Economic Analysis

Argentina Economic Outlook. First quarter 2019

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2019, the turnaround year?

2018 was a year to forget. The exchange rate crisis that the country suffered since the end of April, the result of a combination of worsening global financial conditions, internal shocks (drought), policy errors and pre-existing structural weaknesses, derailed the model of "fiscal gradualism, inflation targeting and (dirty) currency float" which had been financed during the transition from the imbalances of the Kirchnerist administration by issuing public debt (mainly in international markets) and by loans from the Central Bank (BCRA). As a consequence of the lack of market access, the primary fiscal balance target was brought forward to 2019, the government replaced financing in the debt market by an IMF loan and the inflation targeting with floating exchange rate scheme was replaced by a monetary base growth control program, including exchange rate bands with no Central Bank intervention allowed within the zone.

All this implied a resounding change in the 2018 economic scenario and in the economic and political outlook for this year. Thus, the consensus growth estimate of 3.1% expected for 2018 (Dec-2017 Central Bank REM survey) will end up a GDP contraction of -2.4% (BBVA Research estimate), the inflation that the consensus estimated for December 2018 at 16.6% ended at 47.6%, and the exchange rate expected to close 2018 at 20.5 ARS/USD climbed to 37.81 ARS/USD. In social terms, the costs of this correction were a sharp fall in real wages and consumer purchasing power, and an increase in unemployment due to the sharp contraction of economic activity. Certainly, an *annus horribilis*.

The two big questions for 2019 are whether there will be a turnaround in economic activity and inflation, and whether the foundations for Argentina to achieve sustained growth, with low inflation and stability of nominal variables from 2020 onwards have finally been laid. A question intimately related to the latter is who will be the new president of the country as of December.

Regarding the first question, in our base scenario GDP will grow starting in 1Q19 but at a slow pace (0.6% QoQ average in the year), which implies a U shaped rather than a V shaped recovery. In addition, inflation will fall from the 47.6% recorded in Dec-2018 to 30% in Dec-2019, due to the effect of the BCRA's extremely tight monetary policy. Its central objective continues to be to lower inflation by maintaining the growth of the monetary base at 0% MoM until June and at 1% MoM in 2S19 (well below inflation). This would make it possible to reach the elections with the economy growing and inflation falling, but in no way does this imply that the economy will be a big helpl for the ruling party during the election period, since the levels of GDP will be lower than those of the previous year (YoY) and the inflation will continue processing the abrupt acceleration of 2018 descending, albeit slowly, to 43% in August (during the Primary, Open, Simultaneous and Compulsory elections, PASO) and 33% YoY in October (1st round of presidential elections).

Moreover, the weak rebound in growth will not be enough to counteract the strong negative statistical drag from the 2.4% contraction of GDP in 2018 and, together with the impact of contractionary economic policies, the lagged impact of the exchange rate crisis on consumer and investor confidence, and a less dynamic global growth environment, have lead us to lower the GDP growth forecast for 2019 to -1% from the previous -0.3%. Domestic demand will be a drag on growth in 2019 (contribution: -4%) but external demand will react to the strong real depreciation of the peso and partially offset it (contribution: 3.1%). At the same time, the fall in GDP, which is an average both in terms of time (of the 4 quarters) and sectors, will hide a high disparity between different activities, especially the fact that the agricultural sector will grow strongly due to the drought reversion effect on the harvest and that investment and production of shale gas and oil in Vaca Muerta will continue to grow.

In fiscal terms, we expect the government to achieve the primary balance target agreed with the IMF in 2019, a significant effort in an election year considering the primary deficit of 2.4% of GDP achieved in 2018. While the government plans to reduce national primary spending by 1.4 % of GDP in 2019, there are doubts about fiscal revenue growth in the context of still weak economic activity during 2019. Total tax revenues fell by about 1 pp of GDP in the 2018 recession and the government expects tax collections to grow 1.3 pp of GDP this year due to a 125% rise in export taxes (measured in dollars), which looks optimistic in view of our exports forecasts. The Treasury's financing needs (interest maturities and debt amortizations), assuming compliance with fiscal and monetary goals, are covered in 2019 by disbursements from the IMF agreement and the renewal of 46% of short-term local debt, but in 2020 Argentina will have to return to credit markets at least to refinance existing debt maturities and issue new debt by about USD 4.7 billion. In a scenario of compliance with fiscal goals and recovery of market confidence, the debt stock will fall from the peak of 81% of GDP that it reached in 2018 (due to devaluation, given the high share of foreign currency debt and the economic downturn) to 76% in 2019 and 69% in 2020, maintaining a sustainable profile.

