BBVA | RESEARCH

Argentina Economic Outlook

1ST QUARTER 2017 | ARGENTINA UNIT

01
The economy began to recover in 4Q16 and will grow 2.8% in 2017 driven by investment, mainly public

02
The downward stickiness of core inflation and the increase in tariffs will keep inflation at 20.8% YoY in 2017, and the CB in a tight stance

03
Slow fiscal consolidation in 2017 despite the planned reduction in energy subsidies due to commitments to retirees and public works programme

04
2017 financial needs at USD 40 billion to be covered by debt issues will result in capital inflows and tend to appreciate the real exchange rate

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Closing date: 13 February 2017

1. Editorial

The most recent indicators confirm GDP s.a. growth of about 0.6% QoQ that our nowcasting models estimated for the last quarter of 2016, but the slower exit from the recession of 2016 has led us to revise GDP growth in 2017 downward (from 3.2% to 2.8%), maintaining our growth estimates of 3% for 2018. Investment will continue to be the main driver of expansion this year, although we have revised the expected increase downward from 11.1% to 9% YoY since the launch of announced investments has been slower than anticipated. However, considering the ambitious public infrastructure investment plan and private investment in agriculture and renewable energies being encouraged by regulatory changes, the recovery will be significant compared to 2016 when investment is estimated to have contracted 4% YoY.

We expect the inflation rate (CABA index) to decline to 20.8% in 2017 and 12.9% in 2018 after reaching 41% last year. Although the trend in inflation has clearly been decreasing since 2H16, we have raised our forecasts in relation to our previous Outlook due to the downward stickiness shown by core inflation and scheduled adjustments to energy prices. The reduction in Central Bank financing to the Treasury of 0.5% of GDP, the BCRA's positive interest rate policy in real terms, falling inflation expectations and relative exchange rate stability will contribute to the convergence of inflation towards lower levels. The main upside risks could come from potential second-round effects of increases in regulated prices or their negative impact on inflation expectations and wage negotiations.

The BCRA has set ambitious inflation targets (12-17% YoY in 2017) that it will seek to achieve by maintaining positive real interest rates. The challenges of monetary policy are not trivial as a strong reduction in inflation needs to be achieved in a context of very gradual consolidation of public accounts and reduction of fiscal dominance. Having overcome most legal obstacles, we expect the reduction of subsidies to energy and transport sectors to continue at a faster pace in 2017. However, social security expenditures will continue to grow as a result of the Pensioners Reparation Programme as will investment in public works, with the result that in 2017 primary spending will decline by only around 2% of GDP while fiscal revenues will fall by 1.7% of GDP due to the approved tax cuts. The primary deficit will thus only be reduced to 4.2%, which will not translate in the same proportion to the total result (4.7% of GDP) due to the increase in the interest burden on the debt. Financial needs will amount to USD 40 billion of which debt placements in the domestic market of USD 14 billion are projected in both pesos and dollars. The government issued USD 7 billion in debt in international markets in January on favourable terms and is also negotiating a USD 6 billion repo loan with international banks, thus virtually covering all the financial needs in US dollars for the year.

The current account deficit will deteriorate slightly to 2.8% of GDP in 2017 as the trade balance will record a deficit of USD 200 million in 2017 due to a slight decline in the terms of trade and slower growth in export volumes than in imports. In a context of removal of practically all foreign exchange market restrictions, positive real interest rates, private investment flows and public debt issues, we expect capital inflows to outstrip the current account deficit in 2017. The resulting accumulation of international reserves will continue to pressure the exchange rate downward during the year, although we cannot rule out episodes of short-term volatility that could occur as a result of the local electoral cycles or international financial tensions. The relative uncertainty regarding the future of global trade agreements, the expected increase in international interest rates and the moderate deterioration in the terms of trade highlight the fact that the appreciation of the real exchange rate, which we expect to continue, has become an important challenge for Argentina. To counterbalance this problem, the country will need to improve its competitiveness and enhance the dynamism of its exports by other means such as investment in infrastructure, the reduction of the tax burden, or the improvement of labour productivity.

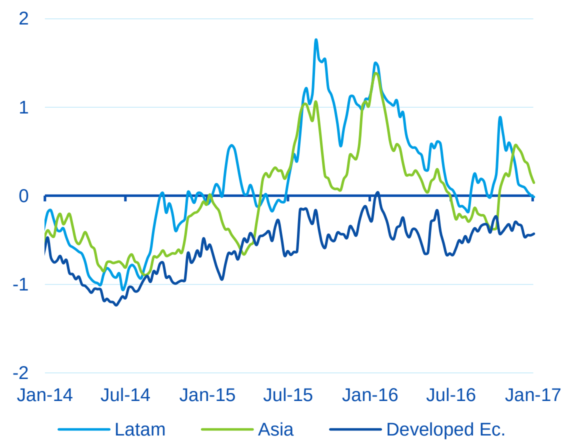
2. Global context: more growth, greater uncertainty and long-term risks

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. Global growth accelerated in the last quarter of 2016, there has been a notable increase in confidence in all areas, and the indicators for the industrial sector are growing alongside a budding improvement in world trade.

