BBVA Research

Argentina Economic Outlook

Second quarter 2018

Argentina Unit

Creating Opportunities

Contents

Closing date: **6 April 2018**

1. Summary

Growth for the world economy and trade is being confirmed despite the fact that protectionist and political risks either persist or are on the increase. This context strengthens Argentina's external demand, given that GDP has been revised upwards for major trading partners such as the United States and the Eurozone, while expected growth for Brazil remains unchanged in spite of the political volatility over the election period. Our latest estimates suggest that in the opening half of 2018 activity will continue to advance at a clip of around 0.8/0.9% QoQ in seasonally adjusted terms. The economy will grow again in 2018, having done so by 2.9% in 2017, although it will only increase by 2.6% owing to the harsh drought afflicting the core agricultural zone. This exogenous factor does not affect the economy's potential on a permanent basis, so next year GDP is expected to grow at 3.3%, as we were predicting at the beginning of the year.

The first four months of 2018 will show the worst inflation figures of the year, mainly due to a strong impact from regulated prices, which will add three percentage points to the rise in headline CPI out of an overall total of 8.7%. Even so, of greater significance within the pick-up in the inflation rate is the increase in core inflation that was brought about by the upward revision of inflation expectations following the change to the central bank's targets and the moderate pass-through from the recent peso depreciation. Although wage agreement levels at around 15% YoY and greater exchange rate stability mean that inflation will slow down to an average rate of 1.2% MoM over the rest of the year, it will likewise fall back by only five percentage points with respect to the previous year and close 2018 at 19.8%. In 2019 the national CPI will continue to drop to 13.5% YoY thanks to smaller hikes in utility rates and maintaining the contractionary bias to monetary policy.

Even though we expect a substantial lowering of the Monetary Policy Rate (MPR) to 21% at the end of 2018, the estimated real policy rate should be markedly higher on average for the year than in 2017, when there was a significant initial loosening of monetary policy. In 2019 we forecast that the central bank will continue to cut the rate in line with the drop in inflation, though also in real terms so as to produce an annual average of 4.5%, which is closer to its medium term targets. After two years of stressing the benefits of a floating exchange rate system, in March the central bank embarked on a new phase of exchange rate policy claimed to be "complementary" to monetary policy. This involved soaking up pesos through selling more than USD 2 billion in the Forex market so far this year and setting a limit to depreciation of the ARS. 2018 will end with a dollar exchange rate of ARS 21.5 and a depreciation rate which will outstrip the inflation rate for the first time in two years, thereby resulting in a 4% improvement in multilateral competitiveness.

With the positive fiscal results to date we forecast that revenue growth will continue to surpass primary expenditure and reach the targeted primary deficit of 3.2% of GDP. In 2019, the task will be more complex, given that the lion's share of making cuts in subsidies to energy and transport sectors will have concluded and Pension and social subsidy spending will remain relatively constant as a percentage of GDP under the new adjustment formula. The State Modernisation Law will help to reduce the weight of other government spending items in order to meet the primary deficit target of 2.2% of GDP in a context of a gradual decrease in the tax burden according to the fiscal reforms approved in late 2017. Bringing down the current account deficit will be slower and it will remain at close to 5.5% of GDP in 2018/19 because vigorous import growth will continue to exceed that of exports given the slow progress in improving competitiveness.

The modest headway made in terms of economic reforms in 2018/19 could prove insufficient to attract the foreign direct investment required to head off the increase in foreign borrowing and boost the economy's long term potential. In a highly adverse risk scenario, a sudden stop in capital flows could lead to a sharp correction in activity levels. Although social discontent related to inflation pressures seems to be contained and does not appear as a major risk, a strong drop in activity level and an increase in unemployment would jeopardise not only meeting fiscal targets but also the chances of achieving president Macri's stated ambition of substantially reducing poverty rates during his mandate.

2. Global economy: growth rate holds firm, but risks of protectionism intensify

The global economy is currently being subjected to divergent forces. The new fiscal stimulus measures approved by the US administration will prolong the favourable phase in the world economic cycle, which has so far been supported by high levels of confidence and the positive tone of industrial activity and international trade, which also benefit China and Europe. On the other hand, the increased vulnerability of the US public accounts brought about by these fiscal stimulus measures, combined with the prospect of financial markets facing greater volatility than in 2017, make this scenario more uncertain. Added to this is the ratcheting up of protectionist rhetoric in the US, which has started to find expression in specific measures. All this is in a context of the normalisation of monetary policies following years of exceptional stimulus measures, which may also give rise to additional doubts.

Growth has held stable at the beginning of 2018 (Figure 2.1), with greater dynamism in the emerging economies and some signs of slowing up in the developed countries. Data available for the first two months of the year suggests that global growth in the first quarter will have been at a similar rate to the average for 2017 (1% QoQ). This growth has been boosted first and foremost by a decent performance by trade worldwide, which picked up substantially, especially as regards exports from emerging economies, and in particular (in February) by Asian countries (mainly China and India). A second factor is the sound growth in industrial production, likewise particularly in the emerging markets.

Probably the biggest news in the past three months in the global context has been the fiscal stimulus approved in the United States in February. This ought to have a moderate effect on short term growth (as the US economy is now very close to full employment) and could put upward pressure on interest rates (at a point where Fed normalisation is fully underway). For all these reasons, we estimate that this will exert a small multiplier effect on activity (of around 0.4), which would involve an upward revision in GDP of around 0.2 to 0.3 pp in both 2018 and 2019.

