BBVA Research

Argentina Economic Outlook

Third quarter 2018

Argentina Unit

Creating Opportunities

BBVA Research

Contents

Closing date: **20 July 2018**

1. Summary

The international economy continues to be subject to the tensions of disparate forces, among them the good economic performance and potentially negative factors such as the impact on inflation of the increase in the price of oil, and protectionist measures. In a context of increased risk aversion, financial tensions in most emerging countries have increased, due to the depreciation of currencies and the widening of risk premia, although countries with higher external financing needs have been particularly punished, as is the case of Argentina. Argentina's achievements in terms of fiscal consolidation and advances in productivity were too slow to ensure debt sustainability in a harsher international environment, and this, together with several policy mistakes, led to the closing of credit markets and severe tensions on the local currency market. In order to restore credibility and achieve an orderly adjustment process, in June the government signed a stand-by agreement with the IMF for US$50 billion, subject to compliance with stricter fiscal targets and objectives of increases in international reserves, together with a commitment to strengthen the independence of the BCRA (Banco Central de la República Argentina, the central bank).

However, exchange rate volatility persisted until early July, with the peso depreciating by a cumulative 47% from year-end 2017, forcing the BCRA to raise the policy rate to 40% and to engage in further monetary tightening by intervening in the secondary market for Lebacs (Central Bank bills) and increasing minimum reserve requirements. It is likely that the reduction in the monetary policy rate will not start until the end of 3Q, reaching 32% at the end of 2018, although we cannot rule out higher levels and greater volatility in Lebac rates given the new monetary policy approach of closely monitoring monetary aggregates in addition to using the interest rate instrument.

As a result of the high degree of uncertainty and tighter monetary and fiscal policies, we estimate that the economy will contract in 2Q (-2.1% QoQ s.a.) and 3Q (-0.8% QoQ s.a.), which will come on top of the heavy impact of the drought that affected the country during the summer. However, the economy will grow by 0.5% in the year, thanks mainly to the very positive performance in 1Q18. In 4Q18 the positive outlook for the tradeable sector post-devaluation, in particular for the agricultural sector, will power the recovery of the economy, which we believe will consolidate in 2019 with the improvement in confidence and real wages to reach an average growth of 1.5%.

The peso's rapid depreciation led to an acceleration of core inflation, which averaged nearly 3% a month in 2Q18. We expect a gradual slow down, in line with the stabilisation of the currency market, to reach an increase in the CPI of 29.6% YoY in December 2018 and 20.8 % in 2019, somewhat above the middle of the target range but within the IMF's outer bands. Attainment of the new targets will depend fundamentally on the levels of pass-through, which we expect to be contained by the decline in activity and the tight monetary policy.

Considering the 26.7% YoY decline in the primary fiscal deficit to June, it will be possible to achieve the corrected target of 2.7% of GDP, even with a certain ease, which makes attaining the primary deficit target of 1.3% of GDP set for 2019 more feasible. This will require not only continuing with the envisaged cuts in energy and transport subsidies and the cuts in public works that have been announced, but also greater reduction of public sector payroll and discretional transfers to provinces, which will have to be negotiated with provincial governors for congressional approval of the Budget for 2019.

The devaluation and the lower rate of economic growth will tend to adjust the external imbalance, mainly through reduced growth in imports and the reduction of the real services deficit, especially tourism, but the process will be slow, about 0.2 pp of GDP in 2018 and 0.6 pp in 2019, in part due to the weakness of exports, due in turn to the impact of the drought. Adjustment of the current account imbalance is crucial in order to stem the loss of international reserves, but the moderate recovery of the reserves in line with the agreement reached with the IMF will be achieved only if, as we expect, the sharp depreciation of the peso curbs portfolio dollarization by residents.

It is crucial that the 25% YTD gain in real exchange rate competitiveness be maintained over time, since exports react not just to a high but also to a stable real exchange rate. We estimate that the nominal exchange rate will hold relatively steady in 2H18, while in 2019 it will increase less than the inflation rate (32.9 ARS/USD eop), so in real terms the peso will strengthen moderately by around 3% in the next 18 months.

The international environment might continue to deteriorate, and we cannot rule out new bouts of risk aversion affecting Argentina, since despite the IMF loan, the Treasury will need to continue to place relatively short-term debt to absorb the surplus Lebacs. A disorderly adjustment to the level of activity has been successfully avoided, but the next few months will see a deterioration in the economy and employment together with an acceleration of inflation which could generate greater social unrest. In the medium term, the greatest risk to the economy is that the need to deal with short-term emergencies together with the political cost of rebalancing the economy towards greater savings might lead the government not just to pause the structural (e.g: labour) reforms but to back track on the fiscal pacts which have already been reached, endangering the reduction of distortive taxes. Argentina's potential as an FDI destination derives not only from its natural resources and the size of its market, but also from legal and institutional stability, which is a key variable when determining the attractiveness of an economy for long-term investors.

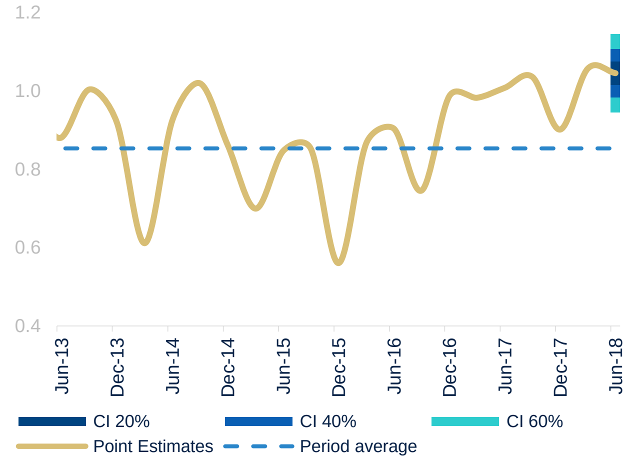
2. Global economy: robust growth but with certain signs of moderation and intensification of risks

The international economy remains subject to the tensions of disparate forces, between the good economic performance in recent quarters, now prolonged by the fiscal stimulus of the US economy and the stability of the Chinese economy, and several potentially negative factors that have been generated gradually in the first half of this year, but which so far have not been directly reflected in activity.

World growth is expected to have slowed slightly in the second quarter of the year (Figure 2.1). Although the pace of expansion remains solid, it is occurring in a less synchronised manner, with accelerating growth in the US that contrasts with certain signs of moderation in China and some emerging economies and in a more intense way in the euro zone.

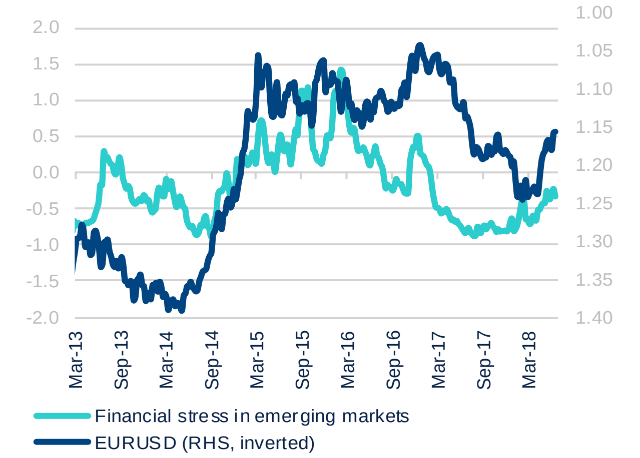
The increased growth of the US economy, driven by tax measures and the recovery of global trade at the beginning of the year, continues to sustain the strength of the global recovery. However, some of the supports to growth have been fading in the last few years, while uncertainty has increased.