Despite this acceleration, the outlook for 2017 and 2018 is plagued with uncertainty. This is principally related with the economic policy of the new US administration, the shape of which remains largely to be seen. Fiscal stimulus and deregulation measures have been announced in various sectors, which was positively received by the markets in developed economies, but not in the emerging economies, which registered capital outflows and depreciation in their currencies, reflected in an increase in financial tensions at the end of 2016 (Figure 2.1). However, announcements of protectionist measures could seriously damage international trade in the medium and long term and affect confidence in the near future, especially outside the US. Likewise, the uncertainties still pending on US economic policies appear to have been moderating market optimism since the beginning of the year.

Figure 2.1

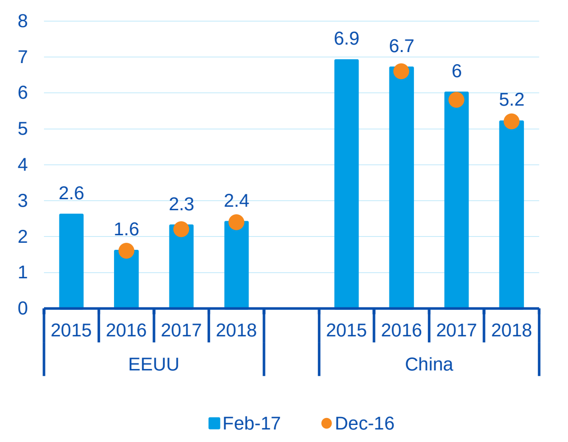
BBVA financial stress index



Source: BBVA Research

Figure 2.2

GDP growth in the US and China (%)



Source: BBVA Research

The magnitude of inflationary pressures is another unknown factor opening out at a global level. Raw material prices (and in particular oil) have picked up somewhat more than expected in recent months, following the OPEC agreement and the improvement in activity. If to this we add the size of the balances accumulated in recent years by central banks in developed countries, due to quantitative easing programmes and the prospects of fiscal stimulus, the result is that the deflationary risks of a few quarters ago have been replaced by inflationary pressures in developed economies, generating a number of questions about the reaction of its monetary policies.

In principle, the Federal Reserve remains cautious and continues to aim for a relatively slow rate normalisation. Our forecast is for two interest rate increases to take place this year, with another two in 2018. For its part, we expect the ECB will begin the process of withdrawal from QE in early 2018 and decide on the first interest rate increase at the end of that year.

All in all, our growth projections for 2017 in the major economies have undergone no substantial revision, although they are subject to a higher degree of uncertainty than normal. The base effect of increased growth at the end of 2016 and its inertial effect, together with the fiscal stimulus packages expected in the US, encourage us to revise the forecasts moderately upward for the US and Europe, and slightly more for China, while the forecasts for Latin-American countries are being revised downward, principally due to idiosyncratic factors. In particular, in the US we anticipate growth of 2.3% and 2.4% in 2017 and 2018 (Figure 2.2). In China we expect growth of 6% in 2017, which would be reduced to 5.2% in 2018, given the vulnerabilities with which the economy is faced and an economic policy geared more towards ensuring financial stability than maintaining growth. Thus, overall growth should increase slightly from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

> Global growth will increase from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018

The risks are largely downward and are governed by the previously mentioned uncertainty linked with protectionism in the US, a less friendly attitude towards immigration and the danger that the fiscal stimulus policies will not have any impact on growth and will increase inflation, or that the deregulation announced in various sectors will not be properly managed. In addition, there is the potential reaction of other countries or regions to these protectionist impulses. An unexpected rise in inflation could lead to the tightening of monetary policy by the main central banks, with global consequences. In the long term, the risks of the accumulation of imbalances in China, together with the lack of structural reforms in public companies, could have an impact on its capital flows and currency and lead to sudden slow-down in growth. In Europe, the political risk is high, in a year filled with election dates. And, generally speaking, geopolitical risks continue to run high.

3. Finally, some green shoots

The INDEC (EMAE) economic activity estimator (see Figure 3.1), which is a monthly proxy for GDP, in November, and for the second consecutive month, registered a monthly increase; after the 0.5% (seasonally adjusted) rise in October, it grew by 1.4% in November, in line with the turnaround in the economy in 4Q indicated by our nowcasting estimates (MICA). However, despite the GDP growth of 0.6% QoQ we forecast for the last quarter of 2016, last year was expected to have closed with a fall in GDP of 2.2%, somewhat higher than previously expected (-2%), as the GDP data for 3Q16 were more negative (-0.2% QoQ s.a. and -3.8% YoY) than projected, especially in terms of investment, although private consumption also showed greater weakness. The recovery of activity in the period, both in industry and in agriculture, is confirmed by other indicators such as car production, which grew by 2.2% YoY in 4Q16 and the wheat harvest, which increased by 30% over the previous year due to the lifting of restrictions that had affected the sector.