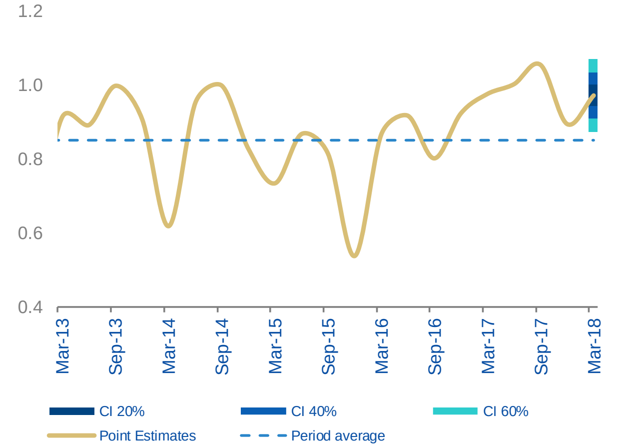
That said, in the short term the US fiscal stimulus might prolong the global expansionary phase by extending cyclical recovery and lead to an increase in demand worldwide. However, this effect will be offset under our scenario by the increase in volatility globally or by the resurgence of greater political uncertainty in certain areas, as well as by the possible negative effect of uncertainty associated with protectionist measures.

Following a year dominated by optimism and risk-taking in financial markets in 2017, the first quarter of 2018 has shown a more cautious tone. On the one hand, financial conditions, which have been highly accommodative, have started to tighten. And above all volatility, which has been unusually low, seems to be transitioning toward a more “normal” situation (higher volatility and possibly more persistent volatility shocks), while monetary policy continues to normalise. Specifically, in the Fed’s case we expect the process to speed up a little (with four separate 25 bp reference rate hikes in 2018, in contrast to the three previously forecast) following the fiscal boost. Furthermore, interest rates at the long end are settling at higher levels, especially in the United States, due to higher growth and fiscal decline, which implies greater net borrowing and adds a risk premium to the US Treasury’s financing.

On the other hand, the bout of volatility in early February, which prompted a sharp correction on the stock markets of the developed countries, has for the time being led to very little spill-over to other kinds of assets. All this has contributed to pushing up our financial stress indicator in both developed and emerging economies (Figure 2.2).

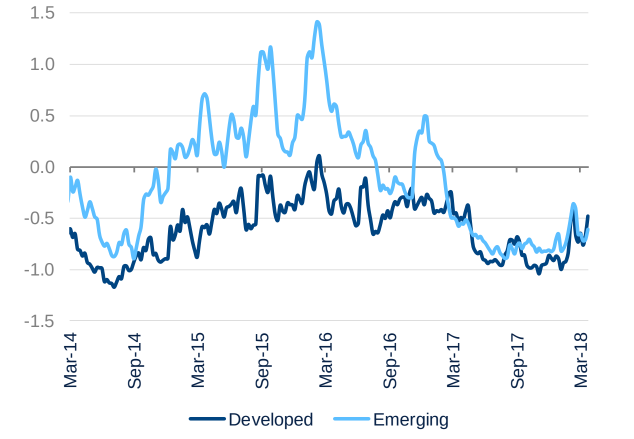
Given this scenario, we are standing by our forecast for world growth of 3.8% for the 2018-19 period. This does however involve an upward revision of growth prospects for both the US and the Eurozone, offset by slightly less buoyancy in emerging economies, especially in South America.

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



Source: BBVA Research

Figure 2.2 BBVA Financial Stress Index



Source: BBVA Research

For China, we are holding our growth forecasts at 6.3% and 6.0% for 2018 and 2019 respectively. Most recent data show that momentum in both domestic demand and exports is holding up. Confirmation of an economic policy approach that is a blend of prudent monetary policy and expansive fiscal policy, together with approval for restrictive financial regulation measures, make us somewhat more optimistic about the domestic risks associated with China's economy.

In the case of the United States, the positive figures for activity and foreign trade for the past few months come on top of the aforementioned short-term effects of a more expansive fiscal policy, which combines both tax cuts approved in December (already factored into our previous forecasts) and the new fiscal stimulus measures. As a result, US growth is estimated at 2.8% for both 2018 and 2019 (involving upward revisions of 0.2 pp and 0.3 pp respectively).

In Europe, the solid figures for exports and fixed investment last quarter, plus resilient private consumption, lead us to maintain the growth forecast for the Eurozone (revised slightly upwards to 2.3% in 2018). For 2019, we continue to forecast more restrained activity, with growth of around 1.8%, given a degree of fatigue in cyclical momentum, as already anticipated by the leading indicators.

Although we are leaving our forecasts for China unchanged, we expect the bloc of emerging countries to grow rather less, as they are being affected by idiosyncratic factors (in the case of South America). Added to the weak activity data for the past few months is the materialisation of certain political risks in some cases and supply-side shocks in the agricultural sector in others, which, taken together, end up neutralising the increased growth expected in advanced countries. Despite this, the Latin American economies will continue to revitalise growth relative to previous years, underpinned by the dynamism of external trade and improved terms of trade, thanks to higher commodity prices.

Global risks are abating as regards China, though they are mounting in the United States, especially from protectionism.

Risks attaching to our global scenario have increased owing to protectionist threats in the form of higher tariffs on the part of the United States and the response from China. Although the impact of the measures adopted on global activity has so far been limited, uncertainty has been fuelled about a possible escalation in trade restrictions among the major economic regions that could end up discouraging investment worldwide. Other sources of uncertainty lie within the normalisation of monetary policies, especially a swifter than expected exit by the Fed that might not relate to higher growth but instead to an unexpected speeding up of inflation. On the other hand, the risk associated with a sudden correction for the Chinese economy has lessened to a certain degree following the measures approved as a result of the Chinese Communist Party Congress in October and signs of a progressive reining in of borrowing.

