BBVA Research

Argentina Outlook

2Q19

April 2019

Creating Opportunities

Key messages

- The weakness in global activity is prolonged and uncertainty continues. which has led to a reaction in the form of economic policies, especially monetary ones, intended to soften the deceleration
- In Argentina. domestic risks have intensified towards the end of 1Q19 due to the renewed volatility in the exchange market and the rise in interest rates
- As rates are likely to remain high throughout most of the year, we have revised our growth forecasts downwards from -1% to -1.2% for 2019 maintaining the vision of positive inter-quarterly growth throughout the year although at a lower rate
- Inflation is not falling at the expected rate, probably due to the volatility of the exchange rate and the greater indexation of the economy. We forecast inflation at 35% in December 2019 (vs. 30% in our previous estimate)
- The exchange rate will depreciate in line with inflation to reach ARS 49/USD by the end of the year, with lower tensions in 2Q19 due to the contribution of agricultural exports and sales by the Treasury. The key issue continues to be the size that portfolio dollarization may reach if political uncertainty widens.
- For whoever wins the elections, the management of the economy and access to financing in 2020 will require continuing to fulfil the fiscal and monetary commitments agreed on with the IMF

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01 International context

02 Argentina: 2019 will see key elections

01

Global Environment

The moderation of growth has resulted in a shift of the monetary policy of the US and the Eurozone. and new stimuli in China

Fed

- **Long pause in rate hike**. but an increase could occur at the end of the year.
- **Normalization (reduction) of the balance will end prior to the date forecast** (September 2019)

ECB

- **Delay in monetary normalization**
- **Low rates** for greater periods and **greater liquidity** (TLTROs)
- **Rate increases are not expected until** December 2020.

China

- **Additional monetary stimulation**: rate and fund deposit cuts
- **Increase of public deficit** up to 2.8% in 2019
- **Tax cut** (2% of GDP)

Latin America and other developing economies

- Margin for a **looser monetary policy**

Protectionism: the agreement between the USA and China is delayed while the EU begins to gain prominence as a focus of tensions

US

Negotiations are ongoing. so an agreement is likely in 2Q19

USA threatens higher tariffs on EU vehicles

China

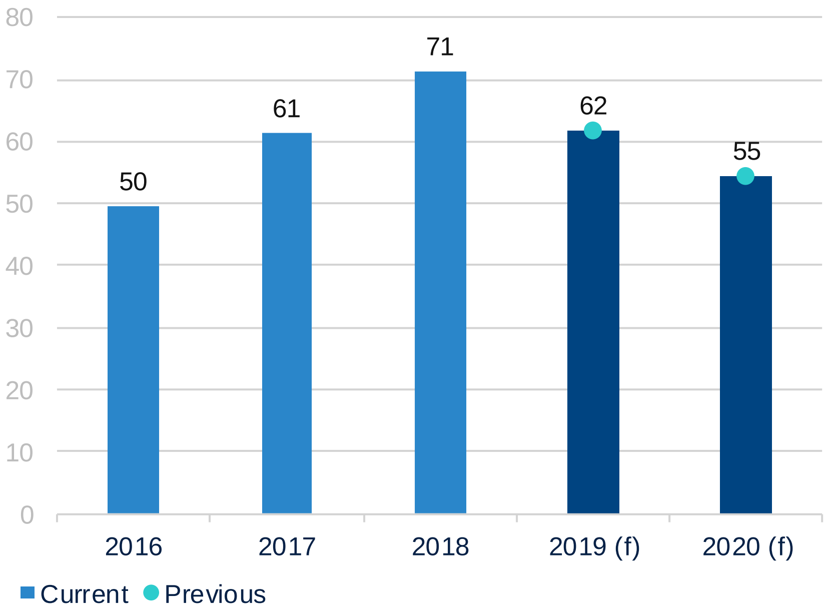
The EU hardens its tone against China. seen as an “economic competitor” and “systemic rival”

European Union

Oil: supply adjustments provided support for prices in 1Q19 which nonetheless must be corrected downward

Oil: Brent prices

(Dollars per barrel. end of period)



Source: BBVA Research. based on INE data.

- Production cuts have allowed an increase in the price of oil (on average. 65 dollars per barrel in 1Q19)
- The perspectives of lower prices are maintained in the second half of 2019 and 2020. in line with the expected slowdown in demand and the expansion of supply in the USA .
- We maintain the long-term equilibrium level of $60 per barrel

Action by central banks and an absence of "accidents" would enable the slowdown in world growth to be mild

More signs of global deceleration → **New stimulus policies**

Assumption based on the evolution of the global environment without "accidents"

