BBVA Research

Argentina Economic Outlook

1Q19

January 2019

Creating Opportunities

Key messages

- The currency crisis of 2018 derailed both the gradual fiscal approach and the inflation targets, and drastically changed the 2019 outlook. The key questions are whether there be a turnaround in activity and inflation, and who the next President will be.
- Activity will recover and inflation will fall from its 2018 peak as a result of the BCRA's contractionary monetary policy, but the economy will be of no help electorally to the party in power, as GDP will decline by 1% on average during the year, and inflation will descend very slowly to 43% YoY during the primaries in August and 30% in December.
- The government should meet the strict primary balance target following the 2.4% deficit of 2018, a milestone in a year of elections, cover its funding programme with the IMF and a partial *roll-over* of local debt, but doubts are arising about the 2020 Financing Programme owing to uncertainty about the result of 2019 elections.
- The "currency *truce*" will continue into 1H19, but starting in June, the pre-electoral jitters could lead to portfolio dolarisation. During the year, the exchange rate will decline, offsetting inflation and closing at 49 ARS/USD (+29%), helping reduce the current account deficit to 3.3% of GDP due to the reversal of the trade deficit.
- Argentina will have to continue to correct its macreconomic imblances pursuant to the arrangement with the IMF, and from 2020 undertake reforms that can capitalize on its productive and export potentials.

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Global environment: slight easing of growth, but with significant uncertainty

Towards a slight easing of world growth, but with significant uncertainty

Slowdown of world growth, which will nevertheless remain robust

Sharp downturn in retail and the industrial sector, while investment and consumption hold up against the deterioration in confidence

Lower inflation following fall in oil price

Less pressure on central banks and more support for oil-importing economies

Rising financial tensions in developed countries

Steep fall in asset prices and outflow of investment, but not in emerging economies

Central banks more cautious and patient

The normalisation of monetary policy will depend on trends in the economy and is key for curbing market worries

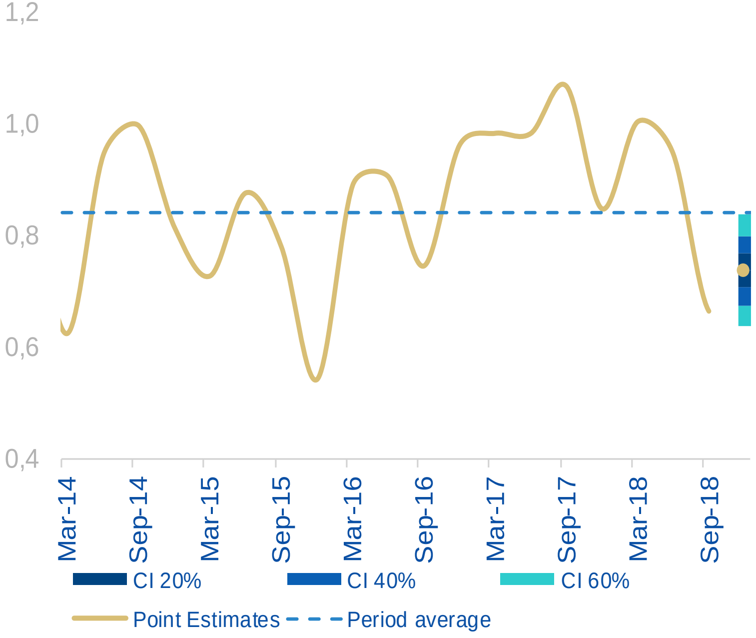
Global risks are mounting

Protectionism is combining with a potentially bigger slowdown in China and the US, and growing uncertainty in Europe

World growth is slowing, while remaining sound, due to the impact of protectionism on industry and international trade

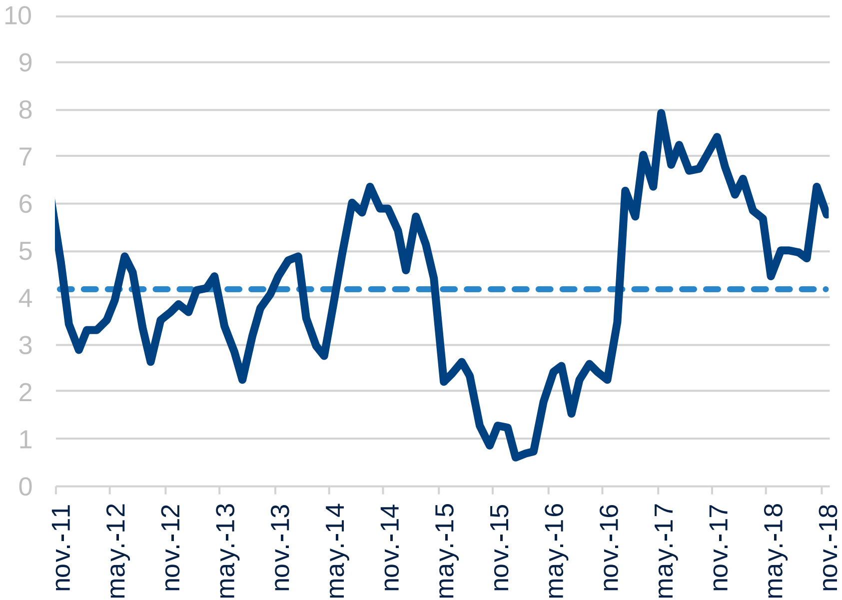
World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



BBVA Nominal global goods exports

(% YoY, three-month moving average)

