BBVA | Research

Argentina Economic Outlook

4th QUARTER 2017 | ARGENTINA UNIT

Contents

Closing date: 12 October 2017

1. Summary

Economic growth more widespread and at a faster pace. GDP posted growth of 0.7% QoQ in 2Q17 and would reach 4Q at 4% YoY, in line with our estimated increase of 2.8% for 2017. There was widespread growth in most sectors, including manufacturing; confidence brightened and there was increased growth in lending. A confirmation of the **government's positive political momentum** in October elections would dispel doubts about continuity in the reform agenda and give a greater boost to private investment, putting a positive bias on our estimated growth of 3% for 2018.

Although 3Q17 inflation was down from the average figures registered in 1H17, it fell more slowly than expected. Hence, due to this and the higher than expected impact which regulated prices had on National CPI, **we have revised our inflation estimates to 22.2% YoY for 2017 and 15.6% for 2018**, above the Argentinian Central Bank's targets. **The Central Bank of Argentina will continue with its contractionary monetary policy**: as inflation and expectations have not been brought down to levels consistent with the target of 12-17% for 2017. Monetary policy became more contractionary in 3Q17, and we do not expect a reduction in the monetary policy rate until there is specific evidence that inflation is heading towards the expected values, probably towards the end of the year.

Fiscal targets for 2017 will likely be met and budget discussions for 2018 will be focused on the Nation/Provinces relationship: In the 2018 Budget bill, the primary deficit is estimated to fall by 1% of GDP through an adjustment in primary spending, but the proposal does not include the effects of the announced tax reform, which is not expected to be very deep. The government will refinance debt maturing in 2018 and issue new debt to cover the fiscal deficit with a total net bond issue of around USD 18.7 bn. The Fiscal Responsibility Act is aimed at improving the fiscal solvency of the provinces, and it is the first step in the important debate between the Nation and the Provinces.

In 2018, the trade deficit is expected to reach USD 8.8 billion against a background of higher domestic growth and a slight fall in the terms of trade. The deficit in real services and interest will keep the current account deficit above 4% until 2020. **Argentina will be able to finance the higher deficit with external savings in the short term without running into sustainability problems** but it needs to carry out reforms to make exports more competitive. **The real appreciation of the peso will put some upside pressures on the nominal exchange rate** and thus we have slightly increased our depreciation estimates for 2017-18, but kept them below expected inflation and below consensus.

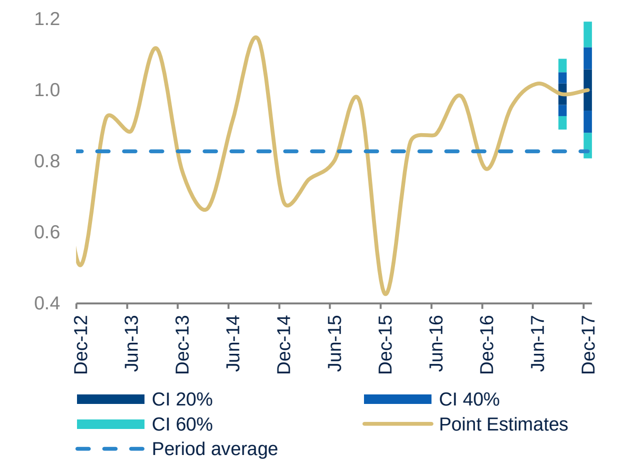
A favourable election result would be expected to increase the government's political capital, allowing it **to launch a cycle of structural reforms to resolve long-standing problems in Argentina.** This process **is not exempt from political risks** as the Provinces will have to agree to reduce fiscal pressure, and seek alternative sources of income. Political skills will also be needed to make changes to improve the competitiveness of the economy as it entails addressing Argentina's problems of labour productivity and its role in the international trade; bringing with it a larger scale for domestic production but also a potentially negative impact on less competitive sectors.

2. The positive global environment is strengthening

Robust and steady global growth with a more synchronized recovery across areas

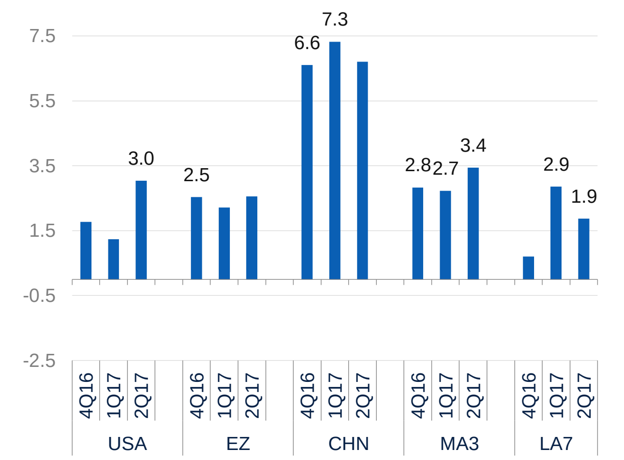
The growth rate of the world economy has stabilised by mid-year at around 1% QoQ, and the available indicators suggest so far that this trend will continue in the second half of the year (Figure 2.1). **Global confidence indicators continue to improve**, both in advanced and emerging economies, and anticipate a more positive outlook than the activity indicators, which slowed down at the beginning of the third quarter. Nonetheless, **global trade growth remains solid and the recovery of the industrial sector continues apace**, underpinning the upturn in investment, while private consumption remains resilient despite weaker tailwinds.