Figure 2.1 World GDP growth.
(change % QoQ)



Source: BBVA Research

Figure 2.2 Euro-dollar exchange rate and BBVA index of financial tensions in emerging markets



Source: BBVA Research based on Bloomberg

The first factor is the withdrawal of the United States from the nuclear agreement with Iran, which caused a supply shock in the oil market that has increased the price of oil by around 20% so far this year. This will place additional upward pressure on inflation and has already encouraged central banks to take another step towards the normalisation of monetary policy. This is particularly the case with the US Federal Reserve, which so far this year has accumulated a rise of 50 basis points in its reference rates to reach 2% and plans to raise them to 2.50% by the end of the year and to 3.25% by the end of 2019. The interest rate differential and favourable growth in the US compared with the rest of the world has resulted in generalised appreciation of the dollar.

An additional uncertainty factor during the last few months is associated with the increase in trade tensions. It is still too early to know which measures will finally prevail of those already approved by the US administration, those that were previously announced and the possible countermeasures from its trading partners, nor is it easy to discern their impact on trade and activity. In principle, the direct effect through the trading channel of the measures announced up to now should be limited. However, additional measures by the US are under discussion at this time, as is possible retaliation on the part of the affected countries, with an effect on growth that would already be significant, to which we should add potential indirect effects on the confidence of financial markets and economic agents depending on the magnitude of the trade conflict.

As a consequence of these uncertainties, there has already been a readjustment in the perception of global risk, especially in the emerging countries. Financial tensions in emerging countries have increased generally (Figure 2.2), due to the depreciation of currencies and the widening of risk premiums, although countries with higher external financing needs have been differentiated negatively.

The global forecasts for the next two years remain unchanged, at 3.8%, supported by solid US growth. Nevertheless, the lower degree of synchronisation observed recently is reflected in a downward revision in the growth expected for 2018-19 for both the euro zone and South America (mainly Argentina and Brazil), while we maintain the forecasts for the coming years in US and China, after recording a good economic performance in the first part of the year and with the fundamentals still being solid for domestic demand.

The global scenario continues to be subject to mostly negative risks, which in recent months have increased. Apart from this, the risk of a trade war has intensified in the wake of the latest measures adopted by the United States and the response from China, mainly, and to a lesser extent, from the rest of the countries affected. Added to this are new protectionist threats that would involve the interests of important sectors in other regions, such as the automotive sector in Europe, Mexico, Canada and Japan. While the direct impact of the measures, as discussed above, should be limited, the risk of a trade war could act as a drag on confidence, increase risk aversion in the markets and curb global flows of direct investment, with the consequent impact on the potential of global growth.

In addition, in a more volatile financial environment, systemic risk would increase in emerging economies. The combination of greater protectionist risk and the risks posed by a faster normalisation of monetary policy in the US and a possible slowdown in the global economy could trigger the perception of risk in emerging financial markets, raising the likelihood of a sudden stop or even a reversal of capital flows. In this context, the risk of an abrupt adjustment in the Chinese economy remains, since some measures to respond to a possible trade war could limit and delay the process of deleveraging and restructuring of the Chinese economy.

3. Argentina: an abrupt end to the gradualist dream

Negative differentiation of Argentina as global risk aversion mounts

In our previous report we drew attention to the risk of a sudden stop in external financing to Argentina given its growing current account deficit (4.9% of GDP in 2017) and the inadequate level of reserves in case of an abrupt tightening of conditions in the international credit market. However, the impact of global financial tensions on the local currency market was much greater than estimated, in part due to previous policy errors and to mismanagement of the currency crisis.

By mid-May, the currency had already depreciated by 32% relative to December 2017 and by 20% since the end of April, despite frequent interventions and the loss of nearly US$12 billion of the BCRA's reserves compared to the January peaks. The lack of credibility of the Central Bank of Argentina to moderate the run on the currency and capital flight led to the request for IMF assistance to restore market credibility and achieve an orderly adjustment process without crowding out the private sector. A high level acces Stand-By Arrangement of USD 50 billion over three years was signed in mid-June subject to compliance with stricter fiscal targets, and net international reserve targets, but with more relaxed inflation targets and without requiring broader structural reforms.

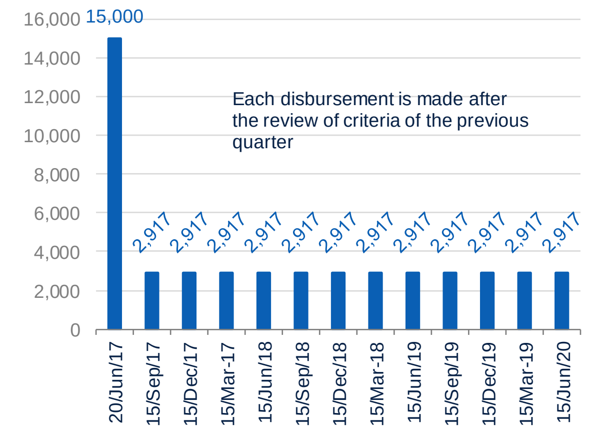
Emphasis was placed on the need to give the central bank greater independence, with reforms consisting mainly of the immediate prohibition of continuing to finance the Treasury and the clean-up of the BCRA's balance sheet by reducing the stock of Lebacs, but the agreement did not include other conditions such as structural reforms in the area of labour or social security, although it did provide a floor for social expenditure which could rise to 0.2% of GDP in the event of profound deterioration of conditions in the most vulnerable sectors.

Despite the sizeable amount of the loan and the speed with which the first disbursement of USD 7.5 billion was obtained (see Table 3.1), the currency market did not start to stabilise until the beginning of July, following the change of President of the Central Bank and the implementation of a new monetary squeeze. In a country that is used to abrupt changes in relative prices, with a high propensity to dollarization of portfolios on the part of savers, the run on the currency significantly increased uncertainty regarding the economic future, damaging the government's approval ratings and taking consumer confidence to levels of greater pessimism.

The plentiful international financing of 2016-2017 enabled the Macri administration to fulfil its initial aspiration of avoiding an abrupt adjustment of the economy in order to correct the macroeconomic imbalances inherited from the previous administration. However, in the markets' eyes the fiscal consolidation and the advances in productivity achieved by Argentina in the first 2 years were too slow to ensure the sustainability of the debt ratios in a global environment of sharply falling liquidity and declining flows to emerging markets. This, added to BCRA policy mistakes such as the raising of inflation targets in December 2017 and the consequent cut in interest rates of January 2018, led to significant foreign private capital outflows from Argentina and the impossibility of tapping global credit markets, making a faster reduction in the fiscal and external imbalances inevitable, with the consequent decline (Figure 3.2) in the expectations of improvement in incomes that had characterised the early days of the Cambiemos administration.