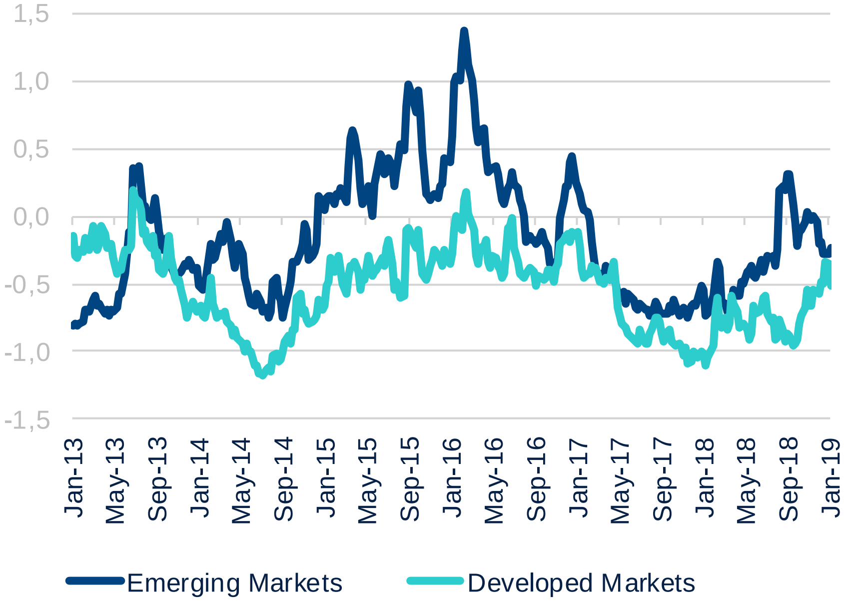


Source: BBVA Research

Recent turbulence in financial markets related to risk of sudden downturn in global growth

BBVA index of financial tensions

(standardised index)



Source: BBVA Research

01

Developed markets (the US) lie at the heart of this episode

02

Emerging countries withstood the downturn well in spite of the fall in oil prices

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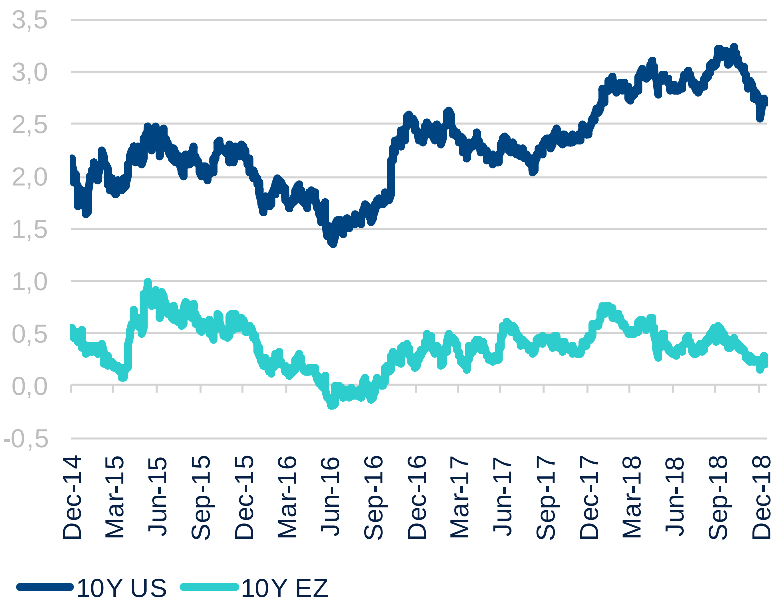
Investors are adjusting their portfolios: unwinding of riskier assets and **entry into more liquid funds**. Emerging countries remain unable to attract capital

04

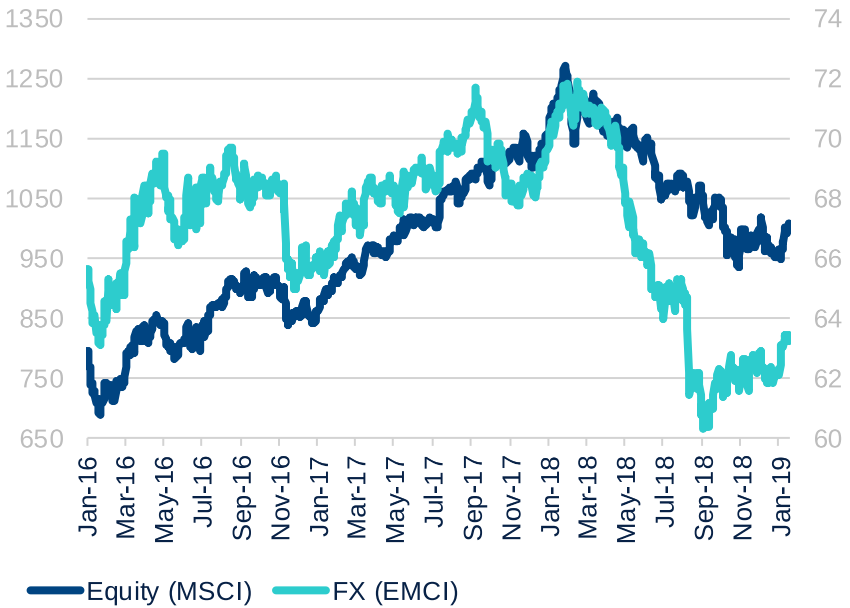
The **response of central banks** (Fed) is once again key for easing tensions