01
Protectionism:
a US-China agreement remains probable. despite the delay

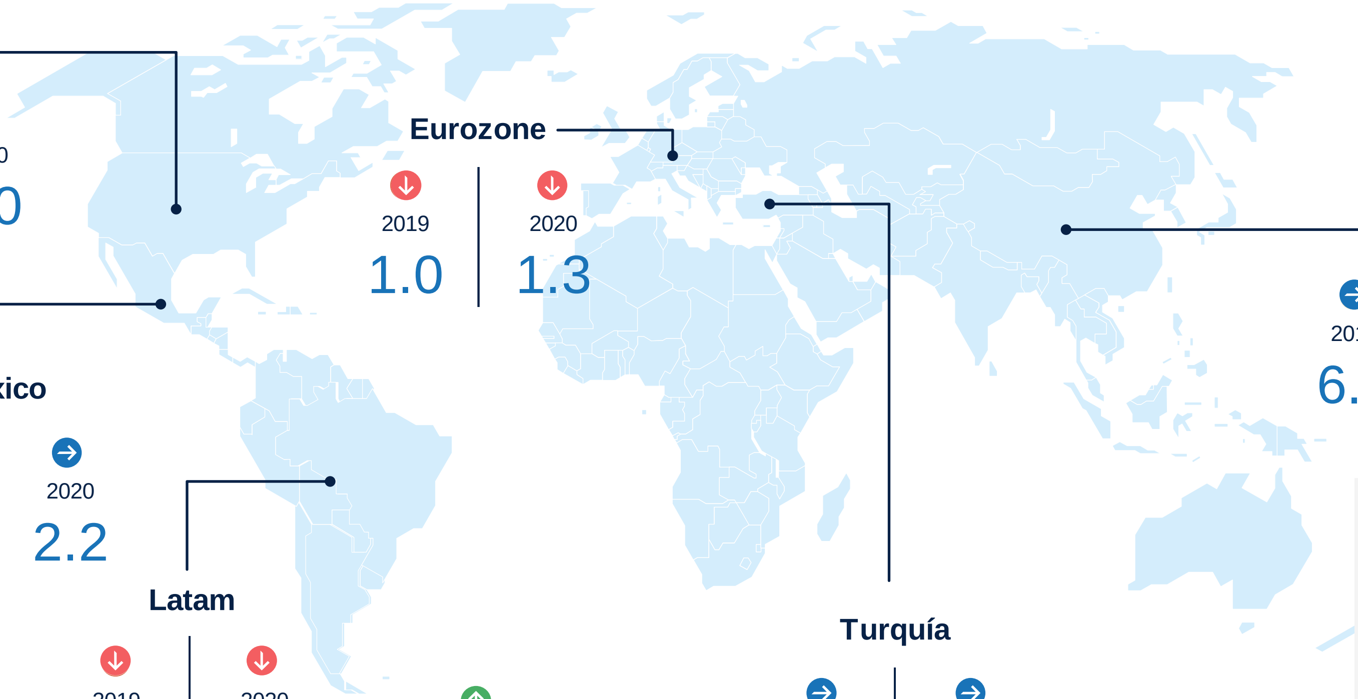
02
Brexit:
more uncertainty over a greater period of time

03
Financial markets:
volatility limited by the actions of central banks

04
Oil
price moderation after recent upturn

Global growth gradually softens

Without "accidents" global growth will gradually slow



US

2019	2020
2.5	2.0

Eurozone

2019	2020
1.0	1.3

China

2019	2020
6.0	5.8

Mexico

2019	2020
1.4	2.2

Latam

2019	2020
1.7	2.3

Turquía

2019	2020
1.0	2.5

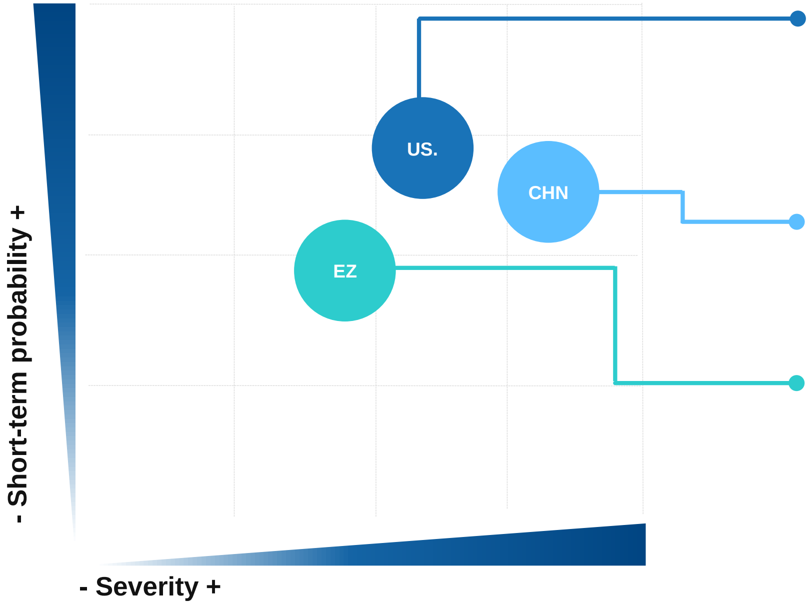
World

2019	2020
3.5	3.4

Up
Unchanged
Down

Source: BBVA Research

Global risks: fear of an economic recession in the US and the Eurozone continues despite greater support from central banks



- **Economic recession: high**
- **Protectionism: high.**
- **Withdrawal of the Fed: significantly less than three months ago**

- **Disorderly deleveraging: relatively greater than three months ago**
- **Protectionism: high.**

- **Economic recession: growing**
  - *Brexit:*
  - Italy:
  - Increase of eurosceptic forces in Parliament
- **Protectionism: growing**
- **ECB exit risk: significantly lower than three months ago**

Source: BBVA Research

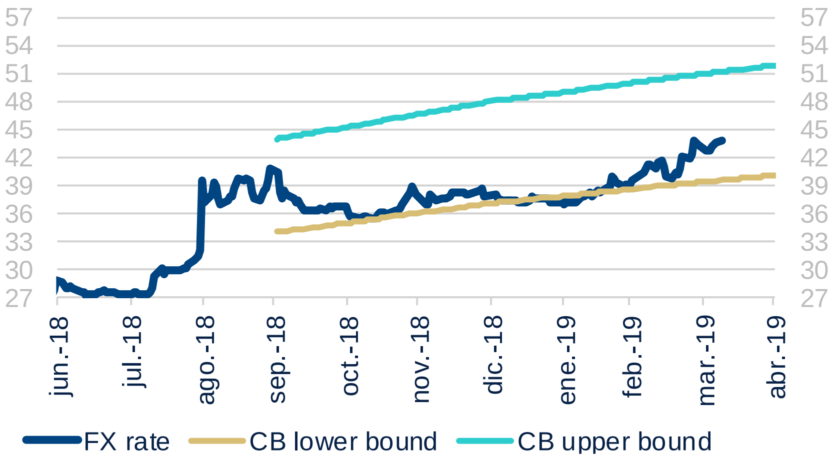
Financial vulnerabilities may amplify the severity of risks