3. Argentina: The economy continues to grow but at a slower pace in 2018 due to the drought

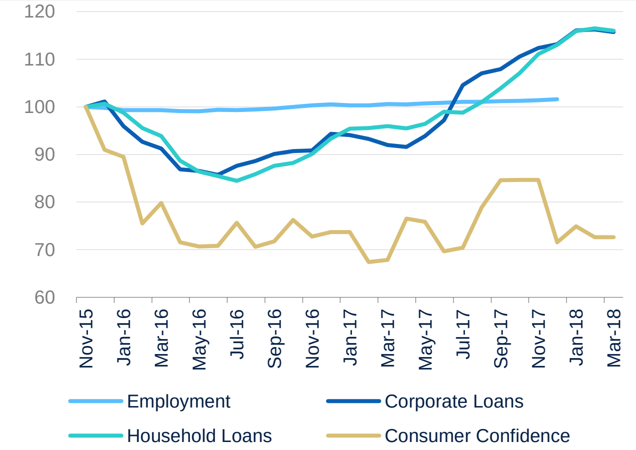
2017 closed with GDP growth of 2.9%, slightly ahead of our forecast of 2.8% and featuring a slight pick-up in the rate of quarterly GDP increase to a seasonally adjusted 1% in 4Q17. The key driver here came from investment, which grew 11.3% over the year, both in Machinery & Equipment (+13.9% YoY) and Construction (+12.4%). Private consumption also recovered by 3.6% on the increase in consumer confidence and the strong credit growth of the second part of the year (Figure 3.1). In the opposite direction, the external sector made a negative contribution of 3.8%, far higher than its counterpart of -0.6% in 2016, on strong import growth (+14.7%). The increase in economic activity was also mirrored in job creation in a similar proportion, which gave rise to a drop in the unemployment rate to 7.2% (from 8.3% in 3Q18) in spite of the rise in the labour force participation rate.

Even though consumer confidence has not recovered from the fall it experienced following the dispute over approval of the pension adjustment reform and the concentration of energy and transport rate hikes between December and February, the preliminary figures for 1Q18 suggest that private consumption is still growing at an average rate comparable to that of the last quarter of 2017 despite a bit of a slowdown in auto sales from 27.8% to 17.5% YoY. Thus, in real terms, domestic VAT collection is growing at 16.2% YoY vs. 9.6% YoY in 4Q17. Our MICA nowcasting model shows a very slight slowdown in growth from 0.96% QoQ in 4Q17 to 0.89% QoQ in the first part of 2018.

Nevertheless, the key reason behind our downward revision for the 2018 growth forecast from 3.3% to 2.6% is the harsh drought which is affecting the core agricultural region and which, due to both poorer harvests and yields will bring about a decrease in soybean production of 18/30% YoY in 2018 and 14/24% YoY for maize (Figure 3.2). While a portion of the impact on demand will be offset by the rise in international prices for these grain crops of 7%/10% which took place between March and December, we estimate that GDP growth could be reduced by 0.7% relative to our previous forecast, both on the direct impact on the agriculture and livestock sector and owing to spill-over to other related sectors such as transport and trade.

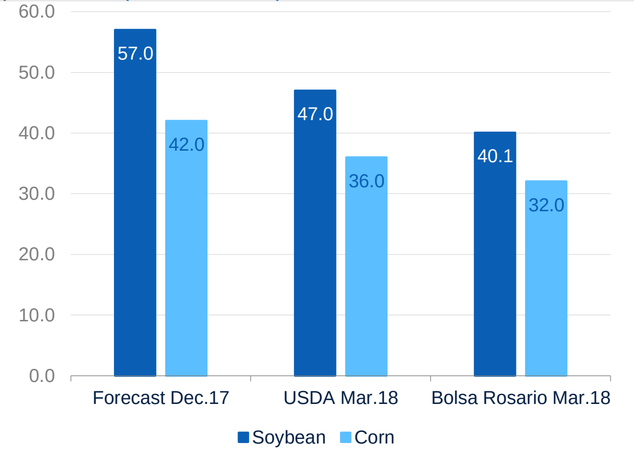
In terms of domestic demand, the losses caused by the strain on water resources will affect both investment (less demand for agricultural machinery) and private consumption (lower demand for goods and services in rural areas), for which reason we have revised our forecasts down from our previous estimates by 0.6% and 0.3% respectively. Even though in nominal terms the drop in exports will be tempered by the rise in prices, in volume terms we estimate that they will rise by 4.6% YoY in 2018, compared to 5.4% in our previous estimate. Following almost negligible growth in 2017, the stronger export performance is mainly due to the acceleration of growth in Brazil, which has boosted the market for manufactured exports, and the lowering of export taxes on soybeans, which offers an incentive to producers to sell off stocks of previous harvests that they have held in storage.

Figure 3.1 Trends in credit, employment and confidence (base 100=November 2015)



Source: BBVA Research based on BRCA and SIPA data

Figure 3.2 Impact of the drought on soybean and maize production (million tonnes)



Source: BBVA Research based on USDA and Rosario Exchange data

Investment will reach 23% of GDP in 2019, the highest level since the 80s

After poor performance in the wake of the implementation of the "cepo cambiario" (the so-called currency control "clamp"), for the first time investment will achieve three years of growth in a run with an increase of 11% in 2018 and 7.7% YoY in 2019, driven by both infrastructure building and the additional contribution from machinery and equipment. Thus, investment's participation in GDP is gradually recovering, albeit without yet attaining the higher proportions seen in other regional partners such as Chile. The average propensity to consume, on the other hand, will stay relatively constant at around 73%, since private consumption will grow at a rate on a par with GDP, due to the increase in the size of the wage bill, while government expenditure will on the margin continue to lose participation given the fiscal tightening process underway. The brighter outlook for the economy will mean that the participation rate in the labour market will not fall back again significantly from its current level of 46.4%, although we estimate that the unemployment rate will continue to come down to an average of 7.9% in 2018 and 7.7% in 2019 as we assume that the economy's job creation capacity will be slightly above the average levels of the previous decade.

The prospects for global economic growth remain stable and have been revised upwards in the United States and Europe, which helps towards moderating the downward revision for GDP in 2018. Probably the biggest risk to our growth forecasts is weaker investment trends, bearing in mind the delays in funding for infrastructure projects which might be caused by the recent implementation of the Public-Private Partnerships Act and slow progress in the structural reforms geared toward improving Argentine productivity. Unless it persists for a prolonged period, we understand that the drought is a temporary event that does not affect the economy's potential in the medium term, so we are standing by our growth forecasts for 2019 of 3.3%. As in the two previous years, we expect the economy to continue to rebalance in favour of greater share of investment and exports, although strong import growth will mean that the external sector's contribution remains negative. Following the continued drop recorded since 2011, the Argentine economy's gross savings will finally begin to recover by 3.6% in 2018 and 5.6% in 2019, but will only reach the levels prior to implementation of the FX controls in 2022.

