BBVA Research

Argentina Economic Outlook

Fourth quarter 2018

Argentina Unit

Creating Opportunities

Contents

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1. Summary

The global economy continues to show positive signs, albeit within a context of growing uncertainty. World growth has continued over recent months, although protectionism increased between the US and China. Dollar appreciation was reflected in the increase in financial tension in emerging economies. The Fed and the ECB continue to make progress toward a normalisation of monetary policy, representing a gradual tightening of monetary conditions, which will continue to put pressure on these economies, although it should be added that this is not a systemic crisis. Within an overall panorama of a slight slowdown in 2019, the main risk is still that of protectionism.

The June agreement between Argentina and the IMF did not lead to the expected recovery of confidence. 3Q18 saw a new round of capital outflows and another important depreciation of the peso which only slowed down after a further fiscal adjustment in search of a fiscal balance in 2019, with an extension to the IMF agreement from US$50 million to $57.1 million and a doubling of the available funds for 2018 and 2019.

Furthermore, with the appointment of a new governor of the Central Bank of Argentina, the country has abandoned the previous inflationary target system, opting instead for a new monetary-exchange framework that seeks to keep the monetary base constant in nominal terms until June 2019, creating an extensive currency non-intervention zone in which the peso can float, with the Central Bank controlling intervention beyond this band. The aim is to control demand for dollars by drying up excess peso liquidity. Nonetheless, doubts remain as to the Central Bank's ability to stabilise the exchange rate and reduce inflation and interest-rate volatility, as well as to mitigate the recessionary impact of such a strict monetary target.

These events represent the end of Mauricio Macri's plan for the first two years of his presidency, which, in fiscal matters, was based on a softly-softly approach to reducing the significant deficit he inherited, financing the transition with debt, while on the monetary side, looking to bring inflation down to single-figure levels in 2019 by using an inflationary target framework.

In 2018, the government has more than met its fiscal targets and may well reach a primary balance in 2019 with its new export tax, with spending cuts reducing the margin. Nevertheless, due to the depreciation of the peso, the interest burden will be 3.3% of GDP. The IMF programme ensures that Argentina can implement its financial programme with a *roll-over* of just 60% of US dollar Treasury bill maturity in pesos and dollars.

The prolongation of the exchange-rate crisis, with its substantial impact on confidence, and the new monetary and fiscal belt-tightening have led us to cut back our gross domestic product growth forecasts for 2018 and 2019, two years in which GDP will fall, although in quarterly terms it will start to recover in 1Q19. We are also significantly revising our inflation estimates upward for both years, to 46% in December 2018 and 29% in December 2019.

The job market is also starting to show the effects of the recession, with unemployment rates increasing in 2Q18 and continuing at an average of 9.3% in 2019. As far as the external aspect is concerned, a new panorama marked by a strong real depreciation of the peso and the ongoing recession will see a sharp close to the current account deficit of -2.3% of GDP in 2019, with an adjustment to the commercial balance of goods and services that will fuel currency trade flows.

There are still many unresolved uncertainties regarding 2019. Locally, a crucial question is whether or not the new monetary-exchange framework can stabilise the currency market and reduce inflation (in itself a recessionary factor), with unclear implications of the outcome in terms of social conflict as well as with regard to electoral impact in 2019. Further afield, the main doubts concern Brazil's economic and political performance after the country's elections, and, above all, how worldwide trade tensions might play out.

2. Global growth to slow slightly

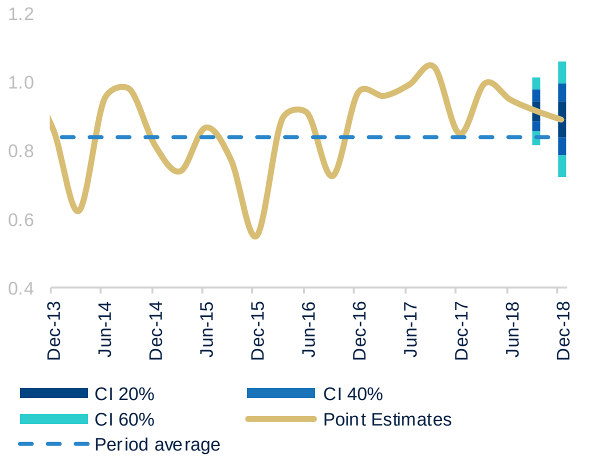
The global economy continues to show positive signs, albeit in an environment of growing uncertainty. World growth continued over the past quarter, as a result of the ongoing fiscal stimuli in the US economy and a certain stability in the Chinese and European economies. However, the growing protectionism between America and China will further intensify, while appreciation of the dollar will increase financial tensions in emerging economies which, with clear differences in the countries concerned, led to a significant adjustment in the most vulnerable, such as Turkey and Argentina. The Fed and the ECB continue to normalise monetary policy, representing a gradual tightening of monetary conditions which will continue to put pressure on emerging economies, although it should be stressed that this is not a systemic crisis. Within an overall panorama of a slight slowdown, the main risk is still that of protectionism.

A slight slowdown in global growth, with less synchronisation

World growth slowed down in the third quarter of the year (BBVA-GAIN: 0.92% QoQ after 0.95% in 2Q18) (see Figure 2.1) while **regional differences intensified**. The strength of the US economy contrasts with a certain moderation in China and the Euro zone and, above all, with the significant adjustments observed in the emerging economies most vulnerable to the increased financial tensions.

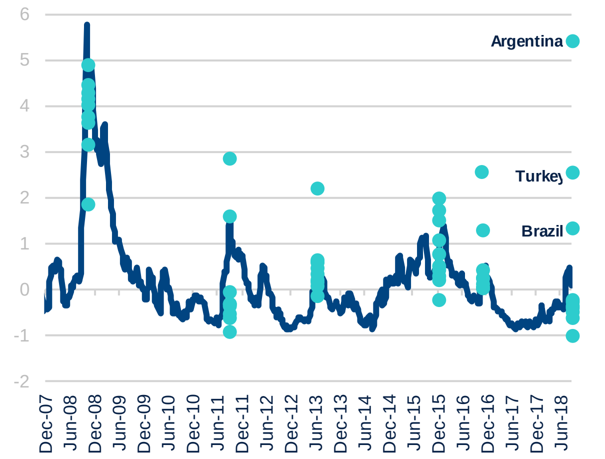
The **growth of the industrial sector is very moderate** and is still yet to recover from poor performance at the start of the year. This **seems more to reflect the worsening outlook for domestic demand in emerging countries than the solid improvement in global trade** until August, with the good export performance of Asia-Pacific countries being particularly worthy of mention. Nevertheless, it is still too soon for trade figures to reflect the possible negative effects of the escalation of protectionism in recent months between the US and China.