Even so, a slower exit from the 2016 recession, according to the results of our MICA model, has led us to revise GDP growth downwards in 2017 (from 3.2% to 2.8%), maintaining it at 3% for 2018 as private consumption will provide slightly more momentum to the economy. Domestic demand will be the main driver of GDP this year and next, despite the fact we are still expecting exports to perform well, although not as spectacularly as in 2016 when the remainder of early years' harvests was liquidated after the release of the "exchange rate trap" ("cepo cambiario"). It is estimated that the harvest of the 4 main grains will exceed that of 2016 by 12% (depending on the final impact of the floods on soybean production). The gradual recovery of the Brazilian economy (+0.9% YoY) is likely to contribute to boosting industrial exports, which in the case of the placement of cars already began to show a growth of 12% YoY in 4Q16. However, the external sector will have a negative contribution of 0.8% to GDP in 2017 and 2018, since imports of both inputs and capital goods will grow at a faster pace than exports in the face of the recovery in investment (Figure 3.2).

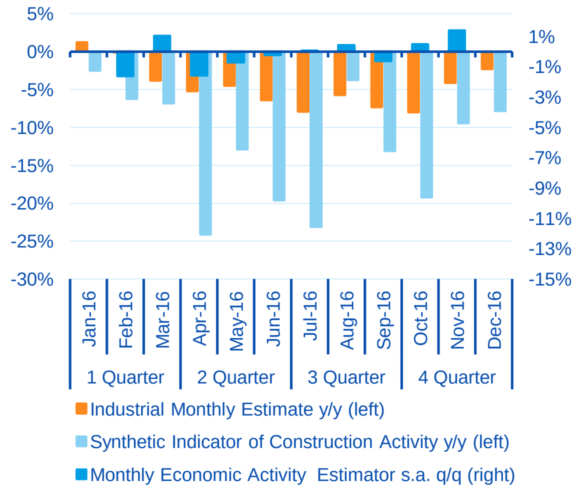
Private consumption will also perform positively in 2017 to the extent that the increase in nominal wages is likely to, on average, exceed expected inflation for the year. Consumer confidence still remains below historical averages, but with some ups and downs it has begun to recover slowly from August 2016. This trend is likely to continue in the face of continued low inflation and deepen in 2018 leading to a 2.9% YoY increase in private consumption next year, which is up from 2.2% in 2017.

Investment will continue to be the main driver of expansion this year but now we are expecting slightly less momentum (we reduced the increase in 2017 from 11.1% to 9.0% YoY), as the latest available official information suggests that the implementation of the announced investments has been slower than anticipated. However, together with the ambitious plan of public investment in infrastructure (USD 11 billion according to the budget) and private investments in agriculture and renewable energies (USD 4 billion in 2/3 years) encouraged by regulatory changes, the recovery will be significant vis-à-vis 2016, where investment would have contracted 4% YoY. Much of the poor performance of investment in 2016 was due to the considerable delays in the progress of public works, due to implementation difficulties linked to the need to clarify the legacy of the previous government and establish corruption-free contract awarding circuits. Private construction also showed no greater dynamism as building costs did not register a reduction in relation to real estate prices while mortgage credit in indexed units has not yet taken off. These projects, which are generally multi-annual, will also have an impact on the formation of capital assets in 2018, rising 7%, after falling 2.3% per year from the imposition of the trap (cepo).

Although the results of the first and second stages of the justification of undeclared assets were very significant, around USD 92 billion, it is still a question of whether new declared assets (15% of GDP) will translate into greater investments within the country because more than 80% of the new declared capital remains abroad. But this possibility, opening up as it is, could potentially be turned over to real estate and other short-term investment projects. This, together with the recent changes in the Ministry of Treasury and Finance, which promise greater control of the fiscal deficit that is worrying potential investors, could turn out to be two events that strengthen confidence and boost higher levels of investment, thus further increasing GDP in the current year.

Figure 3.1

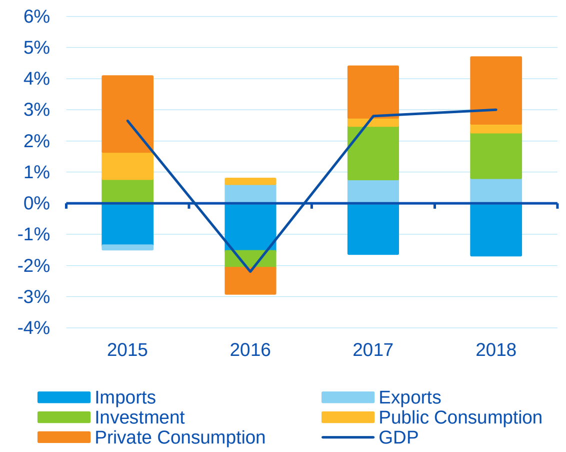
Selected activity indicators (Variation %)



Source: BBVA Research

Figure 3.2

GDP growth and contribution from aggregate variables



Source: BBVA Research

4. Inflation will continue to decline

Although following the beat of scheduled increases in energy rates and wage adjustments

