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Argentina's Presidential Election: Dollarization dreams

Country at a crossroads as it approaches its October elections

Macroeconomic Research

Luis Lopez-Vivas,
Economist (Latin America),
Macro Research – Core Investments

Key points

- Three potential candidates will face off in Argentina's Presidential elections on 22 October, against a backdrop of an ongoing economic turmoil
- Javier Milei of the libertarian La Libertad Avanza party leads the polls by a wide margin
- Milei's proposals envision the full dollarization of Argentina's economy, removing currency controls and shutting down the central bank
- Benefits of dollarization potentially include lower inflation and lower interest rates, encouraging more investment and boosting growth
- However, it can also act as a fiscal straitjacket, with a fully dollarized economy potentially more vulnerable to both real and financial shocks

A libertarian surge amid economic turmoil

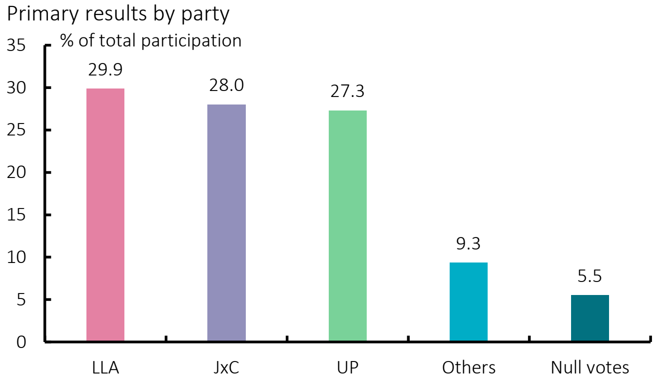
Argentina is at a pivotal juncture as it gears up for its general elections on 22 October. These elections are not just about choosing a new President and Vice President; they will also determine the makeup of the National Congress and the governors of most provinces. What's more, these crucial political decisions will unfold against a backdrop of economic challenges which have hit the nation hard.

This profound economic crisis has significantly weakened the ruling Peronist coalition (Unión por la Patria, or Unity for the Homeland, following the ideology of former President Juan Perón) resulting in a surprising turn of events. Despite being eligible for a second consecutive term, both incumbent President Alberto Fernández and former President Cristina Fernández de Kirchner have opted not to pursue re-election. Instead, the Peronists have nominated Sergio Massa - the current Minister of Economy - as their candidate, aiming to bolster the party's chances of success in the elections.

In Argentina, each Presidential term lasts four years, and the electoral system follows a two-round approach. To win outright in the first round, a candidate needs either more than 45% of the vote or 40% with at least a 10-point lead over their closest rival. Otherwise, a run-off will be scheduled for 19 November. The new government will take office on 10 December.

This election features three viable candidates for President, each representing different ideologies and proposals to deal with the country's beleaguered economy. However, it is Javier Milei who is stealing the limelight. The libertarian economist, who is leader of the right-wing La Libertad Avanza (LLA) party, shocked the political establishment with his victory in the recent primary elections (known as PASO) on 13 August, garnering 29.9% of the vote. Meanwhile, Sergio Massa - representing the left-wing Unión por la Patria coalition (UP) - obtained 21% of the vote and Patricia Bullrich, former Minister of Security and candidate for the centre-right Juntos por el Cambio coalition (JxC) secured 17%. It's worth noting the primary results were quite tight at the party level, with JxC receiving 28% of the vote when considering all its candidates, while UP received 27.3% of the support collectively (Exhibit 1). Milei ran unopposed within his party.

Exhibit 1: Three parties, one race



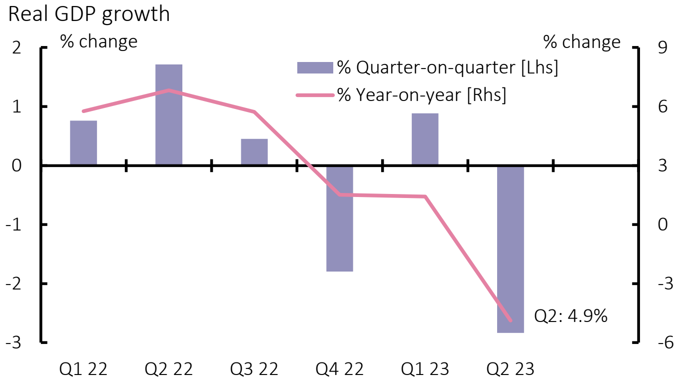
Source: Opinaia and AXA IM Research, September 2023

The PASO primaries are a critical precursor to the general elections and serve as a bellwether as voter participation is mandatory, ensuring a representative sample of public sentiment (around 70% participation rate). Milei's impressive performance in the PASO primaries was particularly striking, given he had been trailing in independent polls. This unexpected outcome underscores the growing disillusionment with the traditional political establishment and a desire for more radical solutions to address pressing issues such as rising crime, security issues and the economy.

