BBVA Research

Argentina Economic Outlook

4Q18

October 2018

Creating Opportunities

Key messages

- The global environment remains positive, although growth is moderating due to the poorer performance of emerging economies. The impact of protectionism is so far limited
- In Argentina, a new round of capital flight and currency depreciation in August led to a further fiscal adjustment, the revision of the agreement with the IMF and the abandonment of the inflation target regime, which means an end to the economic program of President Macri’s first two years
- The new monetary-exchange rate scheme seeks to control FX volatility by absorbing all surplus liquidity in pesos and targets holding the nominal monetary base constant until June 2019 setting up broad bands within which the FX can float, with limited intervention by the Central Bank outside this band
- In 2019 the government will attain primary fiscal equilibrium with spending cuts and a new tax on exports, and the programme with the IMF ensures that the financial programme can be met with limited roll-over
- The currency crisis and the new monetary and fiscal tightening lead us to revise our forecast for GDP growth in 2018 and 2019 downwards and our estimates of inflation upwards. The sharp real depreciation of the peso and the recession will result in rapid correction of the current account deficit

Contents

01

Global environment still positive

Positive global inertia continues, although the risks are intensifying

Robust global growth, albeit more moderate and less synchronised

The strength of the US economy contrasts with moderation in China and Europe

Divergent monetary policy between the US and Europe from 2019

The Fed ends its cycle of increases, while the ECB starts its cycle and prepares to withdraw liquidity

Increased financial tensions in emerging markets

With clear differentiation between countries, the most financially vulnerable of them will face abrupt adjustments in their economies

Intensification of the trade war between the USA and China

Impact still limited, but could increase if new measures are taken. Conflict between the US and other regions diminishes,
for now

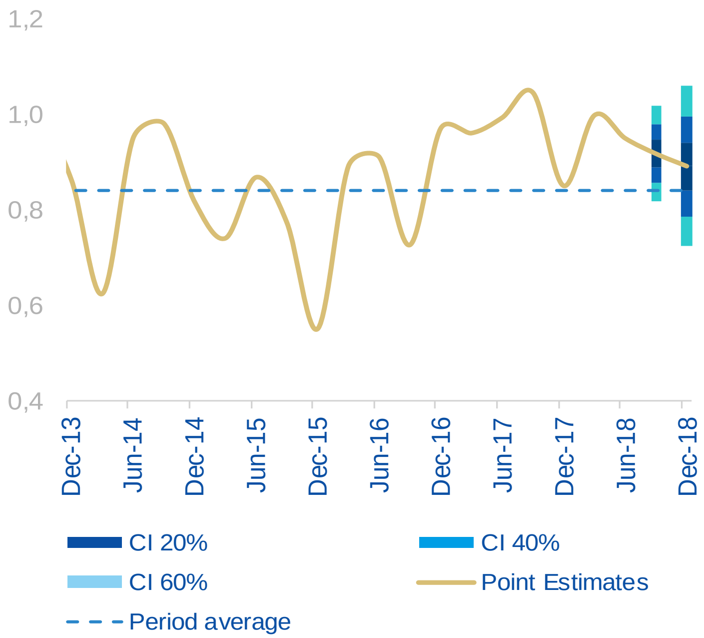
Global risks are intensifying

In addition to protectionism and the normalisation by the Fed, tensions are rising in emerging countries, and there is greater uncertainty in Europe

Moderation of global growth

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



Source: BBVA Research

- Slight moderation of global growth towards rates slightly below 1% QoQ in 2H18
- Activity data remain solid, but have lost momentum, as the increase in protectionism weighs down on confidence, trade and investment
- Apart from this volatility, world trade has improved and stabilised after the slowdown at the beginning of the year

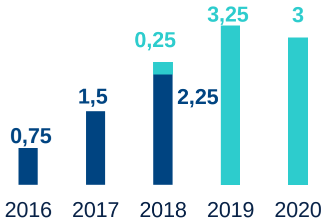
Monetary policy continues to normalise and will be divergent between the Fed and the ECB from 2019 onwards

Balance sheet

Interest rates

Balance sheet reduction continues (US$450 billion in 2018)

More rate hikes in 2019, but the cycle is ending (neutral interest rate)

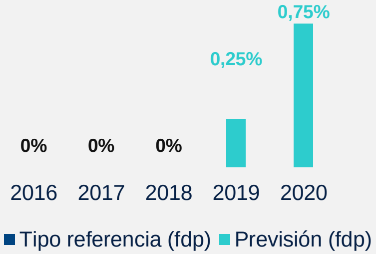


End of QE (December 2018)