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



Source: BBVA Research

Figure 2.2. GDP growth by region
(Seasonally Adjusted Annual Rate, %)



Source: BBVA Research

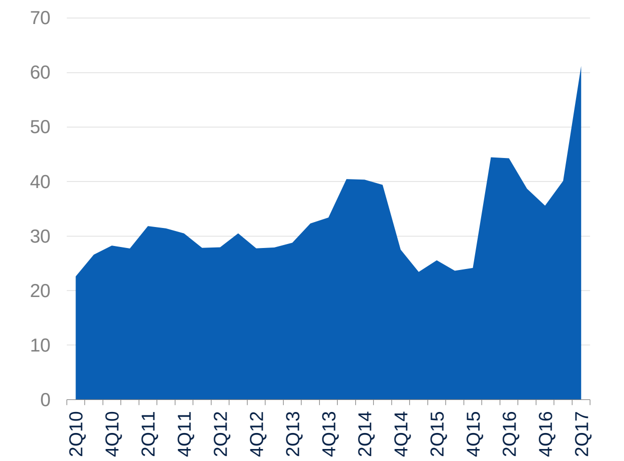
This positive dynamic reflects a stronger economic performance in all areas (Figure 2.2). In the advanced economies, US GDP rebounded in Q2 and dispelled doubts over the persistence of moderate growth in the coming quarters, while a greater strength from domestic factors was behind the positive surprise in Europe. In emerging economies, stable growth in China will continue to support the rest of Asia, which, coupled with favourable financial markets conditions, is also allowing growth in Latam countries to gain traction. In addition, the recovery in Russia and Brazil means that these countries are no longer dragging global growth. Hence, unlike other episodes of growth since the financial crisis (in early 2013 and mid 2014), the current recovery is proving to be more synchronised[1], according to our index[2].

1: Proof of this can be found in the fact that Harding and Pagan's concordance index for growth in developed and emerging economies has risen 25% since 2016.
2: The synchronisation index given here is the product of inverting the standard deviation of quarterly growth observed across countries. The index therefore associates less (more) growth volatility among countries with a higher (lower) degree of synchronisation worldwide.

This environment of positive and more synchronised growth has thus far been accompanied by **moderate levels of inflation**, also generalized by areas, despite the abundance of liquidity in the markets, while there are still no clear signs of accumulation of inflationary pressures. In the case of the emerging markets (EM), the appreciation of their currencies due to a weak dollar and a certain increase in commodity prices has helped inflation to continue to abate. Among the developed economies, the reduction in inflation results from the disappearance of the base effect of energy prices (especially in Europe) and certain transitory factors (mainly in the United States), although **core inflation remains at low levels** and doubts persist on whether the factors underlying this weakness of inflation are temporary or permanent. This context helps **central banks in the emerging economies to have greater room for manoeuvre to continue supporting** growth, **while it allows the monetary authorities in the advanced economies to remain cautious in normalizing their monetary policies**.

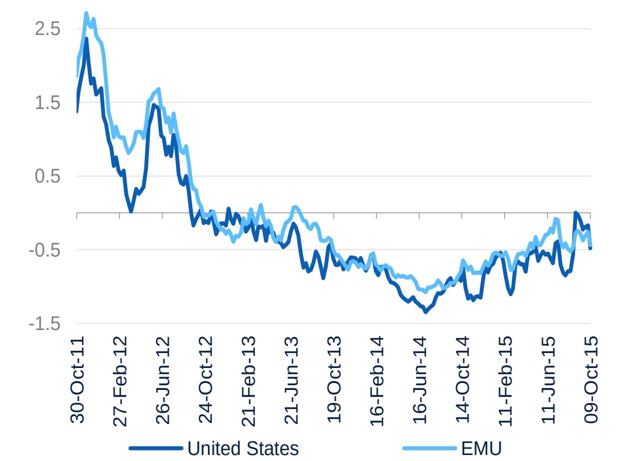
Other drivers behind the global performance, such as **fiscal policies, have generally been neutral or expansionary lately,** while relatively subdued commodity prices appear to extend over the forecast horizon, and **relatively complacent financial markets** are not suffering persistently from sources of political stress.

Figure 2.3. Synchronisation index (based on the time variance of GDP)



Source: BBVA Research

Figure 2.4. Financial tension index. USA vs. Eurozone (normalised)



Source: BBVA Research

Favourable environment in financial markets and normalization of monetary policies

In this quarter **market dynamics have been broadly unchanged since the first half of the year in spite of episodes of stress** (Figure 2.4), above all of a political (debt ceiling debate in the United States) and geo-political nature (tensions in North Korea). These events have caused a certain safe-haven effect on debt, which has led long-term interest rates to the lower end of the market range. However, its effect has been only transitory.

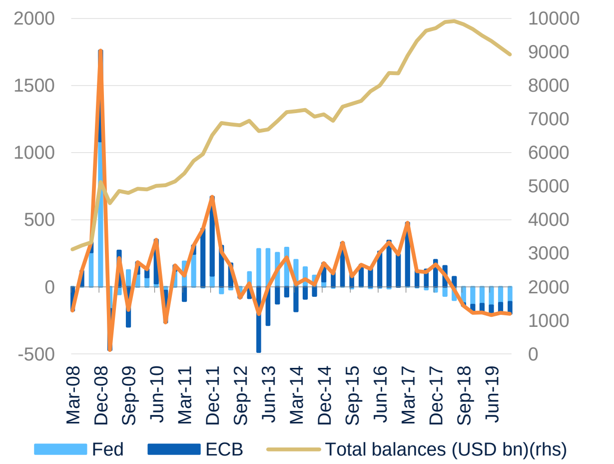
In an environment where growth remains dynamic and with no downward surprises on inflation, **central banks are pressing ahead with the gradual process of withdrawing monetary stimulus**. Specifically, the **US Federal Reserve**

(Fed) has announced it will start reducing its balance sheet as from October. This would take the form of a passive reduction, by allowing a portion of public and private bonds to expire, which has been well communicated, so it has not generated any tensions in markets. Moreover, the Fed, still expects to implement a series of rate hikes, even though the markets have systematically shown themselves to be more bearish. **We expect a 25 bp hike for official rates in December this year and then two further hikes up to 2% in 2018**. However, uncertainty about these hikes has increased, not only because inflation is still at low levels, but also **because of the changes that are going to take place at the Fed** following the exit of many of its members, including the vice chair, and with the uncertainty on whether its Chair will remain in office.

The European Central Bank **(ECB) will announce the tapering of its asset purchase programme in October**, which it would start to implement in January next year. The withdrawal of stimulus will be gradual and the ECB will be as flexible as possible, although the precise strategy it will adopt is uncertain as regards how much it will scale back its purchases and for how long the programme will continue. Our scenario contemplates a gradual reduction in purchases until the programme ends in summer 2018. **Rate hikes, however, will be delayed until mid 2019,** largely due to the ECB's growing concern over euro appreciation and its potential impact on inflation.