It's the economy, stupid

What lies beneath this political drama is an unabated economic crisis. A historic drought this year exacerbated pre-existing macroeconomic imbalances, many of which can be traced back to the incumbent government's ill-fated economic policies. The drought inflicted significant additional damage on the country's key agricultural sector which produces around 65% of total exports and employs around a third of the labour force. As a result, GDP growth plummeted by 5% year-on-year in the second quarter of this year (Exhibit 2). Adding to the nation's woes, the peso has been in freefall in the parallel currency market, headline inflation has soared above 100% and foreign reserves have been exhausted.

Exhibit 2: From boom to gloom



Source: LSEG Datastream and AXA IM Research, September 2023

In parallel to its failing economy, Argentina finds itself dependent on a critical arrangement with the International Monetary Fund (IMF) to meet upcoming debt payments. The programme, agreed in 2022, was itself a restructuring of a failed 2018 loan that was designed to stabilise the country's economy. However, this newly devised programme quickly went off the rails, reflecting the impact of the drought along with policy slippage and delays. Argentina's difficulties in meeting the programme's targets prompted the IMF to adjust some conditions to facilitate ongoing disbursements. This flexibility played an important role in helping Argentina meet its financial obligations and avoid default. Meeting the targets and fulfilling repayment obligations will remain a challenge for the next administration to solve in the absence of a stabilisation plan.

Latest polls

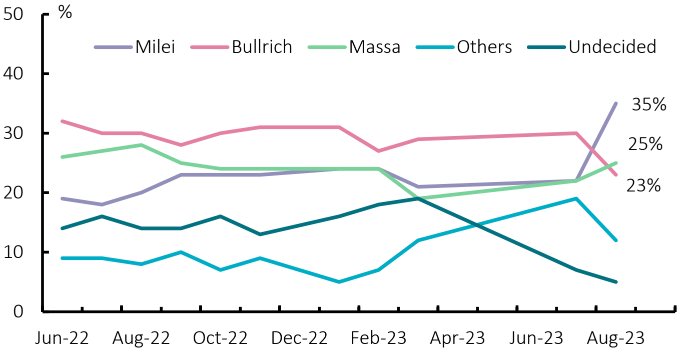
Milei's triumph in the primary positions him as the frontrunner for the Presidential race. Although securing an outright victory and avoiding a run-off appears improbable, the strong likelihood of a second round keeps the race wide open. According to local pollster Opinaia, Milei is projected to garner 35% of the vote, with Massa at 25% and Bullrich at 23% (Exhibit 3). This would leave him just five percentage points (ppt) shy of the 40% threshold required to skip the run-off. Moreover, a significant number of undecided voters (9%) could sway the election's outcome.

These polls therefore suggest Milei will face Massa in a run-off. Notably, Massa carries the highest rejection rate, with 65% of voters indicating they would never vote for the left-wing candidate, followed by Bullrich at 52%, and Milei at 43%. This implies that Milei could capture a substantial portion of Bullrich's votes in the second round in a potential Milei-Massa scenario. Bullrich's centre-right stance also aligns more closely with Milei's libertarian principles. Therefore, it is reasonable to expect Milei to gain the support of Bullrich's voters.

Polls by Opinaia examining different second-round scenarios seem to reinforce this assessment. In a Milei-Massa match-up, polls suggest the libertarian candidate would secure victory with a nearly 20ppt lead (49% versus 30%). Similarly, Milei would outperform Bullrich in a second round, albeit by a smaller margin (38% versus 31%). In the unlikely event of a Bullrich-Massa face-off, the centre-right leader would win with a significant advantage. While these polls suggest a highly probable victory for Milei and a challenging path forward for Massa in any scenario, it's important to remember that most polls did not anticipate Milei's primary election victory, leaving plenty of room for potential surprises. Likewise, a higher participation rate could contribute to an unexpected outcome.

Exhibit 3: Milei leads polls by a wide margin

Voter preference



Source: Opinaia poll and AXA IM Research, September 2023

Candidate policy agendas

The upcoming Presidential elections could chart a new course for the country's economy as the candidates present differing views on crucial areas such as monetary policy, foreign relations, fiscal strategies and taxation. These varying stances suggest the election outcomes could bring about significant changes. Notably, Massa stands out as the candidate aligned with the current status quo, advocating for a somewhat 'muddle through' approach to address the nation's challenges.