4. Lower inflation from April onwards, although failing to achieve the Central Bank's target

Regulated prices will account for over one third of inflation in the first 4 months but core inflation will have a bigger impact on headline

In February the national CPI figure rose 2.4% MoM with a 1 pp impact from regulated prices, mainly due to the adjustment of bus and train transport rates. Cumulative inflation in 1Q18 is likely to top 6%, chiefly on the impact from regulated prices, which represent over 2.2 pp of the cumulative total. Also taking into account the programmed schedule for hikes in natural gas and electricity prices which ends in April, we expect that in the first four months of 2018, the impact from regulated prices will have climbed to 3 pp, whereas over the remainder of the year it will only accumulate an additional 1.5 pp, essentially owing to fresh rises in energy rates in the final quarter and certain additional adjustments in transport fares. Whatever the case, for the year as a whole the impact of regulated prices will be smaller than the figure of 7 pp recorded in 2017 and is likely to surpass the number that will be registered in 2019 given that the timetable for energy rate adjustments has been brought forward to this year.

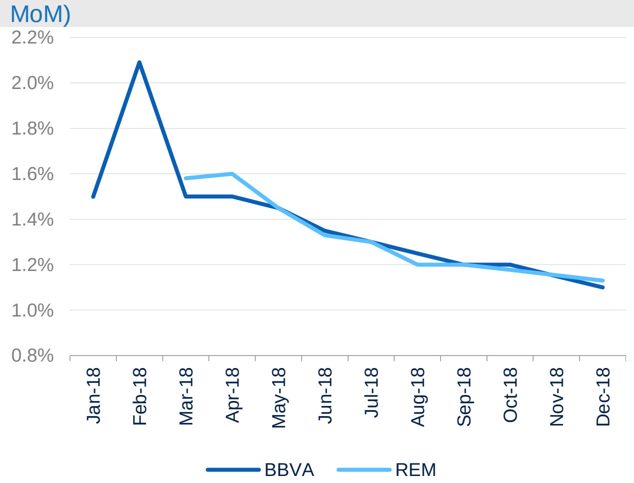
In the initial two months of the year core inflation also gathered pace at an average rate of 1.8% per month, which was significantly higher than the average of 1.4% MoM in 4Q17, although we foresee this being gradually reduced from mid-year to reach an average of 1.15% MoM in the final quarter (Figure 4.1). Even though analysts' inflation expectations have been revised upwards by almost 400 bp in the wake of the change to the central bank's targets, the consensus estimate still includes a drop in inflation of more than 4 pp in 2018 and a further fall of 6 pp in 2019, which, beyond the scheduled utility rate adjustments, implies a sustained downward path traced by core inflation to around 1.15% in 4Q18 and 0.88% in 4Q19. This fall is more gradual than had been previously expected and, as the central bank admits, probably reflects second round effects from the rise in regulated prices on core inflation and a certain degree of pass-through to prices from the recent currency depreciation, especially as regards fuels and also foods, which increased by over 2% MoM in the first two months of the year, which is almost 1 pp above the average in 4Q17.

Although the scarceness of data makes it hard to gauge the current magnitude of the pass-through from the currency depreciation to prices, our preliminary analysis suggests that this will probably have diminished under the inflation targeting framework, assuming a model which correlates inflation with the exchange rate and controlling for inflationary inertia and US inflation (when using monthly figures, we do not include the output gap).

The estimates indicate that for the entire sample (1960-2018) Argentina's pass-through to consumer prices of a 10% depreciation over a 12-month period rate is 3.7 pp (Figure 4.2). This is much higher than in the rest of Latin America, where pass-through to prices is closer to 0.5% (except for Uruguay). Even so, if we only take into account the 2002-15 post crisis period, the pass-through to prices comes down to 2.8 pp, and if we also include the Cambiemos administration, considering the whole 2002-18 period the rate falls to 2 pp.

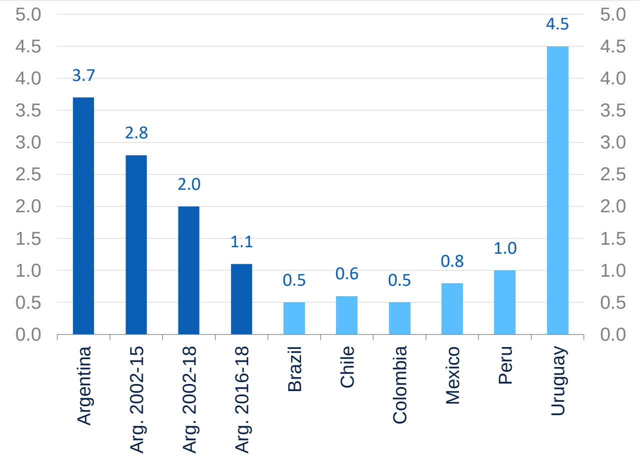
Finally, if we only estimate the pass-through between 2015:11 and 2018:2 (with the appropriate caveat owing to the paucity of observed data), the rate drops to 1.1 pp, which shows a far weaker correlation between inflation and the exchange rate under the Inflation Targeting regime (values similar to those in Peru).

Figure 4.1 Core inflation expectations of the BCRA Market Expectations Survey and BBVA Research (ch. MoM)



Source: BCRA and BBVA Research

Figure 4.2 Pass-through from a 10% depreciation to prices in an annual period, (percentage points)



Source: BBVA Research based on BCRA and INDEC data

Monetary policy finds support in wage agreements and the Forex market

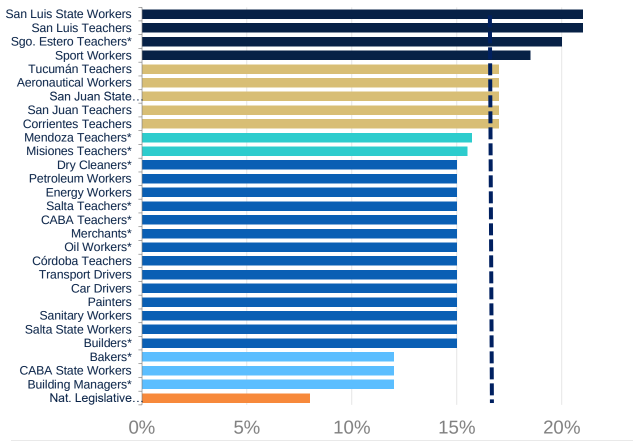
Our baseline scenario with respect to the path of inflation does not differ substantially from consensus estimates since recent evidence points to a slower reduction in core inflation and a bigger impact from tariff adjustments than we were predicting in December. We estimate that the national CPI will rise by 19.8% in 2018 and 13.5% in 2019, though with a considerable slowdown from May onwards.

