BBVA | Research

Argentina Economic Outlook

1st QUARTER 2018 | ARGENTINA UNIT

Contents

Closing date**: 2 February 2018**

1. Summary

The better-than-expected results for the government in the October 2017 parliamentary elections dispelled doubts about the continuity of economic policy changes after 2019, stimulating more spirited investment in Argentina. The increased political capital allowed the government to announce a raft of prompt structural reforms, many already approved by Congress. At the same time optimism has swelled over the recovery of the world economy, and an upward revision of approaching 0.5pp for growth for Brazil and one of 1pp from 2019 for China point to a substantial improvement in external demand. Given this context, and also bearing in mind that the latest figures confirm that Argentina's economy is still growing at around 0.9% QoQ, **we now estimate a 3.3% rise in GDP in 2018 and 2019, which is a shade higher than was previously being forecast**.

2017 inflation closed at 24.8% YoY, which was well above initial expectations, owing to a bigger-than-expected impact from the correction of regulated prices and greater core inflation inertia. Faced with this fact and given the failure of analyst expectations to converge towards the target of 10% (+/-2%) for 2018, the Executive announced that it is postponing its goal of achieving 5% inflation by one year (to 2020). The target for 2018 will be 15%, with 10% (previously 5% +/-1.5%) for 2019. The prospect of an easing of monetary policy after modification of the targets, which the central bank corroborated by lowering the MPR by 150bp in January, prompted an upward revision of analyst expectations and a rapid depreciation in the exchange rate. **After taking account of the potential impact of a de-anchoring of expectations regarding wage bargaining and signs of a more dovish central bank, we are changing our forecast rise for the CPI to 18.5% for 2018 and 12.2% for 2019. We predict that the central bank will continue to pare down the monetary policy rate very gradually,** especially in the first four months of 2018, since the inflation figures will give no cause for optimism, until arriving at 21% by year end. The MPR will in any event stand at around 8% at the end of 2018 in real terms, which is still firmly positive.

The fiscal pact with the Provinces and the tax reform passed in December 2017 imply a sharp redistribution of tax revenues, yet since this involves only a very gradual tax reduction of 1.5% of GDP in five years, it will not produce any substantial diminishing of public revenue. The Fiscal Responsibility Act will enable a gradual reduction of distorting taxes such as that on gross income without any deterioration to provincial finances. The 2017 primary fiscal deficit was 3.9% of GDP and, since this was below target, it meant that 2018 expenditure could be brought forward. It we add into the mix the reduction of energy and transport subsidies and the saving from the adjustment to the formula for calculating pension benefits, **the public sector is highly likely to manage to achieve the deficit target of 3.2% for 2018 with some degree of comfort.**

More vigorous domestic demand, together with the real appreciation of the Argentine peso contributed to a sharp rise in imports in 2017 without any clear signs of recovery for exports yet. We forecast that, with the economy growing at close to its potential rate of 3%, imports will continue to rise at a sustained clip, but that the reforms to boost productivity and a restoration of growth for Argentina's trading partners will lead to increased export buoyancy and a stabilisation of the trade deficit at around 1.5% of GDP. **Given the slow fiscal adjustment and that companies will continue to finance their expansion plans abroad, the current account deficit will remain high in the next few years up to 2020, averaging close on 5% of GDP.** Financing for this deficit will continue to flow, with the surplus supply of dollars remaining in place beyond occasional bouts of volatility, thereby giving rise to peso depreciation below the inflation rate, while, monetary policy, though looser, will buoy interest rates above expected inflation, underpinning the appeal of investments in pesos for non-residents.

This pattern underlines Argentina's vulnerability to any change in international conditions, and so it is crucial for the reforms that Macri's Government is pushing through to start bearing fruit in terms of improving productivity so that the financing of the current account is mostly channelled via foreign direct investment rather than through portfolio investments that are subject to sudden stops. There are likely to be major political limitations on forging ahead more swiftly with an agenda of supply-side reforms, but the government remains oriented toward its goal of bringing Argentina back onto the world stage to expand the size of the market and generate economies of scale

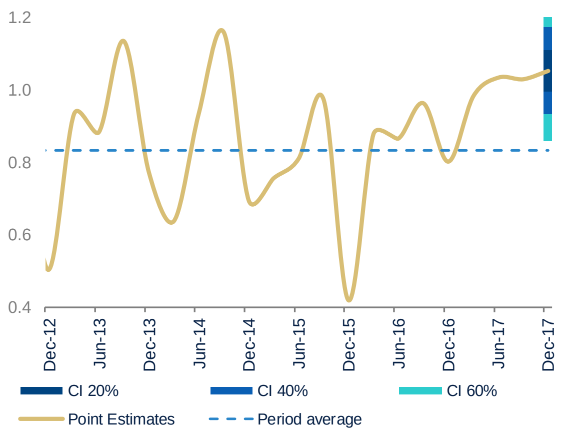
2. Global growth confirmed

World economic growth consolidated at around 1% QoQ (Figure 2.1) in late 2017, reflecting improved results in all major areas and prospects of continuing in good health over the coming quarters. The support of economic policy, especially in the developed economies, has at last had a clear impact on the real economy, with recovery in investment gaining traction, underpinned by increased demand and an upturn in world trade, which in turn continues to drive the recovery of the manufacturing sector. Meanwhile, private consumption continues to perform well in the advanced economies, while gaining momentum in emerging economies. Prospects and confidence in many emerging economies have also been favoured by the increase in commodity prices, as well as by the relative calm in financial markets. In respect of those, an absence of adverse global shocks has meant that fundamentals have sustained risk-taking by investors (Figure 2.2) who continue to prompt capital inflows into the emerging economies, although there has been a certain gradual let-up to this in recent months. World growth could have picked up by 0.4pp to around 3.7% in 2017, i.e. 0.2 pp more than was being predicted three months ago.