02

Argentina: 2019 will continue in electoral mode

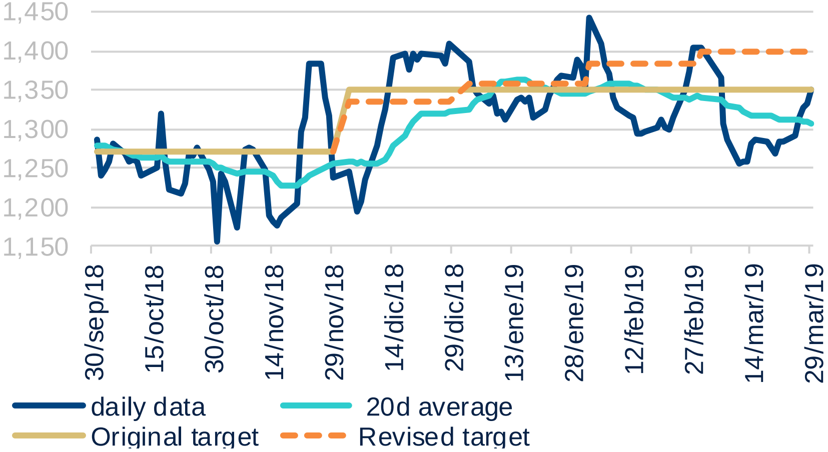
Despite strict compliance with monetary targets. volatility returned to the foreign exchange market

Peso/dollar exchange rates and ranges in non-intervention zone
(ARS/USD)



Source: INDEC, BCRA and BBVA Research

Monetary Base targets
(AR$ billion)



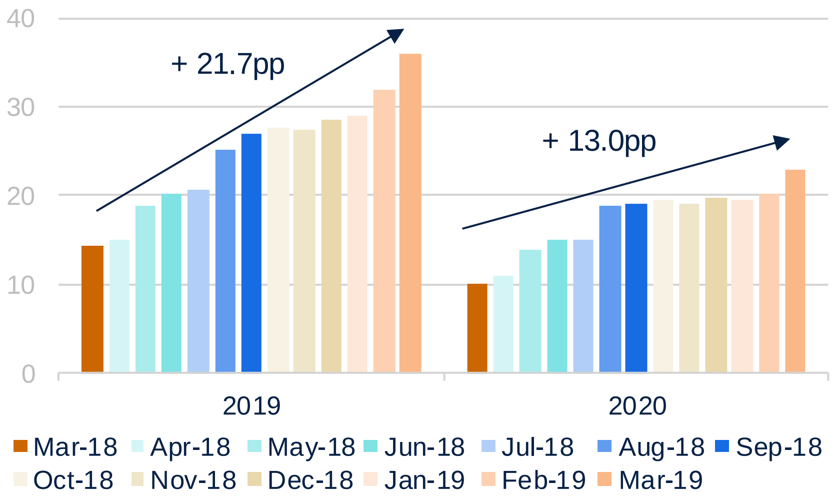
Source: BCRA and BBVA Research

The high inflation of February (3.8% MoM) raises doubts regarding the capacity of the monetary program to quickly reduce inflation and improve consumption recovery prospects

The BCRA is attempting to recover credibility by increasing outperformance of monetary base targets and further tightening monetary policy after the abrupt Leliq rate drop in February

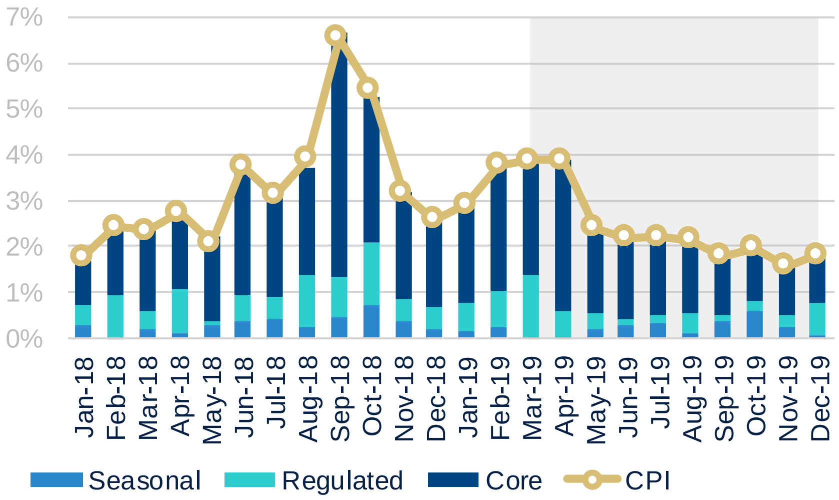
An inflationary inertia that is difficult to tame casts doubts on the credibility of the Central Bank

Central Bank survey inflation expectations
(% change YoY)



Source: BCRA and BBVA Research

Contribution to inflation by component:
(Incidence and % change MoM)



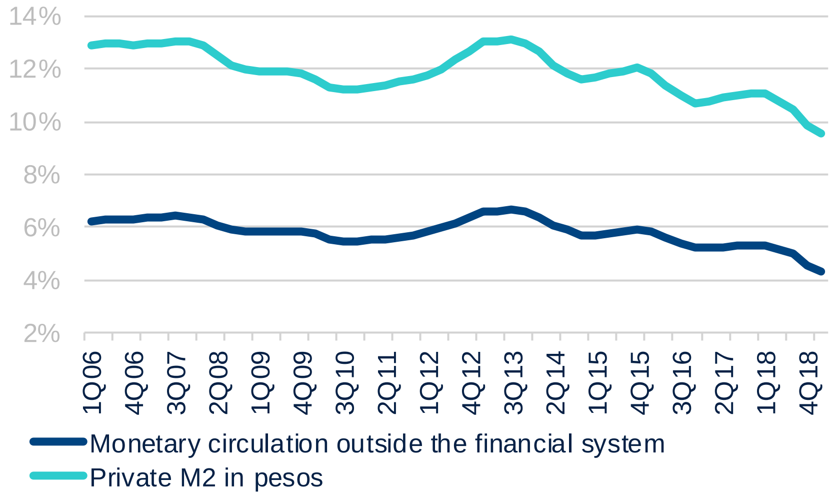
Source: INDEC and BBVA Research

Inflation expectations increased as the extremely tight monetary policy seems insufficient to reduce inertia quickly in a context of continuous adjustment of utility rates and greater indexation in the economy (pensions and to a lesser extent, wages)

