Large Investments (RIGI):
  - A new regime that offers incentives and guarantees of regulatory, fiscal, customs, and exchange rate stability for investment projects in key sectors such as energy, mining, and technology.

- Despite some false starts, the bill's passage bodes well for governmental neophyte Milei's progress in learning to navigate the byzantine Argentine political system.
- Crucially, the Chamber of Deputies was able to preserve the original language of the fiscal package, empowering the government to enact a comprehensive regularization scheme for non-declared capital, a key tenet of the administration's fiscal surplus policy.
- The package also includes expanding the scope of the income tax to cover specific groups alongside significant reductions to the wealth tax.

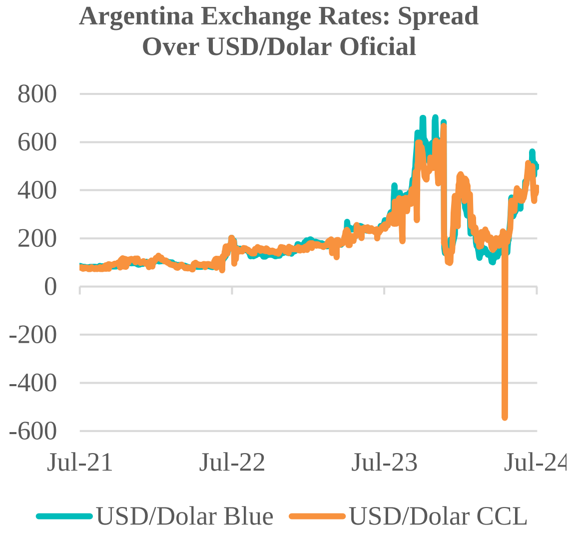
2. Deregulation Next on the List

- For the next phase of Milei's political agenda, he hopes to aggressively pursue deregulation.
- The newly founded Ministry of Deregulation and Transformation of the State is led by a familiar figure in Argentine economic circles, Federico Sturzenegger, the former Central Bank president under the Macri administration.
- Sturzenegger authored key sections of the Minibus bill and Milei's initial emergency decree. He has now been tasked with cutting down the size and cost of the state and removing various regulatory restrictions he believes to be constraining economic activity.
- He has been tasked with introducing the "Hojarascas Bill," named metaphorically after "leaf litter," symbolizing excessive, useless regulations that need trimming. While specifics are unclear, the bill aims to repeal existing regulations.
- True to this metaphor, his first policy as Minister was the enactment of the Open Skies policy, which deregulated the aviation sector.

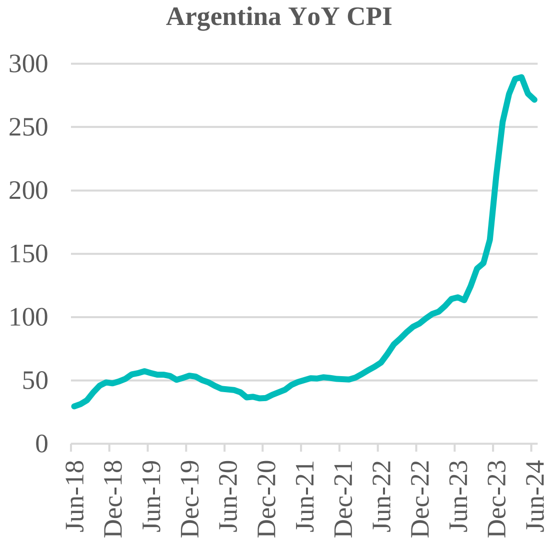
3. A turbulent macroeconomy: market mistrust and tensions with IMF

- On June 28th, the day after both bills passed Economy Minister Luis Caputo and Central Bank President Santiago Bausili held a press conference.
- They announced no set deadline for lifting capital controls, instead confirming the continuation of the current exchange rate regime—a 2% monthly crawling peg.
- Additionally, the 80/20 blended dollar for exporters will remain, allowing them to liquidate 20% of their foreign currency at the "contado con liquidacion" (CCL) rate.

- The CCL rate allows companies and individuals to exchange Argentine pesos for dollars abroad, circumventing local exchange restrictions and tapping into a better exchange rate than the official one.
- Recently, tensions have risen with the IMF, which, in its Staff Report, proposed a swift move from capital controls to a free-floating exchange rate ending the differential exchange rate for exporters by June and presenting a credible plan for lifting capital controls by July.



- With a 40% exchange rate gap—20% from the PAIS tax on dollar expenses and imports, and 20% from differences between official and financial dollar rates—a free-floating exchange rate would likely cause a sudden inflation surge as the official rate aligns with other dollar rates and prices follow. Milei, heavily reliant upon his anti-inflation stance for political support, appears predictably unwilling to pursue this approach.
- Markets reacted negatively: on July 1st, both the blue dollar and financial exchange rates surpassed the $1,400 barrier for the first time. Argentina's Emerging Markets Bonds Index (EMBI) increased by 57 points, reaching 1,513 basis points, while Argentine stocks fell by almost 10% abroad,
- The market was further unsettled by two consecutive rate cuts in May and June respectively, totaling 40 percentage points, compounding the Central Bank's struggle to build reserves, which widened the exchange rate gap, and no news regarding capital controls.



- In response, Caputo quickly clarified that the PAIS tax rate would be reduced between August and September once the Bases Law becomes fully implemented, and the Treasury starts receiving revenues from the fiscal package.
- Caputo also announced plans to fully eliminate the PAIS tax in the preliminary 2025 budget.