Although the increase in the exchange rate exacerbated inflationary pressure in the first quarter of the year even in an environment where there was less pass-through to prices, the relative stability that we foresee for the peso over the rest of the first half will help to contain the increase in tradable goods prices. Despite the rise in inflation expectations, the bulk of collective bargaining wage hikes that have been agreed on to date for 2018 are not significantly far off the inflation target of 15%, although in some cases they do include a review clause in case inflation overshoots the central bank’s target (see Figure 4.3). The process is still not over yet and certain major agreements need to be reached, such as is the case for the teachers union, but what we have seen happening so far suggests that wage agreements could be acting more like a nominal anchor.

Monetary policy is proving a bit looser than we were expecting in late 2017, given the 150 bp cut in the MPR in January, but the central bank’s statements have become more hawkish in February/March, firstly indicating that there will not be a rate cut until there are clear signs that inflation has been pared back and then saying that “the BCRA is ready to act by raising its policy rate” if inflation fails to converge on the intended level after the transitory effects are over. Additionally, from mid-March the central bank has begun to intervene significantly in the Forex market so as to put a “ceiling” on currency depreciation and soak up pesos, which has also tightened monetary policy.

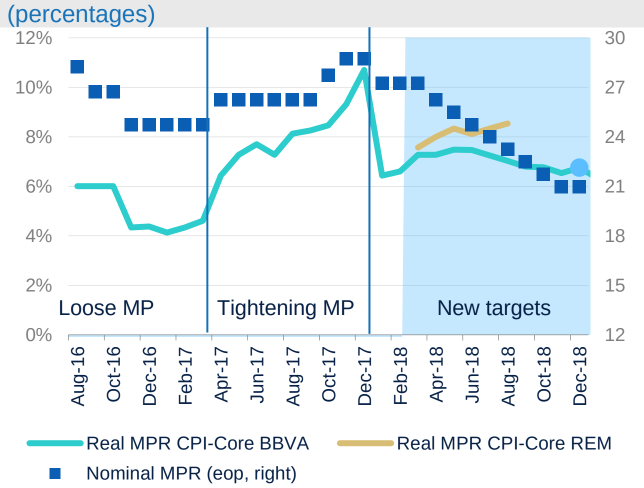
In this situation and bearing in mind that inflation expectations exhibit a major reduction from May on, the considerable loosening of monetary policy that took place in January will gradually be corrected to the extent that the rate remains unchanged. Despite the fact that we envisage a significant lowering of the MPR to 21% at year-end, the real ex ante rate (compared to expected core inflation YoY for the next three months) should be strongly positive at 8.5% in December 2018, which is only a shade below the level of 10% recorded at the end of 2017. On average for the year, in real terms the intervention rate will be clearly higher than it was in 2017, when there was a major loosening of monetary policy in the first four months (Figure 4.4). In 2019 we predict that the central bank will continue to cut the 7-day Repo rate in line with the fall in inflation to the level of 14% at year-end, which equates to a real interest rate (compared to expected core inflation YoY in the next three months) approaching 3%. For the year on average, the real rate will be 4.5%, which is 250 bp below the 2018 mean.

Figure 4.3 Rises negotiated in wage agreements by union (percentages)



(*) Without review or trigger clauses
Source: BBVA Research based on INDEC and BRCA data

Figure 4.4 Monetary policy rate vs. Expected core inflation (percentages)



The real MPR is the nominal MPR adjusted for inflation resulting from annualising the average monthly core inflation rate expected for the next three months
Source: BBVA Research based on INDEC data

5. Sound fiscal results in 1Q18 and bond issues pave the way for a calm financing outlook in 2018

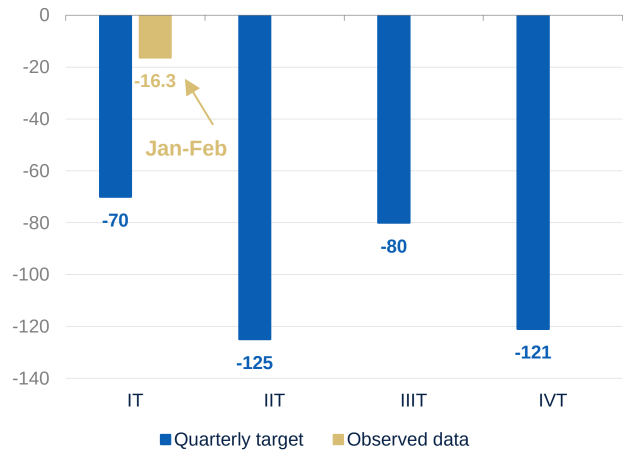
In the first two months of the year the primary deficit fell by almost 30% YoY suggesting that the targets for the first quarter of 2018 will be comfortably more than fulfilled. While revenues rose 22.6%, driven by domestic taxes such as VAT and Bank Debits and Credits tax, primary expenditure increased by 18.9% YoY due to the reduction of energy and transport subsidies (-18.5% YoY) and capital expenditure (-27.9% YoY). Thus a primary deficit of ARS 16.3 bn has accumulated in the January/February period, compared to a quarterly target of ARS 70 bn. On the other hand, the overall deficit rose by over 50% YoY, reflecting the 200% surge in the interest burden (Figure 5.1).