Total reinvestment at least until December 2020

Repayment of TLTROs from June 2020

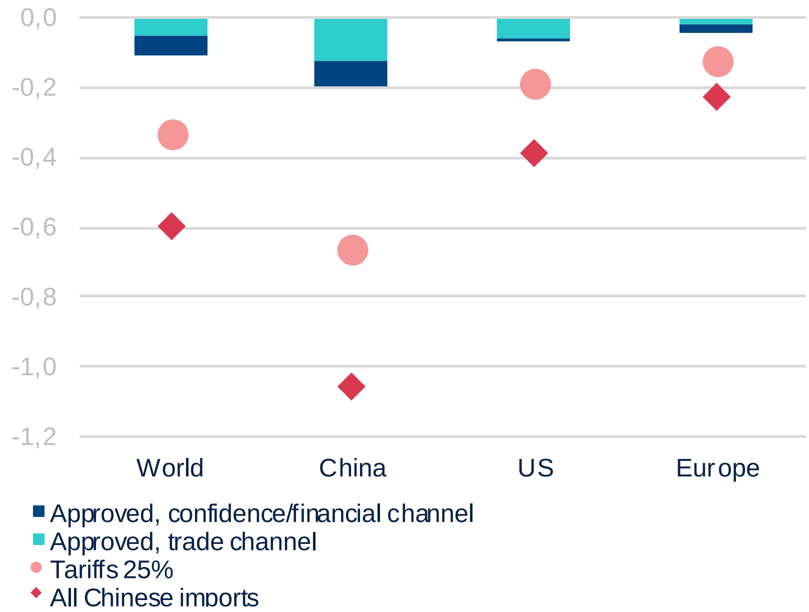
Anchored expectations of low rates for an extended period. **No interest rate increases expected until September 2019**



Source: BBVA Research

The US and China have announced higher tariffs, but the estimated effect on global GDP is limited

Effect on GDP growth of US tariff increases and other countries' reactions (2018-20, pp)



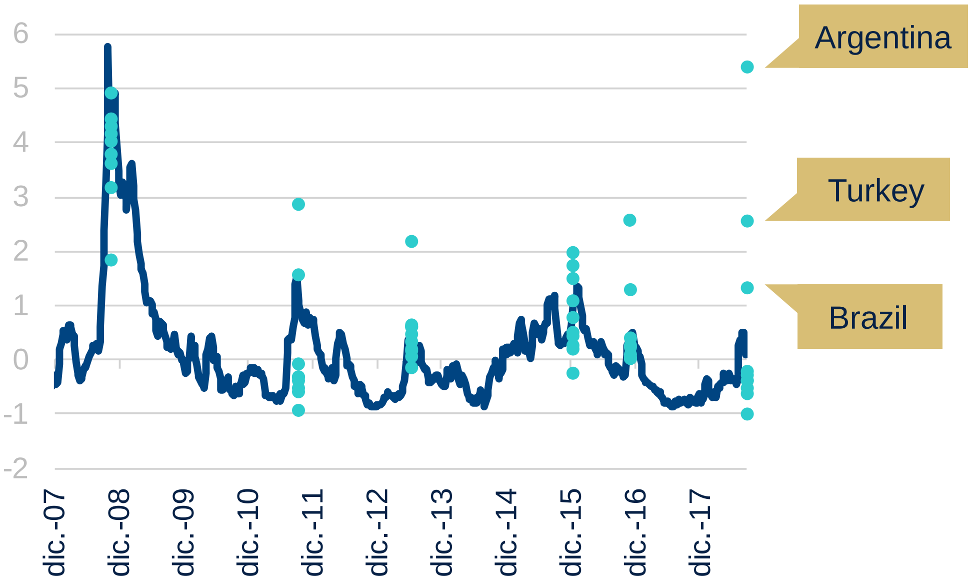
Approved tariff increases: US (25% on steel, 10% on aluminium, 25% on US$50 billion worth and 10% on US$200 billion worth of Chinese imports); China (25% on US$50 billion worth and 10% on US$60 billion worth of US imports)
Source: BBVA Research

- The impact on growth of the measures adopted so far through the trade channel might be limited, but the indirect effects would be considerable, especially for China and emerging economies
- The signing of the USMCA, assuming it is approved, reduces the uncertainty with Mexico and Canada
- In Europe, the increase in import duties on cars is on hold for the time being, but will be negotiated again starting in November

Financial tensions are rising again in emerging markets, but in a less synchronised way than in previous bouts