Figure 2.1. World GDP growth.
(% QoQ)



Source: BBVA Research

Figure 2.2. BBVA index of financial tensions for emerging economies



Source: BBVA Research

Confidence indicators, while remaining at high levels, also point to a gradual slowing of world growth. The deteriorating confidence in the manufacturing sector is due to a worsening of employment expectations and export orders, affected by uncertainty concerning trade relations and the need for certain emerging economies to reduce their external deficit. Expectations regarding the service sector have also worsened, although they remain well above the historical average, supported by the strength of domestic demand in developed economies.

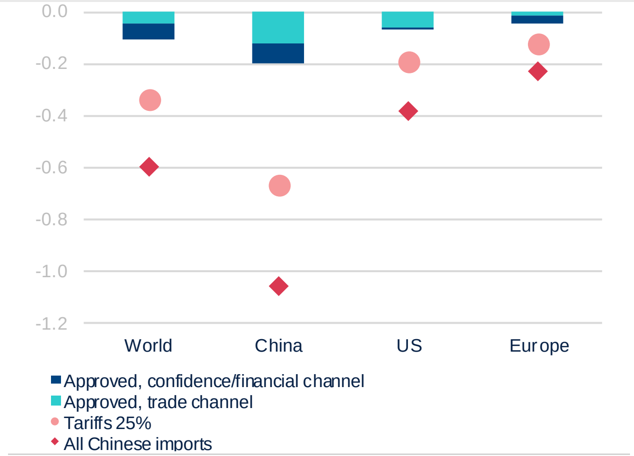
The normalisation of monetary policy will continue to put pressure on emerging economies

Despite recent moderation, **global economic inertia remains positive, strengthening the normalisation process** of the main central banks, which will continue to affect the **financial conditions in emerging countries**. Investor risk aversion continued for another quarter, **especially affecting emerging countries** with the greatest need for foreign credit and high levels of foreign currency borrowing (see Figure 2.2). **Argentina and Turkey suffered more than others** in this regard, with a depreciation of their currencies and a notable increase in the risk premium, although **tensions eased after monetary and fiscal measures were adopted**.

Meanwhile trade tensions continue, but with limited effects so far on markets, helped by **China stabilising its currency and slowing the growth deceleration** through economic policy stimuli. The other centre of attention was **Europe**. Firstly, **risk tied to Italy** increased after the government's fiscal proposals, which deviated from the path set by Europe, with a subsequent widening of the Italian risk premium to above the 300 bps barrier. Secondly, **deadlock in Brexit negotiations** increased the probability of the UK leaving the EU without a deal in place.

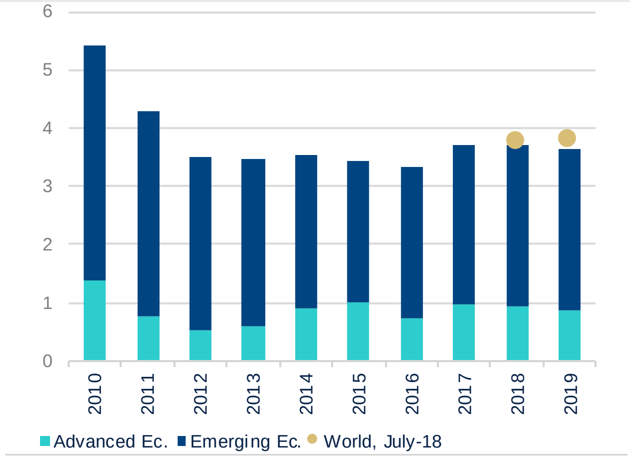
The **heightening of tension in global credit conditions will persist while the Fed continues with monetary policy normalisation**, with a further increase of 25 bps to 2.5% at the close of 2018 and 3.25% by late 2019, with **the ECB also embarking on its exit strategy**. This has ensured that **dollar appreciation** continues, driven by a flight to quality and an increasingly favourable rate differential.

Figure 2.3. Effect on GDP growth due to US tariff increases and the response of other countries (2018-19, %)



Source: BBVA Research

Figure 2.4. Forecast world GDP growth (% YoY)



Source: BBVA Research

Uncertainty over the escalation of protectionism remains high. Although **trade tensions between the US and some areas have eased for the time being**, the agreement with Mexico and Canada has yet to be ratified and negotiations on the automotive sector with Europe will be reopened after the US mid-term elections. Meanwhile, **some of the protectionist threats between America and China have materialised**. The US approved a tariff increase to 10% for Chinese imports worth US$200 billion, in addition to the $50 billion worth of Chinese products with 25% tariffs. China reacted by increasing tariffs to 10% on American imports in a move worth US$60 billion, while announcing additional tariff rises to 25% on products worth $50 billion. **The impact from the commercial arena of these measures on GDP**, together with those affecting steel and aluminium, **is limited** (see Figure 2.3), although **indirect effects** need to be considered as well (less confidence, the repercussion on financial markets etc.). Negotiations with China will resume later this year. If the outcome does not meet US demands (particularly on intellectual property rights), **the tariff could rise to 25% from January 2019** onward. If China reacts with further increases, **the impact on growth will be significant**.

A slowdown in global growth due to the downward revision for emerging economies

Global growth forecasts were cut back by 10 bps to 3.7% in 2018 and 3.6% for 2019 (see Figure 2.4) as the slight slowdown over the second half of the year takes hold. This deceleration in global activity is **due to the slower-than-forecast growth in emerging economies**, above all in those that are most vulnerable to financial conditions worldwide.

In the US, the increase in consumption and the strength of investment continue to support the forecast of 2.8% growth in 2018-19. The strength of private consumption continues to be supported by the dynamism of the labour market and higher wage growth, which reinforces optimism in households. For its part, investment continues to benefit from favourable financial conditions and rising oil prices. However, slowing dollar appreciation is expected.