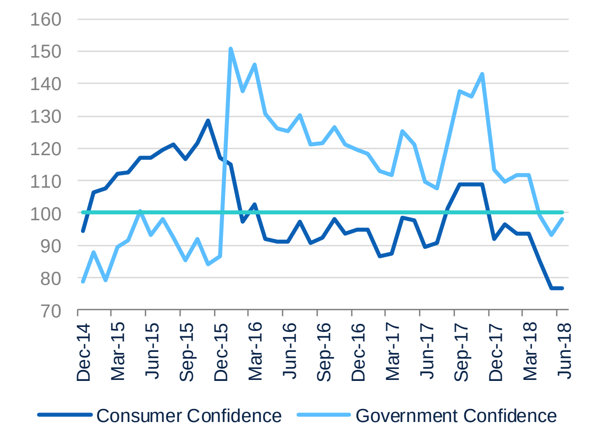
Our assessment of the IMF agreement is positive, given the closing of access to capital markets for emerging countries in general and Argentina in particular, since it avoids a more abrupt fiscal and current account adjustment than would be the case without IMF support. The key now is to finish consolidating the stabilisation of the currency market and for the government to meet the new fiscal targets so as to regain access to credit markets in 2019 with more sustainable fiscal and debt paths.

Figure 3.1 IMF Stand-By Arrangement Disbursement Schedule
(USD millions)



Source: BBVA Research on IMF Memorandum of Understanding

Figure 3.2 Consumer confidence index and Confidence in the government (Base 100 = historical average)



Source: BBVA Research based on data from the Financial Research Centre of the Torcuato Di Tella University

4. Despite solid performance in 1Q18, the economy will grow by only 0.5% in 2018 due to the drought and the currency crisis

In the first quarter of this year, economic activity continued to expand as seen since mid-2016, with a GDP growth of 1.1% QoQ (seasonally adjusted) and 3.3% YoY. However, initial indicators of activity in the second quarter already show a significant slowing from the effects of the drought, which led to a fall of 39% YoY in the soybean harvest and a 15% YoY fall in the maize (US: corn) harvest. Industrial activity contracted for the first time in twelve months: -1.2% YoY (Monthly Industrial Estimate (EMI in the Spanish acronym)), in part influenced by lower food production (soybean oil and meal), while at the same time there was a significant slowdown in construction activity from 14.5% YoY in the first four months of 2018 to 5.8% YoY in May due to the slowing of public works and the reduced number of public works starts. We estimate that the negative trend will have deepened in June (when exchange rate volatility and interest rates were very high), to end the second quarter with a fall in GDP of 2.1% (seasonally adjusted) relative to 1Q18.

The uptick in inflation caused by the exchange rate volatility will probably lead to a fall in real wages and incomes, which together with still very high interest rates will in turn lead to a certain brake in consumer and investment decisions, causing an additional contraction of the economy (-0.8% QoQ seasonally adjusted) in the third quarter of 2018. We believe growth will start to recover again modestly (+0.2% QoQ) in 4Q18 on the back of a bumper wheat harvest and improved prospects for sowing maize and soybeans (see Figure 4.1). The main impact of the currency crisis will be seen in private consumption, due to the fall in real incomes, and public consumption due to the fiscal adjustment, since investment will continue to grow above the average, albeit to a lesser extent (6.4% in 2018, slowing sharply relative to the 18.3% YoY in 1Q18) due to the continuation of projects already under way and the implementation of construction programmes for road and rail networks financed through public-private partnership (PPP) schemes which had already been awarded. Adjustments to the external sector will be slow, since exports of goods will not react quickly, affected as they are by the drought, (+3% YoY in volume in 2018 compared to -0.4% in 2017), while the inertia of imports, which increased by 16.5% YoY in 1Q18, will prevent a fall on average in 2018, and delay full year import contraction until 2019.

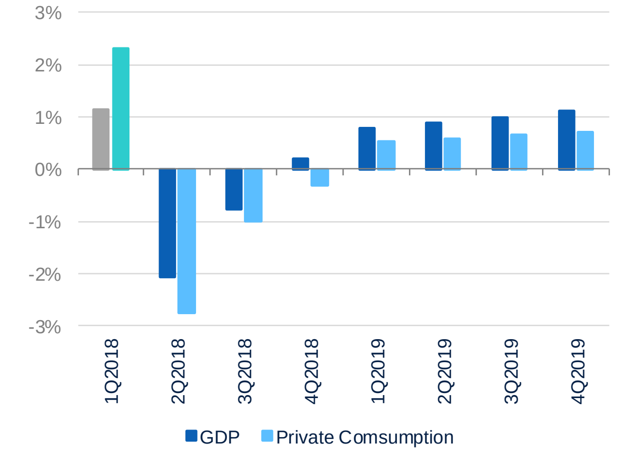
Next year, due mainly to the negative statistical lag from 2018, the economy will grow by only 1.5% on average, although GDP at the end of the year should be up by 3.9% YoY, driven by the recovery of exports (+2.3% YoY) and investment (+4.3% YoY). The economy will continue to grow at a rate of around 0.8/0.9% per quarter, once the impact of the crisis has been overcome, and taking into account the favourable effect of the depreciation of the peso on tourism and other tradeable sectors (such as wine and timber production) which will improve the performance of regional economies.

Our forecasts for both this year and next depend on the currency crisis stabilising in the second hal of the year and also on the change in relative prices (depreciation of the currency in real terms) being maintained over time so as to stimulate demand in tradeable sectors and encourage substitution of certain imports. The economy could slow more than envisaged if volatility persists along with doubts about the future of the economy, and above all if much of the devaluation is quickly passed through to prices, eroding the correction of the currency appreciation achieved so far.

Unemployment, which had fallen significantly at the end of 2017, will probably increase again in the next few quarters as a result of the decline in the level of economic activity. Social security data for April already show stagnation in formal employment (both public and private) since the end of 2017 while at the same time there has been a slight reduction of 0.5% in the number of self-employed or independent workers, which suggests a certain deterioration in temporary employment.

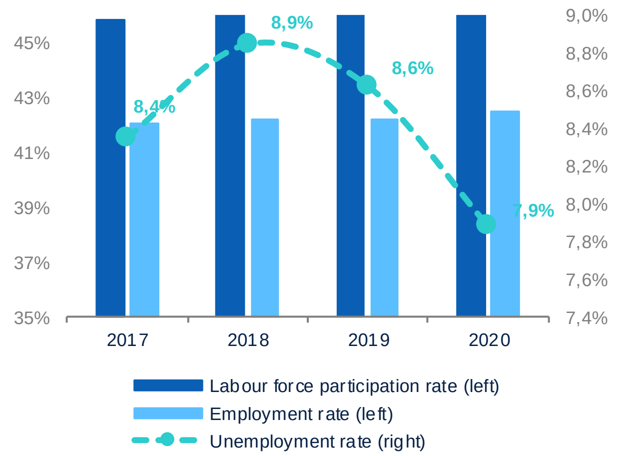
The increase in the unemployment rate in 2018 will however be relatively moderate, to 8.9%, since there will be mitigating factors such as a possible moderate reduction in the labour force participation rate (people removing themselves from the labour market due to reduced chances of finding work) and certain preventive programmes of the government, such as REPRO, which grant subsidies to companies in order to avoid lay-offs (Figure 4.2). In 2019, unemployment will probably fall again modestly on the back of the recovery in economic activity, although it will not go below 8% until 2020, assuming that labour participation remains slightly below the current levels.