In his policy proposals, Massa aims to keep the current central bank charter, meaning he would not grant autonomy to the monetary authority. He also supports maintaining current currency and price controls, policies that have created significant economic distortions. On the fiscal front, he intends to achieve a primary balance next year by reducing tax credits, although this promise may seem questionable given his plans to increase infrastructure spending.

Bullrich takes a more traditional approach to steer the economy toward stability. For example, she supports central bank independence, ending debt monetization, and eliminating currency controls. She also advocates 'bimonetarism', allowing people to choose their preferred currency. On the fiscal front, Bullrich is committed to avoiding default, reducing deficits in State-Owned Enterprises (SOEs) within six months, and considering the closure or privatisation of deficit ridden SOEs. Additionally, she pledges to abolish agricultural export duties and decrease labour taxes. However, some critics question this approach as it is reminiscent of the 'gradualist' strategy used by Mauricio Macri's administration from 2015 to 2019, which ultimately failed.

Milei's platform represents the most radical departure from the current state of affairs, characterised by his so-called 'Chainsaw Plan'. At its core, Milei's flagship proposal envisions the full dollarization of the economy, which entails abolishing currency controls and shutting down the Banco Central de la República Argentina (BCRA), the nation's central bank. He also aims to reduce public spending by 15ppt of GDP through privatising SOEs and the public healthcare system, reducing the number of ministries, eliminating subsidies to provinces and cutting spending on pensions. It's worth noting that social benefits and economic subsidies currently account for a significant 73% of public sector current expenditures.

Dollarization dreams and nightmares

A macroeconomic stabilisation plan via exchange rates is not a novel concept in Argentina, as the nation had previously ventured into this territory in the early 1990s. During that period, Argentina introduced a currency board, similar to full dollarization. Under this setup, the peso was pegged to the dollar at a one-to-one exchange rate. Initially, the arrangement was embraced as a stabilising force that curbed inflation. However, by the late 1990s, the economy had fallen into a currency-growth-debt trap exacerbated by external shocks. The peso was overvalued, growth was weak and external debt became increasingly hard to service.[1] The currency board eventually unravelled in 2001, leading to a severe economic crisis and a traumatic default on the country's debt. This experience from Argentina's recent history serves as a poignant reminder of both the potential benefits and dangers associated with dollarisation and other similar strategies.

Full dollarization might seem like a radical change, but it's worth noting that many developing countries already use the dollar to some extent, especially in financial agreements. Full dollarization takes it a step further, making the US dollar the official legal tender for all transactions. While there are similarities between full dollarization and a currency board, there are some key differences.

[1] Living and Dying with Hard Pegs: The Rise and Fall of Argentina's Currency Board by Augusto de la Torre, Eduardo Levy Levy-Yeyati, Sergio L. Schmukler: SSRN

One crucial distinction is that dollarization is permanent. Reversing this strategy is much more challenging than abandoning a currency board, as Argentina did back in 2001. This permanence is considered as its primary advantage by supporters of dollarization, as it enhances credibility and stability precisely because it cannot be undone.

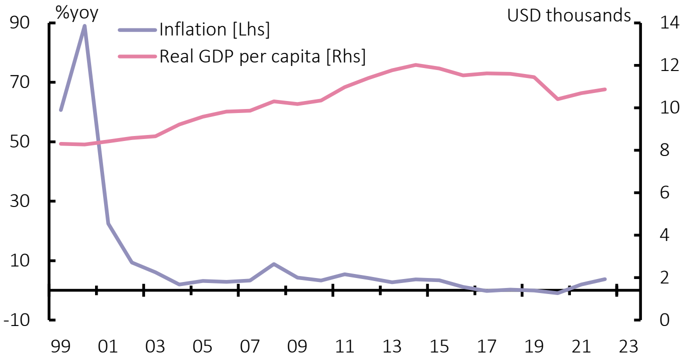
The main immediate benefit of dollarization is that a country imports the credibility of the Federal Reserve as it gives up monetary and exchange rate policy. In doing so, it also eliminates the risk of currency devaluation, a significant contributor to inflation. The idea is that removing this devaluation risk also lowers the risk premium on foreign borrowing, resulting in lower interest rates for the government and private investors. This, in turn, can encourage more investment and boost economic growth.[2] In the case of a country like Argentina, dollarization can also act as a fiscal straitjacket, preventing the central bank from printing money to finance public spending, a debt monetisation that has been the primary driver of inflation in Argentina.