In China, the authorities are implementing flexible policies in order to halt the slowdown in domestic demand and counteract the increase in protectionism. The strong performance of the economy in the first half of the year leads us to revise the 2018 GDP growth forecast upward to 6.5%, although the figures we have seen so far show **that progress is slowing**. - On the fiscal side of the economy, taxes are being cut, encouraging investment in infrastructure. Monetary policy is seeking to ensure that banks extend credit to SMEs, as well as stabilising the exchange rate. All of the above has led us to **maintain our growth forecast of 6% for 2019 unchanged**.

In the Euro zone, strong demand and flexible monetary and fiscal policies will compensate for greater uncertainty and the slowdown in global demand. As a result, we are maintaining our growth forecast of 2% for 2018 and 1.7% in 2019. The depreciation of the euro since 2Q18 and world trade, which is still showing momentum, will continue to bolster exports.

Protectionism and the Fed's exit represent the most significant risks

The threat of a trade war continues unabated and could worsen after the November mid-term elections in the US, especially in the case of China, although negotiations with the EU and Japan will also be reopened, involving important sectors such as the automobile sector. While the direct impact will be limited, the risk of a trade war **could act as a drag on confidence, increasing risk aversion in the markets and curbing global flows of direct investment**, hitting growth. **Escalating oil prices** due to sanctions on Iran is a further risk to be borne in mind.

Meanwhile, the combination of greater protectionism, a swifter normalisation of US monetary policy and the slowdown of the world economy may heighten risk in emerging countries and increase the chance of capital flow coming to an abrupt halt. Within such a context, the risk of a sudden adjustment in China remains.

Lastly, **political risk has intensified in Europe**, especially in Italy due to question marks concerning the sustainability of the country's public accounts and in the United Kingdom, where the possibility of a no-deal Brexit cannot be ruled out.

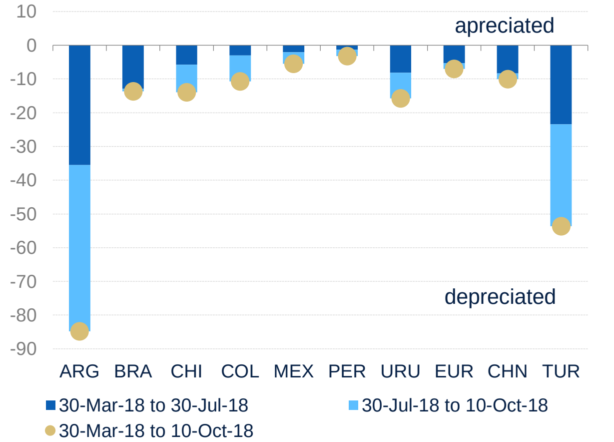
3. Argentina: Reshuffle and deal again

Goodbye to the gradual fiscal approach and inflationary targets, hello to a zero deficit and monetary base targets

Despite the size of the loan amount, the low conditionality and the speed with which the first US$15 million disbursements were made, the June agreement between Argentina and the IMF did not lead to the expected recovery in confidence. August saw a return to capital outflows, which was initially driven by the currency collapse in Turkey, but which, within a month, had taken on the mantle of a fully-fledged local crisis. The exchange market, which had stabilised in June after the appointment of the Central Bank of Argentina's new governor and the implementation of further monetary belt-tightening, once again showed signs of turbulence due to increasing concerns regarding compliance with the government's financial programme in 2019 (see Figure 3.1). The exchange rate rose by 35% in August despite the Central Bank of Argentina's significant loss of reserves, a 20% hike in the monetary policy rate and the gradual accumulated 21% increase in bank swaps over the year. Faced with a loss of credibility, the government announced a new round of fiscal adjustments which are now seeking primary fiscal balance in 2019, asking the IMF to bring forward the funds set aside for 2020-21 to 2019. Luis Caputo resigned as governor of the Central Bank of Argentina after only three months in charge. He was replaced by Guido Sandleris, who had, until that point, been the Vice-Minister of the Economy, a post that he had also held for only three months.

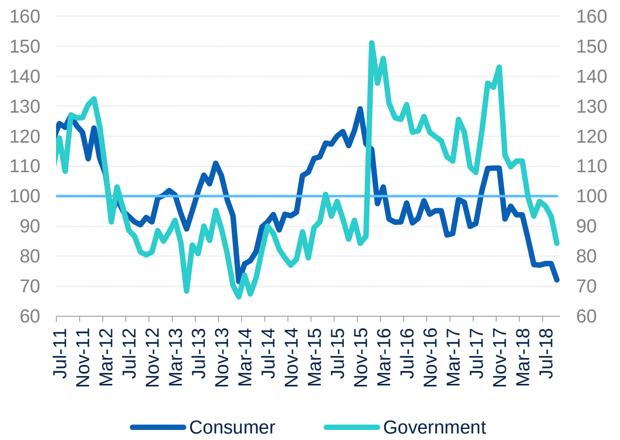
The announcement of a new agreement with the IMF came in late September, with an extension from US$50 million to $57.1 million of the available funds for 2018 and 2019. Sandleris also announced that Argentina would be ending the inflationary target system, replacing it with a very simple monetary rule that consists of a nominal growth target of 0% of the monetary base to June 2019 and the establishment of a broad “currency non-intervention zone” in which the peso can float freely, with the Central Bank only intervening “outside these bands” without defending the parities that set the limits on such a space.

Figure 3.1. Exchange rates against the US dollar (accumulated % variation)



Source: Haver and BBVA Research

Figure 3.2. Consumer confidence and in the government (100 = historical average)



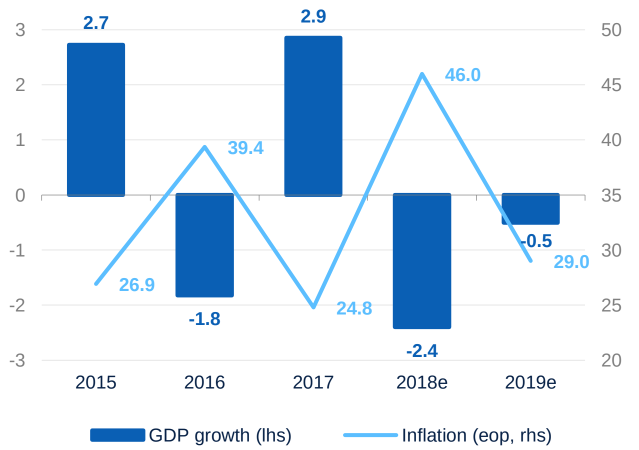
Source: CIF-UTDT and BBVA Research

This new system seeks to control the demand for dollars by “drying up” excess peso liquidity, although there are still doubts: (i) regarding the impact of volatility on interest rates that such a strict monetary policy target will have, given the high level of instability of the demand for the local currency and (ii) regarding the Central Bank of Argentina's capacity to stabilise the exchange rate and swiftly reduce inflation, given the volatility and sensitivity of the local market and foreign capital flows and (iii) regarding what will happen if the strict compliance of the 0% monetary base growth target, which implies very high interest rates, has markedly recessionary effects, especially after the intrusion of the executive branch in monetary policy as a result of the events of 28 December. There are numerous concerns surrounding the Central Bank, which changed its governor and the monetary-exchange-rate system twice this year.