Figure 4.1 GDP growth and Private consumption
(change % QoQ seasonally adjusted)



Source: BBVA Research based on data from INDEC (National Statistics and Census Institute)

Figure 4.2 Labour force participation, employment and unemployment rates
(in % of the urban population and of the working population)



Source: BBVA Research based on INDEC data

5. The impact of the devaluation is accounted for in the new looser inflation targets but they could be overshot again...

Expectations of a fall in inflation to below 2% a month from May on were once again dashed by the rapid depreciation of the peso (by 32% since the end of April), despite there being no material increases in regulated prices. With core inflation averaging 2.95% a month, the CPI showed a cumulative increase of 8.8% in 2Q and of 16% for the first half of the year. In fact inflationary inertia, far from slowing, remained high, as shown by our measurement of trend inflation calculated using “optimal trimmed averages” which improves on the performance of core inflation of the CPI-CABA which is constructed by excluding regulated and seasonal prices (See Box: An alternative measure of core inflation for Argentina).

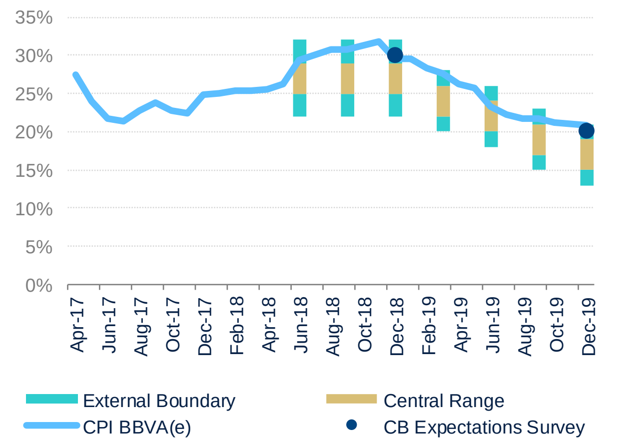
In this context of accelerating inflation, the programme agreed on with the IMF emphasised immediate reduction of fiscal dominance and greater independence for the BCRA (at the same time as Argentina committed to sending a draft reform of the Central Bank’s Charter to Congress) in order to reduce inflation. In this way all direct or indirect financing of the Treasury was eliminated and the Central Bank will not be able to transfer its profits to the Treasury again until it has reached an appropriate level of capitalisation. The stand-by agreement retains the system of inflation targets using the monetary policy rate (MPR) as the main instrument and a floating exchange rate system (with occasional interventions by the BCRA in the event of exceptional turbulence). The new targets reflect a more gradual disinflation path, but include a system of accountability to the IMF, and presumably also to Congress, for targets missed.

In line with what was agreed with the IMF, the central inflation targets were revised upwards to 27% YoY for the end of 2018, 17% for the end of 2019 (from the previous target of 10%), 13% (from the previous 5%) in 2020 and 9% (previously 5%) in 2021. However, these are not considered quantitative evaluation targets for disbursement purposes and consultation with IMF board and proposal of additional measures being required only if inflation exceeds the outer bounds of 32% and 21% at the end of 2018 and 2019 respectively (see Figure 5.1). Looking ahead, we expect a gradual slowing of monthly inflation to 1.7% average in 4Q18 (1.9% MoM in core inflation) and 29.6% YoY in December, somewhat above of the central target range but within the outer bands of the IMF, although much will depend on the levels of pass-through. It is too early to assess, but the pass-through to prices of the depreciation of the currency will probably be below Argentina’s historical average, taking account of the impact of the abrupt fall in private and public consumption and the high level of interest rates.

In our baseline scenario, much of the fall in inflation comes from the stabilisation of the currency market, but there may also be significant inflationary pressures from possible revisions of wage agreements from the 15% YoY increases in the first four months of 2018. For the time being, this risk seems limited, since a process of mass renegotiation between employers and employee representatives has not yet started. Bearing in mind that until April the growth in formal wages lagged the increase in prices, we estimate that the average wage increase is unlikely to exceed inflation in 2018. Furthermore the fall in activity in 2Q and 3Q will help to moderate inflationary pressures.

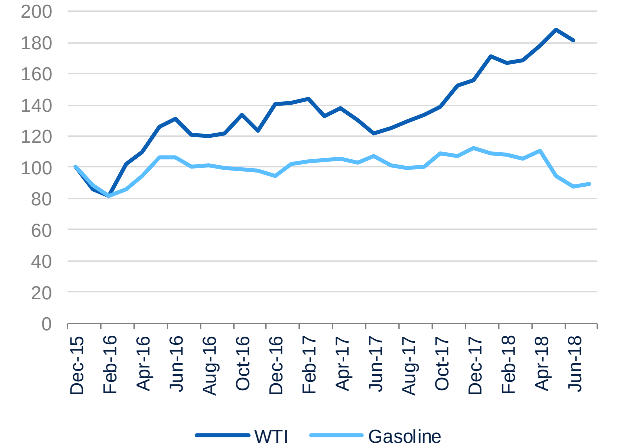
Although no major increases in tariffs are envisaged for the second half of 2018, the sharp depreciation of the peso and the increase in the international price of crude oil could generate additional pressures on energy prices in a market in which prices of liquid fuels have been deregulated since the end of 2017 (see Figure 5.2). Prices of gas in the domestic market continue to be controlled by the government, since they are subject to subsidies and incentives to encourage investment in the Vaca Muerta shale, but they will also suffer upward pressure from the depreciation of the peso, especially in a context in which the government will have to continue to reduce subsidies to the energy sector in order to meet the fiscal targets. Again, it is unlikely that the whole increase in crude prices will be passed through to domestic prices or gas tariffs bearing in mind the expected fall in demand, but undoubtedly the negotiation of prices will involve conflicts regarding distribution among sectors.

Figure 5.1 IMF targets and CPI estimates
(changes % YoY)



Source: BBVA Research based on INDEC and IMF data

Figure 5.2 International price of oil and price of petrol (gasoline) in dollars
(Index Base 100: December 2015)



Source: BBVA Research based on data from Haver and the Ministry of Energy

Box: An alternative measure of core inflation for Argentina

Consumer price indices may give inaccurate signals about the trend rate in increase in prices in an economy, if for example the discretional upward correction of regulated prices leads to “discrete jumps” in the CPI that can be mistaken for an acceleration of inflation. It is therefore crucial to have a measure of trend inflation, to separate short-term movements from the “cruising speed” of prices on which the BCRA’s monetary policy must focus. The usual measure of underlying inflation is “core” inflation, obtained by removing from headline CPI the items considered most volatile, notably food and energy. However, the categories excluded may contain useful information on inflationary pressures in the economy, and those included may reflect the impact of transitory factors, so this method too may give erroneous signals about trend inflation. To resolve this, BBVA Research uses an alternative measure of trend inflation for the CPI of the City of Buenos Aires (“CPI CABA”), constructed using the “optimal trimmed means” method[1]. This method “trims” the extreme changes in the distribution of the variation in CPI CABA each month, choosing the “trim” with the greatest predictive power for headline inflation at a six-month horizon. We thus seek to separate the inflation trend from the temporary noise, ignoring the most volatile monthly price changes the better to measure the nature and speed of the inflationary process, which is crucial in an inflation targeting scheme.