For the rest of the year we forecast that revenue growth will continue to surpass primary expenditure to achieve the prescribed deficit figure of 3.2% of GDP. In 2019, barring any significant over achievement of the 2018 targets that could enable bringing forward expenditure for the following year, the task will be more complex, given that the lion's share of reductions of subsidies to economic sectors will have concluded. With the new CPI adjustment formula for pensions and welfare subsidies, this item of expenditure will not increase substantially in terms of GDP as it did in past years, but since it is index-linked to past inflation, its burden will only start to lighten when inflation has stabilized at its long-term one digit target. In this regard, the state modernisation and simplification of bureaucracy law will help to boost efficiency and continue to reduce other items of government expenditure in a context of a gradual reduction in the tax burden as approved in the tax reform bill of December 2017 (see Figure 5.2).

The net borrowing requirement for 2018 comes to about USD 30 billion, but in a less favourable international environment in which risk aversion has increased, bond issues by emerging economies become less attractive. Fortunately, Argentina managed to bring forward its international sovereign issuance program for the year with a USD 9 billion placement in January, prior to the US bond sell-off. International funding will be rounded off using other types of credit (for example the recent repo for USD 1 billion) and the remainder will be placed in the domestic bond market. To date, USD 6.2 billion in bonds have been issued in the domestic market, meaning that a little over 50% of the requirement for the year has been secured. The key bond maturities falling in 2018 (USD 15 billion) are concentrated on short-term dollar-denominated Letes (T-bills) that were also placed in the domestic market and have been refinanced with no problems so far.

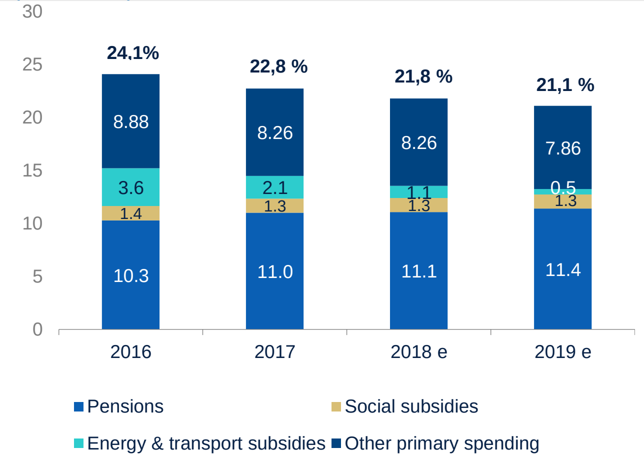
While Argentine bond yields have risen by over 90 bp and new placements are being made at rates higher than those last year, Argentina could still offset the hike in the rate on US 10-year Treasuries via lower country risk premium if its macroeconomic performance continues to improve. Our own rating model (which averages several different models) indicates that Argentina's rating could rise a notch in 2018, even in a conservative scenario in which ratings are anchored to the historical average for the global risk premium (BAA). If we were to use a value closer to current BAA levels instead of the historical average, we would probably achieve an additional rating improvement. Argentina's potential inclusion in the emerging markets category (from frontier market) in the MSCI index would also make it possible for there to be a wider universe of funds that would be willing to finance the country's macroeconomic transition.

Figure 5.1 Quarterly primary fiscal deficit targets (billion pesos)



Source: BBVA Research based on BCRA data

Figure 5.2 Reduction of primary expenditure (% of GDP)



Source: BBVA Research based on BCRA data

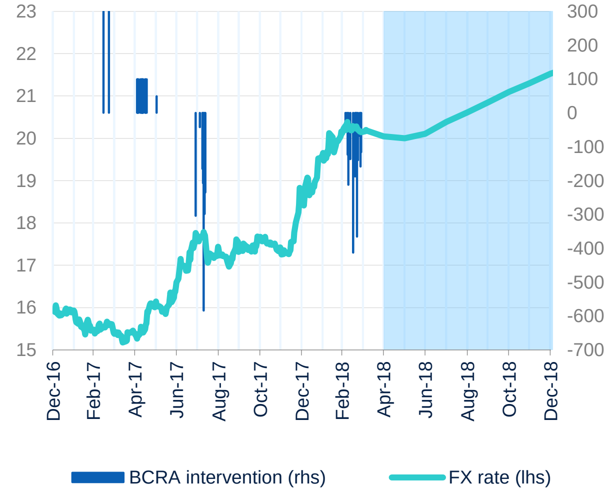
6. Change of direction in the exchange rate policy in a context of greater demand for dollars

The inflow of dollars from January's international bond placement acquired by the BCRA and reserves of over USD 8 billion were built up in the opening two months of the year, yet this did not alleviate the exchange rate depreciation which had begun in mid December and gathered speed following the changing of inflation targets. Expectation of a less contractionary monetary policy together with a higher level of international volatility in early February helped to boost the demand for foreign currency and the peso depreciated by 15% between December and January after virtually six months of stability or mild appreciation.

At first, the central bank reiterated the importance of a floating exchange rate regime to cushion external shocks and avoided Forex market intervention, leaving market forces to determine the exchange rate. Nonetheless, in early March and presented with the evidence that the pause in loosening monetary policy was not managing to dampen expectations of depreciation, and also concerned over the impact of this on inflation, the BCRA started to intervene more actively by selling dollars in the private forex market, claiming that any further depreciation would not be justified by real economic fundamentals. It has thus embarked on a phase of exchange rate policy that is meant to be "complementary" to monetary policy and includes an additional instrument to the interest rate. The BCRA made overall sales of USD 2.04 billion in March and since March 9 has managed to hold the reference dollar exchange rate below its historical peak of ARS 20.387 (Figure 6.1). We estimate that in the next three months a degree of stability will prevail in the exchange rate at around these values, consistent with the signals sent by central bank's intervention and the seasonal export flows of agricultural exports. In the second half we expect a gentle depreciation in line with the gradual reduction of the interest rate and a smaller volume of export flows, to average a dollar rate of ARS 21.5 in December. While for the first time in two years, the depreciation rate (21.5%) will outstrip inflation in 2018, it should be pointed out that most of the weakening of the peso took place in the opening months of the year and that it will only depreciate by 7% in the second half of the year. This process will revert in 2019, as the dollar exchange rate will depreciate by 9.5% and fall behind inflation, reaching ARS 23.5 at the end of the year.