These recent events represent the end of Mauricio Macri's plan for the first two years of his presidency, which, in fiscal matters, was based on a softly-softly approach to reducing the deficit he inherited, financing the transition with debt, while on the monetary side, looking to bring about single-figure inflation in 2019 by the end of his presidency through an inflationary target framework. However, the prolongation of the exchange-rate crisis, with its notable impact on confidence (see Figure 3.2), and the new monetary and fiscal austerity that is central to the “0% policy” (0% fiscal deficit, 0% monetary base growth) will nevertheless hit the economy. We have therefore revised GDP growth forecasts for 2018 and 2019 downward, while significantly increasing inflation estimates for the two years (see Figure 3.3). Within a foreign context, the positive take-away from this scenario is that of a rapid closing of the previously forecast current account deficit of 4% to one of 2.3% for 2019 (see Figure 3.4).

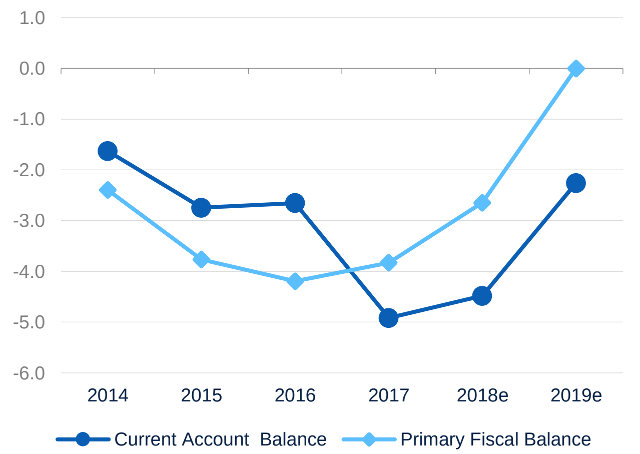
The electoral implications for the government of this new economic panorama are unclear. It will depend on numerous imponderable factors on all fronts, especially the political arena, although there can be no doubt that the re-election of President Macri is much less certain now than at the time of our previous report. The breaking news in August of the scandal known as the “corruption notebooks”, which directly implicated ex-president Cristina Fernández and her leading officials, preventing her – who polls say is the only person with enough support among the electorate to go to an election run-off – from capitalising on the serious deterioration of Mauricio Macri's presidency. However, it is highly possible that new viable electoral options emerge, for example the so-called “Federal Peronism” movement, if the economy does not get back on track this year and the first six months of 2019. Election results will depend on whether or not our controlled dollar-base scenario is borne out, with a slight depreciation over the year, falling inflation and a recovery of quarterly growth in early 2019.

Figure 3.3. GDP growth and inflation
(%)



Source: INDEC (National Statistics Institute) and BBVA Research

Figure 3.4. Fiscal and current account deficit
(% GDP)



Source: INDEC, Ministry of Finance and BBVA Research

4. Activity will grow in 1Q19, although this will not prevent GDP falling in 2018 and 2019

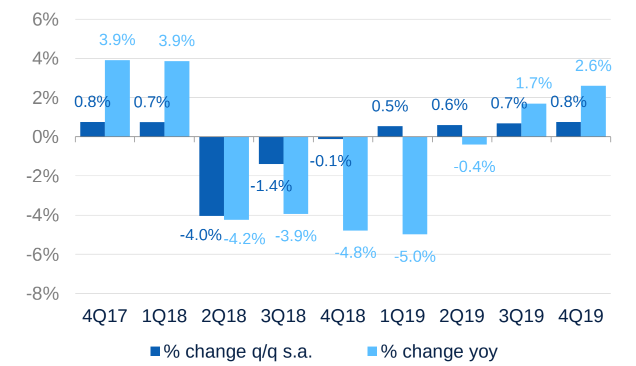
GDP fell sharply in 2Q18 (-4% QoQ, seasonally adjusted) due to a combination of the country's worst drought in 30 years and the recessionary effects of the exchange-rate crisis. The worsening of the crisis in August and September, alongside accelerating inflation and the subsequent fall in effective income, the collapse of confidence, the further fiscal adjustment and high interest rates, will lead to new consumer retraction and a reverse in the second half of 2018, which may not be compensated for by the good wheat harvest forecast for December. The economy will close 2018 with a fall of 2.4%, substantially worse than the 0.5% growth we forecast in July. The impact of the crisis will affect all aspects of domestic demand, although the recovery in exports over the second half of this year will partly mitigate this, without fully compensating for it. Imports meanwhile will fall off sharply due to the recession and the effective depreciation of the peso.

In quarterly terms, GDP will begin to recover in 1Q19, bolstered by agricultural forecasts based on the end of the drought, the positive impact of the depreciation of the peso on all export sectors and the alternatives to imports (such as domestic tourism) and the gradual recovery of real income levels with the slowdown in inflation and wage rises, which it is hoped will compensate for the decline in real terms in 2018. However, growth will remain weak, a seasonally-adjusted QoQ average of 0.6%, due to the negative carry-over effect from 2018. The economy will shrink by an average 0.3% in 2019 (previously we had forecast growth of 1.5%), although GDP in 4Q19 will grow 2.6% YoY.

The job market will also begin to show the effects of the recession. The unemployment rate, which had fallen sharply to 7.2% in 4Q17, increased in 2Q18 to 9.6%, continuing in this line over the coming quarters as the fall in the level of economic activity affects the demand for employment. The unemployment rate will rise by an average of 9.2% in 2018 and 9.3% in 2019, from the 8.4% recorded in 2017.