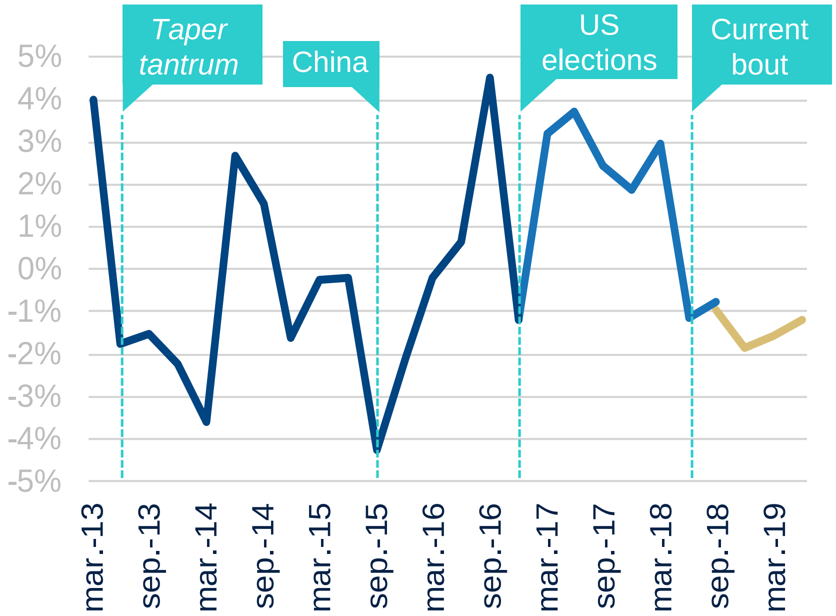
BBVA index of financial tensions for emerging economies

(normalised index)



Portfolio flows to emerging economies

(% of total asset, monthly data)

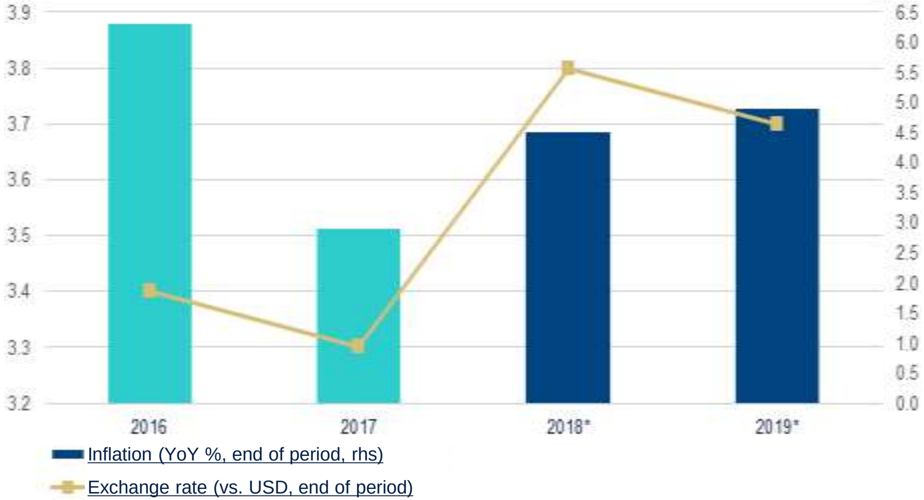


Source: BBVA Research

Brazil: growth gradually recovering

Brazil: Inflation and exchange rate

(% and reales per dollar, end of period)



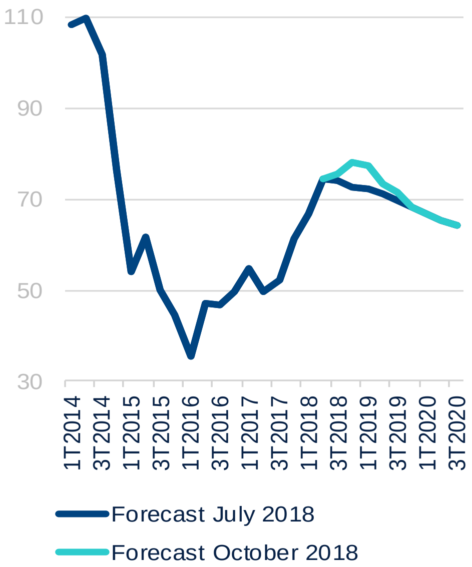
- The economy will continue to recover slowly. After growing by 1.2% in 2018, GDP should increase by 2.4% in 2019 and by around 2% in the following years.
- Although an ambitious reform of social security is unlikely, the next president will have to take steps to reduce fiscal vulnerability.
- The increased dynamism of demand will push inflation up. The central bank will have to raise SELIC interest rates from 6.5% to 10% over the course of 2019.
- The political environment will remain polarised after the elections, but the markets will no doubt allow very little margin for the adoption of non-pragmatic policies

The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019

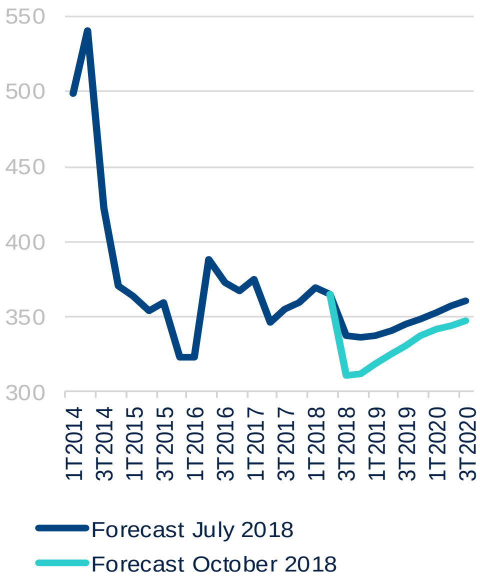
Source: BBVA Research

Disparity among prospects for commodities due to supply factors: Oil up; copper and soy beans adjusted downwards