The CPI CABA (the longest available official series) is divided into 55 items, which are those we use. We proceed as follows: (1) each month we rank in ascending order the monthly variations of each component of the CPI and their respective weights in the consumer basket; (2) we define the cumulative weight to the n^{th} component of the CPI and we determine what percentage of observations that will be trimmed from each series; (3) we calculate the weighted average of the observations that survive the trimming; (4) we evaluate the predictive capacity of 2,600 trims, selecting the optimal trim. Applying this procedure, our results indicate that the “optimal trim” for the CPI CABA is the asymmetrical trim that excludes each month 39% of the extreme values in the left hand side of the distribution and 43% of those on the right. In other words only 18% of each month’s price variations are included.

Monthly inflation as measured by the CPI CABA and as measured by optimal trimmed means have a high degree of correlation (0.78), but optimal trimmed inflation has – as is to be desired – much less volatility and fewer outliers. The statistics bureau of the City of Buenos Aires (CABA) also reports a core CPI constructed using the exclusion method (without seasonal and regulated goods and services prices). The correlation between headline and core inflation is less (0.73) and core inflation is more volatile than in the optimal trimmed means method. Thus inflation measured by optimal trimming emerges as a more appropriate measure of trend inflation than the official core inflation.

Once we have obtained the optimal trimmed mean, we use it to estimate the trend component of the following months. According to these estimates, average monthly trend inflation will be 2.3% until December 2018 and 1.8% in 2019, resulting in an annual inflation of 28.6% in 2018 and 24.4% in 2019 (Figure 2).

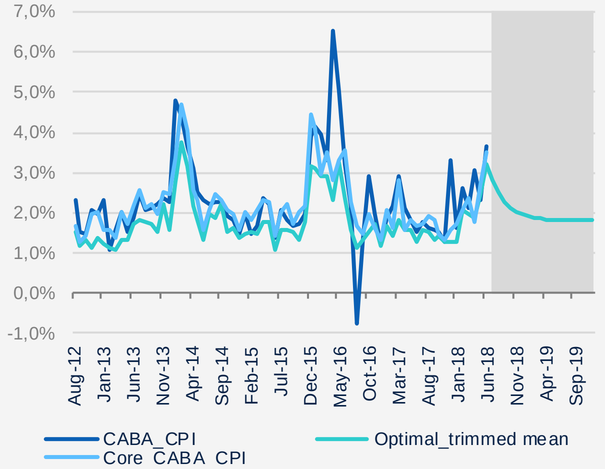
[1] BBVA Research (2018): *“An alternative measure of core inflation for Argentina”*. Download

Table R.1 Statistics of monthly inflation measured by the CPI CABA, the core CPI CABA and optimal trimming

	CPI CABA	Core CPI CABA	Optimal trim
Mean	2.23	2.19	1.77
Median	2.11	2.01	1.56
Maximum	6.54	4.70	3.73
Minimum	-0.075	1.29	1.08
Standard Deviation	1.05	0.75	0.61

Source: BBVA Research and Statistical Institute of the City of Buenos Aires ("SICABA")

Figure R.1 Monthly inflation measured by the CPI CABA, the core CPI CABA and optimal trim, and forecasts



Source: BBVA Research based on SICABA data

6. The strong tightening of monetary policy to combat currency volatility is unlikely to be relaxed in the short term

The cut in the monetary policy rate in January 2018, in a context of accelerating inflationary expectations, led to a significant loss of confidence in the central bank's monetary policy and in its independence, which started to be reflected intensely in the currency market when international financing conditions hardened. The run on the currency, which started at the end of April, forced the Central Bank to raise the monetary policy rate to 40% at the beginning of May, while at the same time the rate on Lebacs in the secondary market started to rise in reaction to the risk posed by the renewal of the stock of BCRA paper (equivalent to US$45 billion at year-end 2017, not counting holdings of the financial system) in a market with very little demand for real balances in pesos.

With this weakness in mind, the agreement negotiated with the IMF was aimed at strengthening the central bank financially by means of a gradual redemption of the Lebacs through the cancellationby the Treasury of non-transferable treasury bills held by the BCRA for USD 25 billion in quarterly instalments of US$3.125 billion over a two-year period. Under this scheme, the Treasury will absorb pesos by issuing debt in the local market while at the same time the BCRA will use these funds transferred by the Treasury to pay back Lebacs at maturity. Although the monetary impact of this scheme is neutral, the Treasury's liabilities to the private sector will increase (cancelling debt to the public sector and BCRA) but with an extension of terms for the public sector debt as a whole through the reduction of the stock of Lebacs concentrated in the 35 day tranche.

The gradualism of this strategy seen against the large stock of Lebacs was not enough to diminish the uncertainty and mistrust that continued to affect the financial market after the announcement of the agreement with the IMF. In mid-June Federico Sturzenegger was replaced by Luis Caputo, until then Minister of Finance, as governor of the central bank, with the objective of improving crisis management thanks to his knowledge of financial markets and in view of the loss of credibility suffered by Sturzenegger in his two and a half years as the head of the institution. Caputo started to implement the policy agreed on with the IMF, replacing the BCRA's Lebacs with Treasury Bills, mitigating the expansionary monetary effect with an increase in minimum reserve requirements of 3 pp in June and another 5 pp in July, which at times took yields on Lebacs in the secondary market to levels in excess of 50% (Figure 6.1).

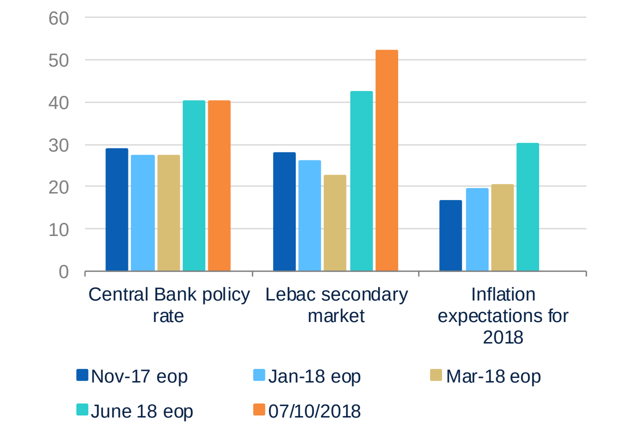
In addition to this strong monetary tightening, on 10 July the BCRA announced changes in its monetary policy approach, indicating that it would complement the inflation targeting scheme using the monetary policy rate as the only instrument of monetary policy with "more attentive monitoring of monetary aggregates". The Central Bank also reduced the frequency of monetary policy decisions from fortnightly to monthly, based on the idea that these decisions should reflect a certain persistence consistent with the outlook for inflation trends of the following months. However, in situations of high volatility such as the current one, the BCRA will continue to intervene actively in the secondary market for Lebacs in order to reinforce the signal from monetary policy, when necessary, between policy rate decisions.