Inflation will continue close to 4% MoM in March and April due to tariff adjustments and a core inflation impacted by food prices. Considering monetary policy lags, inflation is expected to fall to 1.9% MoM in 2H19, but will end the year at 35% YoY

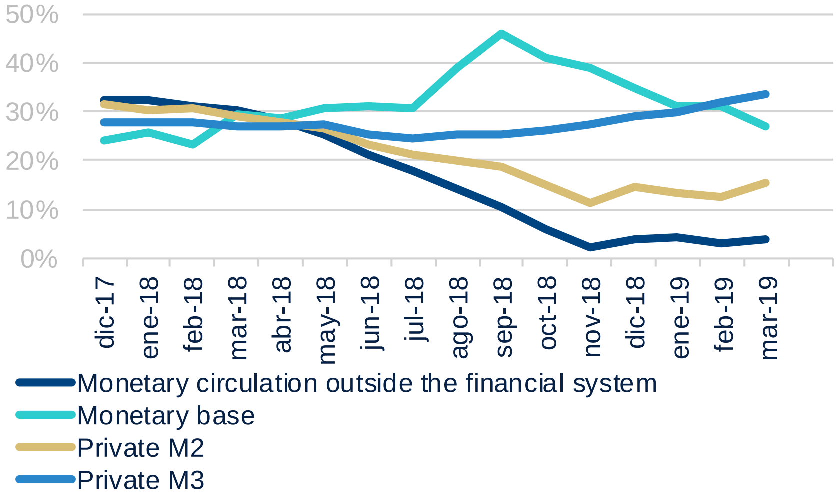
Demand for money at minimum levels and a persistent monetary hangover

Demand for pesos % of GDP
(average last 4 quarters)



Source: INDEC, BCRA and BBVA Research

Growth of monetary aggregates
(% YoY change)



Source: BCRA and BBVA Research.

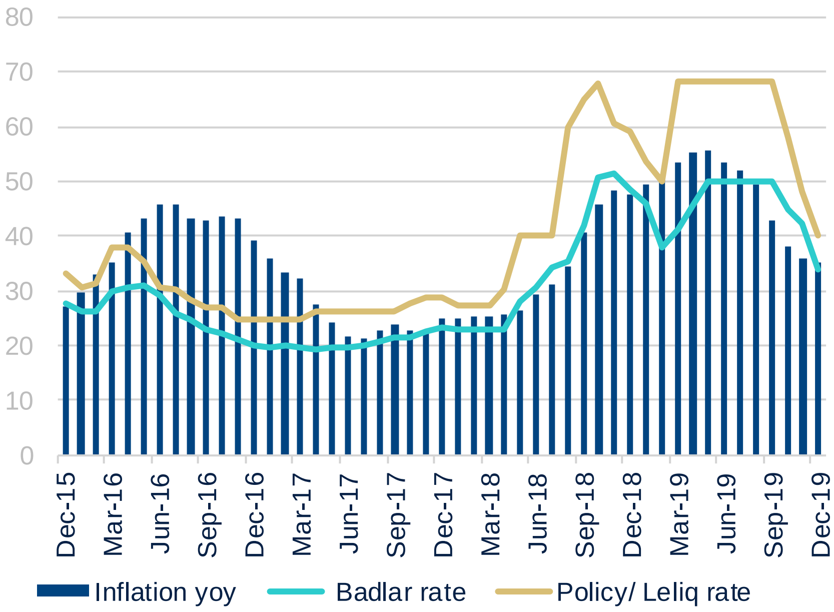
After the 2018 run on the currency, the demand for pesos remains at historical lows and is unlikely to recover quickly in a context of political uncertainty and exchange rate volatility

After the elimination of the main money creation factors, the Monetary Base contracted 8% since the end of 2018 but is still growing 30% YoY due to the expansion resulting from the dismantling of Lebac bills in 2H18

… has led to a reinforcement of tight monetary policies

Interest rates and inflation

(%)



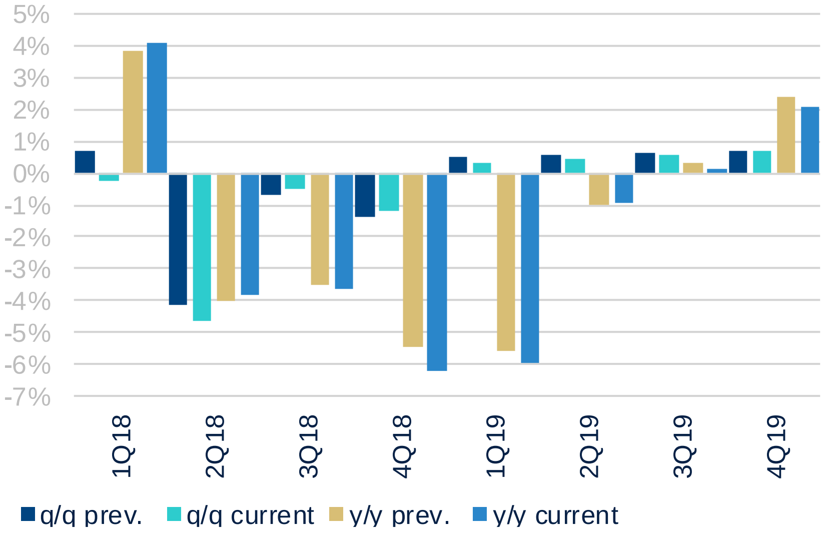
Source: BCRA, INDEC and BBVA Research

- The BCRA announced that it would reduce the Monetary Base expansion to 0% in 2H19 (previously 1% MoM) and reduced the slope of non-intervention zone bands from 2% MoM to 1.75% MoM
- Limiting CB purchase of foreign currency to USD 50 million per day in March and April, maximum at 2% of the Monetary Base
- Absorption via Leliq intensified with 2 daily bidding sessions and improving the ratio for repo rates, which caused interest rates to increase to 68% at the end of March 2019
- The BCRA set a 62.5% floor on the Leliq's rate for April. We estimate that interest rates will remain high throughout Q2 and Q3 and will only be reduced in the last quarter to 40% YoY