In monetary terms, the BCRA will continue with its very tight policy that will imply very high interest rates in real terms, and will be able to reduce inflation from the high 4.1% MoM average of 2H18 to 2.5% in 1H19 and 2% in 2H19, ending in December at 30% YoY. This forecast is not without risks, both from the exchange rate, if there is a stronger depreciation than we anticipate, and from collective wage bargaining negotiations, which will seek to recover purchasing power lost in 2018, and the impact of the adjustment of regulated prices on inflationary pressures. Although we believe that the contractionary monetary program and recession will limit these risks, these are clearly factors to monitor.

The "monetary squeeze" will make it possible for the exchange rate stability of 4Q18 to continue in 1H19, helped by lower portfolio dollarization, higher exports from an improved maize and soybean harvest and the announced sales of the Treasury of US$10 billion. However, volatility could return as of June due to potential pre-electoral increase in dollarized portfolios (with peaks in August pre-PASO and in October pre-1st round), in a context of high uncertainty about a possible binary result (Cristina Kirchner (CFK) or Mauricio Macri) to the elections. We expect the exchange rate will depreciate at an average rate of 2% MoM, in line with inflation and with the change in the "bands" of the BCRA, and end 2019 at 49 ARS/USD (29.3% YoY) The "FX bands" show that the BCRA will seek to avoid any major exchange appreciation that could undermine the substantial exchange competitiveness improvement achieved since May 2018. Although so far the intervention has been cautiously limited by the BCRA to maximum purchases of US$50 million per day in January, it could increase if the monetary authority perceives a tendency to a stronger appreciation of the peso.

In the external sector, the current account deficit will be notably reduced from USD28.4 billion in 2018 (5.3% of GDP) to USD14 billion in 2019 (3.3% of GDP), due to the reversal of the goods and services trade deficit (from US$-10.3 billion to US$+3.9 billion) due to the effect of the depreciated real exchange rate and the economic downturn. The capital account will not record substantial private capital inflows as the appetite for Argentine assets will remain low due to doubts regarding the success of the economic stabilization program and the electoral outlook, especially if the electoral chances of the populist opposition (CFK) do not fall.

In short, Argentina should, despite the recessionary effects in an election year, continue to correct its macroeconomic imbalances (external, fiscal and monetary), avoiding repeating the disastrous 28D change in inflation targets when, in the interest of holding up economic activity , it intervened in the monetary policy of the BCRA, damaging confidence.

With respect to the second question, the 2019 election result is key to the economic scenario from 2020 onwards, since it is very binary: a second term of office for Cambiemos (or the first term of a "rational Peronist" that could eventually appear on the electoral horizon) that continues to correct imbalances within the framework of the agreement with the IMF, or the populist option of former President CFK that raises serious doubts about debt sustainability and the capacity of the Treasury to face interest and amortization maturities after 2020 when the IMF financing agreement ends. After 3 years of the Cambiemos in office, the 2018 economic crisis has managed to

keep the dilemma of whether or not to return to populism alive, an alternative which would be much more harmful than in the past given the current fragile economic situation. Thus, doubts about the 2020 financing program will not disappear this year as long as the electoral outcome remains uncertain depending on the pace of economic and political data (surveys, alliances, candidates) and will be reflected in the exchange rate, bond prices and country risk. The electoral process will be long, with separate dates for early elections in several regional districts, and only in the August primaries could there be a clearer picture of the possible national results for the presidential election. The consequences of the current macroeconomic stabilization program, with the social costs of the reduction of imbalances (lower income, consumption and production) imply that although the economic *momentum* will be more positive in August-October than now, the economy will not be the key that will allow the ruling party to win the elections, but rather the fact that the opposition remains divided.

For 2020, the agenda of the next president should not fail to include, following the correction that began in 2018, in particular the sustained achievement of a fiscal surplus that will allow macroeconomic stability to be maintained for years to come, a *sine qua non* requirement for a more sustained and sustainable growth. After that, it is imperative that structural reforms be undertaken, including reforms of the social security system, the tax system, the labor market (*pari passu* of an improvement in the educational system), and a new, more open trade policy. All this is key to be able to exploit the endowment of natural resources (such as the Vaca Muerta gas and oil fields) and the export of agricultural commodities and sub-products, as well as knowledge-intensive services. It is therefore key to reverse measures that were introduced last year in order to alleviate the crisis but are harmful to these sectors, in particular the increase in export taxes. In any case, until a structural reform program is put into place, we have revised the GDP growth forecast for 2020-23 downwards to levels close to potential growth, since economic policies will remain tight, investment will recover slowly from the 2018-9 contraction, capital inflows will be scarce and global growth less dynamic.

Balance of Risks

Risks in 2019, both global and local, are skewed downwards. The main local risk is political, and consists of polls showing greater chances of CFK's return to power. The main global risks to our base scenario are a worsening trade war between China and the US, surprises on the FED's interest rate hikes, and Brazil's economic and political developments. All of this could translate into a sustained shortage of capital availability for Argentina that could raise doubts about the possibility of tapping global capital market in 2020 and, therefore, about the sustainability of its public debt. Of course, positive surprises on these fronts would imply an improvement of our conservative base scenario.

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