BBVA | Research

Argentina Economic Outlook

2nd QUARTER 2017 | ARGENTINA UNIT

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Contents

Closing date: 05 May 2017

1. Summary

GDP growth continued to increase worldwide, to rates of around 1% per quarter, exceeding the 0.8% average since 2011. Overall, our forecasts for growth in 2017-18 have been revised only marginally. The best starts to the year have occurred in the Eurozone and especially China (where growth of 6.3% and 5.8% in 2017 and 2018 respectively is expected, around 0.5 percentage points more than three months ago), while the rates for the Latin American countries are slightly more negative this year. In the US, we continue to predict growth of 2.3% this year and 2.4% in 2018, supported by a boost in investment. As a result, expected worldwide growth is 3.3% for 2017 and 3.4% for 2018, which, in both cases, is one tenth of a percentage point higher than our previous forecasts. This acceleration has been driven by a generalised improvement in confidence levels, coupled with advances in world trade, stimulated particularly by monetary and fiscal stimulus measures in China. The performance of developed countries continues to be especially strong, with the consolidation of recovery in the US and with Europe growing above its potential. In contrast, Latin America will emerge from this year from the recession, although growth will be moderate. As regards the financial markets, over the last few months they have remained calm, recording low volatility in spite of the high uncertainty. In this context, the central banks are gradually moving forward with the monetary policy normalization process and the Fed, which leads the process, retains its gradual exit message.

In Argentina, the data from the 2016 national accounts confirm that the economy had begun to grow rather tepidly in Q3 and increased the growth rate to 0.5% Q/Q in the last quarter of the year. In line with what our MICA nowcasting model suggests, using the information available to date, we estimate that the economy will have also grown 0.6% Q/Q in Q1 2017 and that it will continue to grow during the next quarters of the year at an average rate of just over 1% Q/Q, to reach an accumulated growth of 2.8% in 2017, as we forecast in January. In spite of a certain reduction in the growth forecasts for investment, domestic absorption will continue to be the main driver of GDP in 2017, contributing 3.4% to total growth. The slight improvement in private consumption will offset this slower growth in capital stock, while the contribution from the external sector will continue to be negative, at -0.6% of GDP.

We expect the inflation rate (Buenos Aires City official index) to reach 22.4% year on year in December 2017. This is an increase on our previous forecast of 20.8%. We are also raising our forecast for INDEC official CPI for the Greater Buenos Aires to 19.5% y/y. Although this represents a deceleration compared to the 41% inflation of last year, which originated in the exchange rate and tariffs shocks, the monthly inflation data for the first quarter are slightly higher than expected due to downward stickiness in core inflation.

The Central Bank reacted to the latest inflation data by raising the monetary policy rate by 150 bp in April, which took the market by surprise as it expected a lower rise. The 2017 inflation target (12%/17%) continues to look difficult to achieve even after the hike in interest rates. While the fiscal deficit targets for 2017 announced last year were revised up (the primary deficit projected by the government for 2017 was raised from 3.3% to 4.2% in 2017) the inflation targets were maintained. Therefore, market expectations for inflation are not being corrected downwards, probably due to the impression that there is a lack of consistency between monetary and fiscal policy. Although we are expecting a downward trend for the monetary policy rate this year and next year, the Central Bank will remain cautious and any reduction in interest rates will be made more slowly.

The government decided to adopt a gradualist fiscal policy and, in 2016, less headway was made than expected due to political restrictions. The fiscal deficit remained almost constant in terms of GDP, in spite of extra income from the successful tax amnesty plan. Access to debt markets contributed to financing the deficit without major conflicts given that, additionally, one of the few solid points from the previous adminstration's legacy was the low level of public debt with the private sector. The Economy Minister, Nicolás Dujovne, announced quarterly targets for the fiscal deficit in 2017 and also targets for annual income, expenditure and deficit until 2019. He also introduced a new methodology for measuring the deficit which contributes to greater transparency. The targets look reachable and involve a gradual decrease to primary deficit of around 1 percentage point per year in order to reach 2.2% of GDP in 2019.

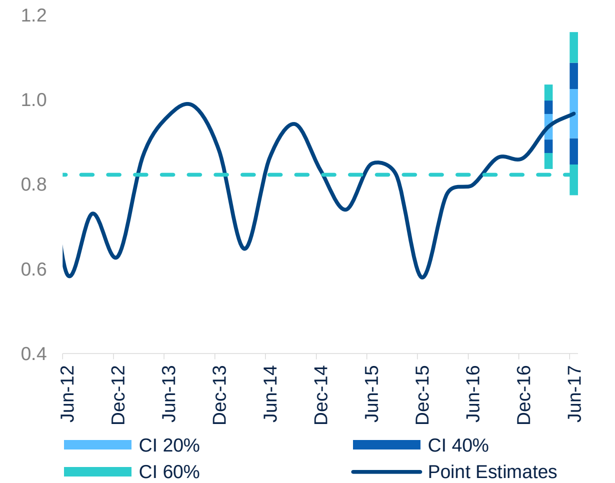
Although we expect a slight surplus in the balance of trade this year due, it will be lower than in 2016 due to a stronger rise in imports than in exports. The current account will continue to show a deficit in the medium term due to the negative balance on Real and Financial Services. In the medium term we expect that the trade surplus will be eroded as economic activity recovers, but that the current account deficit will remain stable at 3% of GDP.

The exchange rate will continue to strengthen in real terms, driven by capital inflows and the Central Bank's restrictive monetary policy which results in positive interest rates in real terms. The stronger exchange rate is sustainable in the medium term because the cost of capital for Argentina has fallen substantially, the majority of export taxes have been eliminated and there is abundant global liquidity to finance the domestic deficit. The country will continue to attract capital inflows as long as economic activity continues to recover and the government retains its target of gradual fiscal consolidation.