Over the past three months, there have been more reasons to remain optimistic in all of the key areas. In the United States the recovery has been taking hold over the year, with slightly higher-than-expected growth rates and improvements in the labour market. Tax reforms were finally passed, which may slow cyclical recovery. Nevertheless, they will not have a very significant impact in the long-term. Meanwhile, recent Federal Reserve appointments point to an unchanged monetary policy, which should be reflected in a very gradual approach to normalisation. In China, the measures passed by the authorities have managed to stabilise the economy, while some structural reforms have been implemented and an economic strategy has been approved that focuses more on getting fiscal imbalances under control and less on meeting growth targets. Finally, the Eurozone recorded higher-than-expected activity growth in 2017, supported by an improved global climate and stronger internal demand which is benefiting from the easing political uncertainty.

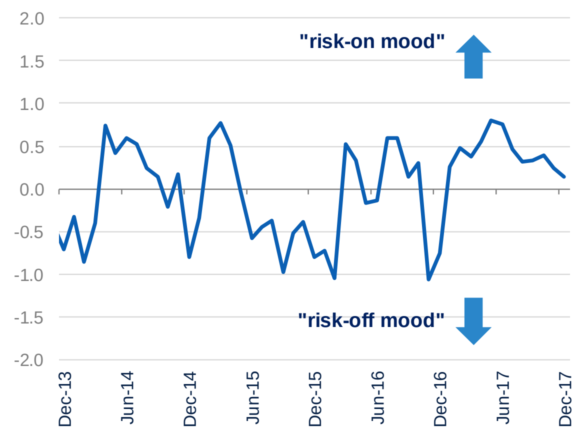
This scenario of increased growth and higher demand has been accompanied so far by subdued inflation, despite the expansionary measures adopted by the major central banks and the gradual reduction in idle capacity in the developed economies. In any case, the increased growth and higher oil prices should push inflation up in the short term, facilitating advances in the normalisation of central bank policy in the developed economies, while many emerging economies still have room for manoeuvre when it comes to using monetary policy to bolster growth.

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



Source: BBVA Research

Figure 2.2 Risk appetite indicator
(global factor using EPFR flows)



Source: BBVA Research based on EPFR

Global risks are abating compared to three months ago, although they are still substantial, especially those of a political hue

Our forecasts point to global growth slightly accelerating in 2018-19 (by around 0.1 p.p.) to 3.8%, meaning an upward revision of 0.3 p.p. with respect to the scenario advanced three months ago. This change has come in response to higher growth forecasts now for the United States, China and the Eurozone in 2018, mainly due to improved economic activity in recent quarters, though also to the economic measures implemented in the first two areas. Specifically, we expect the United States to grow 2.6% in 2018 (0.4pp more than three months ago) and 2.5% in 2019, driven by the effects of tax reform and improved external and domestic fundamentals. For China we predict a more sedate slowdown (thanks to the better international climate and economic policy strategy in the wake of the 19th Communist Party Congress), with growth of 6.3% in 2018 and 6% in 2019, compared to 6.7% in 2017. On the other hand, in the Eurozone we are revising growth upwards by 0.4 p.p. in 2018 to 2.2%, which should be followed up by 1.8% in 2019, shored up by the strength of internal demand and a positive contribution from net exports. Finally, in Latin American economies, we now expect to see a somewhat stronger recovery this year, due to the upward revision for global demand and higher commodity prices. Despite the envisaged stability of world growth, we still expect a certain tempering of growth in developed economies in 2019, while the recovery will continue to consolidate in most emerging economies.

The risks to this relatively benign world panorama continue to exist, although they have declined since three months ago. Prominent above all are risks of a political and geopolitical nature, which may influence both business confidence and the behaviour of the financial markets.

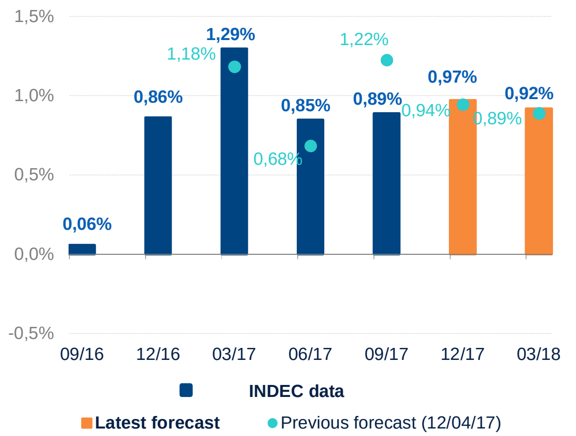
3. Argentina: in the wake of the elections, growth has picked up and the reform programme is making headway

In the parliamentary elections of October 2017 government supporters managed to obtain almost 42% of votes nationally, while they also won first place for senator of the crucial Buenos Aires province, leaving former president Cristina Fernández de Kirchner in second place, who will represent the leading minority group. This electoral victory surpassed prior expectations and leaves president Mauricio Macri well-placed to win a second term from 2019. *Cambiemos* grew in numbers in both the Senate – adding nine more senators – and in the Chamber of Deputies (an extra 21 members), although it fell short of obtaining a majority in either of them. As we anticipated, the greater political capital allowed it to announce a raft of prompt structural reforms, some even already put through Congress and approved, although full approval of the package of laws has required, and will likewise call for, consensus to be reached with the opposition, as well as no small measure of political astuteness.