We expect the inflation rate (official CABA index, Ciudad de Buenos Aires) to decline to 20.8% in 2017 and 12.9% in 2018 after reaching 41% last year (see Figure 4.2), in line with the consensus of analyst expectations that estimate falling inflation, although still above BCRA targets. Although the trend in inflation has clearly been decreasing since 2H16 and the latest record for December was 1.2% MoM, we have raised the projection for both years by around 1 pp in relation to our previous publication due to the downward resistance that core inflation is showing and already programmed adjustments to energy and fuel prices. According to the increases in tariffs, fuels, tolls and prices for health and education services announced for the year, we estimate that the incidence of the regulated price increase in CABA inflation for 2017 will be 4.4 percentage points. This implies that core inflation, which isolates the impact of regulated and seasonal prices on the general level of inflation, should continue to decline gradually in 2017 to average 1.3% per month so as to reach our forecast of 20.8% for the year in total. The first data from January point in this direction, which means substantial progress compared to the 1.7% monthly average recorded in the second half of 2016.

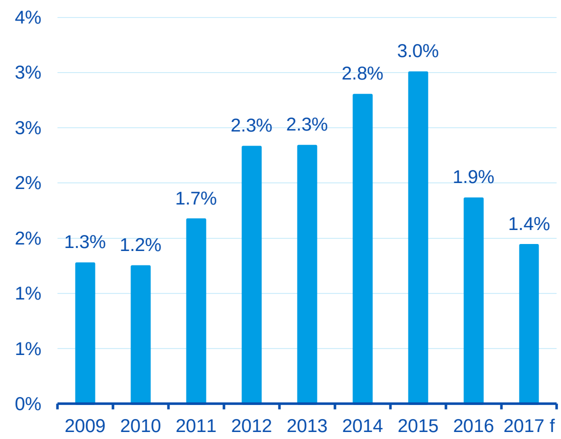
On the other hand, the impact of tariff increases on the CPI of INDEC, which includes Greater Buenos Aires (AMBA), will only be 3.5 pp lower than in CABA, due to the lower share of expenditure on electric energy and water and sanitation in the Buenos Aires metropolitan area. With a similar evolution of core inflation, but a different share in the regulated and core index, we estimate an increase in the INDEC CPI of 18.2% for 2017.

Our forecasts are based on the reduction in Central Bank financing to the Treasury of 0.5% of GDP (see Figure 4.1), the BCRA's policy of positive interest rates in real terms, downward expectations and the relative exchange rate stability will facilitate the convergence of inflation towards lower levels which will continue to gradually decline to about 1% per month in 2018. In this context, the main upside risks could stem from a negative impact of rate increases on inflation expectations or potential second round effects of increases in regulated prices on retail margins.

Given that a large part of these regulated price increases in 2017 will be concentrated between February and April, this could raise the floor of wage demands, making it difficult for the labour negotiations which will really get under way from March. In our baseline scenario, we estimate wage increases for 2017 to be agreed upon based on expected inflation rather than past inflation, although they will exceed the 1-2 pp of this year's average inflation. This scenario contemplates the fact that unemployment will fall slowly in 2017 and that the Income Tax adjustments will improve in-the-pocket salaries, thus contributing to a tempering of trade union wage demands. However, the negotiation process is just beginning and it is too early to say with certainty that the negotiations will converge on our central scenario.

Figure 4.1

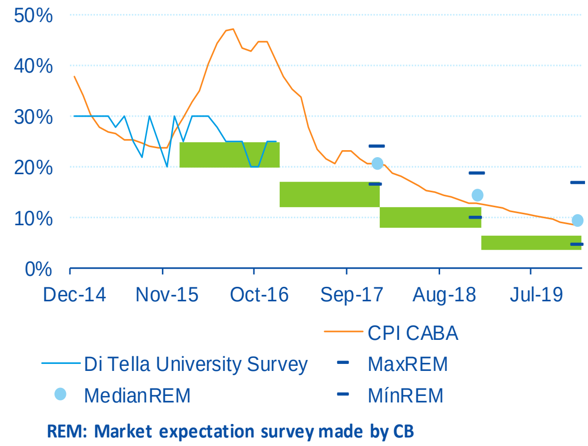
BC financing to the Treasury in % of GDP



Source: BBVA Research

Figure 4.2

Inflation, expectations and BCRA targets



Source: BBVA Research

5. Monetary policy still tight and based on positive real interest rates

Until inflation expectations converge to the Central Bank target

The Central Bank set its inflation targets within a more ambitious range (17%-12% in 2017 and 12%-8% in 2018) using the CPI INDEC, which at the moment is the official index with the largest geographical coverage, since a national CPI still does not exist. The monetary authority said it will create the necessary conditions for monetary and exchange rate policy to meet those goals as it did during 2016, keeping the monetary policy rate in positive territory in real terms. Strategies to achieve this will be based on a floating exchange rate system, using the interest rate as a monetary policy instrument, breaking the fiscal dominance and transparent communication of monetary policy decisions. However, this year some methodological changes will be making a debut: the monetary policy rate will be the swaps brokers' average rate to be announced every 15 days and there will be only be one Lebac tender per month, for which an attempt will be made to concentrate the maturities that, until now, have been weekly. Monetary policy meetings will also be spaced at fortnightly intervals starting in March, aiming to reach a monthly or smaller periodicity like other Central Banks as the disinflation programme progresses.