According to the monetary authority, the aim of controlling liquidity in the broad sense justifies the use of a wider range of instruments (Figure 6.2). It is still not clear whether this is a permanent shift towards a system of monetary aggregate targets, or which would be the objectives and aggregates to be monitored, but it looks as though a scheme is taking shape in which signals of contraction or expansion of monetary policy will no longer come exclusively from the monetary policy rate but from the direction of rates in the secondary Lebac market and possibly macroprudential measures such as changes in minimum reserve requirements. In general, in countries like Argentina with high volatility and unpredictable shifts in demand for money, a system of control of monetary aggregates would increase interest rate volatility and could reduce the transparency of monetary policy, jeopardising the objective of improving communication, transparency and "accountability" as the central bank is proposing with this new scheme.

Although the currency market started to stabilise in July, serious challenges remain ahead, since the BCRA must start to generate confidence once more and show independence in its fight against inflation. In this scenario we expect the reduction in the monetary policy rate to be slower than in our previous scenario, without ruling out occasional hikes if the markets do not stabilise.

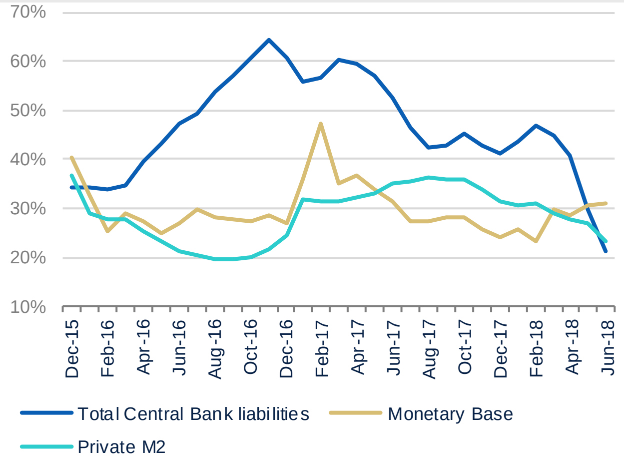
Although the currency crisis did not spread to the financial system or lead to deposit withdrawals requiring contraction in lending, demand for credit will undoubtedly suffer a slowdown in the remainder of the year. Loans, which had been growing strongly (approximately 55% YoY), started to slow down due to the sharp rise in interest rates and the greater uncertainty and the rise in the inflation rate which interrupted the incipient development of the indexed mortgage loan market.

Figure 6.1 Monetary policy rate, yield on Lebac in the secondary market and expected inflation
(changes % YoY)



Source: BBVA Research based on BRCA and market data

Figure 6.2 Trends in monetary aggregates: M2, Monetary Base and Expanded Monetary Base
(changes % YoY)



Source: BBVA Research based on BCRA data

7. Fiscal adjustment at a faster pace will require political agreements to reach the targets agreed with the IMF in 2019

Until June 2018 the primary fiscal deficit had fallen by 26.7% YoY in nominal terms, reaching 0.8% of GDP in six months, which allows us to infer that it will be possible to comfortably meet the corrected target of 2.7% of GDP, if the slowdown in spending continues, which makes attaining the primary deficit target of 1.3% of GDP for 2019 more feasible.

The impact of the devaluation on the primary result may possibly prove neutral in 2018 due to the fact that the increase in export duties (which has a positive impact on tax revenues) will be offset by the greater than expected weight of energy subsidies (negatively affected by the currency depreciation and the increase in international oil prices). We are maintaining our projection for the total deficit after interest at 5.3% of GDP, since the improvement in the primary result will be neutralised by a greater interest burden, since approximately 50% of interest is denominated in foreign currency and will suffer the effect of the increase in the average exchange rate.

On the other hand, in 2019 the total deficit we now estimate will be less than previously estimated (3.9% now as opposed to 4.3% previously). In the first place, the IMF agreement contains a commitment to move faster to correct the primary deficit (new target of 1.3% compared with the previous 2.2%), secondly the IMF financing is presumably at below market rates, and the depreciation of the currency is expected to be less than in 2018, so the interest burden will gradually be lightened. Although the Memorandum of Understanding with the IMF does not define targets for the total deficit after interest, its reduction will be more gradual than the fall in the primary deficit given the growing indebtedness and the effects of the devaluation on interest on debt denominated in foreign currency.

The reduction of the primary deficit committed to for 2019 will require not only continuing with the planned cuts on energy and transport subsidies but also greater reduction in the public sector wage bill and discretional transfers to provinces, which will have to be negotiated with provincial governors for congressional approval of the Budget for 2019. Capital expenditures will also suffer another adjustment in 2019 (Table 7.1) because social benefits (pensions, family allowances, etc.) are not expected to fall in terms of GDP and they account for 60% of primary spending. With the new formula, they are adjusted with reference to past inflation, and in a context of decreasing inflation in the medium term, their relative weight within total spending is unlikely to decline. The implementation of measures aimed at bolstering revenues to preserve fiscal solvency in a more recessive scenario, such as suspending the reduction on duties on soybean exports or delaying the implementation of tax reform, is unlikely. Although these measures were suggested in the IMF staff report of July, the government has consistently refused to reverse its tax cuts due to a logical reluctance to wind back these reforms, since measures of this kind could have effects contrary to those hoped for in the medium term.

The official financial programme for 2019 (Table 7.2) presented recently involves placing US$8 billion (net) of debt in the domestic market plus the renewal of all the Letes (USD-denominated bills issued by the Treasury) maturing during the year. The stock of Letes stood at US$16.9 billion at the end of 2017, but since May 2018 it has been declining, as the Treasury did not renew all maturities, leading to a net cancellation of approximately US$3 billion of these debt instruments in the past three months. Instead, it has been issuing bonds with somewhat longer maturities than the Letes and denominated in pesos or payable in pesos, such as the new “dual” bond, which have also been applied to the strategy for reducing the stock of Lebacs.

The greater part of the fiscal deficit will be covered by the IMF's disbursements and multilateral organizations, so Argentina will not need to actually access the international markets for the rest of 2018 or in 2019. Although this volume of placements should not be a problem, the partial refinancing of short-term debt in foreign currency (Letes) and the exchange of Lebacs (issued by the BCRA) for debt instruments issued by the Treasury (the plan being to eliminate the stock of Lebacs held outside the financial sector in three years) could continue to cause some volatility in the markets.