Confidence, both in the government's management and on the part of consumers, showed a marked upturn from June which, together with the pick-up in credit, accounts for an improvement in the economy's activity levels, as it grew by 0.9% QoQ in 3Q17. In YoY terms GDP grew by 4.2%, while investment (spearheaded by construction) surged ahead by 13.9% YoY in the period, which led to strong growth in imports (+18.7% YoY) and the negative contribution by the external sector, hiving 4.8% off growth in the quarter.

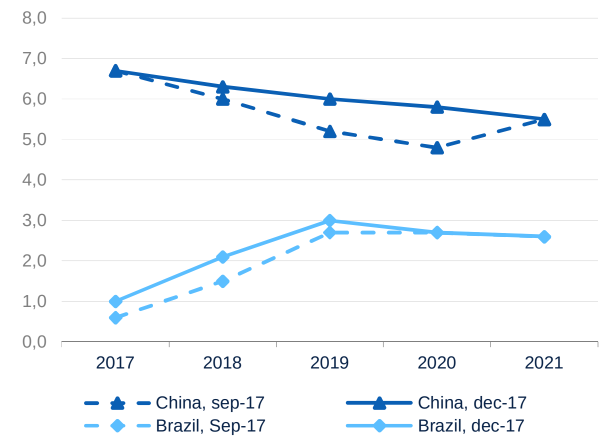
Our MICA nowcasting model estimates that the economy will continue growing at rates of over 0.9% QoQ in the quarters to come (see Figure 3.1), as supported by the partial figures from the Monthly Economic Activity Estimator (EMAE). In this context, our estimate of GDP growth of 2.8% for 2017 is ticking upward, given how it implies growth of only 0.6% QoQ (3.7% YoY) in 4Q17. For 2018 and 2019, we have revised our growth forecasts slightly upwards to 3.3% based on both domestic and international factors. The better-than-expected election results for the government serve to allay doubt over the continuity of changes after 2019 and spur investment, while an upward revision of close to 0.5pp for growth in Brazil and of 1pp from 2019 in China (Figure 3.2) suggests an improvement in demand from abroad. Fiscal policy will continue to target a gradual narrowing of the deficit, which will help to sustain access to international financing at falling rates, without prompting any sharp drop in economic activity.

Figure 3.1 MICA model GDP forecasts (% var. YoY)



Source: BBVA Research based on INDEC, FIEL and Contruya data

Figure 3.2 Revised growth in Brazil and China



Source: BBVA Research

The negative contribution from the external sector will diminish thanks to export recovery in 2018-19

As in 2017, investment will be the economy's most dynamic factor in 2018 and 2019, growing by 11.4% and 6.6% YoY respectively, both due to the road infrastructure programme underway and to higher private investment flows, which will become a reality to the extent that the horizon for the foreseeability of market-friendly policies has been pushed further out and that the reforms in progress lead to productivity improvements. Private consumption is also expected to continue growing at a rate on a par with GDP thanks to a gradual increase in employment, real wages and credit. Thanks to an improved export growth rate, on account of both increased supply and greater demand, the negative contribution from the external sector will fall in both 2018 and 2019 despite the fact that imports will continue to rise at a high rate.

4. Difficult process of disinflation in a context of rising tariffs and a high level of inertia

Despite the highly contractive tendency of monetary policy in 2H17, neither inflation nor expectations converged towards targets and this led to a “recalibration”.

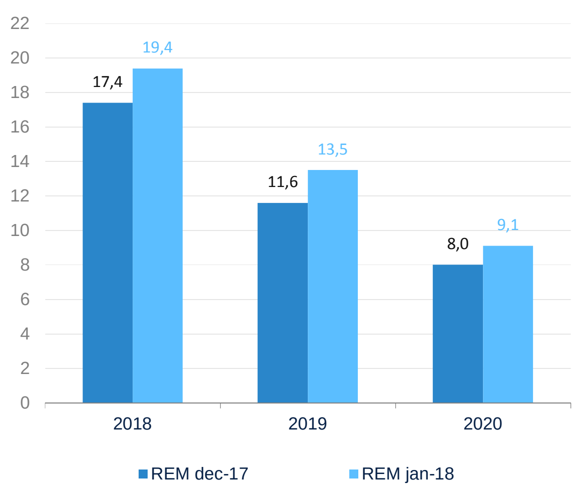
Inflation for 2017 closed at 24.8% YoY, well above our initial predicted levels (we were expecting 19.5% in December 2016) and market expectations (REM-BCRA Dec-16: 19.6%) due to a bigger-than-expected impact from correction for delayed price controls and greater inflation inertia than that initially expected. The fall of core inflation to a monthly average of 1.4% in 4Q17, the smallest moving average since 2012, was not enough for the forecasts in the central bank’s Market Expectations Survey (REM) to converge on lower levels by the end of the year, with the increases forecast for December having taken place for electricity, gas, fuel, pre-paid medicine rates and others besides. The deregulation of fuel prices – now fluctuating with the international crude oil price and the exchange rate – together with the accelerated scheduling for rises in electricity and natural gas rates, resulted in regulated prices rising 38.7% YoY in 2017 with an impact of 7 percentage points on inflation for the year, comfortably surpassing the rise in core inflation of 21.1% YoY.

