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Argentina Economic Outlook 3Q19

Reduced financial tensions augur well for a better second half

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The **electoral process** is becoming clear as the candidates for the presidency are known. The disappearance of Alternativa Federal has given rise to strong polarization in the preferences of the electorate, leaving only the ruling party, which is up for re-election, and the space left by former President Cristina Fernández, who chose to compete for the Vice Presidency, with genuine aspirations to succeed. The markets welcomed the announcements because as were perceived, especially in the second case, as a "moderation".

Exchange rate pressures at the end of April, together with the poor March inflation figures released during that month, led the BCRA to agree with the IMF on possible intervention even in the (now) reference exchange zone. The announcement of the measure significantly reduced FX volatility and helped contain inflation expectations. In addition it strengthened the contractionary profile of monetary policy as pesos obtained from sales of dollars will not again be injected again. Alongside this, the supply of foreign currency from exporters increased and demand eased. We expect an exchange rate at 48 ARS/USD by Dec-19, a 25% rise in the year, after taking into account greater volatility until November as the electoral process progresses. However, in order to contain expectations about depreciation and its effects on prices, the BCRA will maintain high real **interest rates** in order to stimulate the demand for pesos, and use the formidable "firepower" of its (futures and spot) foreign exchange tools.

In conjunction with the FX and monetary measures, the government suspended utility prices **adjustments** to remove support for the inflationary process. These measures are having some success, and inflation in June had the third consecutive monthly reduction since March's peak. In the second half of 2019 monetary contraction will be more effective and, together with the exchange rate stability, will steer inflation toward 2.3% per month with a cumulative figure of 40% for the year. In 2020 inflation will continue to reduce at a moderate pace to reach 30%.

The strong negative statistical drag from 2018 (-2.3 pp) will cause **activity** to contract by some 1.2% in 2019 despite the fact that the quarterly GDP trend will be upward from 2Q19. In seasonally adjusted terms, the final three quarters of the year will see an average growth of 0.8% q/q as the effects of the agricultural season in 2Q19 and 3Q19 materialize, and the impact of revenue wage negotiations and adjustments to pensions have effect on consumption, partially offsetting the contractionary impact of high interest rates on private demand. In 2020, the economy will have already taken into account the stresses caused by electoral uncertainty and will grow 2.5% hand in hand with recovery in private domestic demand.

Arising from the deepening crisis in 2Q18, more than 220,000 **jobs in the private sector** were lost, primarily in the industry, trade, and construction sectors. By contrast, employment in the public sector grew slightly. This reduction in employment has occurred alongside a collapse in real wages, all of which has a restraining effect. The recovery in activity will stimulate more searching for jobs, thereby increasing the rate of activity but also the unemployment rate, since the re-integration of the unemployed back into work will be slow. The unemployment rate in 2019 will be 10.3% on average, and peak at 11% in the next few months but with notable decline toward the end of the year. The big **losses in real wages** recorded in 2018 (-11.6% year -on-year at the end of 2018) imposed a powerful negative drag on 2019 which will not facilitate their full recovery. However, exchange rate stability, declining inflation and the joint bodies anchored to the CPI will cushion the fall.

The **external sector** will have a big adjustment in 2019. In the first 5 months of 2019 the trade surplus amounts to USD 4.5 bn and we expect it to reach **USD 11 bn** by the year end and **USD 10.5 billion** in 2020. This adjustment results from a strong reduction in imports which will end the year at 17.5% below those of 2018 and, to a lesser extent, from a 5.6% YoY growth in exports. The drop in economic activity and the depreciation of the peso are the determining factors behind the severe reduction in imports this year but will, in 1Q20, have already touched bottom and will begin to recover hand in hand with GDP growth. As regards exports, they are recovering in 2019 because of the record harvest, although the dynamics of their pricing is not facilitating stronger growth in their value. In 2020 we expect a 10% increase in exports driven both by prices and volumes. In addition to the significant trade surplus in goods, the adjustment will also take actual services into account. This is dominated by the severe reduction of 48% in the tourism deficit throughout 2019, similar to the adjustment that was made in 1Q19 (-49.8% yoy). Both of these effects will mean that the current account will close this year with a deficit of 2.3% of GDP down from 5.1% of GDP in 2018. For 2020 we expect to maintain the external deficit at 2.3% of GDP.

With regard to the **fiscal outlook**, the 2Q19 goal was achieved with a primary surplus of $30.2 bn (0.1% of GDP), overshooting the $20 bn target agreed with the IMF. Although there was extraordinary income from the sale of the assets of public sector undertakings in June, which offset the increase in seasonal expenditure on the payment of bonuses, tax revenues increased 43% exclusively in the first half of the year compared to an increase in primary expenditure of 33.8% in that period. The financial deficit after payment of interest was 1.3% of GDP, a slight improvement over the first half of 2018 even though interest rates rose by 118% caused by the increase in debt and last year's devaluation. In terms of the target for the year in total, the primary outcome cannot exceed a deficit of -0.5% of GDP (taking into account adjustments to capital spending and social spending) which it is feasible to achieve under the current scenario. But the primary surplus target of 1% of GDP for 2020 looks more difficult. There is a limited scope for continuing to increase revenues through high taxation and the modest performance forecast of economic activity coupled with the fact that opportunities to reduce expenditure are now more restricted. A significant adjustment has already been made to the relative prices of energy and transport and capital spending has been cut, and any further reduction of expenditure will surely require much more in-depth reform of the public spending structure.

Achievement of the fiscal target freed up the outlay of USD 5.4 bn in accordance with the schedule. The IMF said that the markets have stabilized, the fiscal and external situation is improving, the monetary policy is prudent and there is a gentle recovery in economic activity, although it believes inflation is still high. In terms of financial requirements, the government passed the test to renew Treasury Bills in dollars with a maturity of date after to the elections, but at a higher rate, and has also continued with the schedule of short-term placements in pesos, the stock of which has nearly doubled during the first half of the year.

The overall prospects of the Argentine economy for 2020 onwards are not free of risk, but, with the electoral prospects out of the way, and assuming the continuation of current economic policies in the framework agreed with the IMF, they look more promising. Activity will recover alongside private domestic demand and exports, with interest rates that will gradually go down as inflation declines and a lower perception of risk takes hold, and growth will stabilize at potentially around 2.5% per annum. To ensure that the economy grows above this potential requires the implementation of structural and institutional reforms on a number of fronts, such that the productive capacities of the country can be fully unleashed.

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