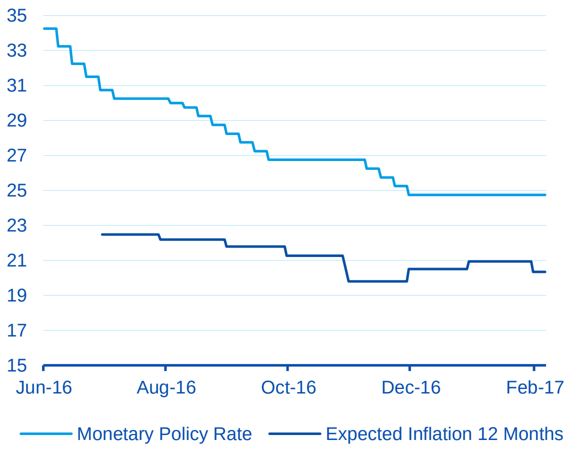
In this new scheme, the BCRA's challenges are not insignificant, since a big reduction needs to be achieved in inflationary inertia in a context of consolidation of public accounts and a very gradual reduction in fiscal dominance. The success of the disinflation programme will depend crucially on its credibility and on the signals it issues on monetary astringency through the single instrument of the monetary policy rate, given its limited impact in a country where the credit to GDP ratio only reaches 13%. We believe that the exchange rate will not be a destabilising factor in either 2017 or 2018, but it cannot be ignored that there is still a long way to go to make consensus inflation expectations converge to official targets, especially in a context where significant changes in relative prices are still required.

In recent months, unclear signals regarding a continued decline in the inflation rate led the Central Bank to keep the monetary policy rate at a level of 24.75% during December last year and January this year, after having trialled scaled decreases from a high of 38% in April 2016 until November. We estimate that the Central Bank will continue to reduce the intervention rate more gradually during the rest of 2017 to reach 19% in December as analysts' consensus inflation expectations remain at 20.8%, even higher than the upper band of the BCRA's target for the next 12 months (Figure 5.1). However, it cannot be ruled out that the Central Bank will decide to raise the rate promptly at some point, if it is observed that inflation's downward resistance is persisting or expectations begin to increase. In line with the BCRA's medium-term commitment to maintaining a nominal policy rate above inflation, for the end of 2018 we expect a policy rate declining to around 11% vis-à-vis the 8.5% rate expected for inflation over the next 12 months, or a real positive rate of around 2.5%.

The only quantitative monetary objective announced for 2017 will be to reduce the Lebac+Swaps / Monetary Base ratio to 81.1% (it finished at 85% at the end of 2016). Although it is a desirable objective, its success could be complicated while the Central Bank continues to buy foreign currency that needs to be sterilised by issuing Lebac to regulate the amount of money. The Lebac stock has experienced exponential growth in the last year (see Figure 5.2), which together with the increase in the interest rate will continue to raise the Central Bank interest rate to figures incompatible with the objective of lowering the inflation rate. The BCRA argues that the risks are lower because Lebac's larger stock will be backed by liquid reserves that can be used if there is any turbulence, while a more professional management of reserves, such as the one it intends to carry out, will increase its yield and reduce the quasi-fiscal deficit.

Figure 5.1

Monetary Policy Rate vs Expected Inflation over 12 months



Source: BBVA Research

Figure 5.2

CB Swaps + Lebac ratio / Monetary Base

Source: BBVA Research

6. Fiscal consolidation will proceed at a gradual pace

Stronger commitment to deficit reduction in 2017

The primary fiscal deficit (excluding income from the Central Bank and the ANSES social security fund) in 2016 was 4.4% of GDP (taking our estimate of nominal GDP for the year), slightly lower than the 4.8% announced at the beginning of the year. In nominal terms, the deficit reached ARS 359.4 billion, an increase of 53% over the 2015 deficit. There was a significant increase in fiscal revenues of 35.3% YoY, reinforced by the collection of the penalty charged for the fiscal justification in the last quarter of the year, which was, however, surpassed by the increase in primary expenditure of 38.2%. In particular, the December figures reflect an increase in primary spending of 84% YoY driven by transfers to the private sector and to the provinces. The government would have taken advantage of this to cancel pending floating debt, transfer funds to public companies such as CAMMESA and to the province of Buenos Aires (ARS 25 billion), in order to compensate for its small stake in the federal tax Partnership. After paying interest on public debt and income from rent, the total deficit reached 4.7% of GDP, up from 3.9% in 2015 (which does not take in floating debt).

The results of the first and second stages of fiscal justification were favourable, as they declared assets of USD 92 billion. There was a one-time increase in income from the payment of the penalty for justified assets (it amounted to about 1.3% of GDP in December) and also from this year new declared assets will start to be taxed. However, according to the law, some of this income will be used to finance the historical reparation programme for retirees, which will have little impact on the fiscal result for 2017.