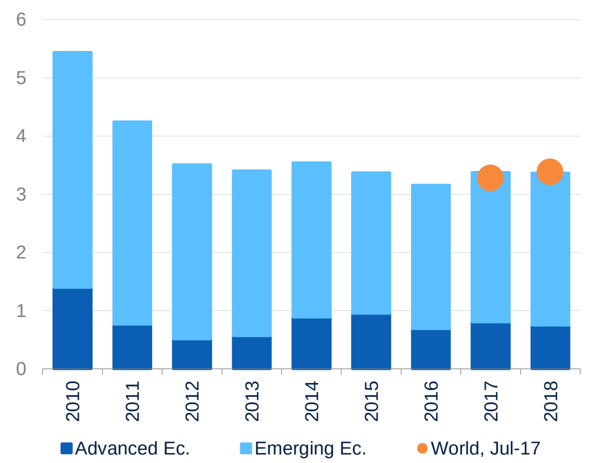
Like in the previous quarter, the combination of low volatility, low rates and dollar weakness have drawn a favourable outlook for EMs. Hunt for yield **strategies have led to strong inflows towards EMs**, particularly in the bond market, as well as currency strength.

Figure 2.5. Fed and ECB balance sheets
(level and quarterly changes, in billions of USD)



Source: BBVA Research

Figure 2.6. World GDP forecast by region
(% YoY)



Source: IMF and BBVA Research

Higher global growth on the upward revision in Europe and China

Our **new forecasts lead global growth to accelerate to 3.4% in 2017-18** (Figure 2.6), which implies an upward revision of around 0.2pp this year and an acceleration from 3.2% in 2016. This change is due to **higher forecasted growth both for China and Europe in 2017** on account of positive surprises in both regions since Q2. For the United States, we are maintaining our estimate of sustained growth of slightly over 2% within the forecast horizon, while the better progress predicted for the Latam economies is being confirmed. In contrast, growth for the rest of the Asian economies will continue to be robust, although it will feel the effect of the expected slowdown in the Chinese economy in the coming quarters.

The underlying factors supporting the acceleration and stability of global growth will remain present, even though some of them could gradually wear off in the coming quarters. The most immediate will be the normalisation of monetary policy by both the Federal Reserve and the European Central Bank (Figure 2.5), as it will lead to gradual reduction in global liquidity and less support for capital flows into the emerging economies. In addition, **there are still multiple political risks that can influence economic confidence and market behaviour.**

The U.S.: sustained growth in spite of political uncertainty and natural disasters

GDP growth **rebounded to 3.1% YoY in Q3**, **bouncing back from the substantial decline experience din the two previous quarters.** Although uncertainty is still high, due to both natural disasters and economic policy, the **economic fundamentals remain consistent with sustained growth of around 2%** which has been recorded over the past two and a half years. The **net economic impact of the hurricanes will be limited at the national level**, given that the 0.2pp that we estimate could be subtracted from growth in Q3 should be offset by the reconstruction efforts in the final stretch of the year. Moreover, the agreement between the government and the Democrats has delayed **the deadline for approving the budget** (guaranteeing government funding until December) **and raised the debt ceiling**. With respect to economic policy, the government is now focusing on **tax reform, but this is still short on essential details** and offers only limited options for enhancing efficiency. Even if it is finally approved**, the tax cuts are unlikely to give a significant boost to economic growth** given the cyclical situation of the economy, which is very close to full employment.

For all these reasons **we maintain our GDP growth forecast of 2.1% in 2017 and 2.2% in 2018**. The solidity of global growth, dollar depreciation, expectations of sustainable oil prices and the mild improvement in construction should support **an upturn in investment.** On the contrary, the more gradual improvement in the labour market and higher inflation lead us to continue to forecast **a slowing down in private consumption** over the forecast horizon. Even so, more sluggish growth in prices in recent months and the absence of any clear signs of inflationary pressures mean that we expect the **Fed to continue slowly with its normalisation process** for monetary policy. The risks for this scenario are still to the downside owing to the unknowns regarding the implementation of the economic policy measures announced, whereas the long period of cyclical expansion together with lax demand-side policies still work in favour of a build-up of financial vulnerabilities that could trigger a recession in the medium term.

China: a more promising outlook in the short term

Support from the Chinese authorities, especially with a pro-growth fiscal policy, has led to **a somewhat better than expected economic performance in the first half of the year**, with GDP growth stabilising at 6.9% YoY. In spite of this, **measures have been taken over the year to tackle financial vulnerabilities and encourage an orderly deleveraging process.** Particularly, the tightening of regulation on shadow banking and real estate markets are being combined with more prudent monetary policy, less expansionary fiscal policy and the removal of certain controls from the exchange market. The Communist Party Congress in mid October should shed more light on both the commitment on the part of the authorities to taking on the expected structural reforms to adjust the growth pattern and whether priority will be given to financial stability over economic growth.

As a result of the recent improved performance, we have **revised up our GDP growth forecast upwards by around 0.2pp to 6.7% in 2017**, somewhat higher than the target of 6.5% that the authorities are aiming for, **although we maintain our prediction of a slowdown in 2018 to 6%**. Since mid-year available indicators were already showing us signs of more moderate economic growth and could be reflecting the impact of more prudent demand-side policies, but with the adverse effect on activity of regulatory tightening, the removal of over-capacity from companies and currency appreciation. Inflation remains subdued, especially in food, although industrial product prices have risen again due to supply-side disruptions. In contrast, the regulatory toughening and a stronger currency should continue to contain price developments, and thus we **are keeping our inflation forecast at 1.7% in 2017 and 2% in 2018**.

The authorities' strategy and the more gradual slowdown in growth have **diminished the risks over the forecast horizon, although they are still rising over the medium term** given that debt remains on the rise with some debt service indicators at high levels, while the adjustments by state-owned companies is still being delayed.