Tensions are centred on developed markets and interest rates fall back to very low levels

Interest rates in developed countries
(%)



Emerging Currencies and Equities
(Indices)



Source: BBVA Research

Central banks are sensitive to growing risk scenarios, and the process of monetary normalisation is slowing

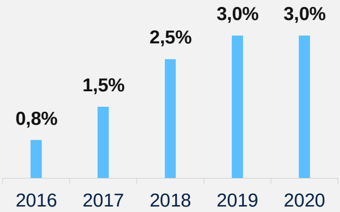
Balance sheet

- **Balance sheet reduction continues** (US$550 billion in 2019)

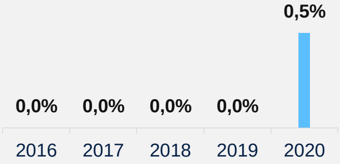
- **End of QE** (December 2018)
- **Total reinvestment of QE** after start of rate hike
- **New LTRO very likely** by June 2019

Interest rates

- **Pause in the cycle of rate hikes coming nearer** (two of 25 bp in 2019)

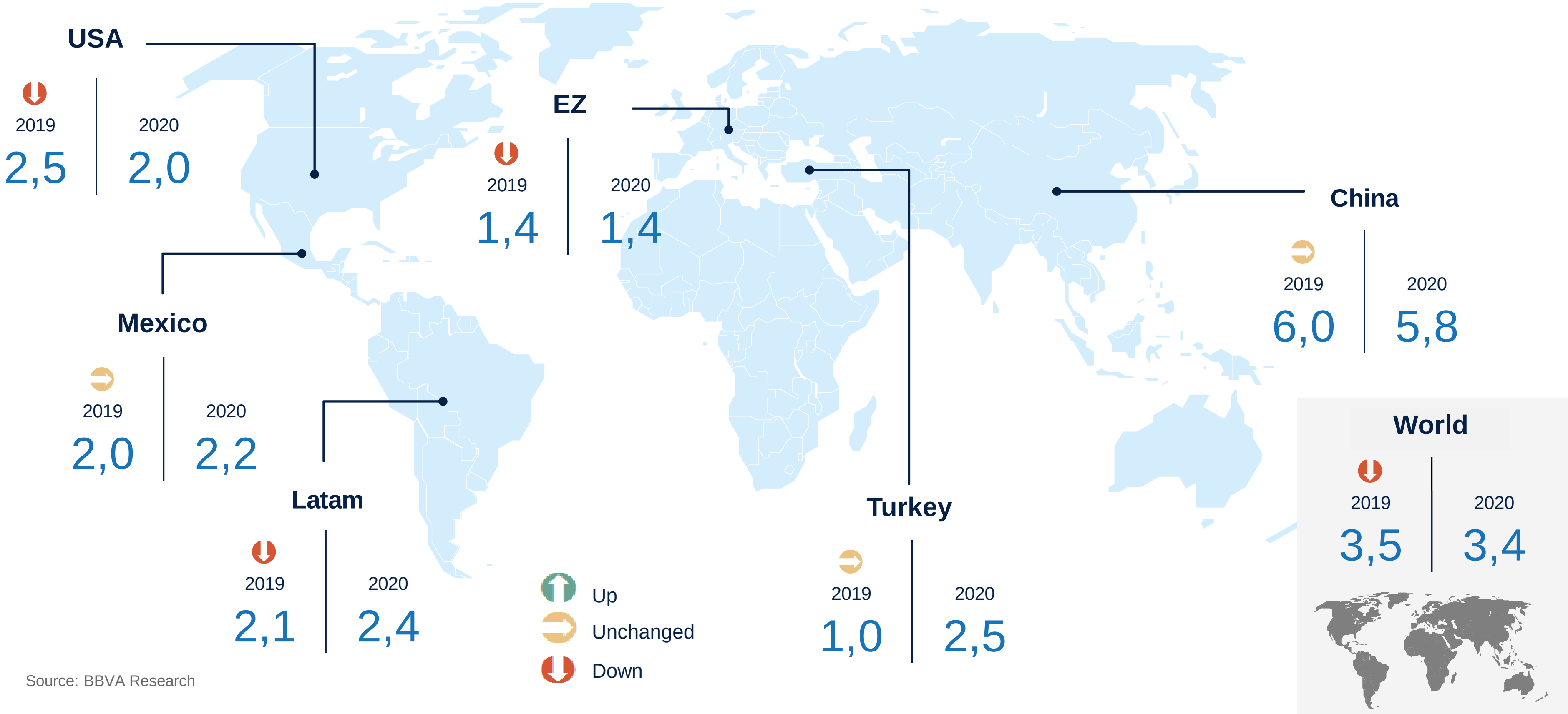


- **Delay in rate hike path** due to less favourable global outlook and greater risks. **Not expected until June 2020**