2. Global environment: global growth consolidates but there are still risks

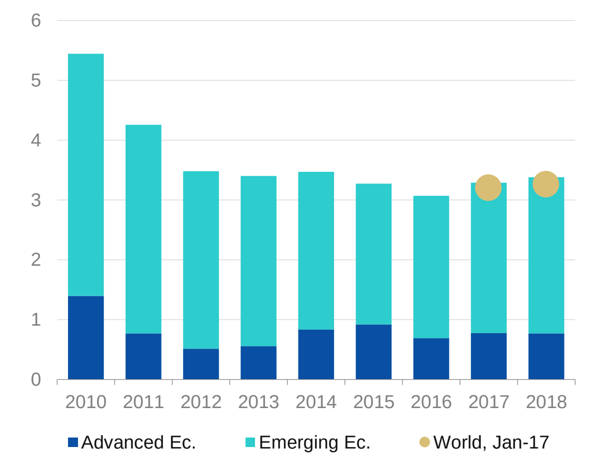
GDP growth continued to increase worldwide, to rates of around 1% per quarter, exceeding the 0.8% average since 2011. This acceleration has been driven by a generalised improvement in confidence levels, coupled with advances in world trade, stimulated above all by monetary and fiscal stimulus measures in China. The performance of developed countries continues to be especially strong, with the consolidation of recovery in the US and with Europe growing above its potential. In contrast, Latin America will emerge from this year in recession, although there will be some moderate growth.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (% QoQ)



Source: BBVA Research

Figure 2.2 Global growth and contributions by region (%, YoY)



Source: BBVA Research

Improved performance worldwide is accompanied by some clarification regarding the American economy, where expectations of rapid reflation supported by a fiscal boost and of a rapid drift towards protectionism have lessened, or at least been delayed. Nevertheless, the difficulty of carrying out a reform of the healthcare system also revealed problems in getting other measures approved, such as those associated with tax cuts or the infrastructure spending plan, effectively eliminating the probability of strong impetus in the short term.

We have revised global growth upwards to 3.1% in 2016, 3.3% in 2017 and 3.4% in 2018

As regards the financial markets, over the last few months they have remained calm, recording low volatility in spite of the high uncertainty. In this context, the central banks are making gradual progress in the process of normalising monetary policy. The US Federal Reserve, which is leading this process, is maintaining its message of gradual withdrawal, so we predict that there will be two further interest rate hikes this year and another two in 2018, up to 2%. At the same time, there are already plans to undertake the third phase of the exit strategy, in other words, the reduction of the balance sheet, something which probably will not happen until next year and will be put in place passively. The ECB also appears more optimistic about growth, but is not yet confident about inflation and is lagging behind the Federal Reserve's speed of withdrawal. Given this process of monetary policy normalisation, a rise in the cost of financing at the global level is to be expected.

Overall, our forecasts for growth in 2017-18 have been revised only marginally. We have raised them in view of the good start to the year in the case of the Eurozone, and above all for China, where we expect growth of 6.3% and 5.8% in 2017 and 2018 respectively, about 0.5 percentage points more than three months ago. In the US, we continue to predict growth of 2.3% this year and 2.4% in 2018, supported by a boost in investment. As a result, expected worldwide growth is 3.3% for 2017 and 3.4% for 2018, which, in both cases, is one tenth of a percentage point higher than our previous forecasts.

The risks continue to be weighted to the downside. Apart from the lingering uncertainty about the measures that will eventually be approved in the USA, above all as regards trade, doubts are focused on the election results in France and Italy, due to the highly negative impact they could have on Eurozone stability in the (unlikely) event of a victory for the fiercely anti-European parties. There is also the risk associated with the Chinese economy, where the recent strength of investment may slow the process of reducing imbalances. Other significant risk factors are the Brexit negotiations (which have not got off to a good start), the multiple geopolitical risks and the risks associated with the normalisation of monetary policy, especially in the US.

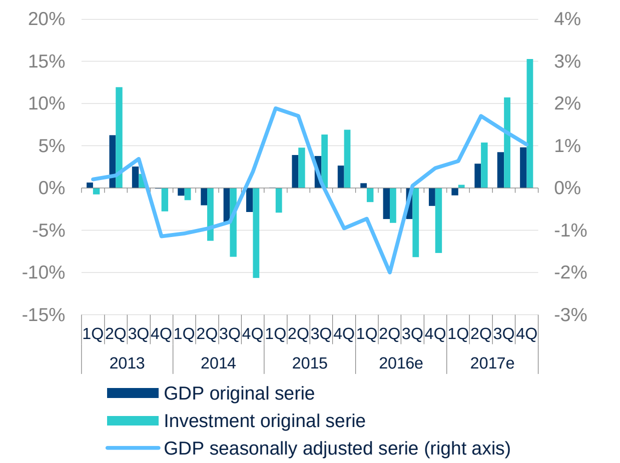
3. Argentina: U-shaped recovery

The economy gradually takes off

The data from the Q4 2016 national accounts confirm that the economy had begun to grow rather tepidly in Q3 to increase the growth rate to 0.5% Q/Q s.a. in the last quarter of the year. Although we expected a recovery path in this shape, the increase in GDP and, in particular, in investment, during the last quarter of the year it was, in the end, more moderate than forecast (BBVA(e) 1.3% Q/Q), which caused the economy to contract by 2.3% in 2016.

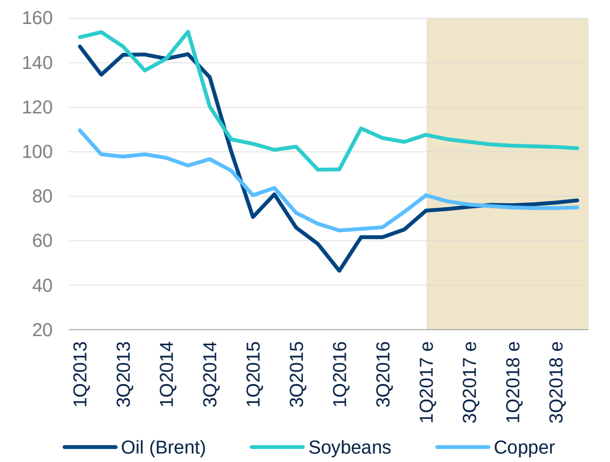
In line with what our MICA nowcasting model suggests, using the information available to date, we estimate that the economy will have also grown 0.6% Q/Q in Q1 2017 and that it will continue to grow during the next quarters of the year at an average rate of just over 1% Q/Q, with an accumulated growth of 2.8% in 2017, the same as the GDP forecasted last January. Although investment will be the component with highest growth rate in 2017 and 2018 (7.9% and 7.1% y/y), we have revised our previous forecasts downwards by around 1 percentage point due to lower momentum in the start u of private investment projects (see Figure 3.1). Public investment continues to grow at a steady pace, as shown by statistics for infrastructure projects tenders, while at the same time private construction is beginning to show signs of recovery driven by the purchase of properties with funds from the tax amnesty plan. In this context investment's share of GDP may reach 20.7% in 2018 which is a similar level to the highs prior to the imposition of exchange rate restrictions, although still lower than the ratios seen in other countries in the region.