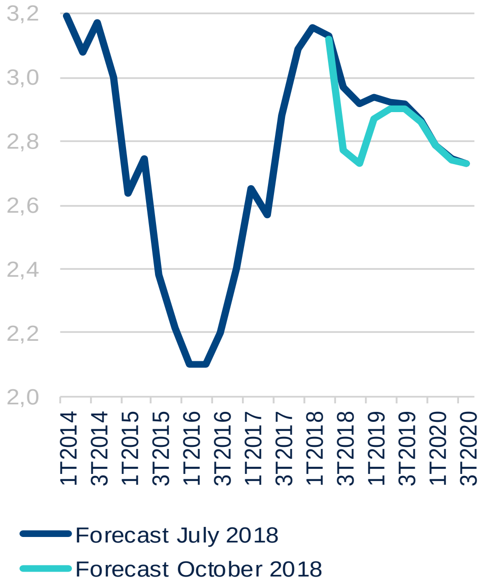
Crude Oil
(US$ per barrel)



Soya beans
(US$ per metric ton)



Copper
(US$ per lb.)



Price of oil revised upwards due to geopolitical factors (Iran and Venezuela). It will begin to flex downwards as export capacity recovers in the US and demand stabilises.

Price of copper revised downwards in view of reduced interest of financial investors. Strong correction in the price of soya beans due to the good harvest in the US. Copper and soy beans also affected negatively by the increase in trade tensions between the US and China

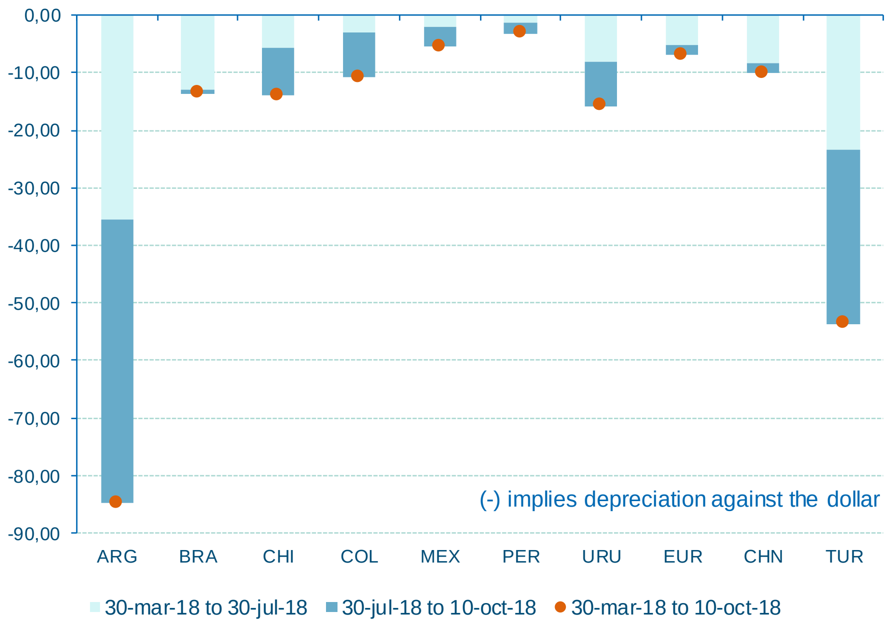
02

Argentina: Shuffle and deal again

New round of capital flight precipitated another adjustment in monetary and fiscal policy and the revision of the IMF agreement

Exchange rates against the US dollar

(chge. % cumulative)