In 2016, it was not possible to achieve the fiscal consolidation committed to at the beginning of the year, basically because, due to social and legal pressures, it was not possible to achieve the desired reduction in subsidies to energy sectors. In fact, as a percentage of GDP these subsidies increased slightly from 2.4% to 2.6% as a result of the delay in the rebalancing of tariffs and the payment of arrears. Having exceeded the required procedural steps and with a three-year time-frame for energy tariffs already approved, we expect that, as from 2017, both the reduction of these transfers to the private sector and those made to cover the deficit of public companies can materialize. However, social security expenditures will continue to grow as a result of the Historical Reparation Programme for retirees and the investment in public works as well, with the result that by 2017 primary spending will decline by around 2% of GDP while incomes will fall by 1.7% of GDP due to approved tax cuts (see Figure 6.1).

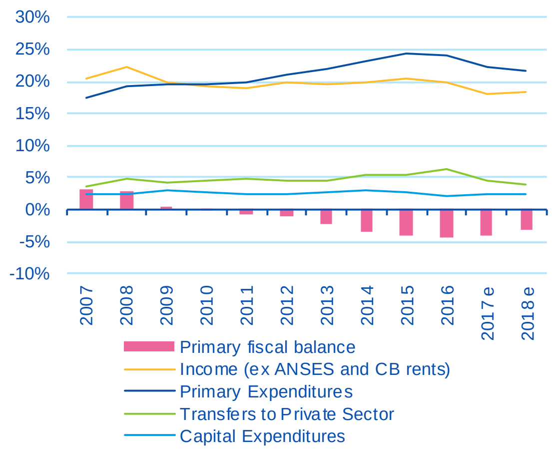
The objective of the new Finance Minister, Nicolás Dujovne, is to meet the national budget targets approved in December 2016, which is achievable and represents a primary deficit of 4.2% of GDP similar to the one we projected considering the above. We maintain our deficit projection path (we estimate a total result after interest of -4.7% and -4.2% of GDP in 2017 and 2018 respectively). The estimate implies a gradual reduction in the primary deficit (-4.2% and -3.2% of GDP in those years) mainly due to lower energy subsidies and transportation, but this does not translate in the same proportion to the total result due to the increase in the interest load on the debt. One of the commitments of the new finance minister is to implement a deeper tax reform that we hope will not lead to a substantial reduction in the fiscal deficit in its transition period.

Although expectations regarding the evolution of fiscal accounts have improved, we only expect a reduction in fiscal vulnerability in the medium term and, therefore, Argentina will continue to depend on debt markets. It is not yet clear that the successful outcome of the justification of assets and changes in the economic cabinet will lead to improvements in the fiscal deficit in the short term, although the new Minister of Finance is committed to the control objective of the budget and the fiscal figures in general and has announced that he will define and monitor quarterly targets for public accounts.

In terms of deficit financing, the 2017 Financial Programme was presented by the Minister of Finance (Table 6.1). Financial needs amount to USD 40 billion in 2017. Debt placements for USD 14 billion are projected in the domestic market, of which USD 733 million were placed on January 26 in Boncer 2021, adjusted for inflation. The government also issued debt onto international markets in January on favourable terms for USD 7 billion and also negotiated a USD 6 billion loan with international banks. With this, the financial needs in dollars for the year would be practically covered, if we suppose that new disbursements refinance the debt maturities of international organisms and, consequently, in an optimistic scenario the rest of emissions could be in the domestic market in pesos as well as dollars. The government has acted securing the necessary funding in an international environment that could become unfavourable for Argentina after the result of the US elections.

Figure 6.1

Fiscal result 2016-17 (% of GDP)



Source: BBVA Research

Figure 6.2

Financial programme

	USD millions	% GDP	1Q17
Financial needs	**40,350**	**7.4**	
Primary deficit	23,000	4.2	
Interest on debt	8,603	1.6	
Maturities of private sector capital	20,247	3.7	
International organisations	2,819	0.5	
Government bonds	17,428	3.2	
Historical reparation law	-3,100	-0.6	
Central Bank	-8,400	-1.5	
Sources of funding	**40,350**	**7.4**	**14,381**
International organisations	3,850	0.7	
Bank repos	6,000	1.1	6,000
Refinancing Letters in USD	4,500	0.8	647
Domestic market	14,000	2.6	734
International market	10,000	1.8	7,000
Public Entities	2,000	0.4	
Average exchange rate (ARS/USD)	17.98	17.98	
GDP (ARS million)	9,750,000	542,269	

Source: Ministry of Finance and BBVA Research

7. External deficit set to rise due to increasing debt burden

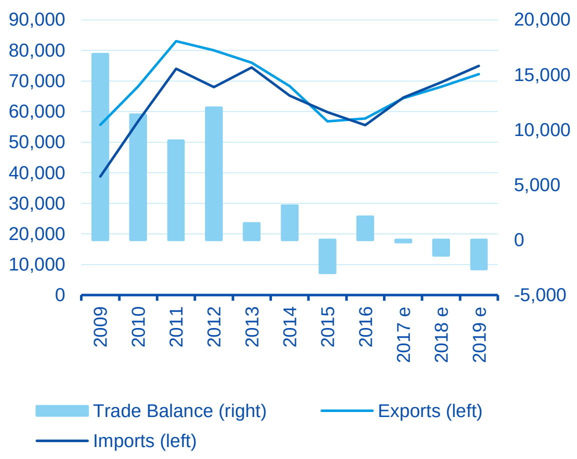
The current account deficit will deteriorate more than expected (from the previously expected -2.5% to -2.8% of GDP in 2017, and -2.4% to -2.6% of GDP in 2018). This is essentially due to the greater interest burden on the public sector because of the debt emissions to finance the fiscal deficit.