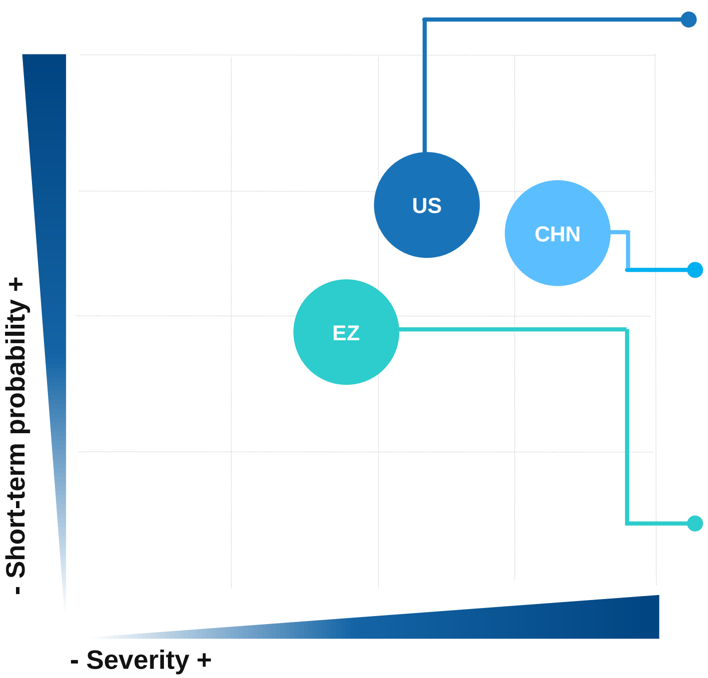
Source: BBVA Research

General downward revision of growth, with a more evident moderation in developed and emerging Asian countries



Source: BBVA Research

Downside global risks: Economic contraction in the US, China and protectionism, the main focal points of concern



- **Economic downturn: increasing** (protectionism, political controversy, geopolitical tensions, credit/corporate leveraging risk)
- **Protectionism: high.** Indirect adverse effects on growth (investment, impact on certain sectors/states) and upward pressure on costs
- **Fed exit: falling**. Less risk of rate hikes above neutral level

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- **Disorderly deleveraging: relatively greater**. Elevated debt in context of more stimuli and lower growth. To continue: RMB, corporate defaults, local debt
- **Protectionism: high**. Differences persist in spite of possible trade agreement in March 19. No progress on structural issues (P.I., IED, reform of WTO)

- **Political uncertainty: relatively greater**. No progress in integration process on eve of European Parliament elections (May 19)
  - **Brexit:** Risk of no-deal Brexit in March 19
  - **Italy:** Elevated political and policy uncertainty. Worries about banking sector
- **Protectionism: constrained** but not to be ruled out (automotive)
- **Risk of exit from ECB: low**. Pending changes in Governing Board

Source: BBVA Research.

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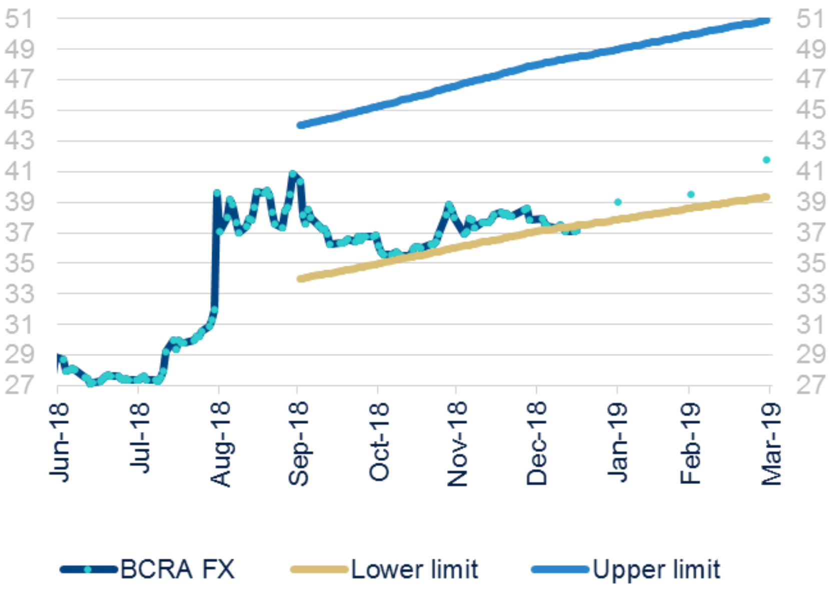
02

Argentina:
2019, the turnaround year?

The new monetary-FX rate programme stabilised the currency market after a difficult end to 2018

Peso/dollar exchange rates and ranges in non-intervention zone

(ARS/USD)



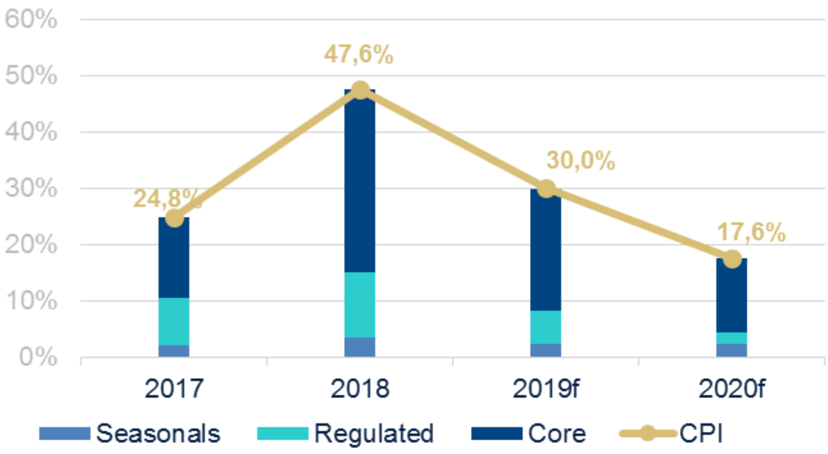
Source: BCRA and BBVA Research.