However, it's important to recognize that dollarization is far from a silver bullet. It does not completely eliminate sovereign risk—the risk of a government defaulting on its debt. There are other trade-offs as well. By adopting the dollar as legal tender, a country gives up revenue from seigniorage (the profit it makes between the face value of its currency and the cost of issuing coins and notes), a source of income not surrendered under a currency board. The central bank loses its ability to act as a lender of last resort to the banking system. Monetary policy tools become unavailable for managing the business cycle – economic shocks thus require real economic adjustments – and the economy potentially becomes governed by developments in the US, rather than at home. Consequently, a fully dollarized country becomes more vulnerable to both real and financial shocks[3].

Ecuador stands as one of the most prominent examples of dollarization. It holds the distinction of being the largest nation to abandon its own currency and unilaterally embrace the US dollar. The decision was made in 2000, during a period of profound economic and political upheaval. While dollarization has effectively tamed inflation, Ecuador has defaulted twice on its debts, despite reaping the benefits of a long oil boom. Furthermore, the economy has experienced stagnation in real per capita terms over the past decade (Exhibit 4). Nonetheless the debate over reversing dollarization is practically non-existent.

Exhibit 4: Taming inflation, suffering stagnation

Inflation and real GDP per capita in Ecuador



Source: LSEG Datastream and AXA IM Research, September 2023

Milei's dollarization plan

Milei has continuously changed his stance on the timing and mechanisms he would use to dollarize Argentina. This ambiguity indicates a lack of a definite plan and the technical difficulties that dollarization would entail. What seems clear is that he would pursue a gradual strategy rather than an abrupt shift, which is an issue in itself as expectations of dollarization currently fuel devaluation expectations and could drive inflation higher.

According to economist Emilio Ocampo, one of Milei's advisors and the architect of the plan, the first step would be to allow companies to conduct transactions in a foreign currency. This action would serve as the cornerstone towards full dollarization. Another integral aspect involves replacing the BCRA's interest-bearing peso debt backing deposits. Once central bank debt is addressed alongside the implementation of spending cuts, Ocampo foresees the removal of currency controls, allowing the public to exchange their pesos for dollars. According to Milei, the process would last between nine and twenty-four months.

While such plans might appear good in theory, the reality could be far more challenging. To achieve dollarization, the central bank would need substantial reserves to cover the monetary base and convert its peso-denominated liabilities into dollars. Argentina's monetary base is currently valued at US$9.4bn (using the market-based parallel exchange rate), while the central bank's debt amounts to $27bn. In simple terms, the country would require $36bn of assets for full dollarization. Not only does the Banco Central de la República Argentina (BCRA) lack such reserves, it actually has a net deficit of -$8.7bn (Exhibit 5).

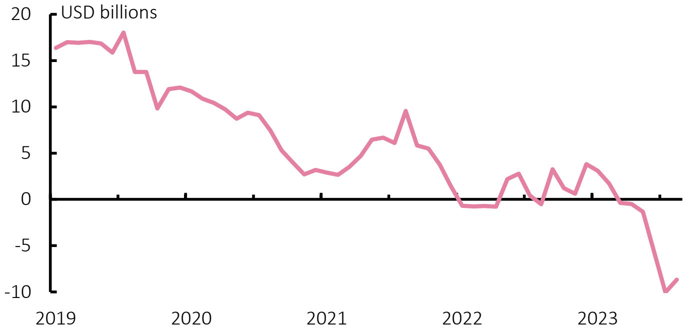
[2] Chapter 30 Dollarization: A Primer: Current Developments in Monetary and Financial Law, Volume 2 (imf.org)

[3] Costs and Benefits of Dollarization

The government faces a critical dilemma in pursuing such a strategy. On one hand, it could opt for an extremely weak exchange rate to achieve dollarization, considering the lack of reserves. However, this approach would pose a substantial challenge for the sovereign in servicing its existing debts. On the contrary, selecting a more favourable exchange rate might facilitate the repayment of its obligations, but given the current economic circumstances, it remains an unrealistic option.

Exhibit 5: Few dollars under the mattress

Net international reserves



Source: Central Bank of Argentina and AXA IM Research estimates, September 2023

Note: Net international reserves defined as official assets minus short-term liabilities

Innovative financing or voodoo accounting?