Table 7.1 IMF agreement, scheduled variation in income and primary expenditure
(% of GDP)

	2018	2019	2020	Accum.
Tota Income	**-0.4**	**0.4**	**0.1**	**0.1**
Primary expenditures	**-1.5**	**-1.1**	**-1.1**	**-3.7**
Pensions and social subsidies	0.1	0.5	-0.2	0.4
Energy and transport subsidies	-0.3	-0.4	-0.4	-1.1
Salaries, goods and servicies	-0.4	-0.2	-0.1	-0.7
Transfers to provinces	-0.2	-0.3	-0.1	-0.6
Other expenditures	0.0	-0.1	0	-0.1
Capital expenditures	-0.7	-0.6	-0.3	-1.6

Source: Ministry of the Treasury

Table 7.2 Financing Programme 2018-2019
(USD billions)

	Jul-Dic 2018	2019
Financial needs	**19.6**	**32.3**
Primary deficit	8.4	7.4
Interest payments (priv., IFIs, pub. Financial sector)	6.0	14.0
Principal payments (priv.)	5.2	10.9
International principal payments (bonds)	0.3	2.8
Repo	3.9	3.2
Domestic principal payments (bonds)	1.0	5.0
Sources	**19.6**	**32.3**
International markets (gross)	0.0	3.0
Repo	0.0	4.0
IFIs	16.4	13.0
IMF	13.4	11.7
Others IFIs (net)	3.0	1.3
Domestic markets (gross)	3.2	12.3
Intra public sector	0.0	0.0
Net financing from markets		**8.0**
GDP (%)	0.4	1.4
FX rate (ARS/USD)	27.81	27.81

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

8. The adjustment of the external sector requires a depreciated and stable real exchange rate

Devaluation and reduced economic growth will tend to adjust the external deficit mainly through a reduction in imports (which are significantly elastic to GDP growth) and through a reduction in the deficit in real services. Thus the balance of trade, which had accumulated a deficit of US$4.69 billion up to May, will grow significantly less in the rest of the year, reaching a full-year figure of US$8.2 billion, slightly less than in 2017, whereas at the beginning of the year we were forecasting an increase in the imbalance to US$12 billion. Imports, which were growing at 12% YoY to May 2018 will slow appreciably to reach an average increase of 7% YoY for the whole year, more in line with the lacklustre performance of economic activity in the coming quarters.

The real weakening of the peso against other trading partners' currencies and the US dollar will particularly affect the balance of real services, since we expect a significant increase in inbound tourism together with a sharp reduction in outbound tourism so that the deficit in real services (nearly 70% of which reflects tourism flows) will be reduced from US$9.9 billion in 2017 to US$4.1 billion in 2019. More than half the deficit in services estimated for 2018 corresponds to that posted in 1Q18, pre-devaluation, when imports of real services increased by 9% YoY, reflecting the real appreciation of the currency relative to the previous year. Argentines' foreign travel and spending will start to fall in the next few quarters and, together with the increase in inbound tourism due to cheaper local costs post-devaluation and the growth of low-cost flights, will lead to a contraction of the real services deficit by practically half in 2018.

However, we estimate that the reduction of the current account deficit will be slow, by around 0.2 pp of GDP in 2018 and 0.6 pp in 2019. This year, exports will remain weak due to the impact of the drought, which has reduced exportable tonnage of soybeans, maize (US: corn) and vegetable oils. Lower agricultural commodity prices as a consequence of the trade tensions between the US and China will also make greater reduction in the trade deficit difficult to achieve in the short term. However in 2019 the adjustment will be greater, since we foresee more dynamic exports due to the expected recovery in grain harvest barring weather problems, while the improvement in the real exchange rate must have a positive effect on placement of other agri-food products such as wines, fruits and vegetables.

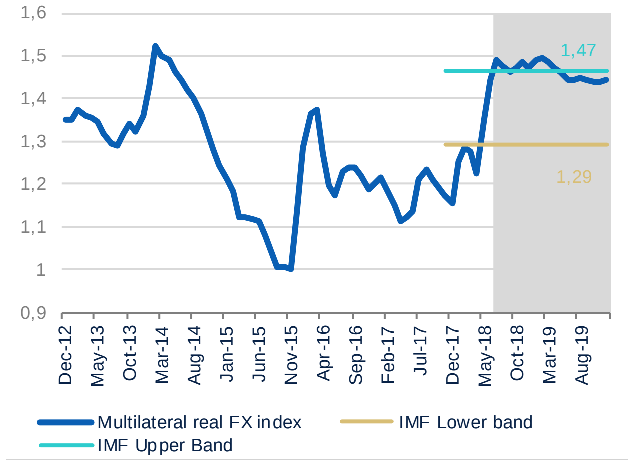
In this regard, it is crucial that the gain in exchange rate competitiveness be maintained over time, since exports react not just to a high but also to a stable real exchange rate. In terms of the nominal exchange rate the peso has depreciated by nearly 50% so far this year, most of the fall occurring between the end of April and mid-June, despite the forceful interventions of the BCRA of more than US$9 billion during the period. Following the IMF agreement it was established that the BCRA would intervene in the currency market only in exceptional circumstances and that it would cease its direct purchases of dollars originating from the issue of Treasury bonds. The dollars originating from the IMF's disbursement of USD 7.5 billion to the Treasury in June are to be auctioned to the public at around US$100 million a day in sessions conducted by the BCRA after the markets have closed.

Furthermore, the new Chairman of the Central Bank implemented a series of measures to "improve the functioning of the market", the main objective of which was to normalise demand and supply of hard currency in order to contain the pressures on the exchange rate. So far, the measures have proved successful (increase in minimum reserve requirements for the financial system, allowing the increase in reseerves to be met by purchase of National Treasury Bonds in pesos maturing in 2020, flexibility for financial institutions to be able to acquire Letes in dollars in the secondary market, daily dollar auctions, etc.) which allows us to posit the start of a phase of relative stability in which the currency may tend to appreciate at times following the initial over-shooting, and in view of the reserve reinforcement deriving from the initial disbursements from the IMF. In this scenario we estimate that in the second half of the year the exchange rate will tend to hold relatively steady (28.9 ARS/USD at the end of 2018) while in 2019 it will vary by less than the inflation rate (32.9 ARS/USD at year-end, +14% YoY).

Up until the end of June 2018, Argentina's currency had depreciated by 25% in terms of the real multilateral exchange rate relative to its peak in December 2017. At its current levels it is even slightly depreciated relative to the equilibrium values estimated by the IMF in its review of Article IV at year-end 2017 when it calculated that the currency was overvalued by between 10% and 25% (see Figure 8.1) . However, part of this gain in competitiveness will be eroded by inflation in the coming months, although we estimate that with a moderate pass-through and less global appreciation of the US dollar, the peso will strengthen by only about 1.7% in the second half of 2018.