The extremely contractive trend in monetary policy as reflected in the 250bp hike in the MPR in the last quarter of 2017 was also unsuccessful in making analysts’ expectations converge, as by the end of 2017 these had risen again to 17.4% for December 2018, in contrast to the central bank’s target of 10% +/-2%. Finally, at the end of December the government announced a “recalibration” of inflation targets.

In a joint press conference by the Chief of the Cabinet of Ministers, the Minister of the Treasury, the Minister of Finance and the chairman of the central bank, Minister Dujovne announced that it had been decided to change the inflation targets originally announced in January 2016 on the basis of information now available and taking into account the current fiscal and financial agenda. The goal of reaching inflation of 5% YoY was thus postponed by one year, and precise targets have been adopted instead of ranges. The specific inflation target for 2018 is now 15% (previously 10% +/-2%), that for 2019 10% (formerly 5% +/- 1.5%), and that for 2020 is 5%. The presentation made it clear that the inflation target is decided by the Executive and that the central bank’s autonomy is on an operational basis of how to achieve such targets, which clears up the criticism that centred on the central bank’s targets being overly rigid and “lacking in coordination” with the rest of the economic programme.

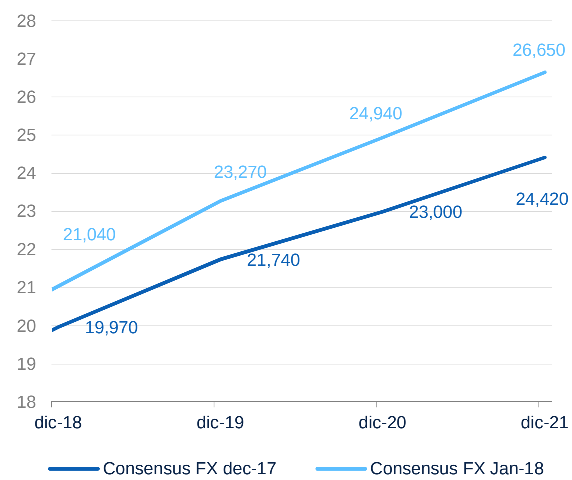
It is still too early to gauge the impact of this change on the central bank’s credibility, but the immediate effect was a rise in the inflation expectations of REM analysts to a median level of 19.4% (Figure 4.1). The prospect of a loosening of monetary policy after the change in targets, which the central bank validated with two successive cuts of 75bp in January 2018, also sparked a rapid exchange rate depreciation, which was as much as 10% in one month, and lifted expectations of peso depreciation (Figure 4.2).

Figure 4.1 Inflation expectations in the REM-BCRA (YoY var. in domestic CPI expected in December each year)



Source: BCRA and BBVA Research

Figure 4.2 Exchange rate expectations (expected ARS/USD rate for December each year)



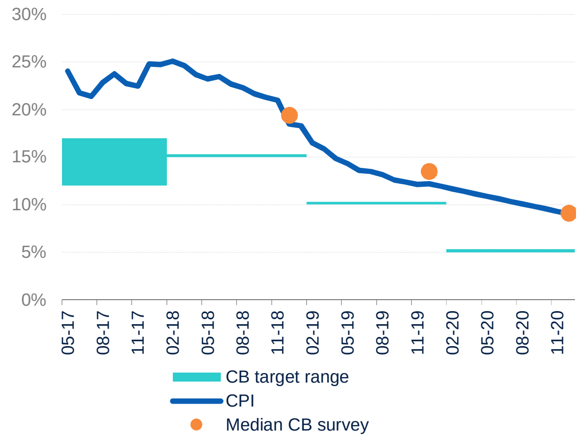
Source: Latinfocus and BBVA Research

The de-anchoring of expectations is prompting an upward revision of our inflation estimates

In 2018, the schedule for reducing energy and transport subsidies (concentrated in the first half) will have the effect of a rise in regulated prices in 2018 of 21.9% YoY, which is less than the increase in 2017, also with a smaller impact of 4 p.p. (Figure 4.4). The inflow of capital to finance the fiscal deficit and the gentle recovery of long term foreign investment will contribute to containing the peso's rate of depreciation over the rest of the year, although the *pass-through* effect of January's sudden rise in the exchange rate remains to be assessed. While in previous episodes once the "clamp" of currency controls had been removed, the "pass-through" to depreciation prices was low, such an effect could now increase given that no sudden reverse in the exchange rate is observable and the depreciation takes effect against more relaxed monetary policy. Although the recovery of agricultural commodity prices and the oil price could work against price containments, this is unlikely to have a big impact over the rest of the year as we think that the oil price will back-track relative to current levels, thereby avoiding any sharp adjustment in fuel prices, which have been deregulated and now move in line with the international price. Nonetheless, what should decide the contest are likely to be the wage agreements that will be bargained in 1Q18 and to what extent these come close to the central bank's target of 15% or market expectations. The few special bargaining committee negotiations agreed for 2018 show strong discrepancies and the government is now encouraging wage rise agreements of around 15% with a "wage review" clause in the final quarter in case inflation should surpass the rises provided for.