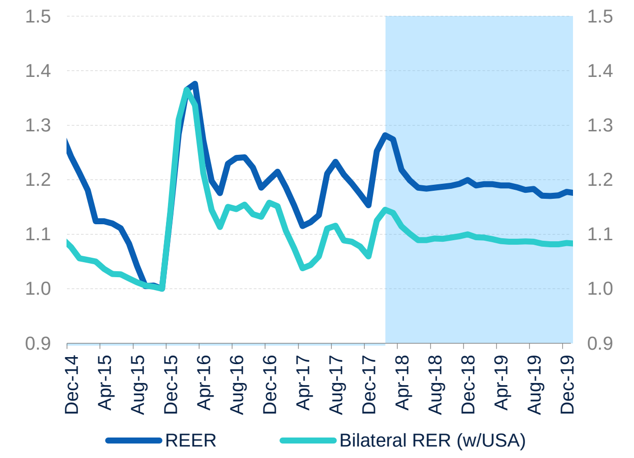
Thus, in terms of the Real Effective Multilateral Exchange Rate Index (or REER Index), this year the peso will improve its competitiveness by 4%, whereas in relation to the US dollar it will depreciate by 3.8% in real terms. Currently, the real effective (multilateral) exchange rate is at levels comparable to those of January 2016, immediately after the currency control regime was removed, and 19% more appreciated than its long term average despite the fact that the BCRA views this as a "relatively high" level. Although we predict that the gradual erosion of inflation will continue to push up the real FX rate by 1.8% towards the end of 2019 (Figure 6.2), it is reasonable to assume that after structural reforms and productivity improvements, the economy can support a more appreciated real equilibrium exchange rate than in the previous period of macroeconomic distortions and institutional weakness.

Figure 6.1 BCRA reference exchange rate and intervention rate (USD million)



Source: BBVA Research based on BCRA data

Figure 6.2 Real bilateral and multilateral exchange rate (1=November 2015)



Source: BBVA Research, INDEC, BCRA and Haver

7. A better export performance slows down the deterioration of the external sector in 2018

In 2017 the current account deficit increased by over 2 % of GDP, reaching a 20 year record level of 4.8% of GDP. The adjustment in the real exchange rate which has already taken place in 2018 is likely to have a positive impact (albeit limited) on the current account deficit. Even though the elasticity of goods exports and imports to the real exchange rate is low in Argentina (see “Argentine exports: How should we achieve greater dynamism?” - tr. from the Spanish - Aug.2017 link), we predict that the depreciation will put something of a brake on tourism-related outflows and the real services deficit. Thus, there will be a marginal slowdown in the deterioration of the current account balance, which is mainly affected by the rapid growth of the economy and of investment in particular. The external deficit should therefore widen at a slower pace in 2018, to 5.4% of GDP, chiefly because of the deterioration in the balance of trade, as we assume that the deficit in real services and investment income will remain relatively constant in terms of GDP. Supposing a new moderate increase in the trade deficit, partly offset by smaller outflows related to dividends and tourism, the current account deficit should rise slightly to 5.5% of GDP in 2019.

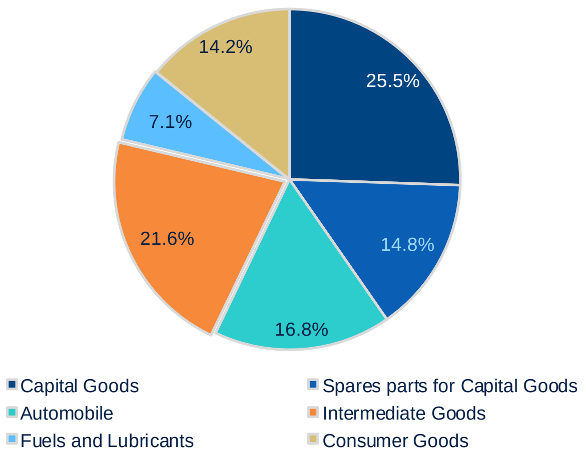
In the opening two months of 2018, the trade deficit remained at around USD 900 million per month, which was a similar level to that witnessed in the closing quarter of the previous year. Exports showed cumulative growth of 5.8% YoY (far higher than the rate of -0.4% YoY in 4Q17), while imports also gathered pace from 14% to 25.9% YoY. The increase in volumes was accompanied by better export prices (+ 4.6%) relative to import prices (+2.7%), due to falls in the prices of imported capital goods and of parts and accessories.

This performance by exports was in the main due to higher exports of primary products on account of the larger wheat crop and the decrease in the export tax on soybeans, since exports of manufactured products (industrial manufactures) maintained their 10% YoY growth rate of last year. We estimate that for the year as a whole, export volumes will slow down to +4.5% due to a smaller supply of maize and soybeans owing to the drought, partly made up for by the sell-off of grain inventories built up in 2017 given the bigger incentives for grain exports arising from the exchange rate depreciation, the rise in the international price of soybeans and the reduction of export taxes. Meanwhile exports of autos and other industrial products will continue to be buoyed by the greater demand from Brazil. We also forecast that imports will lose steam substantially over the remainder of the year after the surge in 2017, which was largely due to strong growth in purchases of capital goods and their spares, which accounted for 40% of the increase in imports for the year. If we include motor vehicle imports (a portion of which can be counted within capital goods), the overall total for capital goods and consumer durables represents 57% of the rise in imports that occurred in 2017.

We are therefore maintaining our forecast of a trade deficit of USD 12.1 billion in 2018 and USD 14.5 billion in 2019, since, even assuming a level of income elasticity akin to historical averages, imports will continue to grow at a faster pace than exports until the effects of the reforms targeting competitiveness start to kick in. The terms of trade will play a positive role in 2018 due to the stronger soybean and vegetable oil prices, but should weaken again a slightly in 2019.