- The ‘double zero’ programme (primary deficit and growth of monetary base) including an extension and frontloading of the IMF stand-by agreement managed to stabilise forex market and reduce dollarisation.
- In January, the peso pierced the lower bound and BCRA again bought currency. The “currency *truce*” will continue into 1H19 owing to dollars from the harvest and the Treasury, but but volatility will return in May-June period due to pre-election dollarisation.
- The exchange rate will depreciate to offset inflation and close at 49 ARS/USD (29% YoY).

Following the inflationary shock of 2018 caused by the steep depreciation of the peso, inflation will fall steadily in 2019 due to the contractionary monetary policy

National CPI and contributions of regulated, seasonal and core prices

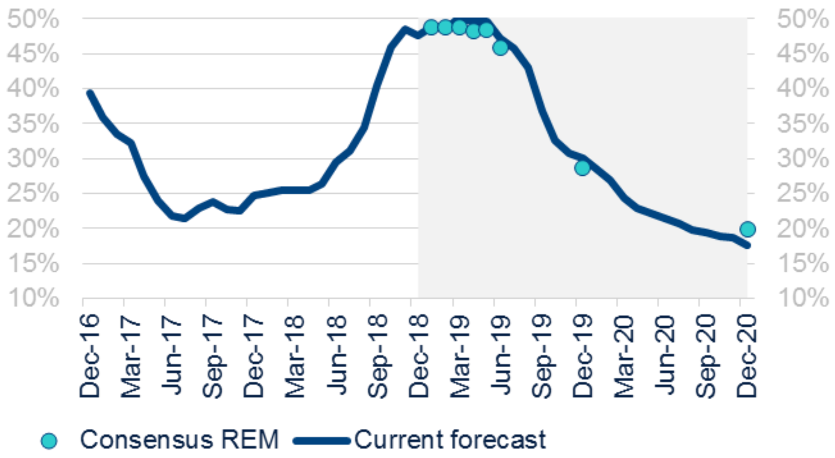
(% YoY change, EOP)



Source: Indec, BCRA and BBVA Research.

National inflation: Research Forecast and REM-BCRA Consensus

(% YoY change)



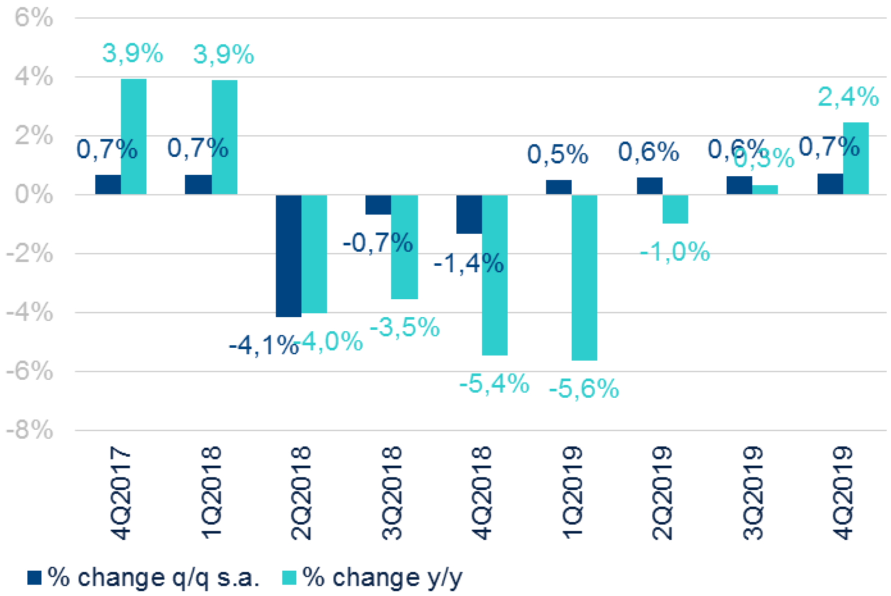
Inflation continued to process the great exchange rate leap and closed 2018 at 47.6%, but with a month-on-month slowdown from the peak of 6.5% in September to 2.6% in December

The restrictive monetary policy will bring inflation down to 30% by Dec-19 (prior: 29%), with average MoM inflation of 2.5% in 1H19 and 2% in 2H19

GDP will grow QoQ in 2019, but the yearly average will decrease by 1% due to strong negative carry-forward from 2018 (-2.4%)