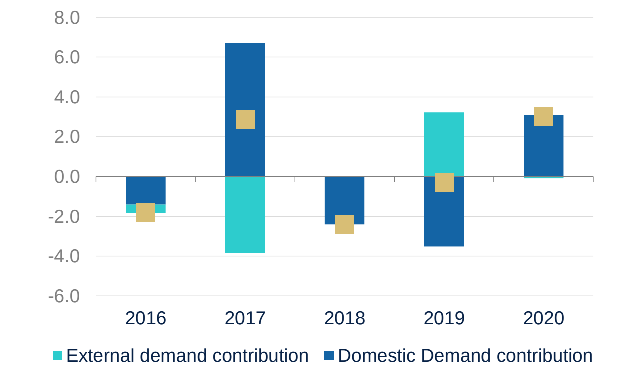
In any event, this forecast has a downward bias, which depends on a stabilisation of the exchange-rate crisis and a gradual reversal of the monetary belt-tightening experienced in 4Q18, on the effective depreciation of the peso remaining through a limited pass-through in order to stimulate demand in the tradable-goods sectors and external factors that are both local (such as the climatic conditions and social and political tension) and from further afield (for example, the Brazilian elections and protectionist tension around the world).

Figure 4.1. Quarterly GDP
(seasonally-adjusted QoQ and YoY % variation, original series)



Source: INDEC (National Statistics Institute) and BBVA Research

Figure 4.2. The contribution of domestic and foreign demand
2017-2020 (%)



Source: INDEC and BBVA Research

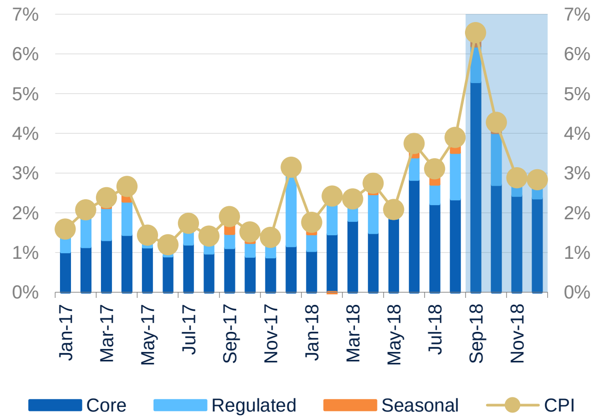
5. Control of monetary aggregates to replace the short-lived experiment with inflationary targets

Progress in the fight against inflation over the first two years of Macri's government, when it fell from 39.4% YoY in December 2016 to 24.8% YoY in December 2017, was reversed in a turbulent 2018. Inflation once again sped up over the course of the year, reaching a peak of 6.5% MoM and 40.5% YoY in September, with the accumulated figure for the year showing an increase of 32.4%. Inflation will continue high in October and November (see Figure 5.1), even taking into account the most recent increase in the dollar, falling at least 3% MoM in December but closing 2018 at 46% YoY. The inflationary process, which in 2017 recorded a monthly average of 1.9% (core: 1.6%), became an average rate of 2.5% in the first six months of 2018 (core: 2.5%), with an average estimated acceleration of 3.9% MoM over the second half of the year (core: 4.2%).

The Central Bank of Argentina's monetary policy from late 2015 until recently, which was based on a system of inflationary targets that used interest rates as an instrument with a floating exchange rate (with sporadic interventions), was firstly “put on one side” in June with the redesign of the system within the framework of the first IMF agreement (new inflation targets, further “monitoring” of monetary aggregates, more bank swaps, changing the monetary policy rate to the Central Bank liquidity bill rate and a 20% increase in this rate to 60%) and finally abandoned after the worsening of the exchange-rate crisis and the most recent change in the governor of the Central Bank.

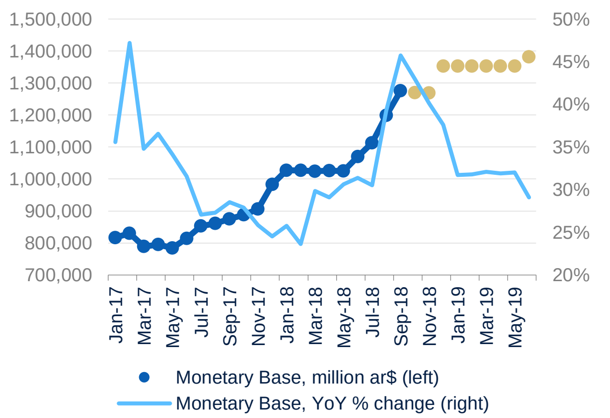
In late September, Guido Sandleris, the Vice-Minister of the Economy (a post he had only held since June), replaced Luis Caputo, who had been appointed in mid-June after Federico Sturzenegger's resignation, as governor of the Central Bank of Argentina. He announced that he would be putting an end to the inflationary target system, substituting it for a simple monetary rule which seeks to ensure that the monetary base (currency in circulation held by the public and by banks + the current accounts of CBA banks) grew 0% in nominal terms to June 2019 (in fact, by allowing seasonal – uncompensated – growth between December 2018 and June 2019, this could see a nominal growth of 8% until the end of that period). Given the 2% MoM and 30% YoY growth (see Figure 5.2), and taking into account a forecast average monthly inflation of 3% until June 2019, this represents a significant real growth of the monetary base (MB).

Figure 5.1. Monthly inflation and contributions (% MoM variation)



Source: INDEC (National Statistics Institute) and BBVA Research

Figure 5.2. Estimate of the evolution of the monetary base ($ million, % YoY)



Source: CBA and BBVA Research

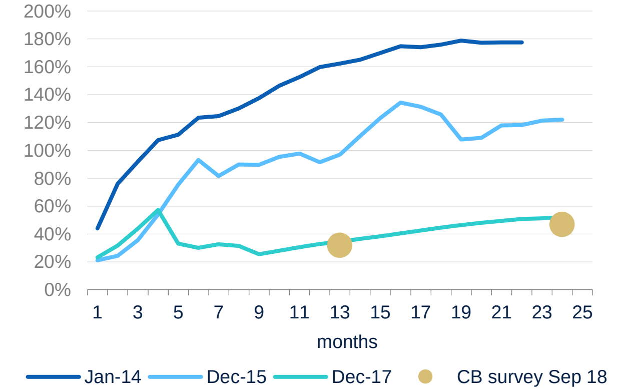
The new system will be complemented on the exchange-rate front with the confirmation of a broad-based free-floating "non-intervention zone", with the Central Bank only intervening "outside these bands". If the exchange rate moves into the upper band, the Central Bank may sell US$150 million a day, strengthening monetary contraction as the absorbed amount will not be injected. Given an appreciation scenario, the CBA may purchase reserves, deciding to sterilise when it feels there is a genuine demand for pesos.