Figure 3.1 GDP original and seasonally adjusted series (% change Y/Y and Q/Q)



Source: BBVA Research and INDEC

Figure 3.2 Prices of major commodities (Base index 2010 = 100)*



Source: Bloomberg and BBVA Research

In spite of a certain downward correction in the growth forecasts for investment, domestic absorption will continue to be the main driver of GDP in 2017, contributing 3.4% to total growth since a slight improvement in private consumption will offset this slower growth in capital expenditures, while the contribution from the external sector will continue to be negative, at -0.6% of GDP. This mix of aggregate domestic and external demand will be repeated in 2018 to achieve growth of 3% in a year where private consumption will continue to increase based on lower inflation and improved confidence as the positive results of the economic programme become evident. Nevertheless, after the strong recovery in 2017, GDP growth will fall to a quarterly average of around 0.5% which we expect to be maintained in the following years.

Gradual growth based on domestic absorption slowly improves employment

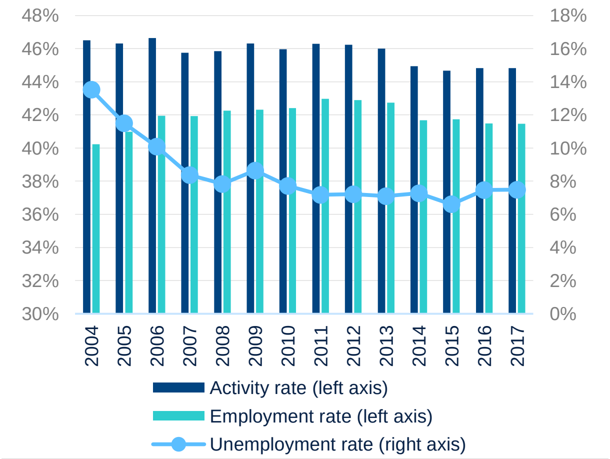
The mildly negative contribution of the external sector mainly arises from a greater increase in imports than exports given the increased need for imported imputs and capital goods in an economy on a growth path. In spite of an improved international trade environment, the recovery in growth by the members of Mercosur and a slight average rise in agricultural raw materials prices (See Figure 3.2), exports will continue to grow at a rate of around 4% per annum in a context of appreciation of the real exchange rate and the slow improvement in structural competitiveness problems.

Throughout 2016, job recruitment in the formal sector fell by less than GDP suggesting a certain optimism prevailed amongst employers with regard to the future prospects for demand for their products, while, at the same time, official subsidy programmes (such as REPRO) contributed to shoring up employment in certain industrial sectors. It is likely that unemployment and underemployment in the informal sector increased at a stronger rate as a consequence of the 2016 recession, but the lack of reliability of previous information from the household survey makes assessment difficult. According to social security (SIPA) statistics in the private formal sector on average, the number of employees decreased by 0.7% last year. However, total formal employment did not fall, but instead increased by 0.6% due to an increase in salaried employees in the public sector (+2.4%) and self-employed workers. At a sectoral level, the most problematic sectors were Construction (-9%), due to the suspension of public works, followed by Mining, due to the decline in oil prices (-5.8%), and the manufacturing industry (-2.2%), while some services sectors, such as financial intermediation, recorded an increase in employment.

The employment situation began to improve from August onwards and there is a 0.8% accumulated increase in formal workers between then and February 2017 (last available data). In the Ministry of Labour's (EIL) survey of large companies the same trend can be seen with 0.6% growth between August 2016 and February 2017 in the private formal sector. Nevertheless, the sharp drop in the unemployment rate from 9.3% in Q2 2016 to 7.6% in Q4 2016 reflects not just an improvement to the employment rate of 0.2 percentage points but also, fundamentally, a sharp reduction in labour force participation from 46% to 45.3%, particularly amongst the youngest and, more particularly, women, which is probably the result of desincouraged workers leaving the labour market.

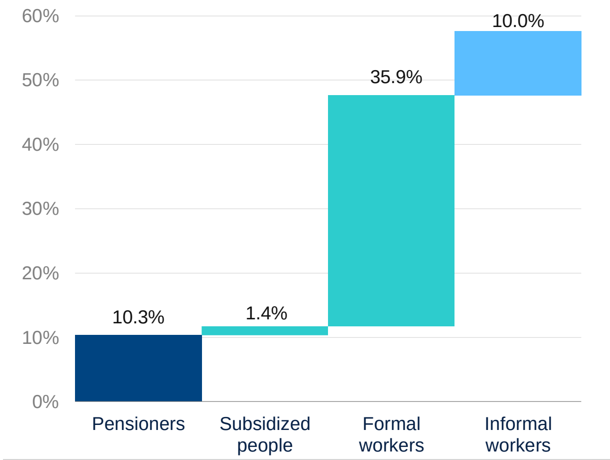
Assuming progressive recovery in labour force participation rates towards levels which are more similar to historic averages, and a relatively low employment/GDP elasticity, suggested by the relatively high levels of real salaries, we estimate that unemployment will not fall in 2017-2018, maintaining an annual average of 8.5%, which is slightly higher than the known average for the first 3 quarters of 2016 (see Figure 3.3). Therefore, improvement in private consumption in 2017 will not come from a sharp increase in new jobs but rather froman increase in real salaries, as the total formal private sector wage bill represents almost 36% of total private consumption. Consumption will also be sustained by transfers to pensioners and beneficiaries of social programmes which will increase by around 40% Y/Y due to the Mobility Act which indexes them to past wage hikes and to the Historical Reparation Act which acknowledges past debt to pensioners (Figure 3.4).