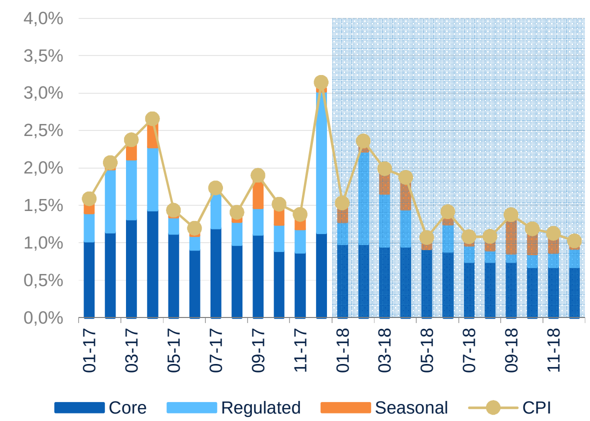
The waning credibility of the central bank makes it harder for wage agreements and expectations of 15% to meet each other, leading to inflation estimates rising to 19.4%, above the level of 17.4% before the change. Bearing in mind the rise in expectations, the higher level of depreciation and the signs of a more *dovish* central bank, we are changing our CPI rise forecast to 18.5% for 2018 and 12.2%% for 2019 (Figure 4.3). Whatever the case, both we and the market foresee a path of disinflation that will end in single-digit inflation in 2020, though not at the pace required by the recently re-defined inflation targets.

Figure 4.3 Inflation expectations, forecasts and BCRA targets



Source: BBVA Research based on INDEC and BRCA data

Figure 4.4 Inflation. Increase in regulated prices by month, Domestic CPI in 2017 and 2018



Source: BBVA Research based on INDEC data

5. The loosening of monetary policy will slowly feed through to financial system interest rates

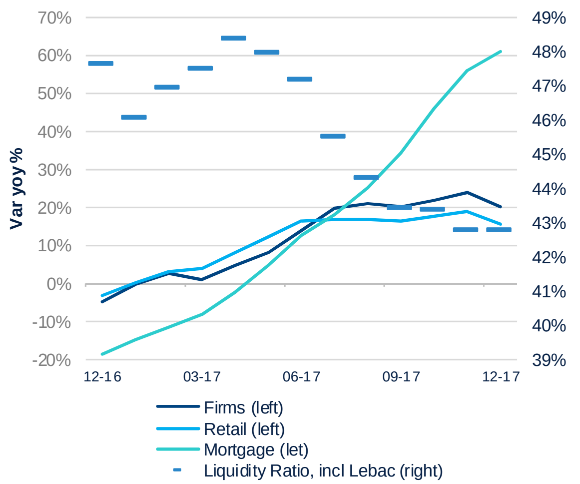
Thanks to powerful sterilisation via Lebacs, monetary base expansion closed 2017 with a change of around 21.8% YoY, below inflation. Private sector credit expanded at a rate of 50.2% YoY as of December 2017, while total deposits (pesos plus dollars) grew at rates considerably under 37.8% YoY, given the strong interest in Lebac investment. Even so, bearing in mind the liquidity that still prevails in the financial system, the feed-though of the central bank's 250bp intervention rate hike in the last quarter of 2017 to short term rates was slow and only showed through in a 200/250bp rise in lending and deposit rates towards early December (Figure 5.1).

The target postponement in the recently announced inflation reduction process allow the central bank chairman some margin to relax monetary policy somewhat, following the sharp rate hikes implemented in the last quarter of 2017 in an attempt to meet the previous targets. In fact, in the Lebac auction the day after the announcement, the cut-off yields were trimmed by 200-300bp depending on the term involved, and this fall was later borne out by a 75bp cut in the MPR in each of the monetary policy decisions in January. The central argument of the chairman of the central bank was that the real interest rates of around 10.8% at which 2017 had ended were excessively high compared to the new target and the progress achieved in reining in inflation, so it was appropriate to reduce the contractive bias to monetary policy on the side of "caution". Nonetheless, the rapid rise in inflation expectations after the change in targets implies that the real expected policy rate came down by 300bp in January 2018.

In this context we estimate that the central bank will continue to lower the policy rate very gradually, especially in the first four months of 2018, given that the inflation figures that will come out (inflation is expected to hold at close to 2% MoM) will not give cause for optimism, while inflation expectations have shifted significantly upwards. Bigger progress in bringing down core inflation in the second half will allow the central bank to increase the pace of bringing down the MPR until it reaches 21% by year end. In any event, if expectations converge towards our estimates for core inflation for early 2019, the real MPR will be 8% at the end of 2018, which is still strongly positive in real terms (Figure 5.2).

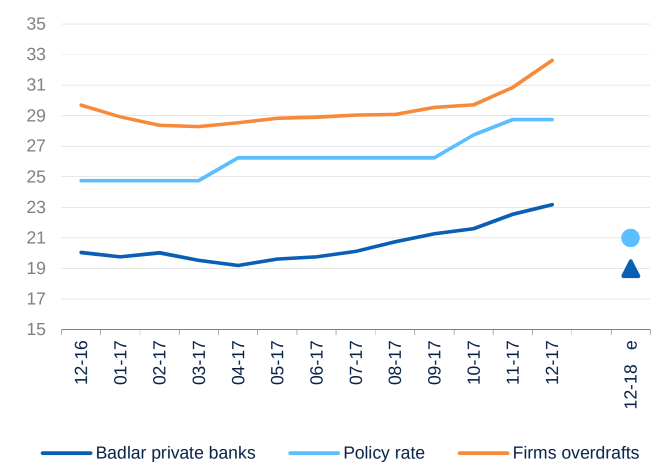
The lowering of the MPR slowly filtered through to short term loan rates and, to a lesser extent, the fixed-term deposit rate in January. As the banks continue to offload their Lebac holdings to allocate credit to the private sector, the process of adjustment of surplus liquidity that began in the second quarter of 2017 will continue to deepen and culminate in the course of 2018. Going forward, deposit rates are likely to fall at a slower pace than loan rates, reflecting less slack in the ratio of credit to deposits and greater leveraging in the system.