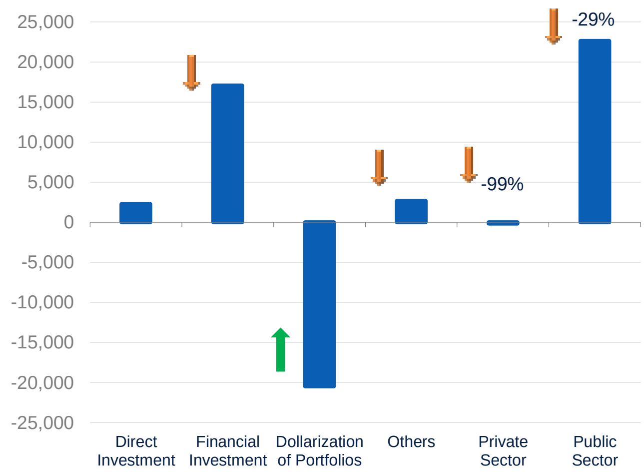
On the capital account, there is still no sign of any swift rise in FDI and there is also something of a dampening of portfolio flows into Argentina following the changing of inflation targets and recent volatility in the Forex market. We nevertheless expect that consistently high real interest rates will continue to attract carry trade flows over the rest of the year (though not as strongly as in 2017). At the same time, peso depreciation will, to some extent, place a limit on the degree of portfolio dollarisation, thereby allowing the central bank’s foreign exchange reserves to improve by an overall USD 4 billion on the year. As in 2017, the principal factor behind capital inflows will be public sector bond placements, in both the international and the domestic markets, since the private sector capital account will continue to run a modest deficit assuming that financial and FDI flows still fall short of managing to offset outflows from residents' savings in external assets (Figure 7.2)

Figure 7.1 Import growth in 2017: share by item (in %)



Source: INDEC and BBVA Research

Figure 7.2 Estimate of the Capital Account Forex Balance 2018 (million dollars and % ch. YoY vs. 2017)



Source: INDEC, BCRA, Haver and BBVA Research

8. The key risk arises from an adverse external scenario which could limit access to funding

Slow progress in economic reforms in 2018-2019 could be insufficient to attract strong investment growth

The two major economic projects that are up for debate in the Argentine Congress are the proposed Productive Funding Law (formerly Capital Markets Law) and the initiative to modernise and eliminate red tape from the State apparatus to reduce costs for the private sector. There has been a degree of progress in discussing both of them and both have a good chance of being passed by Congress, with the potential to provide a boost in terms of stimulating investment and improving competitiveness in the economy. In the first case, this would allow more foreign participants to be drawn into the market by providing more legal security, which is key to one of the government's central elements in its agenda, which is to expand the infrastructure programme based on Public Private Partnerships. Cutting the state's bureaucracy-related costs would at the same time enhance the profitability of businesses and their potential to compete in the international marketplace.

The full labour market reform project (which would reduce severance pay and litigation costs) is not likely to be addressed this year. However, some progress will probably be made in initiatives to regularise unregistered employees under an amnesty and to re-train unemployed workers. The economic impact will be smaller than originally expected but at least a step in the right direction which is supported by trade union organisations.

In a more complex international financial setting with the likelihood of more rate hikes in the United States and protectionist risk (although Argentina has for the time being been exempted from the tariffs imposed on steel and aluminium by the United States), the government will draw more heavily on its strategy of continuing to prioritise the country's "smart insertion" into the world with the probability of initiating the process admission to the OECD in May and via its not inconsiderable chances of reaching a political agreement with the trade agreement with the European Union (though there are still trade differences to be ironed out).

All this said, this modest progress in boosting the Argentine economy's competitiveness could come up short in managing to attract the necessary investment. Increasing foreign investment is not just a requirement to slow down the rise in external indebtedness that has taken place in the past year, but it is also needed to increase the economy's growth potential in the long term. In a highly adverse international risk scenario, the danger of a sudden stop in capital flows could lead to a sharp correction in economic growth in order to reduce the external deficit. Although social discontent related to high inflation pressures seems to be contained and does not appear as a major risk, an externally induced drop in the activity level and an increase in unemployment could jeopardise not only the achievement of fiscal targets but also the chances of fulfilling president Macri's stated aim of substantially reducing poverty rates during his mandate and possibly his election prospects in 2019.

9. Tables

Table 9.1 Annual macroeconomic forecasts

	2016	2017	2018e	2019e
INDEC GDP Base 2004 (% YoY)	-1,8	2,9	2,6	3,3
Domestic CPI inflation (% YoY, eop)	39.4	24,8	19,8	13,5
Exchange rate (vs. USD, eop)	15,8	17,7	21,5	23,5
Policy rate (%, eop)	24,8	28,8	21,0	14,0
Private Consumption (% YoY)	-1,0	3,6	2,6	3,1
Government expenditure (% YoY)	0,3	2,0	1,6	2,4
Investment (% YoY)	-4,9	11,3	11,0	7,7
Fiscal Balance (% GDP)	-5,8	-6,0	-5,2	-4,3
Current Account (% GDP)	-2,7	-4,8	-5,4	-5,5

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	1,0	35,0	15,0	38,0
Q2 16	-3,6	45,7	14,1	30,8
Q3 16	-3,3	42,7	15,1	26,8
Q4 16	-1,1	39,4	15,8	24,8
Q1 17	0,6	32,2	15,5	24,8
Q2 17	3,0	21,8	16,1	26,3
Q3 17	3,8	23,8	17,2	26,3
Q4 17	3,9	24,8	17,7	28,8
Q1 18	1,8	25,0	20,2	27,3
Q2 18	2,6	24,5	20,1	25,3
Q3 18	2,8	22,8	20,7	23,0
Q4 18	3,1	19,8	21,5	21,0
Q4 19	4,1	16,3	21,9	19,0
Q4 19	3,6	14,6	22,4	17,1
Q4 19	3,1	14,0	23,0	15,5
Q4 19	2,4	13,5	23,5	14,0

Source: BBVA Research

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