While control of monetary aggregates instead of using interest rates as an instrument of monetary policy seems more appropriate in a case such as Argentina's, the target of a zero issuance of money to June 2019 appears highly restrictive. This means that any expansion or contraction of the monetary base should be compensated, except for a seasonal increase of 6.3% in December and 1.7% in June 2019. In order to meet this target, the Central Bank will continue with its policy of increasing swaps, above all, when the Treasury Bill Issuance Amounts (LEBAC) programme concludes in December, with this freezing becoming part of the LELIQ liquidity bills initiative, an instrument that does not represent a monetary base, in which power is in the hands of the banks. The interest rate is endogenous and shows signs of marked volatility, as can be seen in its rise from 65% to 73% in the first week of implementation of the new system of liquidity bill auctions.

Although it is still too soon to predict the success that this new programme will have in bringing down inflation, the CBA is clear that it will maintain its commitment to reducing inflation and applying a monetary policy that will ensure positive interest rates in real terms through a real contraction of the monetary base until June 2019. As a result, we take the view that the Central Bank of Argentina can contain any *pass-through* (see Figure 5.3), deflating the economy from the inflation rate of 46% at the close of 2018 (we previously expected a rate of 29.6%, see Figure 5.4) to the 29% that we forecast for 2019, with a downward trend throughout the year, as average monthly inflation for the first half of 2019 will be 2.3% and 2% for the second half.

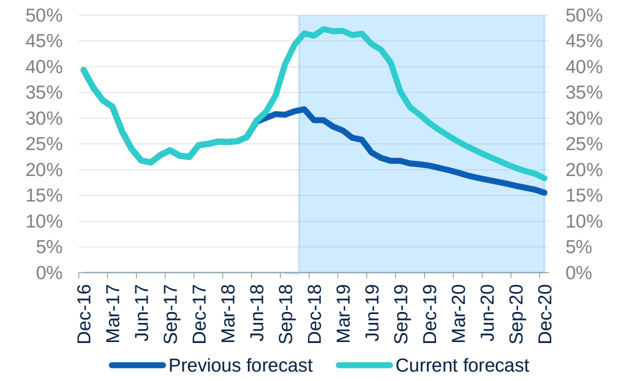
However, there is still much uncertainty. It is very risky to pursue such a strict target for the monetary base, given the marked instability in Argentina's demand for money. Will this objective be viable in 2019, an election year, or will the government intervene in monetary policy if unrestricted compliance with the target has highly recessionary effects, as was the case on 28 December? What will be the outcome if there is conflict between exchange-rate intervention outside the aforementioned bands and the evolution of the monetary base? How important will inflationary pressure be when it comes to the wage reviews, which are now outdated after those granted in the first half of the year?

Figure 5.3. Pass-through projection, BBVA and CBA REM (base = month of devaluation)



Source: INDEC, CBA and BBVA Research

Figure 5.4. Previous and current inflation forecasts 2018-19 (% variation YoY)



Source: INDEC and BBVA Research

6. In search of fiscal balance in 2019

The accumulated primary deficit until August stands at $13,416 billion (-32% YoY). The government has more than met its fiscal target, although this has not prevented widespread distrust in its financial programme for 2018 and 2019. Amidst a new run on Argentinian assets, in September, a further round of fiscal adjustment was announced, along with a US$7.1 million extension to the stand-by agreement with the IMF (from $50 million to $57.1 million). This doubled the available funds for 2018 to $13.4 million (previously $6 million) and for 2019 to $22.8 million (previously $11.4 million), funds which are not of a precautionary nature but which could be used for budgetary support. This has cleared up existing doubts that Argentina will not have to resort to the credit market as it would be able to cover its 2019 financing needs solely with a 60% roll-over of LETES treasury bills both in dollars and pesos (mainly held in Argentina, 80% of which will be renewed) and through repo loans (see Figure 6.1).

In order to conclude this agreement, the government has committed itself to ensuring a primary fiscal balance in 2019, bringing the 0% deficit target forward by a year. It will basically achieve this by levying a tax on exports of 3 or 4 pesos per dollar depending on the type of export, making the support of the governors and the passing of the 2019 budget by Congress both viable. Elsewhere, cuts will be made to capital expenditure and operating costs in addition to those already announced in the first June agreement (see Figure 6.2).

Our forecast for the total deficit after interest for 2018 is 5.6%, due to the fact that an improved primary deficit of 2.6% of GDP will be compensated for by a greater interest burden on the debt as a result of the exchange-rate hike (over 60% are in foreign currencies). In 2019, the total deficit will be less than previously forecast (3.3% at present vs. the original 3.9%) as we expect Argentina to reach primary fiscal balance levels in 2019 while the interest will increase slightly to 3.3% of GDP, as IMF credit is at lower rates than those of the market, with the expected devaluation of the exchange rate less than in 2018.

Figure 6.1. Credit requirements and sources, 2018-2019
(US$ million)

	Oct-Dic 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**	**0,0**
Rollover Domestic bonds	**0,0**	**0,0**
Rollover Letes USD	**0,5**	**0,6**
Rollover Letes Pesos	**1,0**	**0,6**
Rollover Repo	**0,5**	**0,6**

Source: Ministry of the Treasury, BBVA Research

Figure 6.2. Fiscal effort committed to the IMF
(% of GDP)

	Announced June 2018	Announced September 2018
Revenues	**0,4**	**1,3**
Primary Spending	**-1,1**	**-1,3**
Pensions and social subsidies	0,5	0,3
Energy and transport subsidies	-0,4	-0,5
Wages and operating expenses	-0,2	-0,2
Transfers to provinces	-0,3	
Other current expenditures	-0,1	-0,2
Capital expenditures	-0,6	-0,7
Expenditures excluding Pensions	**-1,5**	**-1,6**