QoQ GDP

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

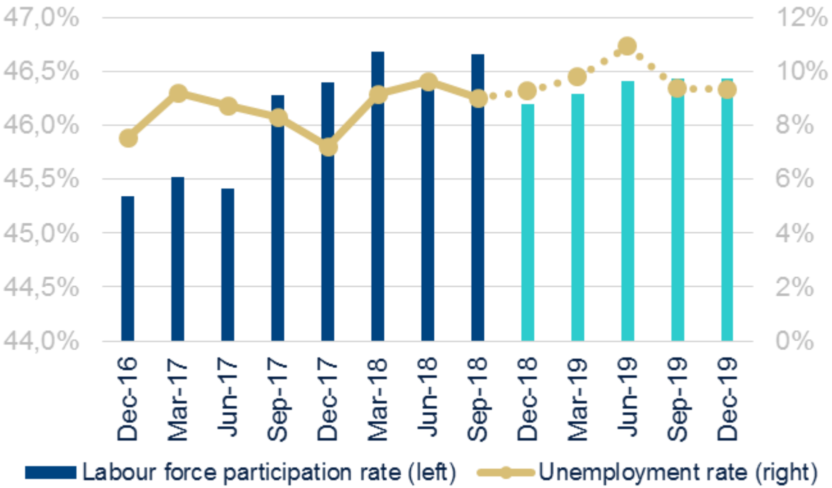


Source: INDEC and BBVA Research

- GDP fell by 0.7% QoQ in 3Q18, which was less than expected given the depth of the crisis and the acceleration of Fx volatility during the quarter, but falling real incomes and further fiscal and monetary adjustment in 4Q18 will lead the economy to fall by 2.4% in 2018
- GDP will begin to grow QoQ in 1Q19 due to the agricultural recovery, the impact of the real depreciation on export and import substitution sectors, and the partial recovery of real incomes
- However, the pace of growth will be weak (0.6% QoQ on average) and will not offset the strong negative statistical drag from 2018 (-2.4%); accordingly, GDP will fall by 1% on average in 2019, with a broad impact across sectors

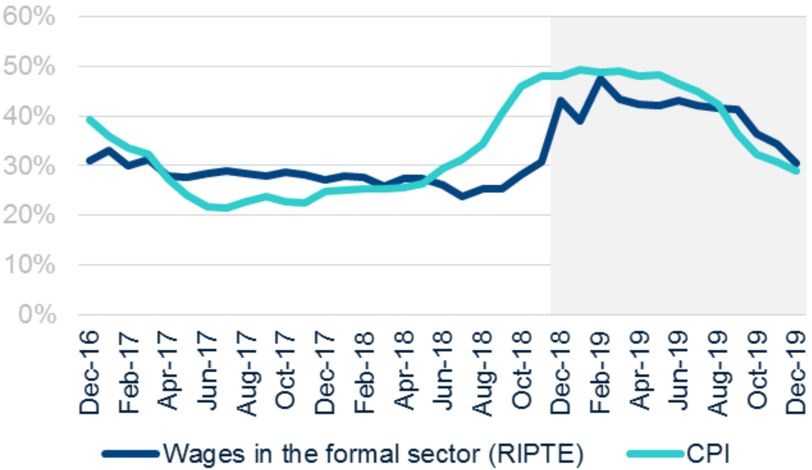
Unemployment will increase due to the impact of the economic downturn

Labour force participation and Unemployment Rate
(in %)



Source: Indec, BCRA and BBVA Research.

Wages and inflation
(% YoY change)

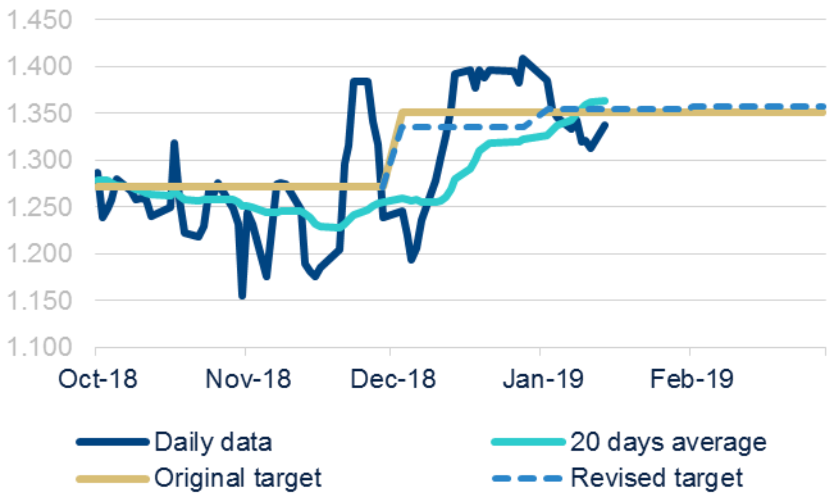


The unemployment rate will rise to 9.9% in 2019 (from 9.3% in 2018), with the increase going no higher due to a decline in the job supply. Great regional disparity as shown by the 3Q18 figures such as 10.5% for GBA, 8.8% for Pampa, 5.6% for Patagonia, 4.7% for Cuyo, etc.)

Although real wages will fall in 2019 on average, at year end they are expected to match inflation and real wages will trend slightly upwards during the the second half of the year.

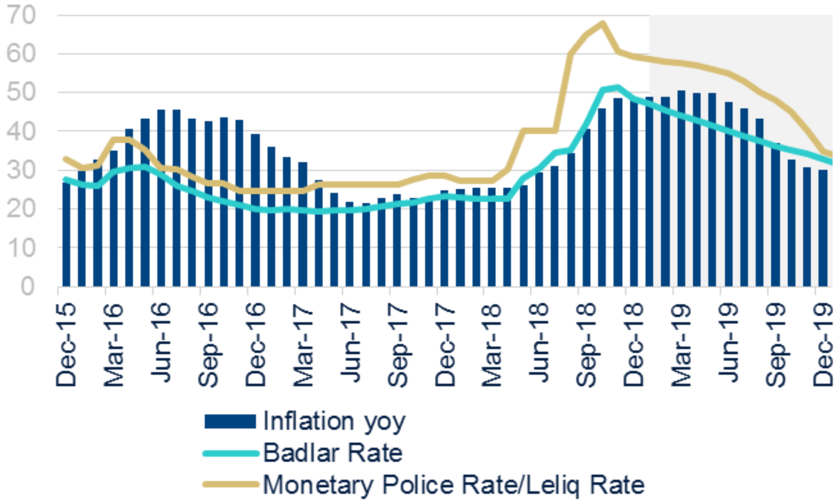
A cautious BCRA will continue to contract the real monetary base in 2019

Monetary base targets and growth
($ billion and % change YoY)



Source: BCRA and BBVA Research.