Figure 5.1 Growth of credit in real terms and liquidity ratio of the financial system (%)



Source: BBVA Research based on BCRA data

Figure 5.2 Monetary Policy Rate and bank lending and deposit rates (%)



Source: BBVA Research based on BCRA data

6. Over-achievement in 2017 and pension benefit reform will facilitate fiscal targets in 2018

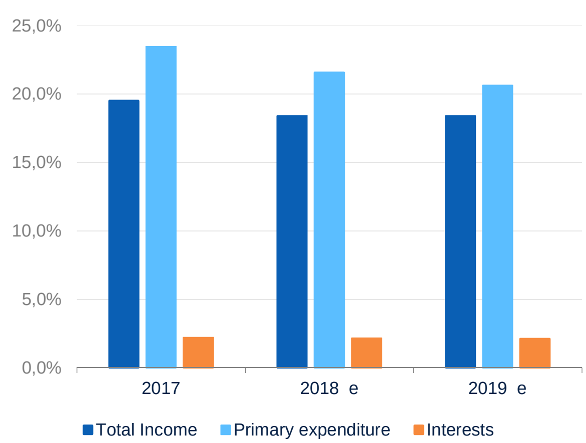
The cumulative primary fiscal deficit stood at 3.9% of GDP at December 2017, below the target for the primary balance of 4.2% of GDP anticipated for 2017 (Figure 6.1). Despite the seasonal rise in expenditure in December, and the bringing forward of 2018 outlays of ARS 25 bn and the reduction of floating debt, the balance was better than expected as, for the time since 2004, revenues (+22.6%) grew by more than expenditure (21.8%) and both did so below the year's average inflation level (25.7%). The smaller increase in tax revenues was due to a lower intake from regularisation under the tax amnesty compared to 2016 and the partial refund of 15% of the co-participation to provinces that had formerly been allocated to the National Social Security Administration. Although welfare payments (led by retirements) grew by 36.7% YoY in 2017, the contraction in subsidies to sectors of the economy (energy) of 22% and the falls in real terms of transfers to provinces and capital expenditure enabled a reduction of primary expenditure of 1.1% of GDP in 2017. Even so, the greater interest burden from the increase in borrowing meant that the overall deficit was 5.4% of GDP according to official estimates.

The fiscal pact with the provinces and the tax reform passed in December 2017 imply a sharp redistribution of tax revenues among the various different agents (social security and the provinces, among the provinces themselves, individuals vs. companies, etc.), yet since this involves only a very gradual tax reduction of 1.5% of GDP in five years, it will not produce any substantial diminishing of public revenue. The Fiscal Responsibility Act intended to enhance the fiscal solvency of the provinces (essentially via guidelines to control the expansion of provincial public expenditure) was also passed in Congress, which will allow a gradual reduction of distorting taxes such as Gross Income and Stamp in line with the aims of the tax reforms.

It we add into the mix the reduction of energy and transport subsidies scheduled for 2018, and the saving from the adjustment to the formula for calculating pension benefit mobility that was approved in December 2017, the public sector is highly likely to manage to achieve the deficit target of 3.2% for 2018 with some degree of comfort. The welfare benefit mobility system was set up in 2009 according to a formula which depended on two factors: variation in tax collection and wage rises, given that at that time no credible official inflation index existed. Although the variation in the mobility index (IM) depends on the economic cycle, from its inception up to the end of 2017 it had built up an increase that outstripped inflation, nominal GDP and wages in the registered private sector (Figure 6.2). IM-adjusted welfare benefits have topped 50% of primary expenditure to form the item that rose most to the detriment of other expenditure items. The reform of the index for making benefit adjustments has meant modifying the IM so that it moves in line with inflation, which will lead to a very sizeable saving that the government estimates to be some ARS 70 bn with respect to what was projected for 2018.

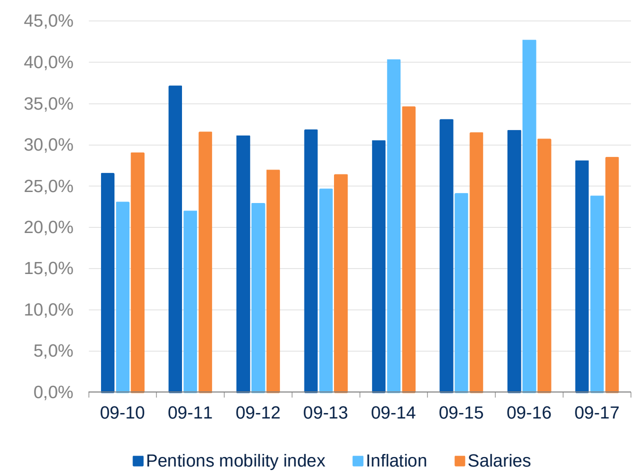
In 2019, a further reduction in primary expenditure is required of 1% of GDP to reach the target of 2.2% of GDP which is planned to be achieved via a final adjustment of energy rates and a freezing of certain items of current expenditure in real terms. In terms of medium term foreseeability, it was positive that in his presentation and when he announced the change in the inflation target, the Minister of the Treasury also presented the financial programme, with decreasing borrowing requirements for 2018 and 2019 and the schedule of a drop in central bank funding for the Treasury of around 0.5% of GDP per year to the point of this being reduced to just seigniorage in 2020. Thus in 2018 net borrowing requirements on account of central bank assistance for the Treasury (without including capital maturities) amount to USD 30 bn, which it is intended will mostly be placed in the domestic market. In January 2018, a USD 9 bn bond issue was carried out on the international market which means advance funding of around one third of the borrowing requirement for the year.