GDP will contract by 1.2% in 2019 due to a weaker quarterly growth in the face of extremely tight monetary policy

Quarterly GDP growth- previous and current estimates

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



Source: INDEC and BBVA Research

- GDP fell 1.2% s.a. QoQ in 4T18 (BBVA Research (e) -1.4%). leaving a slightly lower than forecasted statistical drag for 2019
- However, quarterly growth, although positive, will be weaker in Q2 and Q3 due to high interest rates and greater exchange rate volatility
- Unemployment will gradually increase to 11 % in 2Q19, which may result in moderation of wage demands. Considering the acceleration of inflation in the first four months of the year. it is difficult to assume that there will be an average real wage recovery in 2019
- In light of the weakness of domestic demand, the external sector will contribute positively to growth by 5.4 pp. in 2019

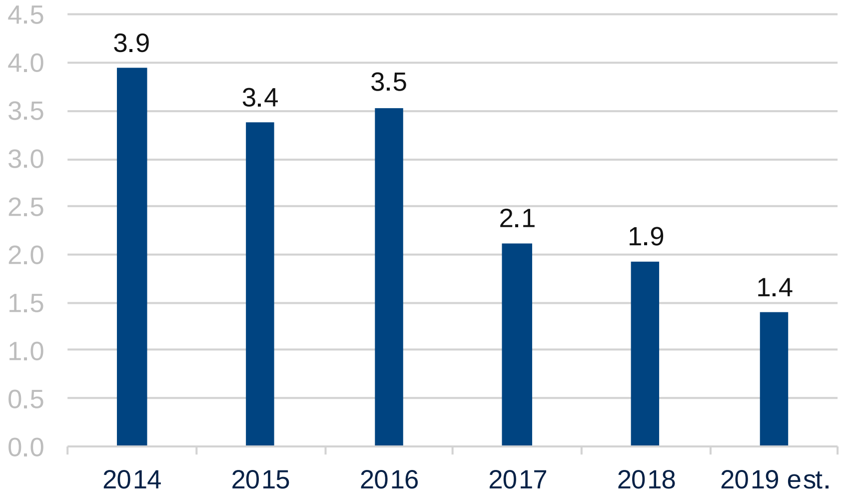
Insufficient revenue growth leads to greater adjustment in spending maintaining the annual zero primary deficit target

Income and expenses, previous and revised
(% GDP)

	2019		
	Budget	II Review IMF	III Review IMF
TOTAL REVENUE	**28.4**	**28.1**	**26.4**
Taxes	19.7	19.8	18.2
VAT	7.8	7.6	7.4
Export taxes	**2.4**	**2.5**	**1.7**
Import taxes	1.0	0.8	0.7
Other taxes	8.5	8.9	8.4
Social security	6.6	6.3	6.0
Non-tax revenue	2.1	2.0	2.2
PRIMARY SPENDING	**28.4**	**28.1**	**26.4**
Wages	**3.6**	**3.6**	**3.3**
Goods and services	0.9	0.8	0.8
Pensions	9.7	9.6	9.2
Social spending	2.6	2.6	2.3
Economic subsidies	1.6	1.5	1.4
Capital spending	**0.9**	**0.9**	**0.8**
Other	0.3	0.3	0.2
Transfers to provinces	8.8	8.8	8.4
PRIMARY RESULT	**0.0**	**0.0**	**0.0**

Source: IMF and BBVA Research

Economic subsidies
(% GDP)



Source: ASAP. Ministry of the Treasury. INDEC. and BBVA Research

Lower collection of export taxes will be compensated by a reduction in capital expenditures and in part by automatic adjustments in Co-participation transfers to provinces and spending on pensions (due to the acceleration of inflation)

The current administration will achieve a 60% reduction in economic subsidies in terms of GDP, but after the last devaluation and the acceleration of inflation, the margin for adjustment through additional utility rates increases has fallen

Higher than expected roll-over rates reduce financial needs for the rest of 2019

2019-20 Financing Programme
(USD millions)

	2019	2020
Primary deficit	**0.0**	**-5.2**
Plan gas payments	**0.6**	**0.6**
Interest on private sector debt	**11.6**	**15.2**
Amortizations of debt held by private sector	**30.8**	**26.2**
IFIs (non-IMF)	3.0	3.0
Dollar denominated bonds	3.9	4.0
Peso denominated bonds	1.7	7.5
Repo	2.9	2.2
Letes in dollars	9.9	4.5
Lecap and Lecer in pesos	9.4	5.0
FINANCIAL NEEDS	**43.0**	**36.8**
Initial balance	**4.7**	**0.6**
Rollover of intra public sector debt 1Q	**3.8**	**0**
IMF	**22.5**	**5.9**
IFIs	**4.3**	**3**
Private sector financing	**8.3**	**27.3**
Rollover international markets	0	0
Rollover domestic markets	0	11.1
Repo	0.5	1.5
Letes in dollars	4.5	4.5
Lecap and Lecer in pesos	**3.3**	**5**
New issuances in domestic markets	**0**	**5.2**
SOURCES	**43.6**	**36.8**
Sources - Needs	**0.6**	**0.0**
ROLLOVER Letes in dollars	**45%**	**100%**
ROLLOVER Lecap and Lecer in pesos	**35%**	**100%**