Interest rates and inflation
(%)



Source: BCRA, INDEC and BBVA Research.

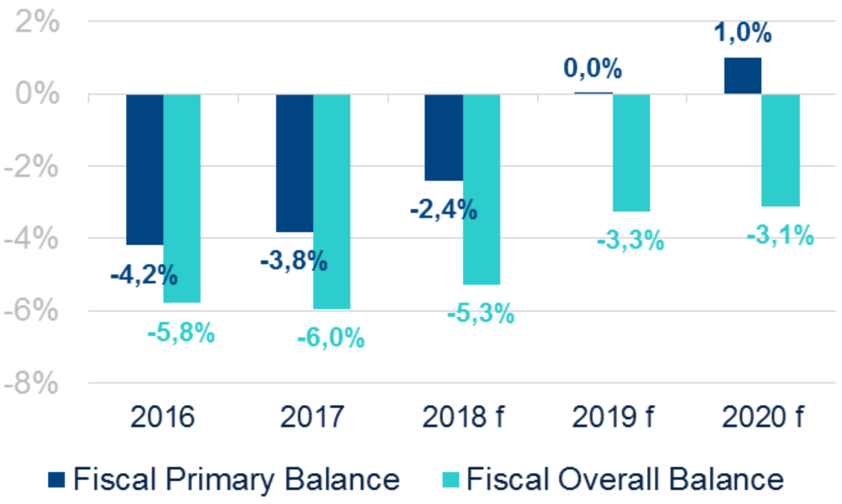
The BCRA continues to outperform its monthly Monetary base targets (corrected upwards in 2019 due to FX purchases)
From July on, it may grow by as much as 1% MoM, but monetary policy will remain tight because the monetary base will shrink in real terms

This highly restrictive monetary policy managed to reduce pass-through from the devaluation in 2018 and inflation will fall slowly to 30% by December 2019

Having outperformed the target for the primary fiscal deficit in 2018, the elusive primary fiscal balance will be achieved this year

Primary and financial fiscal result

(% GDP)



Source: Indec, BCRA and BBVA Research.

2019-2020 Financing Programme

(USD billion)

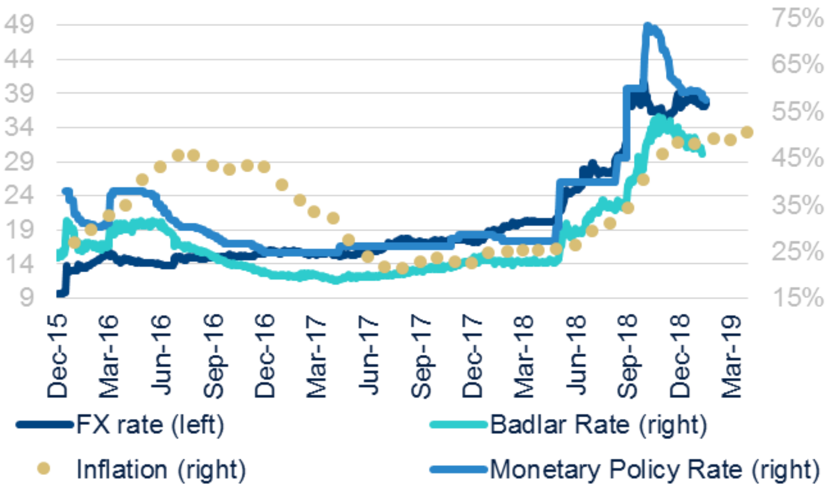
Financing sources and needs	2019 e	2020 e
Primary balance	**0.0**	**-5.2**
2017 Gas Plan	**0.6**	**0.6**
Interests with private creditors	**14.2**	**15.4**
Private sector amortizations	**32.7**	**24.4**
In dollars	**20.7**	**12.7**
Multilateral organizations	3.6	3.0
Domestic bonds	3.9	4.0
LETES	9.7	4.5
Repo	3.5	1.2
In pesos	**12.0**	**11.7**
Domestic bonds	2.6	6.7
LETES	9.4	5.0
Total Financing Needs	**47.5**	**35.2**
Initial balance	**10.9**	**0.9**
Multilateral organizations	**27.1**	**8.9**
IMF	22.5	5.9
Other	4.6	3.0
Private financing	**10.5**	**25.6**
In dollars	**6.2**	**20.6**
International market rollover	0.0	0.0
Domestic market rollover	0.0	15.2
LETES	4.5	4.5
Repo	1.7	0.9
In pesos	**4.3**	**5.0**
LETES	4.3	5.0
Total Sources	**48.5**	**35.4**
Rollover of letes ($ and USD)	46%	100%

The zero primary fiscal balance target should be achieved this year, but 3 percentage points of GDP interest have yet to be financed. The question is whether tax revenue will continue to decline in real terms in a year of economic slowdown, thus endangering achievement of the target

IMF disbursements will cover 2019 financing needs, with rollover of only 46% of LETES in pesos and dollars in domestic markets. In 2020, all maturing debt has to be rolled over and the announced objective is to do so in the domestic market