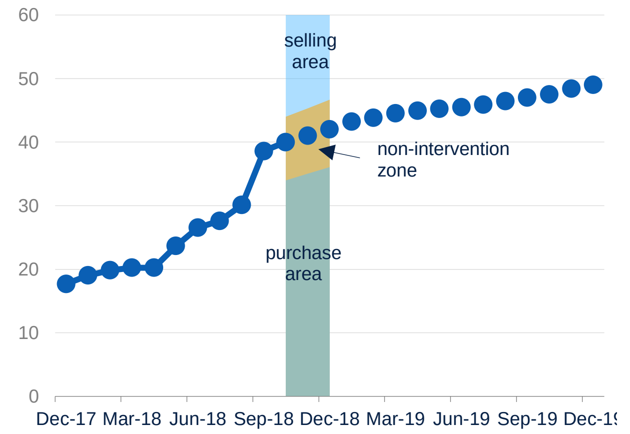
Source: Ministry of the Treasury, BBVA Research

7. Sharp adjustment after marked real depreciation of the peso

The exchange rate rose by 35% in August (with an accumulated rise for the year until then of 98%), despite the fact that the Central Bank of Argentina sold reserves totalling $5.4 million ($9.2 million since the end of June), with the monetary policy rate rising by 20% and bank swaps up 5% (the latter recording an accumulated increase of 21% for the year). Calm only arrived when there was progress with respect to the new IMF agreement and the CBA's new policy programme, which consists of maintaining the monetary base and establishing a broad “currency non-intervention zone” in which the peso floats freely, with the Central Bank only intervening beyond this band.

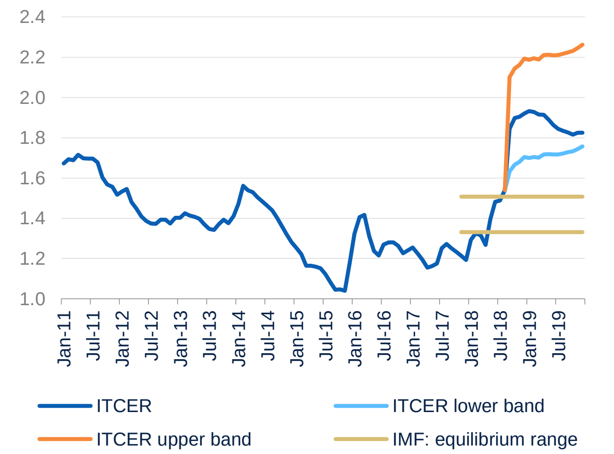
This non-intervention zone began at 1/10 in the 34-44 peso/dollar range and is adjusted on a daily basis at a monthly rate of 3% until December, when its width will be assessed along with the band gradient for 2019 (see Figure 7.1). If the exchange rate moves into the upper band, the Central Bank may sell $150 million a day to prevent excessive peso volatility, reinforcing monetary contraction as the absorbed amount will not need to be injected. Within a scenario of appreciation, the CBA can purchase reserves in order to halt excessive appreciation that might affect economic activity and decide how much to sterilise as it evaluates demand for pesos. We expect to see uneven performance between the bands, as the CBA is not restricted in its currency purchasing and can restore reserves if it reaches the lower band, while above the upper band, intervention will be limited. In the first two weeks of the new programme, in which the aim was to control dollar demand through a tight monetary squeeze, exchange markets were calmed, with the exchange rate falling 11.5% from 40.9 pesos to the dollar to 36.2. Doubts remain as to whether the programme can bring about lasting currency market calm given the Central Bank's limited capacity to intervene if volatility returns. In October and December the Treasury will have IMF disbursements available totalling $6.7 million to cover peso expenditure and bolster the supply of currencies.

Figure 7.1. Exchange rate: forecast and the CBA's “non-intervention zone” (peso/dollar)



Source: CBA and BBVA Research

Figure 7.2. Multilateral effective exchange rate base, factors included in the “floating bands” and the IMF's equilibrium range (1 = November 2015)



Source: Haver, CBA, INDEC and BBVA Research

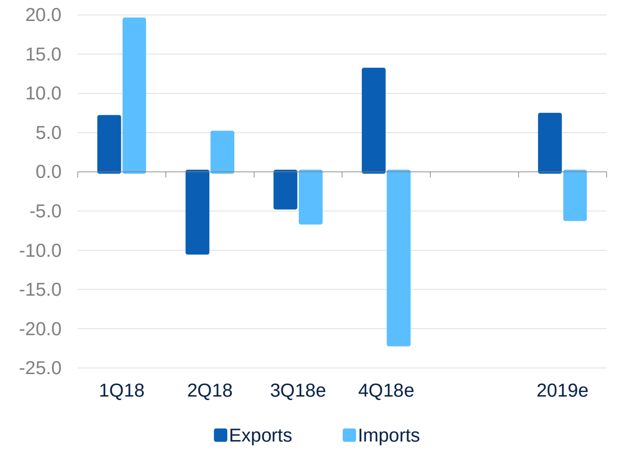
In October 2018, the multilateral effective exchange rate (MEER) rose by 59% against its record low of December 2017 (an effective peso depreciation of 37%), 20% “more depreciated” than the upper limit of the “equilibrium range” estimated by the IMF in late 2017 when it forecast a “real reversal” of the peso of between 10% to 25% (see Figure

7.2). Although part of this improved competitiveness will be eroded by inflation, a pass-through kept in check by the recession and an exchange rate sliding toward 42 pesos to the dollar by the end of the year mean that the MEER will stay at these depreciated levels. In fact, even the intervention band's lower limit means a multilateral effective exchange rate down 10% on the IMF's highest equilibrium level, which would seem to indicate that the IMF and the Central Bank of Argentina are “comfortable” at these levels and will not allow them to appreciate significantly. Starting with a competitive MEER, the new monetary-exchange system has a good chance of success as the marked increase in interest rates will encourage the liquidation of amassed dollars, while an adjustment to the external sector will fuel currency trade flows.

The trade deficit increased by 58% YoY over the first 8 months of 2018 to nearly $7 million, affected by the harsh drought that the country experienced in the second quarter of the year (see Figure 7.3). However, in the coming months, the recession and the sharp increase in the exchange rate will hit imports and drive exports, putting a halt to the downward trend to close 2018 with a trade deficit of $7.1 million (prior to the crisis, we had forecast a deficit of $12 million), 16% below the $8.5 million gap in 2017. In 2019, exports will grow 9%, recovering from the drought, while imports will be 4.8% down, meaning a goods trade surplus of $1.7 million.