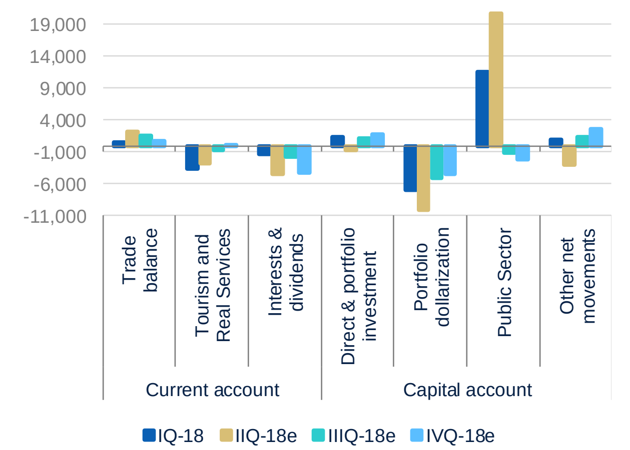
The adjustment to the current account deficit that we are estimating is crucial to stemming the loss of international reserves, but it will not be possible to achieve this if portfolio dollarization by residents is not curtailed. Savings in dollars reached US$22 billion in 2017 (practically double the 2016 figure) and grew strongly in 1Q18 and probably in 2Q18 too. However, the completion of the liquidation of portfolio positions in pesos towards mid-year, together with the reduced capacity for saving in foreign currency post-devaluation, can be expected to lead to an appreciable reduction in dollar hoarding by residents in the remainder of the year (Figure 8.2). In a scenario with no significant portfolio investment inflows or placements of sovereign bonds in the international credit market, this, together with the disbursements of multilaterals, could be enough to achieve a moderate recovery of the international reserves in line with the agreements made with the IMF (+US$5.5 billion compared with June 2018).

Figure 8.1 Real multilateral exchange rate and IMF "bands" (Index base 1 = November 2015)



Source: BBVA Research based on data from BRCA, INDEC and Haver

Figure 8.2 FX market balance 2018: main items (USD millions)



Source: BBVA Research based on BCRA data

9. Given an adverse international scenario, the adjustment programme will require careful navigation through choppy political and social waters so as not to jeopardise structural advances

The risk of a sudden stop in capital flows which we warned of in our last report unfortunately materialised in the second quarter of this year, affecting Argentina with particular virulence because of its large external financing requirements and modest backing in international reserves. The crisis was concentrated in the FX market, but it highlighted the need to advance more quickly towards a reduction in the public deficit to lessen dependency on short-term capital inflows. In this context, although the financing obtained from the IMF moderates exposure to the appetite of international capital markets, the increase in global risk aversion will continue to affect Argentina's currency market via portfolio flows of residents and non-residents alike. We cannot say that the global financial context has stabilised, and it could even continue to deteriorate, given the increase in trade tensions and the imposition of tariffs by the US and China which are starting to affect commodity prices and could produce a negative shock to terms of trade for Argentina. Therefore new bouts of exchange rate volatility in emerging markets cannot be ruled out, and they would have a more than proportional impact on Argentina, given that adjustment of the current account will be slow and the Treasury will need to continue to place relatively short-term debt in order to absorb the surplus in BCRA local currency paper.

The agreement with the IMF has avoided a disorderly adjustment to growth from abruptly balancing the external deficit, but the next few months will undoubtedly see a deterioration in the performance of the economy and in unemployment together with an acceleration of inflation. Although the national and provincial governments have taken measures to contain social discontent stemming from inflationary pressures, conflict could increase, especially bearing in mind that the distribution of the costs of the adjustment among sectors and provinces is soon to be discussed. The budgetary decisions on which segments of spending to cut and how fast to continue with the reduction of the tax burden on the private sector will give rise to strong debate both in and beyond Congress.

In the medium term, the greatest risk is that the need to focus on the short-term emergencies caused by the crisis, together with the political cost of rebalancing the economy towards a lower imbalance between savings and investment might lead the government not just to pause the structural (e.g: labour) reforms but to back track on the fiscal pacts already reached with the provinces, endangering the reduction of distortive taxes such as export duties or provincial taxes on gross revenues. In our recent paper on the potential of Argentina as an FDI destination[2] we pointed out that the potential derives not just from the natural resources and the size of the market, but also from legal and institutional stability, which is a key variable when determining the attractiveness of an economy for long-term investors. As shown in Table 9.1, the first column refers to the ranking of FDI as a percentage of GDP actually received in the period 2010-2017, while in the second column we show the ranking of potential attractiveness to investors without including an "institutional quality" variable, which is taken into account in the last column and significantly changes the ranking.

For 2019, this situation generates uncertainty as to how the government will shape up to the electoral test. As little as seven months ago the consensus of political analysts foresaw no major problems for Macri in being re-elected, but the outlook is less clear after the recent crises of both currency and confidence. It is still very premature to draw electoral scenarios with any degree of certainty, but if the currency market stabilises in this 2H18 and activity starts

[2] BBVA Research (2018): "*Foreign Direct Investment into Argentina*". Download

to recover – as we expect – in 4Q18 and consolidates in 1H19, Argentina will reach the elections with a positive economic momentum which, bearing in mind the fragmentation of the opposition, means a second term of office for the current administration is still on the cards.

Table 9.1 Comparative ranking: receipt of FDI, attractive potential, including the institutional variable (2010-2017) (Total countries: 189)

Country	Actual FDI received	Potential for FDI attraction	Potential FDI attraction including Institutional Variable
Brazil	19	46	58
Colombia	25	77	57
China	27	5	39
Spain	37	27	30
Mexico	41	23	28
Czech Republic	46	12	11
Uruguay	52	71	52
India	61	21	47
Turkey	79	2	5
Argentina	**86**	**33**	**60**
Egypt	89	43	61

Source: BBVA Research

10. Tables

Table 10.1 Annual macroeconomic forecasts

	2016	2017	2018e	2019e
INDEC GDP Base 2004 (% YoY)	-1.8	2.9	0.5	1.5
Domestic CPI inflation (% YoY, eop)	39.4	24.8	29.6	20.8
Exchange rate (vs. US$, eop)	15.8	17.7	28.9	32.9
Policy rate (%, eop)	24.8	28.8	32.0	21.0
Private Consumption (% YoY)	-1.0	3.5	0.5	0.1
Public Consumption (% YoY)	0.3	2.2	-1.1	-0.1
Investment (% YoY)	-4.9	11.0	6.4	0.3
Fiscal Balance (% GDP)	-5.8	-6.0	-5.3	-4.0
Current Account (% GDP)	-2.7	-4.9	-4.7	-4.1

Source: BBVA Research

Table 10.2 Quarterly macroeconomic forecasts

	INDEC GDP (% YoY)	Domestic inflation (% YoY, eop)	Exchange rate (vs. US$, eop)	Policy rate (%, eop)
1Q16	1.0	35.0	15.0	38.0
2Q16	-3.6	45.7	14.1	30.8
3Q16	-3.3	42.7	15.1	26.8
4Q16	-1.1	39.4	15.8	24.8
1Q17	0.6	32.2	15.5	24.8
2Q17	3.0	21.8	16.1	26.3
3Q17	3.8	23.8	17.2	26.3
4Q17	3.9	24.8	17.7	28.8
1Q18	3.6	25.4	20.2	27.3
2Q18	0.7	29.3	26.5	40.0
3Q18	-0.7	30.7	28.0	38.0
4Q18	-1.5	29.6	28.9	32.0
4Q19	-1.8	27.6	29.9	28.8
4Q19	1.1	23.4	30.4	25.9
4Q19	2.9	21.7	31.6	23.3
4Q19	3.9	20.8	32.9	21.0

Source: BBVA Research

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