Figure 3.3 Employment and participation in the labour market (%)



Source: BBVA Research and INDEC

Figure 3.4 Participation in Private Consumption (%)



Source: INDEC, SIPA social security and BBVA Research

4. Negative inflation surprises in Q1 2017

Lingering effect of hikes in regulated prices plus downward “stickiness” in underlying inflation

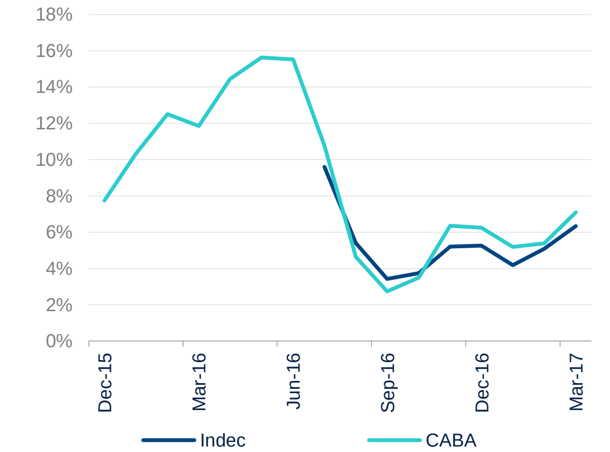
We expect the inflation rate (Buenos Aires City official index- CABA) to reach 22.4% year on year in 2017. This is an increase on our previous forecast of 20.8%. We also increased our forecast for Indec official statistics on inflation to 19.5% (the differences in the figures between the two indices are due to the fact that they have different consumption baskets and cover different geographical areas). Although this is a deceleration compared to the 41% inflation of last year, caused by the initial exchange rate and tariffs shocks, the monthly inflation data for the first quarter are not as encouraging as expected.

In the first quarter of the year average monthly inflation was 2.1% and 2.3% (Indec and Buenos Aires City respectively) while in March alone these rates were 2.4% and 2.9%, respectively, setting an upwards trend. There was a planned hike in electricity prices in February but in the following months inflation did not fall (see Figure 4.1) and increases were also seen in prices for items such as clothing and education. Core inflation is showing a certain downward “stickiness” which should be watched in the next few months. While according to the Indec index, which covers the Greater Buenos Aires and City urban cluster, core inflation has remained at relatively constant on average, the index drawn up by the Buenos Aires City statistics bureau shows underlying inflation on the rise (see Graph 4.2)

The Central Bank continues to be committed to the aim of lowering inflation and has maintained its annual targets (12%/17% in 2017 and 12%/8% in 2018), although these are within ranges which are much lower than those expected by the consensus of analysts. Its strategy continues to aim at reaching single figure inflation in 2019. With this target in mind, the monetary policy rate was raised from 24.75% to 26.25% during the second week of April. This is explained in greater detail in Chapter 5.

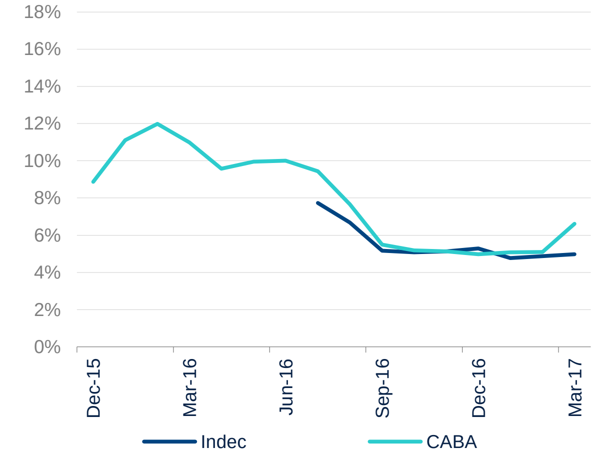
An essential factor in assessing the evolution of inflation going forward is the result of collective wage bargaining agreements, which are usually negotiated during the first four months of the year. Most unions have not yet closed off these negotiations and, in some cases, confrontation with the government has occurred which is still in the process of being resolved, as is the case with teachers’ union. Some agreements have defined similar adjustments to expected inflation but with trigger clauses to compensate for potential deviations from the final inflation outcome. The end result of these negotiations, which may end with larger salary rises than those sought by the government, will influence the the actual inflation rate. The reduction in Central Bank financing to the Treasury, the positive real interest rate policy to pin down expectations and the relative exchange rate stability will be the factors helping inflation converge towards lower levels. Even so, the probability of achieving the inflation target this year is not very likely.

Figure 4.1 Total inflation last quarter (Y/Y change)



Source: BBVA Research, INDEC and GCBA

Figure 4.2 Underlying inflation last quarter (Y/Y change)



Source: BBVA Research, INDEC and GCBA

5. The Central Bank raises the monetary policy rate

Even after the hike, inflation expectations remain above Central Bank target

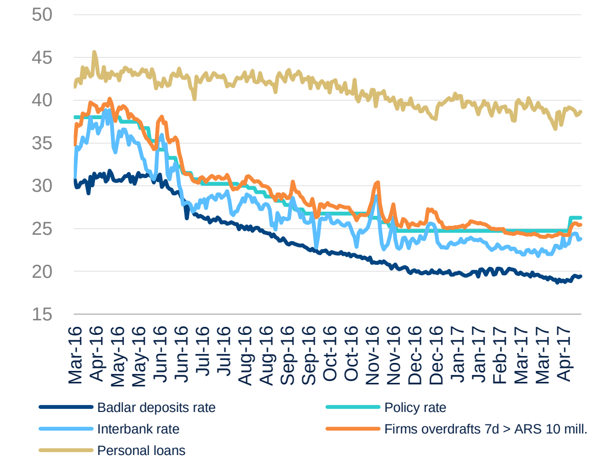
The Central Bank reacted to the latest inflation data by raising the monetary policy rate by 150 bp in April, which took the market by surprise. Monetary policy had already begun to be tightened in March, the money growth rate was reduced and the Central Bank sold short term bills (Lebac)with the aim of increasing the rates on these instruments in the secondary market. The April primary Central Bank Lebac auction (which is now run on a monthly basis) also drove rates up after several months during which gradual drops in interest rates had been accepted by the BCRA in each tender.

The hike in the monetary policy rate began to be reflected in more sensitive rates, such as the interbank rate and overdrafts, which reflect in the short term the financial system's liquidity conditions, while the adjustment to the Badlar deposits rate tended to be slower (see Figure 5.1). The Central Bank's decision caused certain apprehension due to fears that a new rate rise could set back the gradual recovery in economic activity.

During the second half of 2016 the inflation rate's resistance to falling led the Central Bank to maintain the monetary policy rate at a steady 24.75% from December last year until April this year, having piloted scaled drops during the first half of the year from a maximum of 38% in April. We estimate that the monetary policy rate will continue to drop more gradually during the rest of 2017 to reach 21% by the end of 2017 as analysts' consensus on inflation expectations remains above the upper band of the Argentinian Central Bank's target for the next 12 months. The results of the survey on market expectations for April indicate that the market does not expect inflation to meet the target and that the downward path for the monetary policy rates this year and next year will be slower than previously estimated (see Figure 5.2).