The trade balance, meanwhile, will remain in line with previous forecasts (see Figure 7.2), with a deficit of USD 200 million in 2017 and around USD 1.4 billion in 2018, following the surplus of USD 2.1 billion in 2016. This being due to the deterioration in the terms of trade and to a growth in the quantities exported, which was less than those imported, which will be driven by the recovery in GDP. In any case, exports will show greater momentum than in 2016 - excluding the effect of extraordinary grain settlements following the lifting of the "exchange rate trap" - due to an expected increase of 12% in the harvest of the 4 main grains in 2017, and the moderate recovery in growth that we expect in Brazil.

Expectations of an increased harvest could be somewhat frustrated if climate problems in Argentina's core zone persist. In the same vein, the South American climate supports short term prices due to the possible delay in the harvest in Brazil and delayed sowing in Argentina due to excess rainfall. In this context (see Figure 7.2), we corrected the price of soybean to USD 360 for December of this year (+6% YoY) in view of the climatic factor and the strength shown by the demand during recent months, which adds a positive differential to China's growth with respect to the previous review. In a market that is very close to the balance in terms of inventories, speculative positions purchased validate a more toned price scenario for 2017-2018 (+2.7% YoY). In the medium and long term, the stronger dollar, lower growth rate in China and a marginal increase in Argentina's offer due to fiscal improvements lead to a slightly downward convergence for the price of soybeans at around USD 353 per tonne.

Figure 7.1

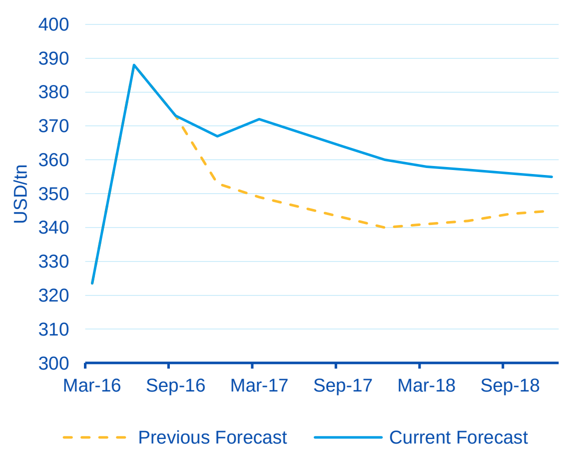
Balance of Trade (in millions of USD)



Source: BBVA Research

Figure 7.2

Soybean Price Forecasts



Source: BBVA Research

8. Capital inflows will drive the FX rate towards real appreciation

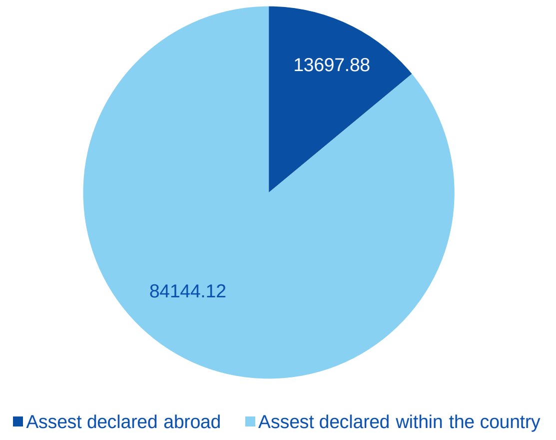
Following the elimination of exchange rate restrictions at the end of 2015, FX rose and 2016 ended with a nominal exchange rate depreciation of close to 40%, concentrated almost exclusively in the first half of the year. In the second half of the year, a monetary policy and external financing scenario began to materialise, which we believe will prevail in 2017, so we do not expect large changes in the exchange rate in the medium term. The exchange rate will increase by 13.2% in 2017 to average ARS 17.8/USD in December 2017 and ARS 18.4/USD (+3.4%) in 2018, in both cases a devaluation lower than inflation.

This forecast is supported by a number of factors, such as the Central Bank's free floating exchange rate policy, the maintenance of positive interest rates in real terms that discourage domestic savings in foreign currency, capital inflows to finance private investment partly due to the success of tax amnesty (Figure 8.1), and finally, debt placements to finance the public sector deficit. Recently, the BCRA has lifted some of the latest restrictions still affecting the foreign exchange market, extending the 10-year export settlement period and eliminating the 120-day rule for financial investments. It is expected that in 2017 capital inflows will also outstrip the current account deficit and accumulate reserves and downward pressures on the exchange rate. Within the framework of this medium-term trend, we cannot completely rule out short-term episodes of volatility, taking into account the local electoral cycle or episodes of risk aversion triggered by the international scenario.