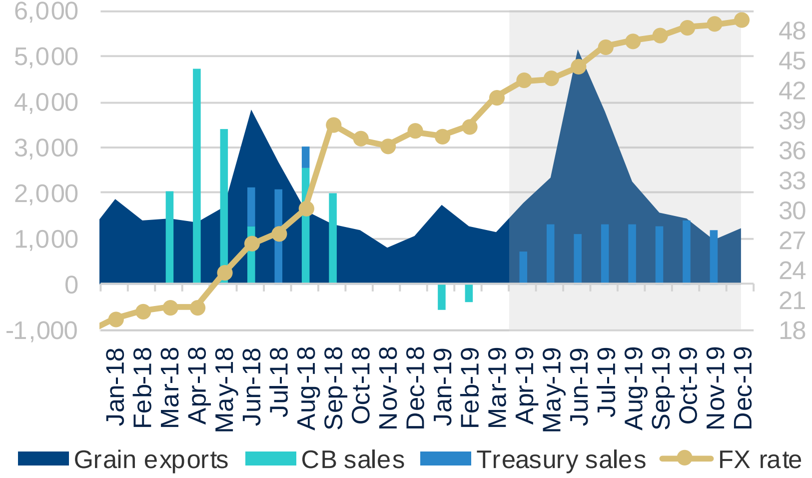
Source: Ministry of Finance and BBVA Research

- High renewal level for LECAPs in 1Q19 and the fact that part of maturities have been transferred to 2020 reduce the need for Letes/Lecap roll-over to 35% in the rest of 2019
- 100% renewal of LETES but since they expire within the year the renewal requirement remains at 45%
- The composition of the expenditure by currency allows the combined average required rollover rate for LETES/LECAP to be reduced to 40%
- Intra-public sector financing will be zero for the year, despite net cancellations in 1Q19
- An average roll over rate of 67% this year means that in 2020 no new debt would need to be issued, only a total renewal of all maturities (35% denominated in dollars)

Exchange market: high volatility but finishing in line with inflation

FX rate, export settlements and BCRA intervention

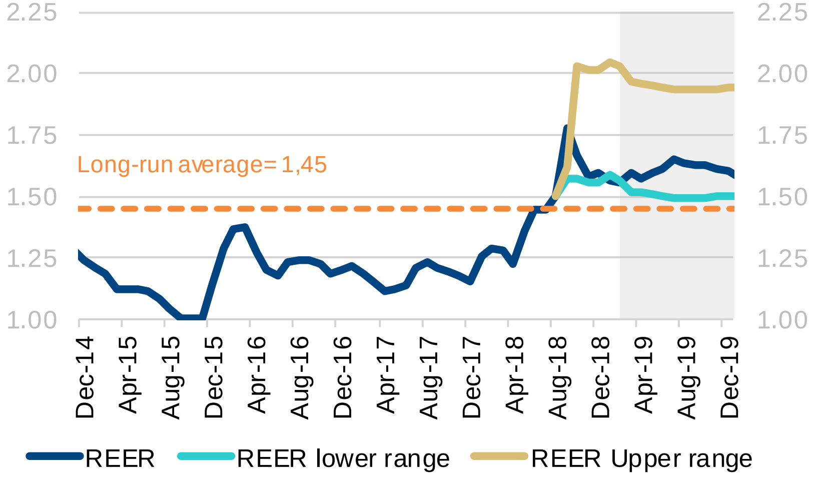
(USD Million y ARS/USD)



Source: BCRA, CEC-CIARA and BBVA Research

Real multilateral exchange rate index (REER)

(base Nov. 2015 = 1)



Source: BCRA, Haver, INDEC and BBVA Research

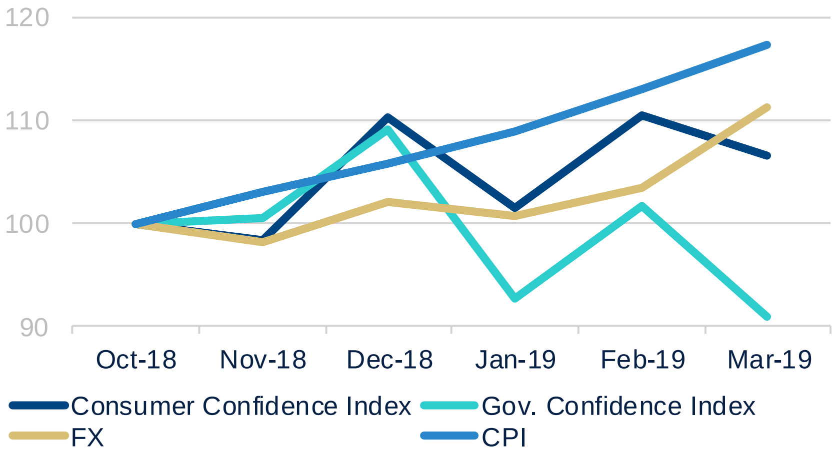
The record harvest of corn and soybeans will add USD 4.5 million to exports in 2Q19. In turn, sales of USD 60M in Treasury dollars per day starting in April will contribute 3 billion to the supply of foreign currency in 2Q19 and USD 9.6 billion for the year

The real exchange rate will remain close to the lower band but slightly depreciated with respect to the IMF's equilibrium estimates (16%) and the long-term averages (7%)

But FX volatility fuels uncertainty... and the demand for dollars

Confidence indexes, inflation and exchange rate

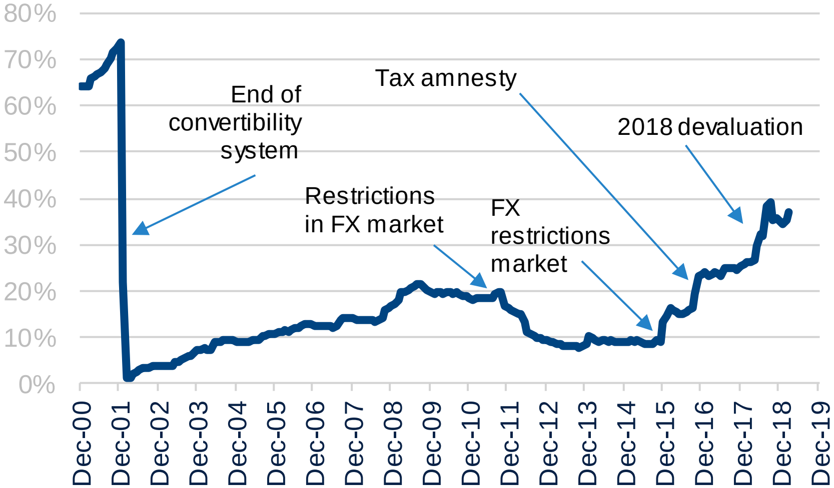
(Base 100 = Oct. 18)



Source: INDEC, BCRA, Di Tella University and BBVA Research.