Figure 6.1 National public sector revenue and expenditure (% of GDP)



Source: BBVA Research with data from the Ministry of the Treasury

Figure 6.2 Benefit mobility index compared to inflation and wages (% var. YoY)



Source: BBVA Research, INDEC and the Ministry of the Treasury

7. The rapid deterioration in the balance of trade highlights the vulnerability to a shift in global conditions

The greater buoyancy of domestic demand in conjunction with the real appreciation of the peso contributed to a sharp pick-up in imports over 2017, which grew 19.7% in the year, while exports have still failed to show clear signs of recovery (+0.9% YoY). The net result was a trade deficit of USD 8.471 bn, which makes a stark contrast with a surplus of USD 1.969 bn in 2016. With the exception of fuels, due to more clement weather and the rise in energy rates, all import items posted surging rates of volume growth on aggregate for the year, particularly items such as Parts and accessories for capital goods (+19.2% YoY) and motor vehicles (+39.9%). In this last case, the vigour of motor vehicle sales in Argentina, particularly models manufactured in Brazil in combination with the stagnation of Brazilian demand, was instrumental in the deficit on the industry's balance of trade racing ahead.

Bearing in mind these trends, we estimate that the balance of trade will reach a deficit of USD 11.2 bn in 2018, even taking into account something of a fall in the elasticity of imports to GDP in the coming year following the readjustment in 2017. We can also expect more vigour from export volumes, from both greater demand from Brazil for industrial products and a lower level of withholding of both primary products and agriculture and livestock manufactures following on from the decrease in withholding of soybean exports and the recent peso depreciation. We forecast that, with the economy growing at close to its potential rate of 3% in the next few years, imports of inputs and capital goods will continue rising at a sustained clip, however reforms to boost the competitiveness of exports will eventually stabilise the trade deficit at around 1.7% of GDP from 2019.

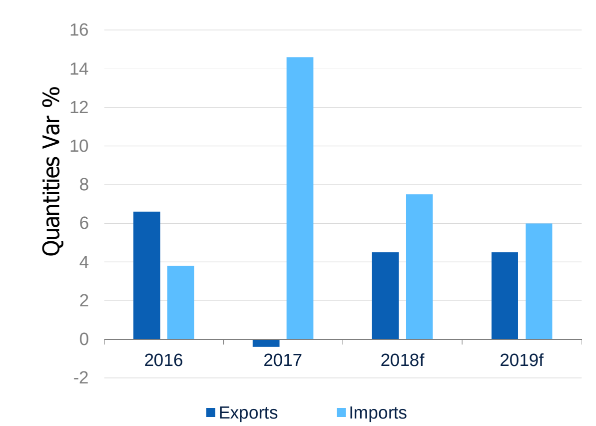
Other items in the current account such as real services should see their negative balances shrink very slowly, especially tourism, since the real exchange rate will remain relatively strong compared to Argentina's key trading partners. Despite the reduction of over 100 bp in country risk in 2017, interest paid abroad will hold at over 2% of GDP in 2018 and 2019, as the closing up of the fiscal deficit is going only slowly and companies will continue to raise money for their expansion plans via external debt issuance. Thus the current account deficit will remain high in the next few years up to 2020, averaging some 5% of GDP.

The funding of this deficit has been plentiful, leading to a rise in reserves of 2.7% of GDP in 2017 while keeping the surplus supply of dollars in the local market. We estimate that, beyond occasional bouts of volatility such as those seen following the changes in monetary policy, this situation should continue to predominate in 2018 and 2019, giving rise to an exchange rate depreciation below the rate of inflation in the next two years. The monetary policy we foresee for 2018, though looser than in late 2017, will keep interest rates above expected inflation, underpinning the attractiveness of investments in pesos for both residents and non-residents.

The surprise 8% exchange rate depreciation in the second half of December 2017 was a foretaste of the relaxation of inflation targets and less contractive monetary policy looking ahead, although in any case the monthly average for December came in at barely over our estimate of ARS17.6/USD. As regards this aspect, we have raised our exchange rate forecasts for 2018 onwards slightly, assuming a marginally bigger depreciation than before and reaching ARS20.2/USD at the end of the year and ARS22.4/USD at the end of 2019. The chairman of the central bank has once again stressed the role of the floating exchange rate system in containing external shocks and the low level of *pass-through* to inflation of the recent bouts of volatility, for which reason we can expect very little intervention by the central bank in the forex market. In spite of this, and given that it is standing by its goal of building up foreign exchange to a level of 15% of GDP, in 2018 we will probably continue to see the central bank directly acquiring foreign currency from Treasury bond placements and reducing the downward pressure on the exchange rate that would prevail if this flow were to be dumped directly onto the forex market.