Eurozone: increased growth due to strong domestic demand

The **European economy** has advanced at a quarterly rate of **around 0.6% since the end of last year.** More sustained global demand continues to support exports, while the impact of a stronger euro has been limited. The strength of the euro partly reflects the best cyclical momentum **of the European economy, driven by the solidity of domestic fundamentals** (improvement in the labour market and increased confidence), which have encouraged a better performance by both consumption and investment. Although economic performance has been somewhat better than expected so far this year, the weakness of core inflation is keeping the ECB wary. Therefore, even if it will begin to reduce the bond purchasing programme at the beginning of next year, monetary policy will still underpin growth through the maintenance of very low interest rates beyond the forecast horizon. Fiscal policy will also be mildly expansionary in 2017-18, being favoured by the positive impact of the cyclical recovery, which provides more room for the Member States to maintain a degree of fiscal support without compromising the achievement of targets. For all these reasons **we have revised forecast GDP upwards by 0.2pp in 2017 to 2.2%**, which represents above-potential growth for the third year in a row. This makes it hard to imagine a significantly higher acceleration in the short term. In addition, **certain tailwinds from the past are faltering somewhat** or starting to blow in the opposite direction (euro appreciation, rising oil prices and the stabilisation of world growth) **and are behind the expected slowdown to 1.8% in 2018**.

Headline inflation has held relatively stable in the third quarter, with lower energy and food prices being offset by a rise of around 0.1pp in core inflation (to 1.3%). Beyond the volatility and seasonality of certain components of inflation, the strength of domestic demand, the improvement in the labour market and the incipient rise in wages should start to push prices upwards in the coming quarters, although **the impact of recent euro appreciation on import prices leads us to revise our forecast for headline inflation downwards** by around 0.1pp in 2017 to 1.5% and 0.2pp in 2018 to 1.2%, while we **are keeping an unchanged forecast of a gradual increase in core inflation** (1.1% this year and 1.4% in 2018).

Domestic risks for the Eurozone as a whole still have a downward bias but are moderate. And most of them are political, such as the obstacles in the Brexit negotiations, despite some recent rapprochement of the positions, the unresolved banking problems in certain countries, as well as the political tensions in certain Member States and the possible lack of support for moving ahead with the European project after the results of the German elections.

3. Argentina: Quickening and more widespread growth

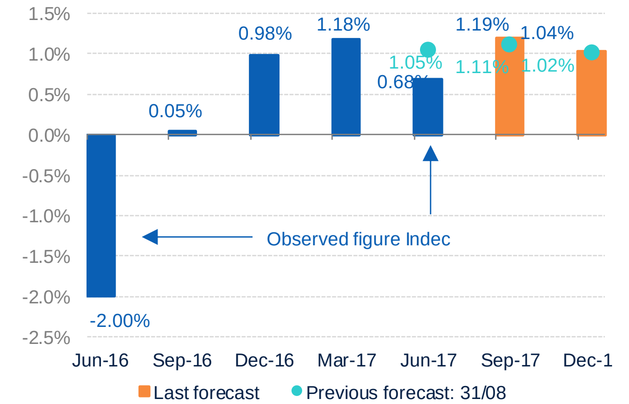
Positive political momentum for the government

According to the latest surveys regarding the legislative elections to be held on 22 October, driven by the buoyant economy, the results for the government will show an improvement over the primary elections held in August, which if confirmed would consolidate the government's positive political momentum, and would dispel doubts about the continuity and the depth of the current government's reform agenda. This is crucial for the economic scenario in coming years, especially in stimulating both local and foreign investment, and the consumption of durable consumer goods, which could be significantly boosted if the planning horizon of more stable macroeconomics and market friendly policies is extended for a prolonged period. These results would introduce a positive bias for the macroeconomic scenario which we are presenting in this outlook report, which has relatively conservative assumptions regarding the potential political capital that the government could obtain in the October 22nd parliamentary elections.

By the end of 2017 the economy will be growing by 4% YoY

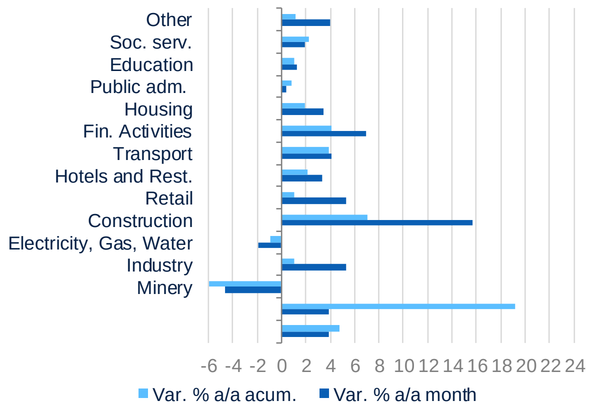
It was confirmed that GDP increased 0.7% QoQ seasonally adjusted in 2Q17 (Figure 3.1), growing for the fourth consecutive quarter, although the rate for 2Q17 was lower than expected (BBVA Research (e): 1%). In turn, there was, generally speaking, growth across all sectors (Figure 3.2), coupled with the recovery in the industrial sector, which showed year-on-year growth in all branches except for Oil and Gas, which was hit by the fall in international prices. Furthermore, from August on both consumer confidence and confidence in the government improved (Figure 3.3), while growth in lending also paced up considerably, strongly driven—albeit from very low levels—by mortgage lending. This suggests, as do our nowcasting models, that growth will continue at a slightly higher rate than was expected in the second half of the year.

Figure 3.1 Forecasts GDP MICA model (chg. % QoQ)



Source: BBVA Research based on INDEC data

Figure 3.2 EMAE: growth by sectors to July 2017 (%)



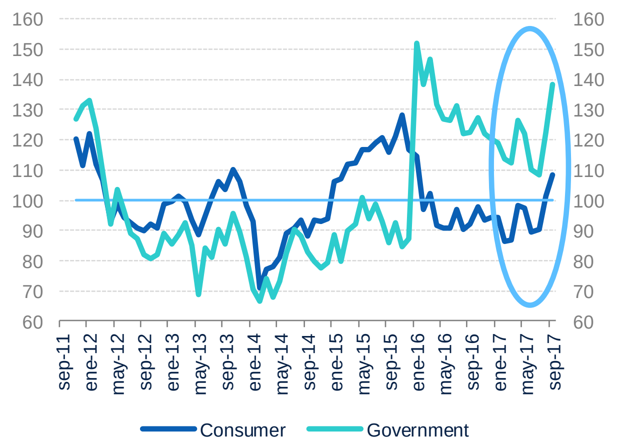
Source: BBVA Research based on INDEC data

This could put an upward bias on our forecast of 3% growth for 2018, but according to the budget, 50% of investment in infrastructure will be funded by PPP, making dynamic investment less certain, while monetary policy could maintain the contractionary bias for a longer time. However, the economy would be able to grow more buoyantly if the October elections confirm the perception that there is little risk of a return to more populist economic policies in 2019, and as growth in private investment gains traction. Hence, as we consider the risk balance is still balanced, we prefer to maintain our former estimates for the time being, which are in general without changes both for 2017 and for the following years.