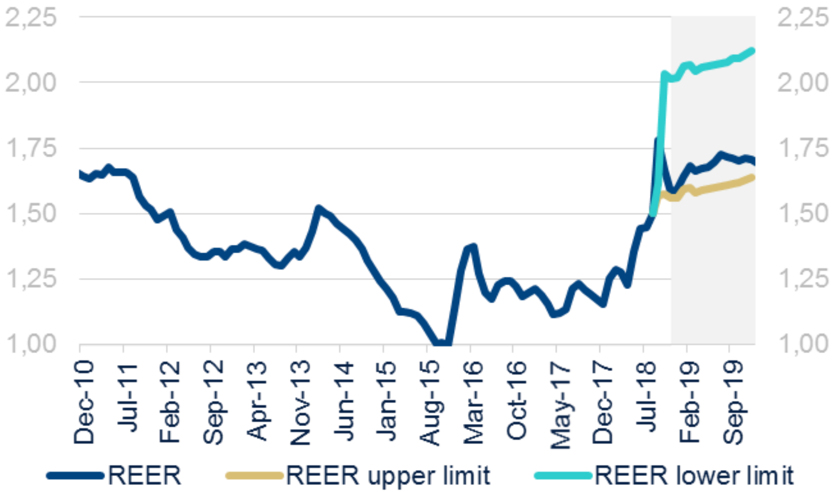
The exchange rate will remain in the low range of the non-intervention zone

Exchange rate, inflation and interest rates
(ARS/USD)



Source: BCRA, Indec and BBVA Research

Multilateral real exchange rate
(Nov. 2015 = 1)



Source: INDEC, Haver, BCRA and BBVA Research

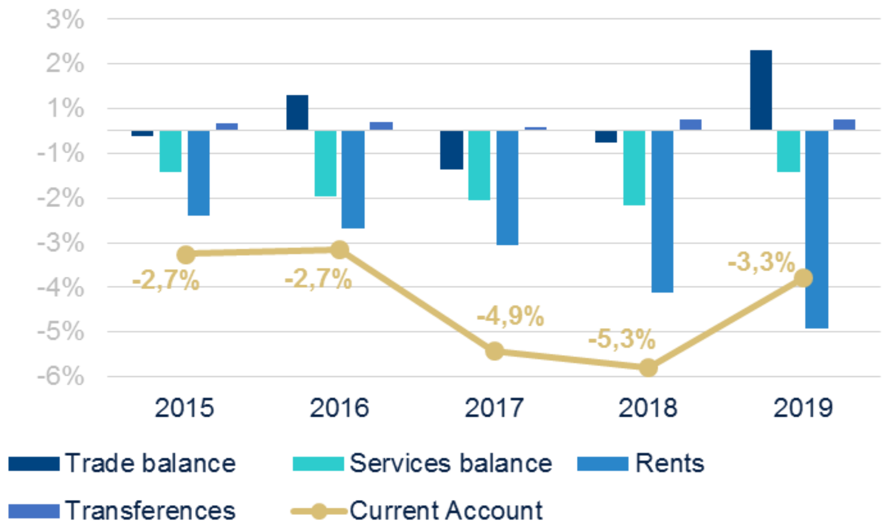
Monetary tightening will help to maintain the "currency truce" of 4Q18, with its reduction in portfolio dollarization, into 1H19, assisted by the dollars from agricultural exports and eventually Treasury sales, but volatility is likely to return owing to the usual pre-election dollarisation

At any rate, 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)

Substantial adjustment of current account due to sharp real depreciation

Balance of payments: current account

(% GDP)



Source: INDEC and BBVA Research.

Reserves and exchange rate balance

(US$ millions)

	2018	2019e
Private Sector	**-45,144**	**-12,518**
Current account	**-4,450**	**4,926**
Trade Balance	8,323	13,106
Tourism and real services	-9,460	-4,867
Interest and other transfers	-2,109	-2,109
Dividends	-1,204	-1,204
Capital account	**-40,694**	**-17,444**
Direct investment	2,424	2,391
Loans and credit facilities	-456	2,350
Dollarisation of portfolios	-27,230	-14,100
Other accounts	-15,433	-8,085
Public sector	**46,816**	**10,849**
Current account (interest)	-6,879	-9,255
Capital account	53,696	20,104
Other net changes	2,940	669
Current account	**-11,329**	**-4,329**
Capital account	**15,942**	**3,329**
Change in reserves	**10,751**	**5,000**
International reserves	**65,806**	**70,805**

Source: BCRA and BBVA Research.

Large reduction of current account deficit of USD 28.4 billion in 2018 (5.3% of GDP) to USD 14 billion in 2019 (3.3%), as the trade deficit (goods and services) will be reversed from USD -10.3 billion to USD +3.9 billion owing to the real depreciation of the peso and the economic downturn

The capital account will probably not see any significant inflow of private capital, as appetite for Argentine assets and the negative differentiation of the country due to doubts about the economic stabilisation and the electoral outlook.

Annual macroeconomic forecasts

	2017	2018 e	2019 e	2020 e
GDP (% YoY)	2.9	-2.4	-1.0	2.5
Inflation National CPI (% YoY, EOP)	24.8	47.6	30.0	17.6
Exchange rate (vs. USD, EOP)	17.7	37.9	49.0	55.0
Monetary policy rate (%, EOP)	28.8	59.3	35.0	22.0
Private consumption (% YoY)	3.5	-1.5	-3.6	2.2
Public consumption (% YoY)	2.2	-3.4	-2.9	-1.0
Investment (% YoY)	11.0	-4.2	-8.8	5.0
Fiscal balance (% GDP)	-6.0	-5.6	-3.3	-2.1
Current account (% GDP)	-4.9	-5.3	-3.3	-2.3

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

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