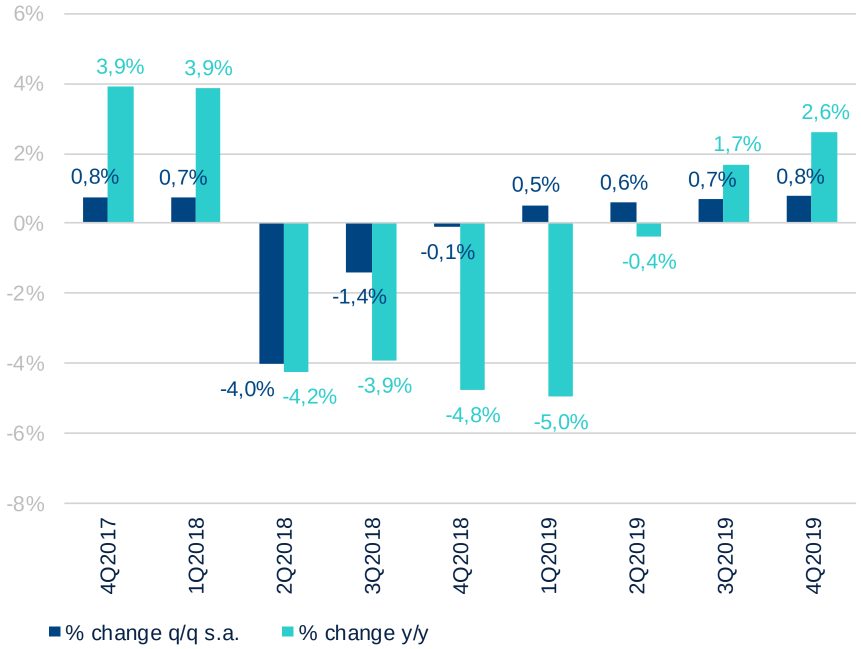
Source: Haver and BBVA Research

- The June agreement with the IMF did not succeed in restoring confidence and gave rise in August to a new round of capital flight and a sharp depreciation of the peso
- In an effort to reverse it, an additional fiscal adjustment was launched, targeting a primary fiscal surplus in 2019, an increase in funding from the IMF and an advance of funds to 2018-19 were negotiated
- Additionally, the new Governor of the BCRA (Central bank) abandoned the inflation targeting regime and put in place a new, highly restrictive monetary aggregates monitoring scheme and a “floating band” for the peso

GDP will fall by 2.4% in 2018, due to the drought and the currency crisis, and by 0.3% in 2019 due to statistical drag

Quarterly GDP

(change % QoQ seasonally adjusted and change YoY original series)



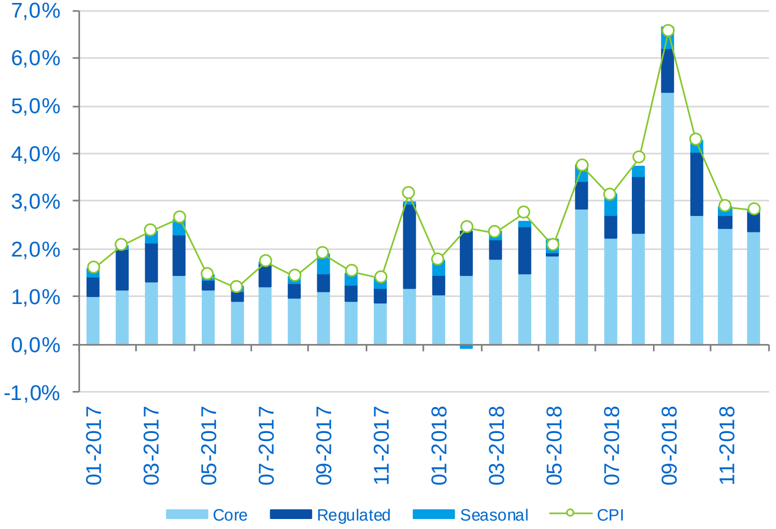
Source: INDEC (National Statistics Institute) and BBVA Research

- GDP fell very sharply in 2Q18 due to the serious drought and the currency crisis
- The continuation of the crisis in 3Q18, together with the acceleration of inflation, the fall in real incomes and the additional fiscal and monetary adjustment will cause domestic demand to contract further and GDP will fall by 2.4% in 2018
- GDP will start to grow QoQ in 1Q19 thanks to the recovery of agriculture, the impact of the real depreciation on exporting and import substituting sectors and the partial recovery of real incomes due to decelerating inflation
- However, the pace of growth will be weak, and due to negative carry forward from 2018, GDP will fall by 0.3% on average in 2019

Strong acceleration of inflation in 2018 due to the depreciation of the peso

National CPI: Contributions to inflation

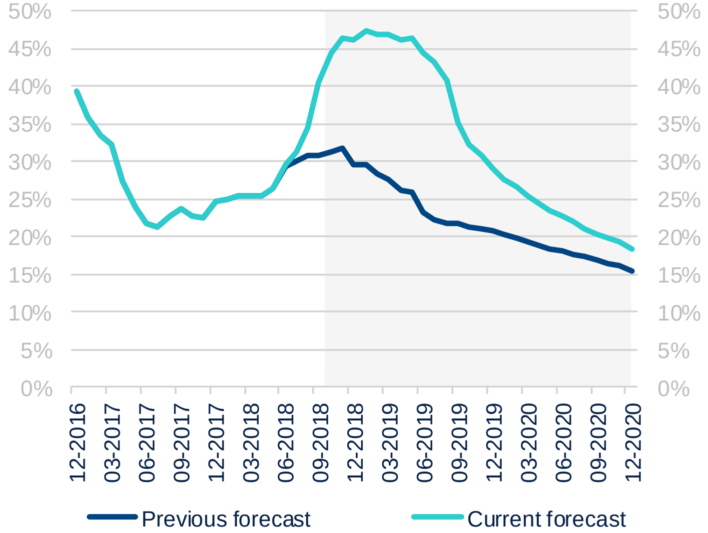
(change % MoM)