In this context, we expect to consolidate a period of real appreciation of the exchange rate over the next few years. Although in the absence of exchange controls and taking into account that the BCRA practically does not intervene in the exchange market, it can be said that the spot exchange rate does faithfully reflect the supply and demand trends of the economy, there are concerns about the excessive strength of the Peso and the sustainability of the scheme. In this sense, it is possible that the economy can currently sustain a real equilibrium exchange rate that is more appreciated (Graph 8.2), considering that there has been a considerable reduction of export taxes and a substantial reduction in the cost of capital for Argentina after the arrangement with the hold-outs, but much will depend on what happens in the main trading partners.

Figure 8.1

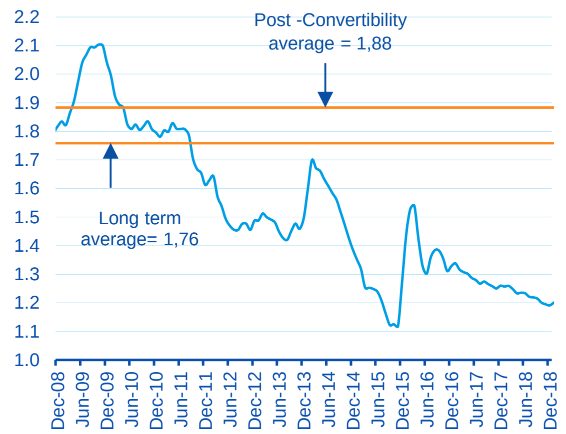
The results of Tax Amnesty



Source: BBVA Research

Figure 8.2

Multilateral real exchange rate (Index base 2001=1)



Source: BBVA Research

9. Greater global uncertainty requires prompt action on structural problems

After more than a year in charge of the country’s administration, the government is more settled and has been able to implement important reforms while demonstrating rationality and governance, obtaining approval of key legislation such as the Budget with 70% of the vote in spite of having a minority in both chambers of parliament. Looking back, some of the potential economic risks that were glimpsed at the beginning of its management are being left behind. However, the most important remaining challenges are to secure a path of sustainable growth and reduce the still high rate of inflation.

With regard to external risks, the risk of the impact of a slowdown in China’s growth in the wake of its unresolved structural problems remains latent. Concerns about the policy that the new US government may carry out seem to be confirmed and it is already a fact that global uncertainty will be greater. This could affect Argentina now that it has emerged from its financial isolation and is more vulnerable to the volatility of international capital markets. If the Federal Reserve were to implement a more abrupt interest rate hike than our base scenario, this would affect the necessary flow of financing required by Argentina this year.

However, in a relatively uncertain international scenario regarding the future of trade agreements, a gradual increase in international interest rates and a moderate deterioration in the terms of trade, it is clear that the main challenge for Argentina is to improve its competitiveness and increase the momentum of its exports. Government initiatives in this regard range from an ambitious infrastructure plan to the reduction of the tax burden on companies via sectorial agreements to increase labour productivity. In all cases, reaching consensus with provincial governments, trade unions, business chambers and opposition legislators to advance in this direction is an inescapable step, albeit not without social and political difficulties, in solving the structural problems of Argentina.

10. Tables

Table 10.1

Annual macroeconomic forecasts	2015	2016	2017f	2018f
GDP INDEC Baseline 2004 (% y/y)	2.6	-2.2	2.8	3.0
Inflation CABA (% y/y, eop)	26.9	41.0	20.8	12.9
Exchange Rate (vs. USD, eop)	11.4	15.8	17.8	18.4
Monetary Policy Rate (%, eop)	--	24.8	19.0	11.0
Private Consumption (% y/y)	3.5	-1.2	2.2	2.9
Government Consumption (% y/y)	6.8	1.0	2.0	2.0
Investment (% y/y)	3.8	-4.0	9.0	7.0
Fiscal Balance (% GDP)	-3.9	-4.7	-4.7	-4.4
Current Account (% GDP)	-2.7	-2.7	-2.8	-2.6

Source: BBVA Research

Table 10.2

Annual macroeconomic forecasts	GDP INDEC (% y/y)	Inflation CABA (% y/y, eop)	Exchange Rate (vs. USD, eop)	Monetary Policy Rate (%, eop)
Q1 15	0.0	28.0	8.8	-
Q2 15	3.9	25.5	9.0	-
Q3 15	3.8	24.0	9.4	-
Q4 15	2.6	26.9	11.4	-
Q1 16	0.6	35.0	15.0	38.0
Q2 16	-3.7	47.1	14.1	30.8
Q3 16	-3.8	43.1	15.1	26.8
Q4 16	-1.5	41.0	15.8	24.8
Q1 17	-0.9	33.8	16.4	24.5
Q2 17	3.4	21.6	16.7	22.5
Q3 17	3.7	23.2	17.2	20.7
Q4 17	4.8	20.8	17.8	19.0
Q1 18	3.8	18.2	18.1	16.6
Q2 18	3.2	15.4	18.2	14.5
Q3 18	2.9	14.1	18.3	12.6
Q4 18	2.1	12.9	18.4	11.0

Source: BBVA Research

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