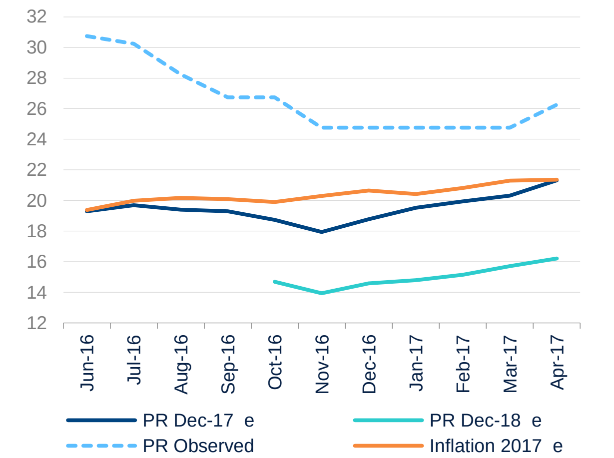
The 2017 target (12%/17%) continues to look difficult to achieve even after the interest rate hike. While the fiscal deficit targets for 2017 announced last year were revised up (the primary deficit projected by the government for 2017 was raised from 3.3% to 4.2% in 2017) the inflation targets remained unchanged, in spite of the fact that there was an opportunity to revise them up when the inflation targeting scheme was formally released in September 2016. Therefore, market expectations for inflation are still relatively high compared to targets, probably due to the impression that there is a lack of consistency between monetary and fiscal policy.

Figure 5.1 Interest rates (%)



Source: BBVA Research and Argentinian Central Bank

Figure 5.2 Monetary policy rate (PR) and inflation expectations (%)

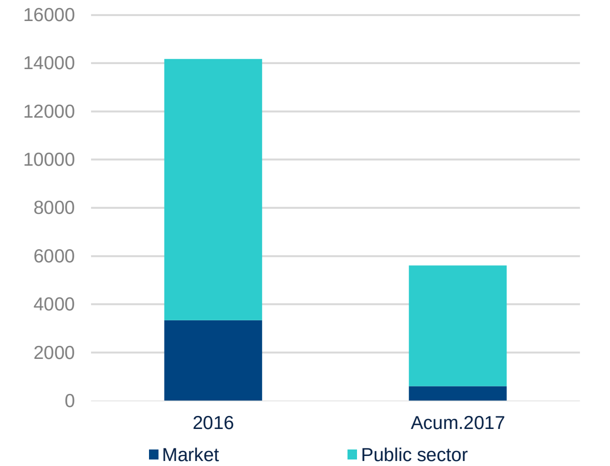


Source: BBVA Research and Argentinian Central Bank

Regarding the exchange rate policy and its impact on monetary policy, although a floating regime was adopted for the exchange rate, the Central Bank has intervened ocasionally in the private exchange market. However, the purchase of hard currency originating in public and private sector debt issues (see Figure 5.3) has led to a significant need for sterilisation which constantly pressures the Central Bank's stock of Bills (Lebac) up.

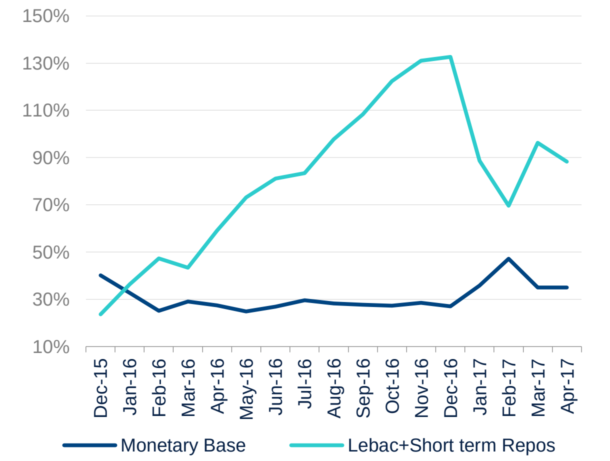
Although the monetary growth rate was finally reduced in April and the monetary base fell 1.5% on a cumulative basis this year, it is still growing at rates of around 35% Y/Y even considering the Central Bank's vigorous sterilization policy (see Figure 5.4). This amount of absorbed liquidity, whether using repos or Lebac's, is also explained by the reduction in reserve requirements mandated by the Central Bank (2 percentage points in March) together with the slow rise in loans to the private sector which compels the financial system to place its excess liquidity in Central Bank instruments. This situation will continue to put the Central Bank under pressure this year, as long as inflation continues to take its time to fall to target levels and slow recovery in economic activity does not trigger stronger growth in loans to the private sector.

Figure 5.3 Central Bank currency purchases (USD millions)



Source: BBVA Research and Argentinian Central Bank

Figure 5.4 Monetary Base and Central Bank Bills (Lebac)+Repos Stock (% change YoY)



Source: BBVA Research and Argentinian Central Bank

6. The announced fiscal targets are modest and achievable

Except for subsidies to the energy sector, primary spending is not expected to drop in real terms

The government decided to adopt a gradualist fiscal policy and, in 2016, less headway than expected was made in reducing the deficit due to political restrictions. The fiscal deficit remained almost constant in GDP terms last year. Access to debt markets contributed to financing the imbalances without major difficulties given that, additionally, one of the few solid legacies of the previous administration was the low level of debt with private sector creditors. Nevertheless, fiscal consolidation continues to be one of the government's and investors' main concerns in the medium term.

The Economy Minister, Nicolás Dujovne, announced quarterly targets for the fiscal deficit in 2017 and also targets for annual revenues, expenditures and deficit until 2019. He also improved the methodology to measure the deficit by completely excluding revenues from the Central Bank and interest on intra-public sector debt from the calculation. Although this method of calculating the deficit is more accurate, it is worth pointing out that it is not fully comparable to the previous measurement, as can be seen by comparing the results for 2016 using both methodologies (see Figure 6.1), above all when looking at the total deficit. Apart from this, another of the initiatives in the move towards greater transparency is that there is greater break-down of income and expenditure items.

Both the quarterly and annual targets are defined in terms of the primary outcome (see Figure 6.2). The primary fiscal results targets for 2017, 2018 and 2019 are -4.2%, -3.2% and -2.2% of GDP, respectively. A gradual reduction of subsidies to energy and transport is implicit to these targets while the Treasury plans to maintain the rest of expenditure constant in real terms. The government expects to begin a more complete tax reform in 2018 (changes to taxes on exports and on income tax have already been made). The idea is to reduce the tax burden though not affecting the level of revenues will remain stable in terms of GDP due to the expected effect of greater economic activity and a decrease in informality and tax evasion.

