



Argentina: The Liberal Experiment at a Critical Crossroads

Description

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A public debt auction was held with paradoxical ease in June 2017. Argentina – a country with a long history of defaults – sold \$2.75 billion of 100-year bonds denominated in US dollars at a yield of 7.9%, just a year after the country settled its 2014 default – the 8th in its history. That settlement took two years to resolve, in part because US courts insisted that the country had to settle the 2001 default at the same time. Three years after the issue, Argentina went bankrupt again and defaulted inter alia, on its 100-year bond, which ended up being a 3-year bond!

This is the mess that Javier Milei inherited when he took over the presidency of Argentina in December 2023. With inflation in triple digits, the currency overvalued, the economy in recession, locked out of international capital markets, and 40% of the population living below the poverty level, he was called upon to implement his vision of a radical shift towards an open economy with a smaller state and free markets, without a majority in Congress. Despite seemingly insurmountable difficulties, his liberalization program of shock therapy exceeded all expectations. Milei managed to balance the budget within a year and cut inflation from a peak of 290% in April 2024 to 32% last month. In June, the World Bank predicted that the country would achieve a growth rate of 5.5% in 2025, the highest in Latin America.

The country's growth potential is enhanced by the giant Vaca Muerta shale formation, which contains huge reserves of oil and gas. The political disfunction of previous decades failed to tap it, but Milei has made the extraction of the precious resource a top priority to transform Argentina from an agriculture-based economy to a major energy producer. If he can create new energy wealth, he may be able to pull the country out of its economic quagmire and convince voters to continue to support his vision. Within a year of taking office, daily crude oil production has increased by 28% and is now approaching 500,000 barrels per day. He did it simply by removing obstacles: he lifted the cap on oil prices, relaxed exchange controls that had been a headache for big companies like Chevron and gave investors tax breaks for 30 years.

Unfortunately for Milei, he has inherited from Argentina's profligate past an exceptionally high debt that threatens the fiscal balance. The grace period of the last debt restructuring in 2020 has already expired and the country faces significantly higher debt service costs of \$13 billion in 2026. Meeting the terms of the restructuring is a precondition for returning to international capital markets and repaying the \$45 billion Argentina still owes the IMF, following the giant \$57 billion bailout package agreed with centre-right President Macri in 2018, making Argentina by far the largest IMF debtor. Can Milei pull off another miracle and avoid another bankruptcy?

Faced with the dilemma between disinflation and growth, Milei gave priority to the former – the politically stronger popular demand. His libertarian government has few seats in Congress and last Sunday's midterm elections were crucial to strengthening his position. But the attempt to reduce inflation through a strong currency has exceeded its limits. The currency is currently more overvalued than it was before the 54% devaluation against the dollar in December 2023. Despite Milei's desire to turn state-reliant Argentina into a beacon of free markets, entrepreneurs are not persuaded to invest until exchange controls are fully lifted. For this to happen, the central bank must have sufficient foreign exchange reserves, which will not happen as long as the hard peso policy creates a current account deficit and is incompatible with dollar accumulation. As one Argentine analyst put it: "Every dollar spent on strengthening the peso carries a cost by increasing the spread on Argentine bonds." Uncertainty about how this dilemma will be resolved is delaying Argentina's return to the capital markets as investors sit on the fence.

Last April, the IMF approved a new \$20 billion loan, of which \$12 billion – an unusually large advance – was disbursed immediately to bolster the central bank's foreign exchange reserves and help ease exchange controls. Most of the financing offered by the

IMF is intended to repay older IMF loans, with only 6 billion remaining for other purposes. The IMF stresses the need to build broad political support, in part through multi-year fiscal programmes that commit future governments to keep the budget balanced and boost confidence.

Then the difficulties began. In July the peso started to weaken after Milei relaxed exchange controls and widened the exchange rate fluctuation band. The central bank reacted by raising interest rates to strengthen the currency, driving the cost of borrowing for small and medium-sized enterprises above 60% and resulting in a suspension of investment and a slowdown in economic activity. Milei's falling popularity led to his crushing defeat in Buenos Aires's regional elections in early September, triggering capital flight and pressure on the currency. In mid-September the central bank spent \$1.1 billion in three days to prop up the peso, raising concerns among bondholders that scarce foreign exchange reserves would be depleted if instability continued. The government inexplicably found itself in a period of deep political uncertainty just a month before the elections.

With the program off track and IMF funding suspended, Milei has turned for support to his close ally President Trump, whom he has referred to as "one of the two most important politicians on planet Earth." In late September, US Treasury Secretary Scott Bessent said, "all options are on the table" to support Argentina, calling the country a "systemically important ally". This willingness partly reflects Trump's desire to push China out of Latin America – a region he sees as a US sphere of influence – and secure access to Argentina's mineral wealth. The US government then intervened in the foreign exchange market to buy pesos and agreed in principle to a \$20 billion emergency credit line for Argentina. But the pressure returned in mid-October, when Trump made it clear that future support depended on the outcome of the mid-term elections for Congress.

The speed with which Milei's promise to reverse a century of decline turned into a nightmare of new bankruptcy was brutal. Argentina's long-standing pathologies – capital flight, devaluation, inflation – resurfaced with a vengeance. The result of the recent elections in the province of Buenos Aires shows that Peronism remains a powerful political force. In these circumstances, the 41% of the national vote in last Sunday's midterm election for Milei's party, "Libertad Avanza" is considered a major victory. This result ensures a veto on any opposition proposals to increase spending, but it is short of an outright majority and insufficient to pass free market reforms without support from center-right parties. The election was the most crucial political test for Milei. Had the Peronists prevailed, Milei's free-market experiment would risk failing and the

pressure on the currency and bonds would continue. Milei's victory is a strong mandate for his radical economic agenda.

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