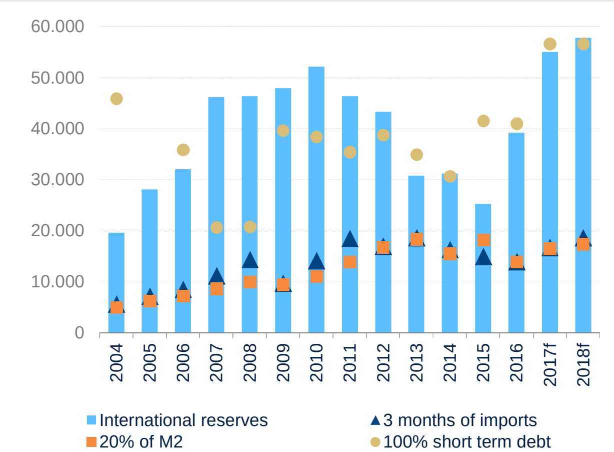
Nevertheless, the current level of reserves of close to 9% of GDP is still relatively low in comparison with the other countries in the region, illustrating how vulnerable Argentina is to an external shock that reduces available funding as a portion of the inflow of capital to the country has been used to build up the private sector’s external assets (building up reserves of dollars). It is crucial for the reforms that the government is pushing through to start bearing fruit in terms of improving productivity so that the financing of the current account is mostly channelled via foreign direct investment rather than through portfolio investments that are subject to sudden stops.

Figure 7.1 Balance of trade: import and export volume growth (% var. YoY)



Source: INDEC and BBVA Research

Figure 7.2 Ratios of reserves



Source: INDEC, BCRA, Haver and BBVA Research

8. The tax reform and the fiscal consensus with provinces will allow a reduction of the “Argentine cost” albeit at a gradual pace

The government has managed to reflect the fiscal pacts reached with 23 of the 24 provinces in laws more quickly than was expected following its October election victory. The fiscal responsibility laws and the fiscal consensus approved in December make it possible to rein in provincial primary expenditure growth in real terms at the same time as they allow tax pressure on the private sector to be gradually eased, especially as regards the more distorting provincial taxes such as Gross Income and Stamp. Funds have been reallocated among provinces with, for example, increased participation by Buenos Aires province, while there has been modification of the percentages of resources received by the Nation and the Social Security system, although this has been without any great setback for any of those involved as the drop in revenues was offset by a smaller increase in pension benefit expenditure due to the amendment to the mobility formula finally approved by Congress after serious rioting and clashes with the opposition.

The unrest associated with the pension benefit reform voting leads one to assume that the passing of the labour reform bill to Congress (which does not have the backing of the full spectrum of unions) will be temporarily suspended. On the other hand, the tax reforms and the draft budget for 2018 were swiftly enshrined in law at the end of December in a set of extraordinary sessions. The changes are aimed at cutting the tax burden that weighs down on companies and stimulating investment, but they will be implemented only gradually. Thus the bundling and lowering of employer’s contributions to the social security system for minimum wages, the removal of the tax on bank debit and credits and the lowering of the profit tax on undistributed dividends will only materialise over a time frame of 4-5 years.

There are likely to be major political limitations on forging ahead more swiftly with an agenda of supply-side reforms that will allow the country to boost its competitiveness, but the government remains oriented toward its goal of bringing Argentina back onto the world stage to expand the size of the market and generate economies of scale. Despite the hurdles to allowing meat products, sugar and biofuels into Europe, an agreement between Mercosur and the EU is still being negotiated with the shared aim of achieving a political agreement that takes account of the needs of both blocs before mid-2018. Argentina has made progress in the process of applying for inclusion within the OECD and will chair G20, which will provide it with a chance to enhance institutional quality, although it is still too early to know when the economy will be in a position to satisfy potentially bigger world demand at competitive prices. A step in this direction is the executive order to simplify procedure and cut through red tape recently approved by the Executive, one that aims to cut administrative procedure costs for the private sector to produce and export by roughly 1% of GDP.

9. Tables

Table 9.1 Annual macroeconomic forecasts

	2015	2016	2017e	2018e	2019e
INDEC GDP Base 2004 (% YoY)	2.6	-2.2	2.8	3.3	3.3
Domestic CPI inflation (% YoY, eop)	26.9	39.4	24.8	18.5	12.2
Exchange rate (vs. USD, eop)	11.4	15.8	17.7	20.1	22.1
Policy rate (%, eop)	33.0	24.8	28.8	21.0	14.0
Private Consumption (% YoY)	3.5	-1.4	3.0	2.9	3.3
Government expenditure (% YoY)	6.8	0.3	2.0	2.6	2.1
Investment (% YoY)	3.8	-5.1	10.0	11.6	6.5
Fiscal Balance (% GDP)	-5.2	-5.9	-5.8	-5.1	-4.1
Current Account (% GDP)	-2.7	-2.7	-5.1	-5.3	-5.0

Source: BBVA Research

Table 9.2 Quarterly macroeconomic forecasts

	INDEC GDP (% YoY)	Domestic inflation (% YoY, eop)	Exchange rate (vs. USD, eop)	Policy 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	2.9	21.8	16.1	26.3
Q3 17	4.2	23.8	17.2	26.3
Q4 17	3.7	24.8	17.7	28.8
Q1 18	3.0	24.6	18.6	26.8
Q2 18	3.6	23.5	18.9	25.5
Q3 18	3.2	21.7	19.4	24.0
Q4 18	3.3	18.5	20.1	21.0
Q4 19	3.2	15.8	20.6	19.0
Q4 20	3.3	13.6	21.0	17.1
Q4 21	3.2	12.6	21.5	15.5
Q4 22	3.5	12.2	22.1	14.0

Source: BBVA Research

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