Dollarization of deposits

(% of the total)



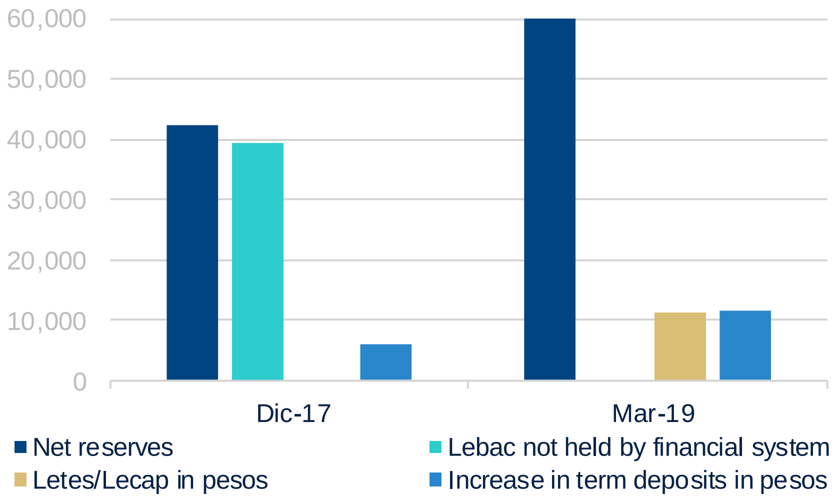
Source: BCRA and BBVA Research

Electoral uncertainty, the persistence of inflation and the perception that the capacity for BCRA intervention in the FX market is limited reinforce negative expectations, making it difficult to lower inflation and reduce fiscal spending

Appetite for assets in pesos and for Argentine assets in general will remain low maintaining negative country differentiation due to doubts regarding economic stabilization and the electoral cycle

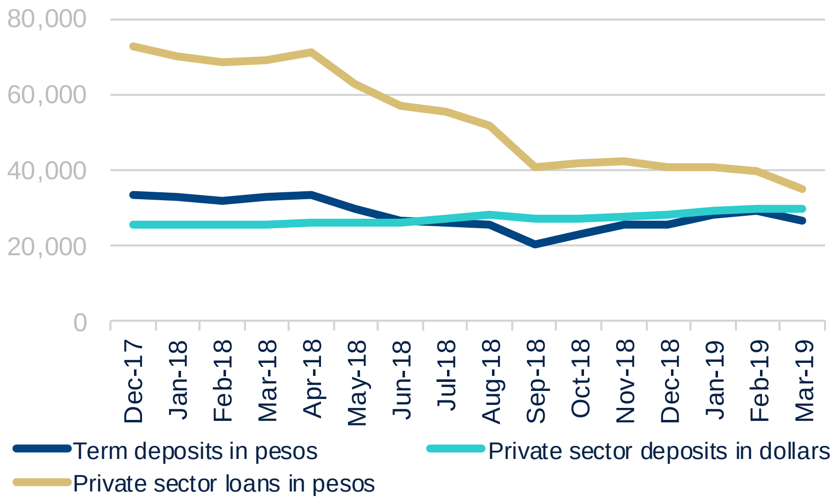
However, the potential for damage is much lower than in 2018

Assets in pesos vs. International reserves
(USD million)



Source: Finance Minstry , BCRA and BBVA Research

Dollarization in the financial system
(USD million)



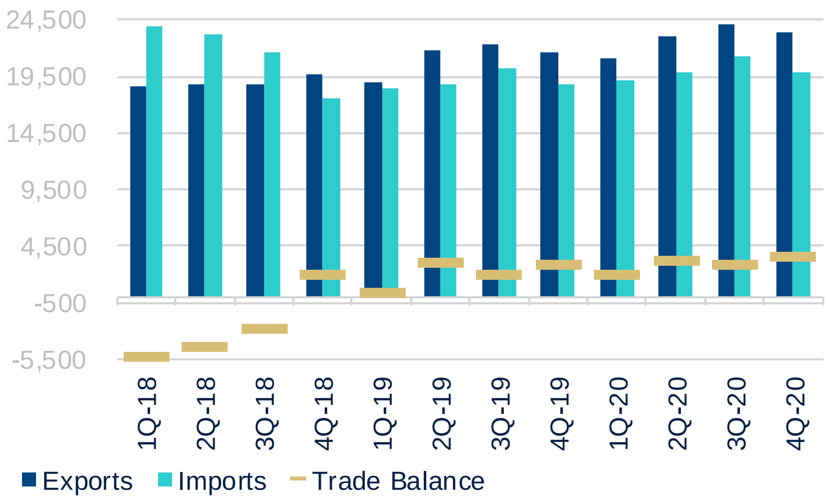
Source: BCRA and BBVA Research

After the dismantling of Lebac bills in 2018, assets in pesos that could potentially be dollarized are half the amount that they were in 2018, while net reserves are 45% higher than in the previous year

Despite a strong increase in 4Q18, fixed terms deposits in pesos now amount to the same amount that dollar-denominated deposits in the financial system, although they have not fallen in nominal pesos. The ratio of private loans/deposits is now 72%