The targets appear to be reasonable, but it is not yet guaranteed that they will be reached. In spite of this, Argentina still has a certain margin to increase indebtedness in the medium term and will continue to depend on debt markets in the coming years. Financial needs for 2017 are USD 40 billion, according to the Financial Programme for the year, and they will be mostly covered by domestic sources taking advantage of the increase liquid assets declared by the private sector as a result of the the tax amnesty. The government has shown itself to be highly active on this market throughout the year, with issues in pesos and dollars. Additionally, a repo agreement with private banks for USD 6 billion was announced and debt placements were made in the international market for USD 7 billion and CHF 0.4 billion, thus covering a large part of the financial needs of the year. In this scenario, the S&P rating agency hiked

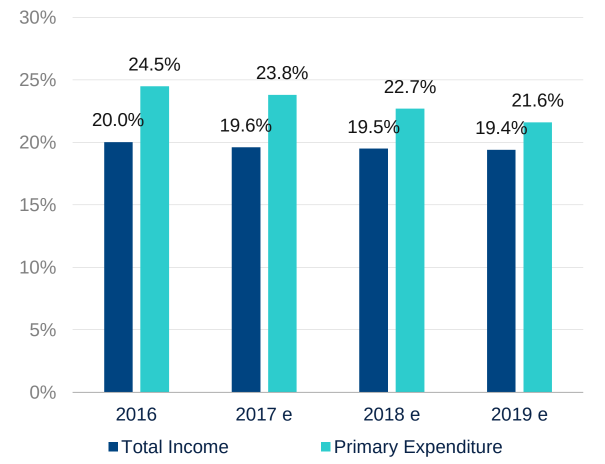
Argentina's sovereign debt rating from B- to B with a stable outlook, given that it saw improvement to the country's economic conditions after the policies applied by the government, although it warned that the political scenario could affect the government's ability to complete the reforms needed to sustain growth in the medium term.

Figure 6.1 Fiscal results comparison between current and previous methodology (ARS billion)

	2016 Previous	2016 Actual
Total income	1,613	1,629
Primary expenditure	1,973	1,973
Primary result	**-359**	**-344**
% of GDP	**-4.5%**	**-4.3%**
(-) Interest private sector debt	131	131
(-) Interest public intra-sector debt	54	0
(+) Central Bank and other income	179	0
Financial result	**-365**	**-475**
% of GDP	**-4.5%**	**-5.9%**

Source: BBVA Research and Economy Ministry

Figure 6.2 Fiscal income and primary expenditure (% of GDP)

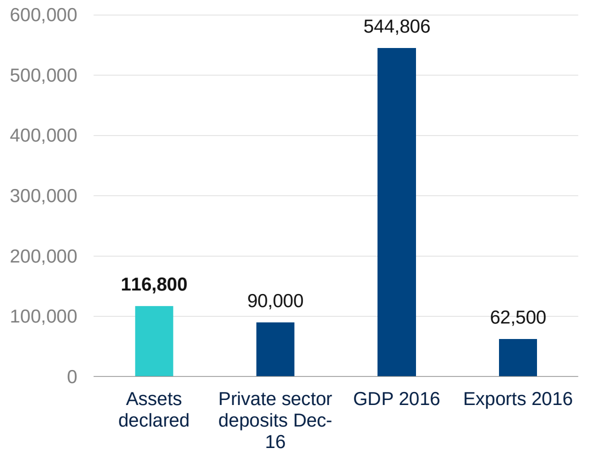


Source: BBVA Research and Economy Ministry

The last phase of the tax amnesty ended on 31 March and the total amount of assets declared was USD116,800 million. The second phase had previously ended with a balance of USD 97,842 million. The result is highly significant, although an influencing factor was the increase in the exchange of tax information between countries increasing the risk of holding overseas assets without declaring them for tax purposes. The tax collection arising from payment of fines was around ARS 140,000 million although this is one-off income and will be used to finance the increase in pensions. Due to the increase in assets declared, the tax base for the tax on personal assets abroad increased to USD 110,527 million, an increase of more than 300% compared to the the base prior to the tax amnesty. Private sector deposits in dollars increased by more than USD 7,000 million because of the effect of the tax amnesty and, although almost 80% of the newly declared assets remain abroad, they are a potential source of investment and growth if the economic conditions in Argentina consolidate, taking into account that the total newly declared assets exceed the stock of deposits in the private sector at the end of 2016 (Figure 6.2).

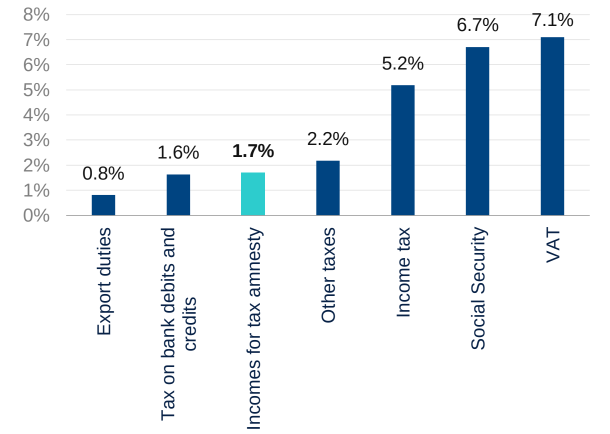
The extra income from the tax amnesty will finance the inertial increase to pensions and social benefits

Figure 6.3 Comparison of assets declared (USD million)



Source: BBVA Research, INDEC, Argentinian Central Bank and the Ministry of Economics

Figure 6.4 Comparison of collections under the tax amnesty (% of GDP)



Source: BBVA Research, INDEC, Argentinian Central Bank and the Ministry of Economics

7. Argentina will continue to attract foreign capital

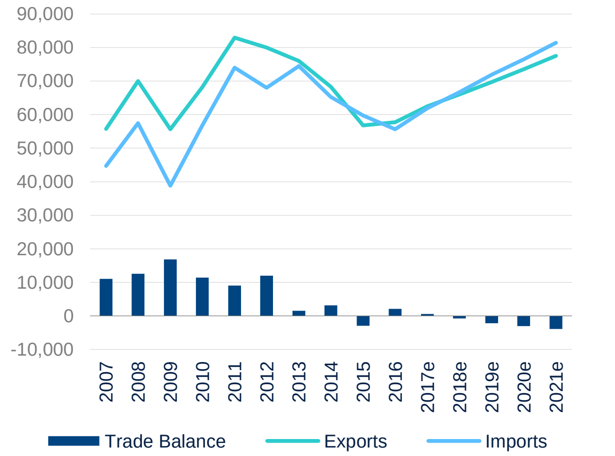
The current account in deficit but will remain stable at -3% of GDP

Although we expect a slight surplus in the balance of trade this year (USD 550 million), it will fall compared to 2016 due to a stronger rise in imports than in exports. The current account will continue to show a deficit in the medium term due to the negative balance on Real and Financial Services. We also expect the trade surplus to be eroded as economic activity recovers (see Figure 7.1).