Source: INDEC and BBVA Research

National CPI: Previous and current forecasts

(change % YoY)



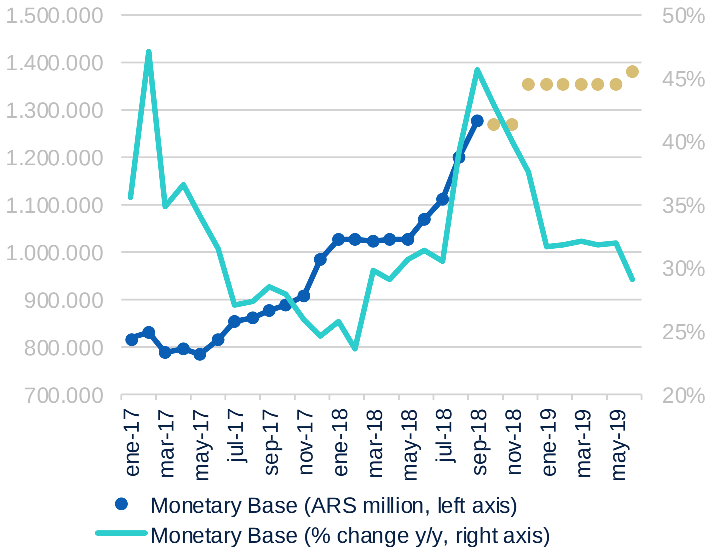
Inflation accelerated throughout the year, peaking in September (6.5% MoM, 40% YoY) and will not fall below 3% MoM until December.
Average monthly inflation went from 1.9% in 2017 to 2.5% in 1H18 and an expected 3.9% MoM in 2H18.

The sharp currency depreciation will lead to inflation ending 2018 at 46%, well above the 29.6% that we envisaged in our last report.
The central bank's restrictive monetary policy will bring inflation down to 29% in December 2019, with average monthly inflation of 2.3% in 1H19 and 2% in 2H19

Monetary aggregates monitoring replace Argentina's brief experiment with inflation targeting

Monetary base

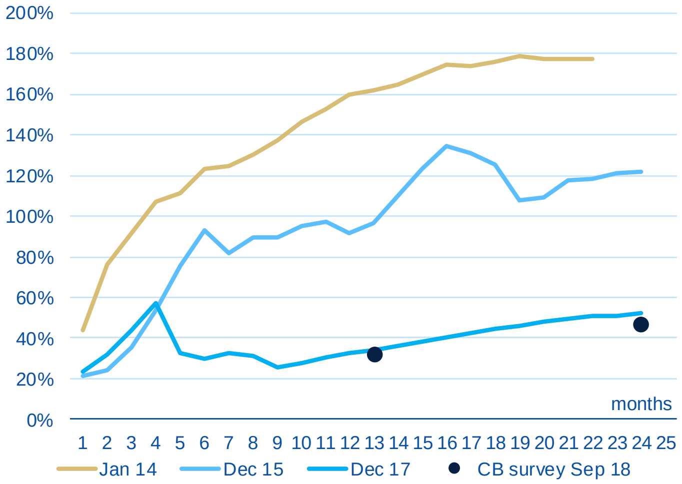
(billions of pesos and % change YoY)



Source: BCRA and BBVA Research

Pass-through to domestic prices

(accumulated inflation/accumulated FX depreciation Base= month of devaluation)



Source: BCRA, INDEC and BBVA Research.

The new Governor of the BCRA has replaced the inflation targeting régime with a simple rule: zero growth in the Monetary Base until June 2019. Growth can rise to 8% since two non-offset seasonal hikes are allowed, but this also implies a substantial fall in the monetary base in real terms.

The idea is to control the demand for dollars by absorbing surplus liquidity in pesos, but at the cost of high volatility and interest rates. This highly restrictive monetary policy will allow the *pass-through* effect to be contained and bring inflation down to 29% in December 2019.