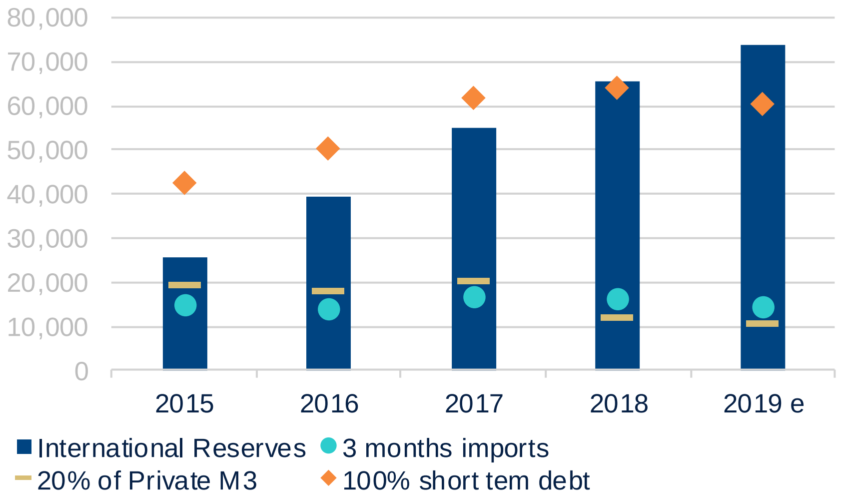
The 2019 current account deficit will fall to USD 9.5 billion, one third of 2018's, reducing Argentina's external vulnerability

Exports, imports and goods and services balance
(USD millions)



Source: INDEC and BBVA Research

Reserve ratios
(USD Millions)



Source: INDEC, Treasury, BCRA and BBVA Research

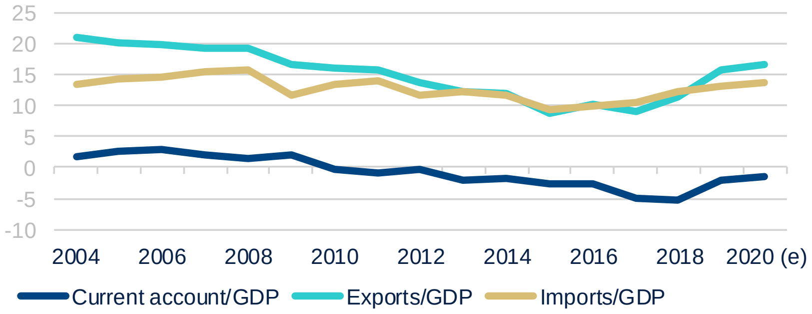
Exports will increase significantly in 2Q and 3Q19 due to the improvement of USD 4.500 M in agricultural production and to a lesser extent demand from Brazil while imports of both goods and services will continue to fall

Reserves will increase both due to the trade surplus as well as the lower capital outflows with contributions from a new swap with China, enough to cover all short-term debt maturities and 110% of existing pesos

Gradual external and fiscal adjustment reduces the debt burden … slowly

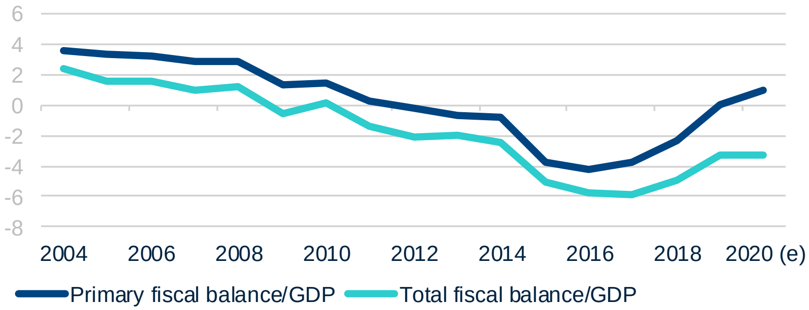
External Sector

(%)



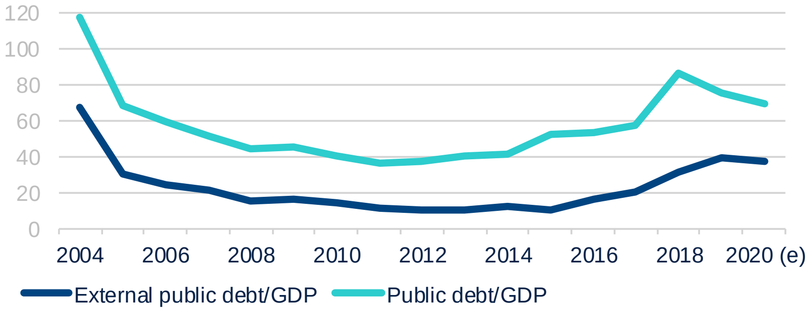
Fiscal Sector

(%)



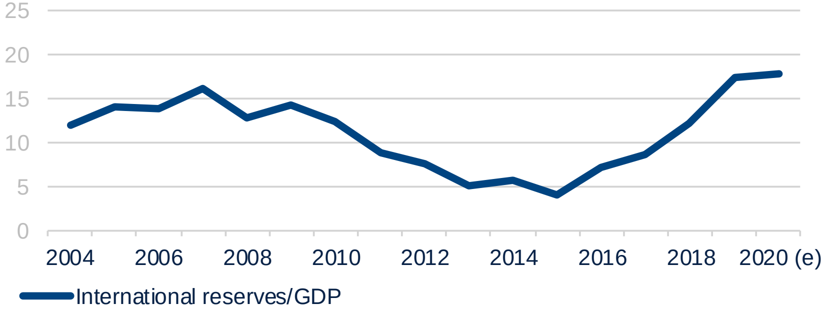
Public Debt as % of GDP

(%)



International reserves/GDP

(%)



Source: INDEC, Finance Ministry, BCRA and BBVA Research

Annual macroeconomic forecasts

	2017	2018 e	2019 e	2020 e
GDP (% YoY)	2.7	-2.5	-1.2	2.5
Inflation National CPI (% YoY. EOP)	24.8	47.6	35.0	25.0
Exchange rate (vs. USD. EOP)	17.7	37.9	49.0	55.0
Monetary policy rate (%. EOP)	28.8	59.3	40.0	29.0
Private consumption (% YoY)	4.0	-2.4	-2.9	3.2
Public consumption (% YoY)	2.7	-3.3	-2.6	-1.0
Investment (% YoY)	12.2	-5.8	-12.3	6.1
Fiscal balance (% GDP)	-5.9	-5.0	-3.3	-2.3
Current account (% GDP)	-4.9	-5.2	-2.2	-1.5

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

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