Slight upward bias in 2018 growth, if private investment takes off after the elections.

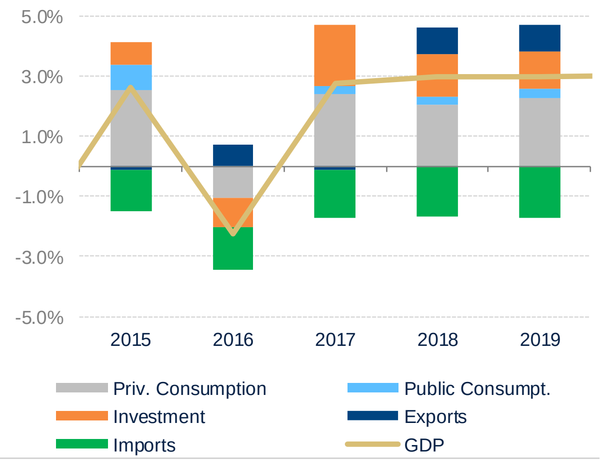
In 2018, growth in investment will strongly outpace the other components of aggregated demand (Figure 3.4). However, compared to our estimates last quarter, private consumption will be much more buoyant due to the improved confidence and growth in lending, while, given the higher imports, the negative contribution by the external sector will be higher than that formerly estimated.

Figure 3.3 Confidence in government and consumer confidence (Base: average 100)



Source: UTDT and BBVA Research

Figure 3.4 GDP: contribution to growth (%)



Source: BBVA Research based on INDEC data

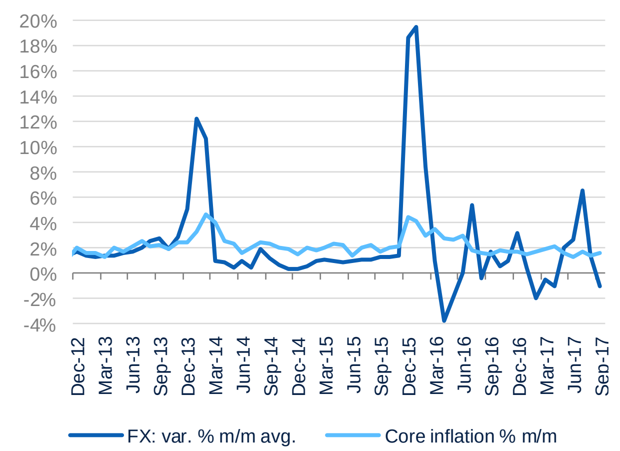
4. Upward revision of inflation forecasts due to high inertia and impact of regulated prices

Core inflation is steadily slowing and has decoupled from the exchange rate

In 3Q17, headline domestic inflation had an average of 1.7% per month and core inflation was 1.6%, slightly dropping from the averages registered in the first half of 2017 of 1.9% (general) and 1.7% (core). It is encouraging to see that the volatility in the exchange rate, and the increase in its level, before August's PASO elections, did not lead to a perceptible increase in inflation, indeed core inflation continued to fall, showing that the exchange rate is still decoupled from prices, as it has been since the end of 2015 (Figure 4.1). We agree with analysts' consensus and expect it to continue falling steadily over the next few months until it reaches 1.2% MoM in December and 1% within 12 months.

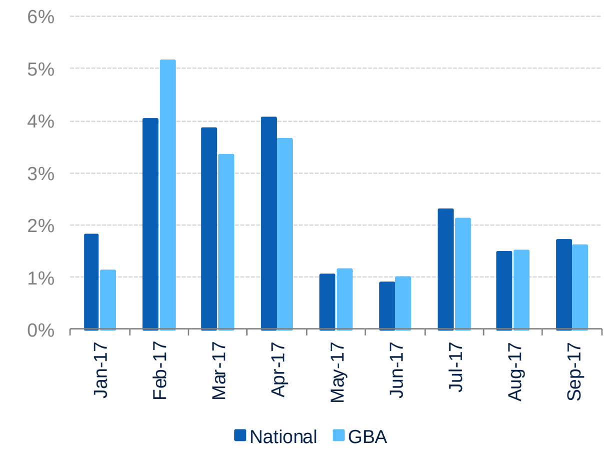
However, we have revised our forecasts upwards to 22.2% YoY for 2017 and 15.6% for 2018, as the weight of the increases in regulated prices in National CPI in relation to GBA CPI was higher than estimated (10% higher in the aggregate figure at September 2017). With a similar trend in core inflation and without significant changes in the outlook for higher utility rates, we estimate that regulated prices will have an impact of 3.8 pp next year, which accounts for the higher expected inflation. This implies that we do not expect the Central Bank of Argentina to reach its ambitious targets in coming years, though there should be a downturn in inflation which will possibly bring the targets within reach, although with a 5-month lag.