- The approved Fiscal Package should cover the revenue loss from the elimination of the PAIS tax. Expanding the income tax will address two-thirds of the loss, while tax amnesty, taxes on undeclared assets, and personal property taxes will cover the rest.
- This would theoretically maintain Argentina's newfound fiscal surplus, though risks include a deeper recession affecting tax collection and new legislation, such as the new pension formula approved by the Chamber of Deputies, now in the Senate.
- If approved, the new pension formula would have a fiscal cost of approximately 0.4% of GDP, complicating the sustainability of the government's fiscal balance program.

4. The monetary Gordian knot

- On July 15, Deputy Governor of Argentina's central bank, Vladimir Werning, outlined the administration's second stage to New York investors, emphasizing efforts to eliminate money printing by targeting the fiscal deficit, Central Bank interest payments to the Treasury, and eliminating put options.
- These measures are intended to eventually allow the government to lift capital controls and transition to currency competition.
- The fiscal deficit issue is addressed by transferring interest payment responsibility on the Central Bank's remunerated debt to the Treasury through the Liquidity Fiscal Letter (LeFi), controlling the money supply and reducing inflation.
- As of July 16, remunerated liabilities totaled ARS 11.7tn. Banks with excess cash can now buy LeFi from the Central Bank, earning interest covered by the Treasury instead of holding put options.
- The Central Bank has significantly reduced put options, with banks rescinding ARS 13.17 trillion, marking the final issuance of pesos to repurchase these liquidity options, key to lifting capital controls and avoiding an issuance equivalent to 4% of GDP.
- Central Bank President Santiago Bausili stated that peso issuance would be limited to accumulating reserves through CCL market interventions, with sterilization measures to control the money supply and curb inflation.
- However, low reserve levels have raised concerns about the Central Bank's ability to meet maturities, negatively impacting investor confidence.
- The Milei administration anticipates an economic rebound, increased private credit and investment, and tax amnesty, boosting demand for pesos, with zero new issuance leading to genuine demand for pesos and eventual removal of exchange controls.

5. Assessing Milei's second stage

- Despite curbing the money supply, the key risks for transitioning through the second stage lie in economic fundamentals, particularly the pace of recovery. While a V-shaped rebound is unlikely, recent data offers some optimism.
- Economic activity rebounded in May 2024, ending a six-month slide with a 2.3% year-on-year increase and a 1.3% rise from April. This improvement was mainly due to the agricultural sector's recovery from last year's severe drought and increased production in Mining and Quarrying, particularly in Vaca Muerta.
- Financial risks are also elevated due to the Central Bank's weak international reserves, particularly with over USD 8 billion in debt maturities by year-end. Only a small portion of

this can be refinanced through World Bank, Inter-American Development Bank, and Corporación Andina de Fomento (CAF) disbursements.

- Without access to international financial markets, the administration plans to secure fresh dollars through a new IMF agreement, which they aim to finalize by the end of 2024.
- Key to the agreement will be negotiating favorable terms with the IMF on the exchange rate regime and currency competition between the peso and the dollar.
- The administration is hoping for a Donald Trump victory in the U.S. to gain it additional U.S. Treasury support for this deal.
- Given the timeline for a new IMF program (likely concluding in 4Q24), limited international reserves, and a tough economic recovery, further market turbulence is expected in the short term.
- Regardless, we expect capital controls to be lifted by 4Q24.

6. Milei's second stage smokescreen?

- Former Minister of Economy Martín Guzmán has described the above as a step towards dollarization, arguing that it helps reduce the amount of dollars needed to dollarize the economy.
- In order to dollarize, a country needs to have enough dollars to convert the entire monetary base (the total money in circulation and reserves) and the remunerated liabilities (debts that the central bank must pay).
- Halting peso issuance to cover the government deficit prevents increasing pesos in circulation, reducing dollars needed for potential dollarization. Additionally, converting some of the central bank's remunerated liabilities to dollar-denominated ones means fewer dollars are required to cover these liabilities.
- Guzmán further highlights that the Argentine government has managed to reduce the amount of dollars needed for dollarization to USD 28.134 billion, down from USD 40.8 billion at the start of the current term.
- This vision contrasts with that of Caputo, who argues that in the third stage of this plan, where there is currency competition, the peso will be the stronger currency, advising people not to buy dollars.
- Nonetheless, dollarization remains a remote possibility under this administration, as any such plans would require the Supreme Court to rule on the scheme's constitutionality, and the judiciary's wariness of Milei's would-be transformative measures appears ongoing.
- It is worth noting that the current Supreme Court President, Horacio Rossatti, stated during the 2023 electoral process that dollarization would be unconstitutional if it eliminates the peso.

7. Defending Fiscal Policy and Supreme Court appointments: Argentina's Congress

- Despite recent legislative successes, monitoring Congress remains crucial for two reasons.
- Until the end of 2024, the president's La Libertad Avanza (LLA) party must defend against fiscal impactful laws that could jeopardize the fiscal surplus, chief among them opposition's new pension formula.

- In order to counter moves by the fiscally populist Kirchnerites in congress, LLA has been cozying up to a new Peronist faction that includes Governors Gustavo Sáenz, Raúl Jalil, Hugo Passalacqua, and Osvaldo Jaldo.
- Secondly, the nomination process for the next Supreme Court justices is crucial and has been winding its way through the legislature. Hearings are currently scheduled for August.

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