In the face of negative reserves, Argentina would need to issue a substantial amount of debt to implement Ocampo's plan. Milei proposes using assets held by the BCRA to facilitate dollarization. The central bank holds Argentine Treasury debt denominated both in pesos and dollars and the idea would be to convert these assets into US dollar bonds under New York law. All these assets, alongside BCRA's liabilities, would be used to establish a trust called Fondo de Estabilización Monetaria (FEM), in a foreign jurisdiction. The government would contribute additional resources such as assets from the state-owned pension fund, proceeds from the sale of the 5G spectrum, the state's stake in energy company YPF and tax revenues from agricultural exports, and so on.

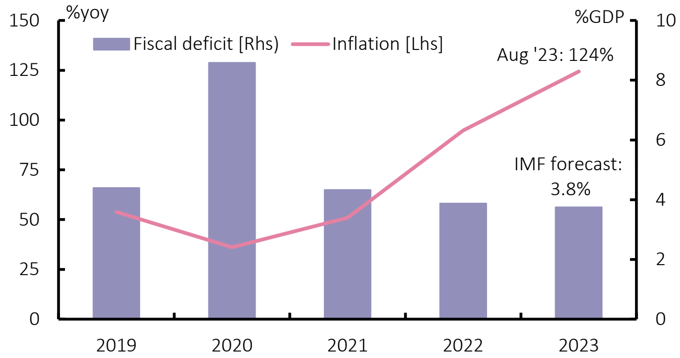
To finance the process of converting the BCRA's assets and liabilities, the FEM could issue asset-backed debt helped by the excess collateral and financing from international financial institutions. This issuance would allow the gradual repayment of the BCRA's short-term debt. However, this proposal faces significant challenges. The FEM, in essence, would be holding the same risky creditor's debt as its collateral (Argentine Treasury notes), meaning that it could be perceived as just as risky as the Argentinean government. This questions whether the government could secure the necessary funding from international markets. Likewise, the possibility of multilateral financing is highly uncertain.

Besides economic constraints, Milei's plan faces political obstacles. Since Congress has the authority to legislate the currency, Milei would need to secure a majority vote. As his party would likely have only a limited presence in Congress, they would have to negotiate with the Juntos por el Cambio party to push the initiative forward. More fundamentally, there are even doubts as to whether full dollarization would be allowed by the constitution.

Given the many economic and political challenges, a Milei administration may need to settle for a more straightforward stabilisation programme. This would involve slashing public expenditure and dismantling the complex currency controls in the country. This approach to stabilisation aims to put an end to the practice of financing government debt through the creation of new money, thus curbing inflation and unifying the various exchange rates in Argentina. These measures should help correct major macroeconomic imbalances such as runaway inflation and large fiscal deficits (Exhibit 6).

Exhibit 6: No money, just a good printer

Fiscal deficit and inflation



Source: LSEG Datastream and AXA IM Research, September 2023

Final thoughts

Argentina stands at a crossroads as it approaches the October elections. Economic turmoil has severely weakened the Peronist party, which has held power for 16 of the last 20 years. Frustration with the political establishment has created an opening for an outsider like libertarian Milei, who currently leads the polls by a considerable margin.

Milei's proposal for radical economic transformation, including dollarization, has garnered significant attention. However, it's important to understand that dollarization is not a silver bullet, as illustrated by Ecuador's experience - and a tighter fiscal policy would still need to be required to tame inflation. The feasibility of Milei's dollarization plan, given Argentina's current economic constraints, remains uncertain. The country's negative reserves and substantial debt raise questions about its ability to carry out such a transformation. Moreover, there are also significant political hurdles to overcome.

While dollarization has potential benefits, including inflation control and reduced sovereign risk, it also has significant drawbacks including a loss of monetary autonomy - making the real economy more vulnerable to economic shocks - as well as surrendering seigniorage revenue. Such a move would also likely be irreversible. The nation must carefully weigh these trade-offs.

As Argentina grapples with its economic challenges, it may find that a more pragmatic stabilisation plan, involving spending cuts and the dismantling of currency controls, is a more viable option. In these uncertain times, what is clear is that Argentina faces critical decisions that will shape its future. Whether through radical reform or more conventional measures, change is imperative to prevent a potential economic implosion.

In terms of economic forecasts, we expect GDP to contract by -3.0% in 2023, reflecting a combination of factors, including a poor harvest impacted by the La Niña weather phenomenon and macroeconomic instability that has adversely affected private consumption and investment. Looking ahead to 2024, while there will likely be positive drivers such as an improved harvest, a more dynamic energy sector driven by domestic natural gas usage with the new pipeline, and increased exports to neighbouring countries, we still expect the economy to contract by -0.5%.

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Our Research is available online: www.axa-im.com/investment-institute

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