Figure 4.1 Depreciation of the Nominal Exchange Rate (% MoM average) and of core inflation (% MoM)



Source: BBVA Research based on INDEC and Central Bank of Argentina data

Figure 4.2 Inflation Increase in regulated prices by month of Domestic CPI and GBA CPI in 2017



Source: BBVA Research based on INDEC data

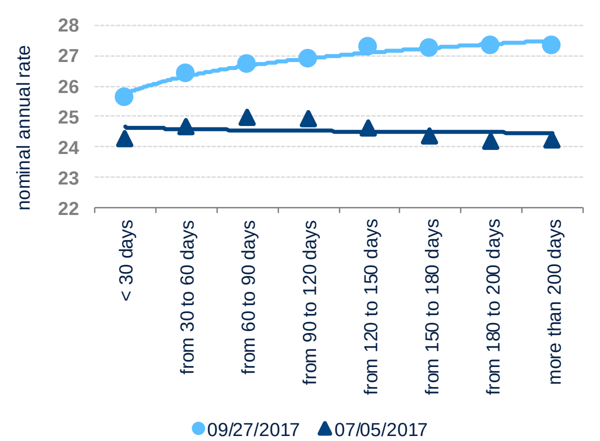
5. Still far from target, the Central Bank of Argentina will maintain its contractionary bias

Inflation and expectations have not been reduced to levels consistent with the Central Bank's target range

Monetary policy deepened its contractionary bias in the third quarter, as not only did the Central Bank of Argentina keep its monetary policy rate (TPM) unchanged since April (see Figure 5.2), but it also intervened in the LEBAC secondary markets and increased the longer-term rates (see Figure 5.1). In principle, this does not appear to be consistent with the target of anchoring inflationary expectations downward, but the Central Bank's strategy is aimed at making the longer-term Lebacs more attractive and bringing down the high volume of short-term maturities. Indeed, the monetary policy rate decision and the primary Lebac auctions were eclipsed in terms of importance by the daily Lebac buy and sell transactions in the secondary market. Because of the absorption in the secondary market, the Monetary Base has only grown 5% over the year so far, neutralising the issue of pesos originated in treasury funding and acquisition of FX from bond placements abroad.

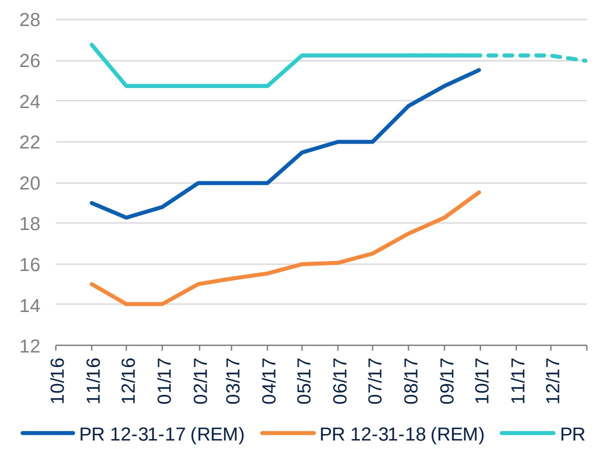
Although the policy rates in real terms are at their highest levels since the government took office, the Central Bank is not expected to make changes to the monetary policy rate until the end of this year when there should be the first actual evidence that inflation is moving towards the expected values. Thus, we expect the monetary policy rate to reach 26% at the end of 2017, and to fall by only 600 bp in 2018. The Central Bank will maintain its focus on strengthening its reputation, and will insist that it will use all the instruments at its disposal to bring inflation to converge at the target range. In turn, the obvious recovery in activity is helping to temper criticisms about the negative impact of high interest rates on the economy and electoral preferences, giving the monetary authority more leeway to maintain its tight bias.

Figure 5.1 Lebac yield curves (%)



Source: BBVA Research based on BCRA data

Figure 5.2 Monetary Policy Rate vs. REM estimates (%)



Source: BBVA Research based on BCRA data

6. Without surprises in the budget proposal, the key fiscal debate will be between the Nation and the Provinces

2017 targets will be met, the focus is on the trend in the next few years

The aggregate primary result up to July suggests that 2017 targets will be comfortably met and that the primary deficit would be lower than 4.2% of estimated GDP. However, the total deficit will amount to 6.1% of GDP (higher than our former estimate of 5.9%), as the burden of debt interests is increasing at a higher than expected rate due to increased public borrowing seen since the opening of the markets the previous year and the Central Bank's reduction in funding to the Treasury.

The budget project for 2018 presented to Congress proposes a realistic macroeconomic scenario though it is slightly more optimistic than our own (see Table 6.1). The deficit reduction is based on adjusting primary spending mainly focused on energy and transport subsidies. There are no significant modifications in the indicators of fiscal proceeds in relation to GDP, from which it can be construed that the budget has been prepared without taking into account changes which will later be introduced in the tax reform to be announced after the October elections. The changes will have to be negotiated with the opposition, and it is very unlikely that there will be space for a far-reaching tax reform in the short term. In any event, the budget projection for future years may be taking for granted that any easing in tax pressure, which is currently at maximum levels, as a result of the reform would be offset with an improvement in tax collection efficiency and less tax evasion.

In coming years, the Budget Act is a statement of the Government's intent to continue to gradually bring down the deficit towards a primary surplus of 0.5% of GDP in 2024, which is quite a challenge in light of political restrictions and the current rigidity in public spending. The reduced need to finance the deficit will in turn tend to stabilise public debt indicators.

In addition to the Budget, the Congress was also sent the Fiscal Responsibility Act, aimed at improving the fiscal solvency of the provinces largely through guidelines for controlling the rise in provincial public spending. This project has already been approved by almost all the provincial administrations (22/24) and is the first step in the important forthcoming debate between the Nation and the Provinces. The Government wants to ease tax pressure on the private sector and bring down the weight of distortionary taxes such as the provincial tax on gross income. However, there is little leeway to bring down provincial taxes taking into account the possible losses in co-participation revenue from the pending judgement about the higher allocation of funds to Buenos Aires province and the virtual freezing of Social Security funds to offset the imbalances of the provincial retirement savings banks. This is taking place against a background in which the federal government needs the support of provincial governors in the Senate to approve key laws.

