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Milei's Argentina: A Long-Term Perspective

Milei took office with an economy on life support. More than a heavy legacy, it was a fatal one. Yet, in just one year of governance, the progress in economic policy has been extraordinary. The administration inherited a monthly inflation rate of 12%, a currency exchange gap of 170%, and significant distortions in relative prices. However, the latest data from November shows inflation at 2.4%, an exchange rate gap around 15%, and largely aligned tariffs.

Initially, the country's reserves were negative by USD 11 billion, with demand for pesos at rock bottom. Today, reserves are negative by only USD 3 billion. Along the way, over USD 10 billion in debt has been repaid, and import-related debt has been normalized. Furthermore, through fiscal discipline, a welcome increase in demand for pesos has been achieved. The government also inherited a primary deficit of 3% of GDP, fully financed through monetary issuance, and a consolidated public expenditure representing 40% of GDP. So far this year, the accumulated primary result has been a surplus of 2% of GDP, and consolidated spending will close the year at around 34% of GDP. This adjustment, though drastic, was necessary. It is worth noting that pensions have maintained their purchasing power, while the universal child allowance (AUH) has grown well above inflation. Perhaps most significantly, these economic policy achievements were made without violating property rights: there was no Bonex plan, hyperinflation, debt rescheduling, or default.

Having mentioned the achievements, I believe the economic team still faces a major challenge ahead: the exchange rate framework. In this point I would like to focus. Is it fair to emphasize the criticisms? Maybe not, especially after the enormous irresponsibility and mismanagement of the previous administration. However, the best way to avoid a return to the failed policies is precisely through a responsible debate, free from petty considerations.

The real exchange rate (RER) against our trading partners has almost returned to the level it was before the devaluation in December last year, when Milei took office. To put this into perspective, we are only 10% away from returning to the values observed during the 1999-2001 period or towards the end of CFK's second term in 2015. On such occasions, history ended very badly. Could it be different this time? For this to be possible, it is necessary for the current account deficit to be manageable. A current account deficit means a country is spending more than it earns, forcing it to rely on external savings to cover this excess domestic spending. There are three solid arguments, often presented by the government, that could justify the sustainability of this RER appreciation. First, with the fiscal adjustment in place, the excess public sector spending has disappeared, which would allow for a lower RER compared to a scenario of public deficit. The second argument is the enormous export surplus that Vaca Muerta will generate. This year, the external balance of the energy sector will be positive by around USD 5 billion and will grow consistently in the coming years. Even with conservative projections, the sector's surplus could reach USD 25 billion by the end of this decade. All new crude production is exportable, and the necessary infrastructure for its transport and export is advancing rapidly. Finally, the Central Bank is buying reserves with this exchange rate. In this regard, the economic team has three more than valid arguments to defend the sustainability of the appreciation process.

These points do not dispel my concern. First, there is the private sector. A highly appreciated exchange rate can create serious problems in the tradable sector, which includes not only goods but also services. At the end of the day, productivity follows a different pace than that of appreciation, even considering the significant advances in deregulation. In fact, production taxes have not yet been reduced, which could lead to severe employment issues in the tradable sector. A simple reminder of the outcome of the Convertibility Plan helps to understand the risks. Second, part of the economic literature highlights the advantages of a competitive exchange rate as a tool for development. Although I acknowledge that this view is a minority (and one I share), there is broad consensus in the literature on the origins of external crises associated with unsustainable current account deficits under fixed exchange rate regimes or schemes like crawling pegs. The often-repeated assertion these days that "without fiscal deficit there can be no crisis" lacks empirical support. In the severe external crises in Chile (1982), Mexico (1994), Brazil (1998), or our collapse in 2001, there were no fiscal problems, but there were external imbalances linked to inflexible exchange rate regimes.

As for Vaca Muerta, it is undoubtedly a reason for hope, but not for overspending. Remember that when the Argentine economy grows by 1%, imports typically increase by around 3%. Therefore, the potential supply of foreign currency from Vaca Muerta could be useful for financing long-term growth, but it will not leave much room for an "overflow" of Argentinians heading to Florianópolis, Miami or Punta del Este. Finally, the Central Bank's excellent buying streak in recent months cannot be ignored. However, this dynamic is strongly linked to the capital repatriation and the flow of dollars within the local financial system. The increase in dollar liquidity in the financial system, combined with credibility in economic policy and the incentives derived from the capital controls, has led to a massive supply of dollars from the private sector, driven by debt issuance. In my view, this dynamic does not seem sustainable over time.

It is too early to determine how deficit-ridden the current account will be, given the profound changes we are undergoing. Historically, Argentina's large external deficits have had unfavorable outcomes. A clear example is 2017, when the Cambiemos government made the mistake of believing it could finance a deficit of 4 or 5 percentage points of GDP. Our country cannot sustain deficits of that magnitude, as this requires a significant inflow of foreign direct investment (FDI). Unlike Mexico, Brazil, Chile, Peru, and Colombia, which finance much of their current accounts with FDI, Argentina has yet to reach that level. We must be patient, especially after so many years of economic mismanagement.

After the great achievements and changes accomplished in the first year of government, the administration faces two alternatives: to fall in love with the current scheme of a rigid exchange rate regime with capital controls, or to move toward a more flexible model that minimizes the risks associated with the external sector. With the latter scheme, disinflation could take longer, and we might face greater exchange rate volatility. However, although this option entails some political cost, it is undoubtedly the most desirable path to break free from our stagnation. Fortunately, debates on the monetization of the fiscal deficit, hyperinflation, or defaults are behind us. Now is the time to make way for a much more hopeful, though no less challenging, discussion about the future of the Argentine economy.

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