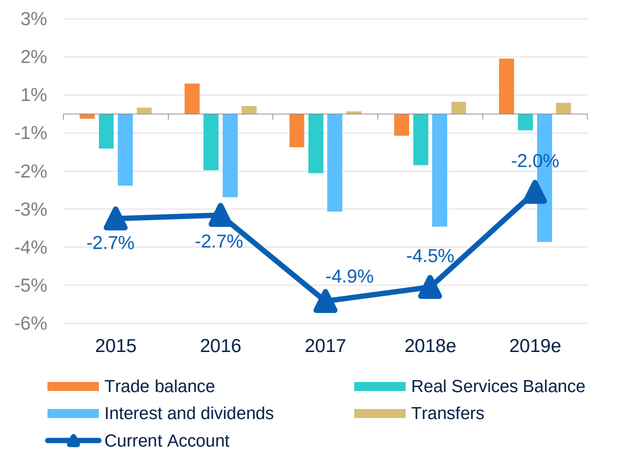
The depreciation of the peso and the recession will also hit outbound tourism hard while bolstering its inbound counterpart. The balance of services will go from a $10 million deficit in 2017 to one of $6.7 million in 2018 and just $1.9 million in 2019. As a result, the current account deficit will go from $31.3 million in 2017 (4.9% of GDP) to $22.7 million in 2018 (4.5%) and $9.1 million in 2019 (2.3%). This sharp reduction in the external deficit is the economy's natural response to a sudden halt to private equity resulting in a closure of the capital account, with borrowing limited to external credit from multilateral sources (see Figure 7.4). The key questions for 2019 are whether or not Argentina will be able to return to the global capital market and how direct foreign investment will evolve. Within a more structural framework, as well as the correction to the misalignment of the multilateral effective exchange rate, which is key to ensuring that this is long-lasting as exports react not only to a high effective rate but also to one which is stable, it is also important to take measures to improve the competitiveness of exports, where momentum has been very sluggish over the past decade and once again and definitively remove retentions on exports.

Figure 7.3. Trade balance: (% variation YoY)



Source: INDEC and BBVA Research

Figure 7.4 Balance of payments (% of GDP)



Source: INDEC and BBVA Research

8. A series of economic, political and external uncertainties in 2019

The successive crises that Argentina has suffered since May have resulted in an abandonment of the gradual fiscal approach. As we go into 2019, the country is now looking to ensure a primary fiscal balance, which has seen a swift, sharp correction to the external deficit, which would have been all the sharper had it not been for the protection of the IMF and the leaving behind of the inflationary target system in favour of a highly contractive monetary policy. We shall see how the main elements of the first two years of President Macri's leadership turn out. That this has taken place due to an exchange-rate and confidence crisis means there are substantial uncertainties regarding the coming year. The considerable support provided by the IMF has allowed Argentina to take this corrective path barely needing to resort to debt markets, although a number of doubts have arisen concerning the course the country will take next year in which there will also be legislative, governorship and presidential elections. These doubts relate to both the internal and external situation, and in both cases, to political and external matters.

Abroad, there are economic and political (elections) concerns regarding Brazil, as well as the uncertainty relating to trade tensions resulting from America's and China's protectionism and the gradual abandonment of the Federal Reserve's expansive monetary policy. While Jair Bolsonaro's convincing victory in the first round of Brazil's presidential election leads us to suppose relatively orthodox economic policies will be applied in Argentina's principal partner in Mercosur, there are still questions as to what type of trade policies will be adopted and whether or not trade openness will persist.

Locally, a crucial question in the economic sphere is whether the new monetary programme can stabilise the exchange market and then reduce inflation. There are also doubts as to the extent of the recessionary impact of the current monetary and fiscal policies, when and at what pace Argentina will return to growth and what the impact of these policies will be on key social variables, such as poverty and employment. A more conservative panorama that our base scenario sees as prolonging the crisis for longer, a delay in bringing down inflation in 2019 after the significant rise in inflation in 2018 or a recession that lasts longer than expected, will mean a social deterioration with very uncertain implications in terms of conflicts. On the political side, the big question is how all of the foregoing will impact electoral panorama in 2019, especially if the current government is re-elected and can move forward with the always pending – due to the urgency that pervades everything – structural reforms (such as in employment) or whether a new government comes in and turns back some of the progress that has been made, introducing a more populist agenda.

Our base scenario assumes that the exchange market will stabilise in this quarter, with the dollar only falling off slightly toward late 2019 which will partly compensate for inflation, meaning that depreciation will continue in real terms, which will help in the recovery of economic activity and the closing of the external deficit. It also supposes that inflation will gradually fall from October to 29% in December 2019, that the government's fiscal targets will be met, guaranteeing the flow of IMF funds and the recovery of confidence in the country. The gradual return of private equity will mean that the recession will be hard but short, lasting only three quarters from 2Q18 to 4Q18, with the economy turning around in 2019. Nevertheless, all the uncertainty mentioned above, which leads economists to be cautious when making decisions, means there is a panorama for the coming year with more questions than answers.

9. Tables

Table 9.1 Annual macroeconomic forecasts

	2016	2017	2018e	2019e
INDEC GDP Base 2004 (% YoY)	-1.8	2.9	-2.4	-0.3
Domestic CPI inflation (% YoY, EOP)	39.4	24.8	46	29
Exchange rate (vs. USD, EOP)	15.8	17.7	42	49
Policy rate (%, EOP)	24.8	28.8	65	32
Private consumption (% YoY)	-1	3.5	-0.2	-3.1
Public consumption (% YoY)	0.3	2.2	-2	-2.2
Investment (% YoY)	-4.9	11	-0.7	-3.8
Fiscal balance (% GDP)	-5.8	-6	-5.6	-3.3
Current account (% GDP)	-2.7	-4.9	-4.5	-2.3

Source: INDEC, CBA and BBVA Research

Table 9.2 Quarterly macroeconomic forecasts

	INDEC GDP (% YoY)	Domestic inflation (% YoY, EOP)	Exchange rate (vs. US$, EOP)	Policy rate (%, EOP)
1Q16	1	35	15	38
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	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	3.9	25.4	20.2	27.3
2Q18	-4.2	29.5	26.5	40
3Q18	-3.9	40.5	38.6	65
4Q18	-4.8	46	42	65
1Q19	-5	47	44.5	54.4
2Q19	-0.4	44.4	45.5	45.6
3Q19	1.7	35.2	47	38.2
4Q19	2.6	29	49	32

Source: INDEC, CBA and BBVA Research

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This report has been produced by the Argentina Unit

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