Table 6.1 Estimates Draft Budget Act

	2017	2018	2019	2020	2021
FX rate (average, ARS/USD)	16.7	19.3	20.4	21.2	21.9
CPI (average change y/y)	24.5	15.7	7.7	6.2	6.2
Exports (USD billion)	58.8	62.0	65.6	69.3	73.3
Imports (USD billion)	63.3	67.6	71.6	76.2	80.9
Trade balance (USD billion)	-4.5	-5.6	-6.0	-6.9	-7.6
Real GDP (% change y/y)	3.0	3.5	3.5	3.5	3.5
Private Consumption (% change y/y))	3.3	3.3	2.6	3.1	3.0
Public Consumption (% change y/y))	3.8	1.3	0.0	0.0	1.3
Investment (% change y/y))	10.1	12.0	10.1	8.4	7.4
Target fiscal primary result (% GDP)	-4.2	-3.2	-2.2	-1.2	-0.2
Target fiscal total result (% GDP)	-6.0	-5.2	-4.4	-3.3	-2.1

Source: BBVA Research with data from the Ministry of Finance

Table 6.2 Financial needs according to the Budget (% of GDP)

	% GDP	USD billion
SOURCES	**17,8%**	**114,0**
Indebtness	**17,6%**	**113,0**
CB advances	**4,6%**	**29,6**
Int. Organisms	**0,8%**	**4,9**
Treasury bonds	**8,2%**	**52,3**
Intra-public sector debt	**4,1%**	**26,2**
Others	**0,2%**	**1,0**
FINANCIAL NEEDS	**17,8%**	**114,0**
Debt payments	**10,4%**	**66,5**
CB advances	**3,5%**	**22,3**
Int. Organisms	**0,6%**	**3,6**
Treasury bonds	**5,2%**	**33,5**
Treasury bills	**3,5%**	**22,5**
Other	**1,7%**	**11,0**
Intra-public sector debt	**1,1%**	**7,1**
Financial investment	**1,9%**	**12,2**
Fiscal Deficit	**5,5%**	**35,2**

Source: BBVA Research and Ministry of Finance

Looking ahead to next year's financial needs, the government plans to refinance all the debt which is maturing that year and also issue new debt to cover the fiscal deficit. Based on the budget information, our estimates are that total net financial needs would amount to 5.3% of GDP and would be financed with transitory advances from the Central Bank (1.1%), disbursements from international bodies (0.2% of GDP), issue of public debt (2.9% of GDP) and new intra public sector funding (1.1% of GDP) (see Table 6.2). With these assumptions, the net issue of debt securities on the market would amount to USD 18.7 billion, although the total issue of debt securities could be in excess of USD 50 billion, taking into account the public debt amortised in 2018, a considerable part of which are short-term bills in dollars. Notwithstanding the above, and the above figure, there will not be so much pressure on the market to issue debt because part of the maturities are debt in public body portfolios.

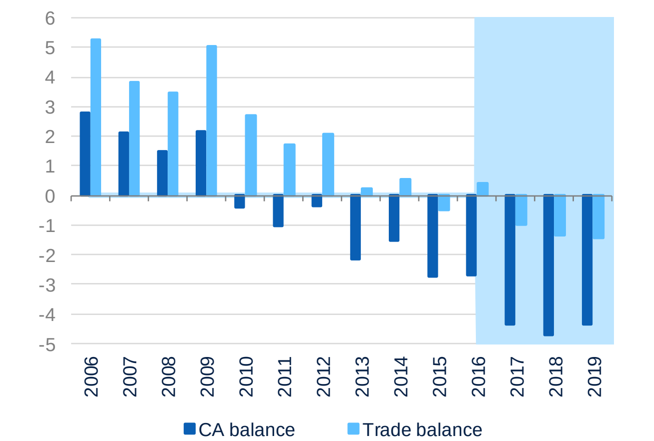
7. The external deficit will continue to widen without becoming unsustainable

The trade deficit continued to burgeon in 2017, with a balance of -USD1,443 million in the first eight months of the year, a trend that will become more pronounced in 2018 up to deficit of USD8,800 million against a background of higher economic growth and slight fall in the terms of trade (Figure 7.1). In turn, the higher deficit in real services, due to the impact on tourism of the real appreciation of the peso, and in net interest burden, due to the rise in external debt, will keep the current account deficit above 4% until 2020.

Against the current global backdrop of low interest rates and low aversion to risk, Argentina should not face serious problems in financing this imbalance with external savings. The weight of external debt on GDP will increase from the low current level of 35% to 37% at the end of 2018, without showing an explosive trend, provided foreign direct investment (FDI) grows to similar levels as in other countries in the region. Meanwhile, reforms have to be made to make exports more competitive (reducing logistics and tax costs and improving labour productivity) in order to be able to sustain higher imports of capital goods to ensure sustained growth in investment.

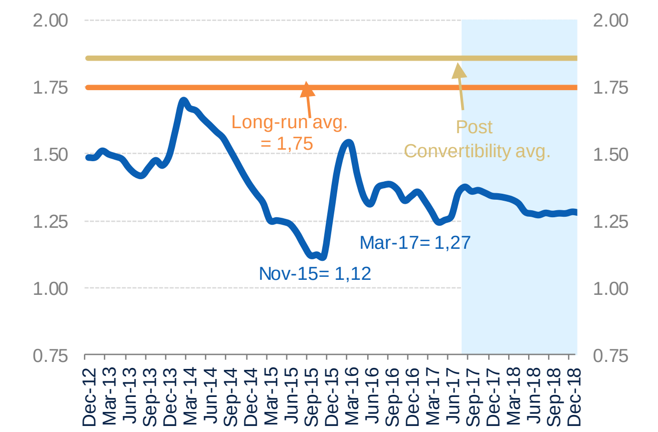
Capital inflows to Argentina, until now concentrated in short-term financial investments, will allow a sustained increase in reserves despite the fall in trade flows. Against this backdrop, and not counting volatility spikes associated with the electoral cycle or external shocks, this inflow of hard currency will continue to put pressure on the real appreciation of the peso (Figure 7.2).