The cash-base exchange balance data for the first quarter of 2017 present a current account deficit of USD 1913 million, partly related to expenditures on outbound tourism. This deficit was financed with capital inflows mainly from issued of public sector debt abroad, although private sector capital flows remained. During the 1st quarter of the year there was a strong build up of international reserves (USD11.7 billion) as a result of these debt issues, which were partly reduced in April after the payment of USD7 billion for the principal amortization of Bonar X sovereign bond. We believe that these flows from the external sector will continue this trend for the rest of the year (see Figure 7.2), as well as in the medium term, as Argentina will continue to attract portfolio and direct foreign capital investment.

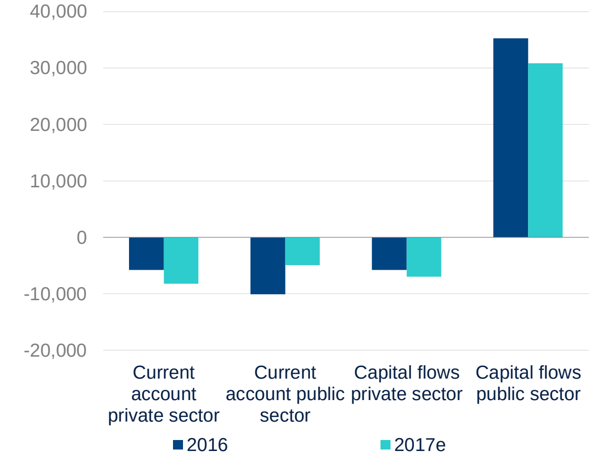
During the rest of the year the accumulation of international reserves from public sector debt placements will be lower, given that almost 80% of the foreign currency issues abroad planned by the government have already been accomplished. Nevertheless, the question remains as to whether there will be a new “surge” of hard currency inflows in the medium term as a result of the tax amnesty which ended in March. If uncertainty wanes and some proportion of the newly declared assets abroad are repatriated seeking higher returns, this would create an increase in international reserves which would exceed historic highs, but at the cost of greater pressure on the interest rate and on the Central Bank’s need for monetary sterilisation.

Figure 7.1 Trade balance
(USD millions)



Source: BBVA Research and Indec

Figure 7.2 Cash-base exchange balance
(USD millions)



Source: BBVA Research,and Central Bank

8. “Verbal” intervention by the Central Bank to put a cap on the peso’s appreciation

New target for accumulation of reserves

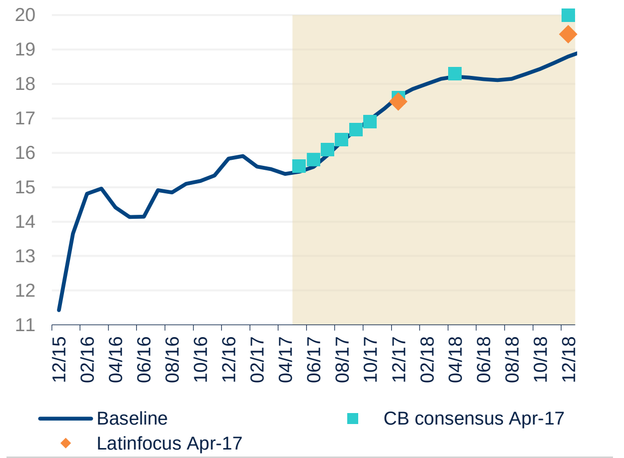
In the base scenario we are not expecting significant depreciation in the exchange rate in the medium term. On the contrary, we are expecting a period of real appreciation of the exchange rate although volatility in the short term prior to the midterm cannot be discarded. The exchange rate will increase 11.4 % in 2017 (ARS/USD 17.6) and 6.6% in 2018 (ARS/USD 18.8) at a slower pace than inflation (see figure 8.1).

This forecast, which is shared by most analysts, is supported by a number of factors, such as the Central Bank’s monetary and exchange rate policy, the maintenance of mildly positive interest rates in real terms that encourage domestic savings in local currency, capital inflows to finance private investment (partly due to the success of the fiscal amnesty) and, finally, debt placements to finance the public sector deficit as well as private debt issues.

The President of the Central Bank recently stated, for the first time, that Argentina’s stock of international reserves was still low in international terms and that the intention was to raise the international reserves to GDP ratio to 15%, which involves an increase in reserves of at least 50% compared to the current level of around USD 48 billion. Although the current level of reserves is adequate in terms of months of imports and short term dollar denominated debt maturities (see Figure 8.2), it still fall below what might be considered an optimal ratio of reserves of around 14% of GDP. The 2017 Monetary Targets succinctly mention that the Central Bank may carry out transactions in the exchange market to strengthen its external assets, but the accumulation of international reserves does not appear as a specific target. The argument the governor of the CB is now putting forward is that this is required by the risk rating agencies to raise the country’s rating and as a strategy for protection against external shocks, as other emerging economies have done. Although the Central Bank did not define a time frames for reaching the reserve ratio, the initiative puts a cap on the peso’s upward trend which is also probably one of the desired effects. Although it is no longer mandatory to settle exports immediately, it is likely that the Central Bank will continue to purchase reserves arising from National and Provincial debt issues.