Targeting primary fiscal balance in 2019

Requirements and sources of financing

(USD billion)

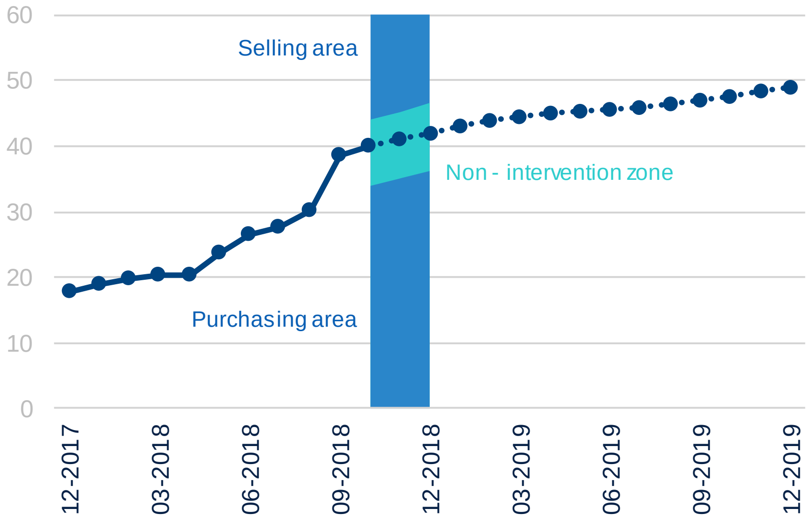
	Oct-Dec 2018	2019
Primary deficit	**5,7**	**0,0**
Natural gas subsidy program	**0,0**	**0,6**
Interest on debt (to private sector)	**4,6**	**14,1**
Debt amortizations (to private sector)	**12,8**	**27,7**
In dollars	**9,4**	**18,1**
International financial institutions	0,5	3,6
International and domestic bonds	0,0	4,0
Repo	3,7	2,9
Letes (Treasury bills)	5,2	7,6
In pesos	**3,4**	**9,6**
Domestic bonds	0,4	2,7
Letes (Treasury bills)	3,0	6,9
Total financing needs	**23,1**	**42,4**
Previous balance	**5,3**	**5,4**
International Financial Institutions	**2,3**	**4,6**
Private financing	**7,5**	**10,4**
In dollars	**4,5**	**6,3**
Repo	1,9	1,7
Letes (Treasury bills)	2,6	4,6
In pesos	**3,0**	**4,1**
Letes (Treasury bills)	3,0	4,1
IMF financing	**13,4**	**22,8**
Total sources	**28,5**	**43,2**
Rollover International market	**0%**	**0%**
Rollover Domestic bonds	**0%**	**0%**
Rollover Letes USD	**50%**	**61%**
Rollover Letes Pesos	**100%**	**59%**
Rollover Repo	**51%**	**59%**

Source: Ministry of the Treasury and BBVA Research

- Although the primary deficit fell by 32% YoY YTD August and the fiscal target was over-achieved, considerable doubts arose about the financing programme for 2018-19. To counteract this, another round of fiscal adjustment was launched and the agreement with the IMF was increased by US$7.1 billion, doubling fund disbursement for 2018-9
- The goal of primary equilibrium in 2019 will be attained by means of a new tax on exports and marginal spending cuts. In 2019 the total deficit would be 3.3%, due to the increase in the interest burden post devaluation
- Argentina will cover its 2019 financing programme with a roll-over of only 60% of maturing Letes (Treasury bills) in pesos and dollars and repos with private banks

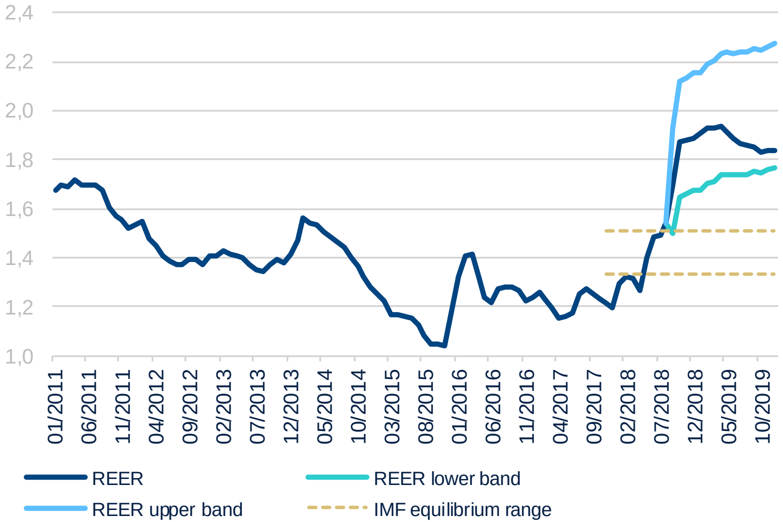
The substantial real depreciation of the peso will be maintained thanks to low pass-through to domestic prices

Exchange rate and BCRA "intervention bands"
(ARS/US$)



Source: BCRA and BBVA Research

Real multilateral exchange rate scenarios
(Nov. 2015 = 1)