Figure 7.1 Trade balance and current account (% of GDP)



Source: INDEC and BBVA Research

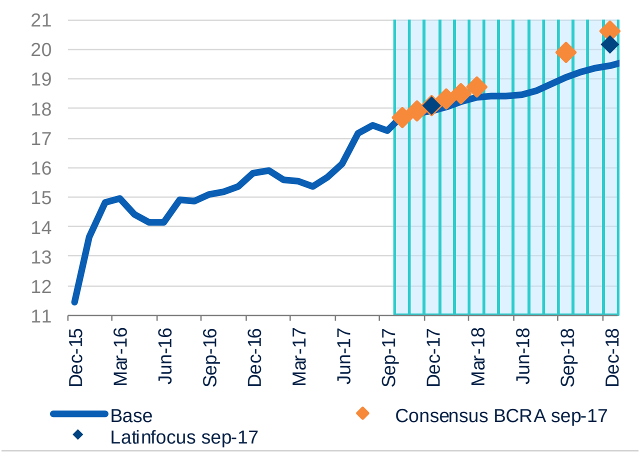
Figure 7.2 Real multilateral exchange rate (2001: 12=1)



Source: Indec, Central Bank of Argentina, Haver and BBVA Research

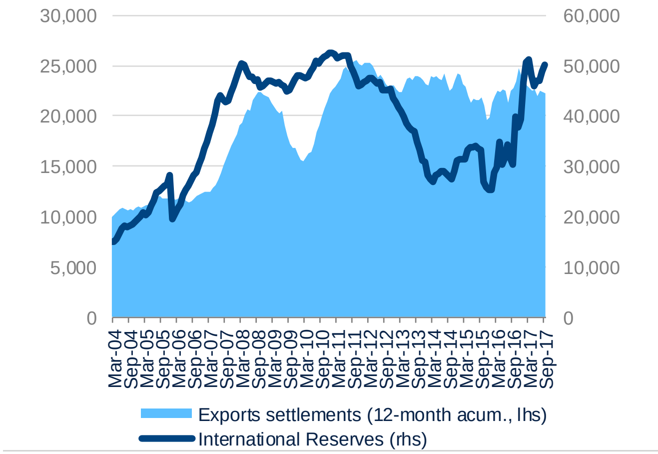
This real appreciation, will eventually reduce net inflows into Argentina, putting upside pressure on the nominal exchange rate which will partially offset it. We have made a slight upward revision of our depreciation forecasts for 2017 and 2018, but have kept them below expected inflation throughout the forecast horizon, and below analysts' consensus (Figure 7.3). The Central Bank has shown that it does not have a specific exchange rate target, but rather that (1) it has sought to build up reserves to make its balance sheet more solid and increase the capacity to react to internal and external shocks, and (2) it only intervenes on occasions when the exchange rate is either below or above certain thresholds which are considered to be dangerous for its target of cutting inflation or for financial stability. Furthermore, the dollar's weakness at global level will help to moderate Argentina's appreciation against its major trade partners, as shown in the evolution in the multilateral real exchange rate index.

Figure 7.3 Peso/dollar exchange rate: Research and consensus forecasts (ARS/USD)



Source: BCRA, Latinfocus and BBVA Research

Figure 7.4 Central Bank of Argentina international reserves and settlements of the agro-exporter complex (UDS MN)



Source: BBVA Research based on INDEC and Central Bank data

8. Cycle of deeper structural reforms will begin but will not be exempt from political risks

After the elections, the government is intending to discuss the budget and the distribution of funds with the provinces, with the aim of limiting the growth in provincial and national primary spending. The prospect of a substantial reduction in the high fiscal pressure on the private sector hinges largely on being able to find alternative sources of stable income not only for the federal government but also for the provinces, in order to be able to do away with the more distortionary taxes. This implies discussing a matter which has been already been postponed on many occasions; the reform of the federal tax co-participation, both primary and secondary. Although the government is likely to emerge from the October elections in a stronger position, it will not be easy to gain the approval of 24 provinces, especially when it requires funds to be reassigned in favour of other jurisdictions. So progress is likely to be slow, and targets will not be too ambitious.

Great political adroitness will also be required to make the Argentinian economy more competitive, as it implies addressing the problems of labour productivity and Argentina's role in an international framework. Although the possibility of a Brazilian-style integral labour reform has been ruled out, the sector agreements with which the government aims to progress will also entail negotiations with unions and companies, where each sector will have to be willing to adopt a more flexible stance. Greater openness of the Argentinian economy through signing bilateral and multilateral trade agreements will give it the advantage of greater scale for domestic production but it will also have to consider the impact on less competitive sectors, which could lose out.

Despite these difficulties, the greater political capital of the Cambiemos administration after the primary elections, which is very likely to be increased after the final parliamentary elections of 22 October, and the potential broadening of the horizon for implementing reforms from a second term of office, means that Argentina has an opportunity to resolve long-standing problems which have historically prevented it from reaching sustained growth closer to its potential, and even to increase its relatively muted potential growth rate—around 2.8% per annum—due to the mixture of structural problems and political errors which have affected Argentina in recent years.

9. Tables

Table 9.1 Annual macroeconomic forecasts

	2015	2016	2017e	2018e
GDP INDEC Base 2004 (% YoY)	2.6	-2.2	2.8	3.0
Inflation Domestic CPI (% YoY, eop)	26.9	39.4	22.2	15.6
Exchange rate (vs. USD, eop)	11.4	15.8	18.0	19.5
Policy interest rate (%, eop)	33.0	24.8	26.0	20.0
Private Consumption (% YoY)	3.5	-1.4	3.3	2.8
Public Consumption (% YoY)	6.8	0.3	2	2
Investment (% YoY)	3.8	-5.1	10.5	7.0
Tax Revenue (% GDP)	-5.2	-5.9	-6.1	-5.5
Current Account (% GDP)	-2.7	-2.8	-4.3	-4.6

Source: BBVA Research

Table 9.2 Quarterly Macroeconomic Forecasts

	INDEC GDP (% YoY)	Domestic Inflation (% YoY, eop)	Exchange rate (per USD eop)	Policy interest rate (%, eop)
Q1 16	0.6	35.0	15.0	38.0
Q2 16	-3.7	45.7	14.1	30.8
Q3 16	-3.7	42.7	15.1	26.8
Q4 16	-1.9	39.4	15.8	24.8
Q1 17	0.4	32.2	15.5	24.8
Q2 17	2.7	21.8	16.1	26.3
Q3 17	3.8	23.7	17.2	26.3
Q4 17	4.2	22.2	18.0	26.0
Q1 18	3.1	20.0	18.4	24.0
Q2 18	3.6	18.9	18.5	23.0
Q3 18	3.1	16.4	19.1	21.0
Q4 18	2.0	15.6	19.5	20.0

Source: BBVA Research

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