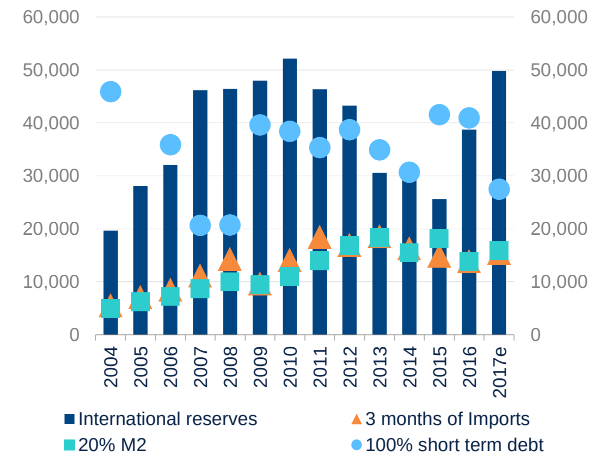
We believe that a stronger real exchange rate is sustainable in the medium term because the cost of capital for Argentina has fallen substantially, the majority of export taxes have been eliminated and there is abundant global liquidity to finance the domestic deficit. Nevertheless, the strong peso is causing problems due to a lack of competitiveness in some industrial sectors which will require the government to put policies in place to improve these sectors’ productivity in the medium term.

Figure 8.1 Forecast and expected exchange rate (ARS/USD)



Source: BBVA Research, Central Bank and Latinfocus.

Figure 8.2 International reserves ratios (USD millions)



Source: BBVA Research, Central Bank and Indec.

9. The international outlook improves but domestic risks continue to lean towards the downside

As regards the external environment, two factors stand out, one related to the resolution of the imbalances in China and the other linked to US economic policies and the Federal Reserve's process of withdrawal of monetary stimulus measures. In the former case, the imbalances in China's economy show no signs of diminishing. Beyond the improved expectations of growth in the short term based on the resumption of stimulus measures, especially fiscal ones, medium-term risks increase, since the process of adjusting the growth model has come to a halt, and the financial weaknesses deriving from a recovery based on an increase in economic agents' indebtedness could become more pronounced. As we have repeatedly pointed out, a sharp adjustment of the Chinese economy would especially affect the economies of South America through the fall in exports to China and in commodity prices, as well as volatility in international markets.

Conversely, the risks associated with US economic (especially trade) policies are decreasing as the new administration seems to be looking at more moderate options for renegotiating NAFTA, while continuing to encounter obstacles to carrying out some of its policies on restricting immigration. However, we also mentioned at the beginning of this report the difficulty of passing measures on tax cuts or the plan for spending on infrastructure, which reduces the probability of a strong boost in the short term.

The deferral of investment projects due to doubts about the continuation of policies may bias growth to the downside

On the monetary side, we are already in a process of normalisation of monetary policy in the US, so we can expect an increase in the cost of financing globally. Communications policy will be the key to this process, to prevent mistakes like the famous "taper tantrum" (overreaction in 2013 by the bond market to the withdrawal of stimulus measures) in the USA. The tightening of financial conditions will depend not only on the policy rates set by the central banks but also, and in particular, on long-term interest rates. In this case, there are factors that continue to anchor the long section of the interest rate curve, such as the high degree of uncertainty, the scarcity of safe-haven assets and certain regulatory aspects.

The Argentine government has managed to negotiate successfully with the opposition in order to achieve many of its initiatives. However, there are still many challenges ahead which force it to negotiate continually with other parties, thus generating additional fiscal costs and a certain political attrition. Although expectations for the future remain optimistic, a slower exit from recession than estimated, or an upsurge in inflation, could be detrimental to the government's approval rating, affecting the results of the October mid-term elections and making it more complicated to strengthen the backing for the economic and political reforms that the government aspires to. Although they continue to be enthusiastic about the policy change in Argentina, a combination of several of these factors could affect foreign investors' expectations and create scepticism about the government's ability and room for manoeuvre to implement the reform plan. This could undermine the confidence and predictability needed for the promised investment plans to materialize. Although this scenario seemed to increase in probability during the first quarter of the year, given the conflicts with certain groups, such as the unions, opposition parties and other social organisations, in April the confidence and government image indicators began to improve sharply and therefore paving the way to a less complicated path to the midterm elections.

The markets have not punished Argentina for failing to fulfil the initial promise of fiscal consolidation of around 1% of GDP or more per year, giving a greater weight to Cambiemos' governance and continuance in power. Given Argentina's low level of indebtedness and prospects for growth, the sovereign debt risk premium has not risen, even in a more uncertain international environment after the new government in the United States took office. The S&P rating agency raised Argentina's sovereign debt credit rating from "B-" to "B" and gave it a stable outlook taking into account the improvements seen in the country's economic situation after the reforms which have already been carried out by the government. Nevertheless, if, in the medium term, an effective reduction in the state's weight in the economy does not materialise and the expected increase in investment levels is not consolidated, there could be an end to market complacency and Argentina's financing cost could be driven up to levels which may cast doubts on debt sustainability.

10. Tables

Table 10.1 Annual macroeconomic forecasts

	2015	2016	2017f	2018f
GDP INDEC Base 2004 (% Year on Year)	2.6	-2.3	2.8	3.0
Inflation Argentinian Central Bank (% Year on Year, eop)	26.9	41.0	22.4	12.9
Exchange rate (per USD, EOP)	11.4	15.8	17.6	18.8
Policiy Rate (%, eop)	33.0	24.8	21.0	18.0
Private Consumption (% YoY)	3.5	-1.4	2.5	2.8
Public Consumption (% YoY)	6.8	0.3	2.0	2.0
Investment (% YoY)	3.8	-5.5	8.0	7.0
Tax Revenue (% GDP)	-3.9	-4.5	-4.9	-4.3
Current Account (% GDP)	-2.7	-2.8	-3.0	-3.0

Source: BBVA Research

Table 10.2 Quarterly Macroeconomic forecasts

	GDP INDEC (% YoY)	Inflation Argentinian Central Bank (% Year on Year, EOP)	Exchange rate (vs. USD eop)	Interest rate (%, eop)
Q1 16	0.6	35.0	15.0	38.0
Q2 16	-3.7	47.1	14.1	30.8
Q3 16	-3.7	43.1	15.1	26.8
Q4 16	-2.1	41.0	15.8	24.8
Q1 17	-0.8	35.0	15.5	24.8
Q2 17	2.9	23.3	15.6	26.3
Q3 17	4.2	24.8	16.7	24.0
Q4 17	4.8	22.4	17.6	21.0
Q1 18	4.6	18.7	18.2	20.2
Q2 18	3.3	15.4	18.1	19.4
Q3 18	2.4	14.1	18.3	18.7
Q4 18	1.8	12.9	18.8	18.0

Source: BBVA Research

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