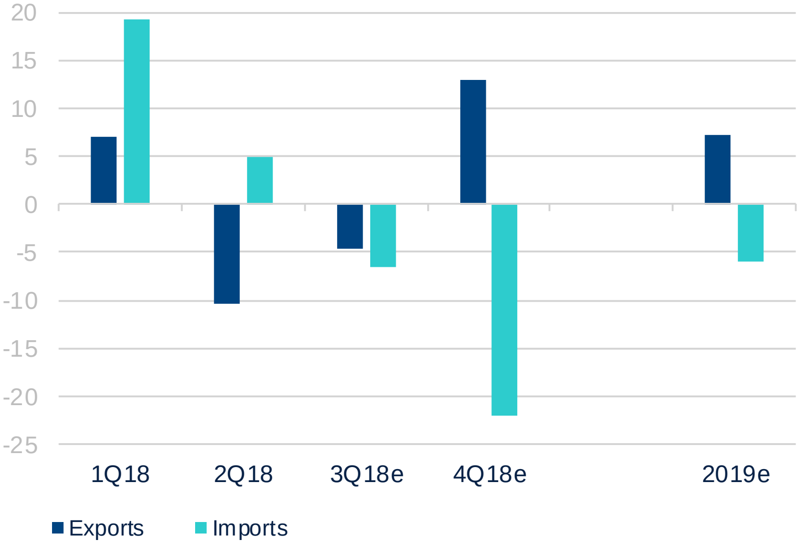
Source: INDEC, Haver, BCRA and BBVA Research

The exchange rate shot up by 35% MoM in August despite sale of reserves by the BCRA and the increase in the monetary policy interest rate and in banks' mandatory reserves. Only with the new IMF agreement and the hard monetary tightening of the BCRA's programme was calm restored

We expect the peso to remain within the CB range, which implies substantially depreciated real levels, due to the strong increase in the exchange rate and the moderate pass-through effect. This will help the stabilization programme, since positive dollar trade flows, shifts in portfolio composition from USD to peso assets and public sector surplus funding in USD will increase supply of hard currency

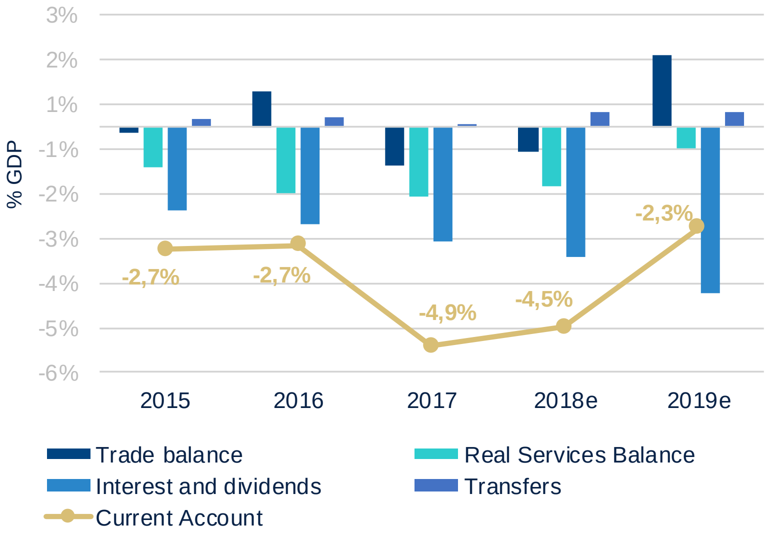
Sharp adjustment to current account due to the substantial real depreciation

Trade balance
(change % YoY)



Source: INDEC and BBVA Research

Current Account deficit
(% GDP)



Source: INDEC and BBVA Research.

In the eight months to the end of August the trade deficit grew by 58% YoY due to the serious drought, but the recession and the depreciation will cause imports to contract and exports to rise, turning around trade balance deterioration to close 2018 with a trade deficit of US$7.1 billion (-16% YoY)

In 2019 exports will recover from the drought and imports will continue to fall, leaving a trade surplus of US$1.7 billion. The real depreciation and the recession will also reduce the tourism deficit, and the current account balance will improve from -4.5% of GDP in 2018 to -2.3% in 2019

Annual macroeconomic forecasts

	2016	2017	2018 (e)	2019 (e)
INDEC GDP Base 2004 (% YoY)	-1.8	2.9	-2.4	-0.3
Domestic CPI inflation (% YoY, eop)	39.4	24.8	46.0	29,0
Exchange rate (vs. USD, EOP)	15.8	17.7	42.0	49.0
Policy rate (%, eop)	24.8	28.8	65.0	32.0
Private Consumption (% YoY)	-1.0	3.5	-0.2	-3.1
Public Consumption (% YoY)	0.3	2.2	-2.0	-2.2
Investment (% YoY)	-4.9	11.0	-0.7	-3.8
Total Fiscal Balance (% GDP)	-5.8	-6.0	-5.6	-3.3
Current Account (% GDP)	-2.7	-4.9	-4.5	-2.3

(e) Estimate.
Source: INDEC, BCRA, Haver and BBVA Research

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