ARGENTINA

HERE WE GO AGAIN

Argentina's economy is in turmoil. Since Q4 2022, it has been mired in a recession that is bound to extend at least through H1 2023. The farm sector has been plagued by misfortune: for the third consecutive year it has been hit by drought – whose intensity has been compounded by climate change – and an outbreak of avian influenza. Inflation has soared, forcing the central bank to tighten monetary policy. Despite fiscal efforts, the balance of payments and foreign reserves are coming under increasingly fierce pressures, even with IMF support. The government has rolled out a series of measures to avoid wasting foreign reserves and defaulting on its external debt with official creditors. It has also had to offer a proposal to reschedule domestic debt in the local currency.

Argentina's already precarious economic situation has deteriorated significantly in recent months. Economic activity contracted and inflation has soared, forcing the BCRA, Argentina's central bank, to raise its key rates significantly. At the same time, the trade surplus shrank even though soybean prices were still holding at high levels, and the central bank had to proceed with net currency sales to the private sector, reducing the already low level of foreign reserves. The IMF continued to provide financial support in accordance with the Extended Facility Fund (EFF) concluded in March 2022. Yet, Economy Minister Sergio Massa still had to resort to two sovereign debt buyback operations to reduce this year's debt repayments. With the approach of primary elections in August and then the presidential election in October, the situation seems alarmingly similar to the one in 2019, when the Macri government, following the outcome of the primary elections, was forced to suspend the payment of Treasury notes and to ask for the restructuring of domestic and external sovereign bonds.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-9.9	8.0	5.5	-3.0	-2.5
Inflation (official), annual average, %	42.0	48.4	77.6	100.5	113.0
Fiscal balance/ GDP, %	-8.9	-5.0	-4.0	-4.1	-3.7
Public debt / GDP, %	104.3	80.9	83.2	77.0	75.0
Current account balance / GDP, %	0.9	1.4	-0.3	1.5	1.0
External debt / GDP, %	69.9	59.2	58.4	50.7	50.3
Forex reserves, USD bn	39.4	39.6	44.6	46.2	52.9
Forex reserves, in months of imports	9.1	7.2	7.6	7.5	8.0

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TOWARDS A HARD LANDING

Argentina's economy held up fairly well in the first 9 months of 2022, with total GDP up 6.5% compared to the same period in 2021, despite a 2.5% decline in farm sector value added, which accounts for 7% of GDP. Growth was driven by domestic demand (including investment), which fuelled activity in construction and services. Given the simultaneous increase in imports, net external demand made a sharply negative contribution (-2.7%), even though exports were robust. At the same time, inflation accelerated rapidly, rising from a monthly average of 3.7% in 2021 to nearly 7% in Q3 2022. But employees benefited from a wage catching-up effect, and employment was on the rise.

In Q4 2022, the economy unfortunately ran out of steam. GDP was down 1.5% compared to the previous quarter. Industrial production stagnated after contracting in Q3, and the construction sector also slumped. After holding to a monthly rate of 5.8% between October 2022 and February 2023, inflation peaked at 102.5% in February, eroding private consumption (-1.5% in Q4) and household confidence. After surging over the summer months, household confidence fell back to levels that were barely above pre-Covid figures. Exports were the only factor that rebounded, but that was after bottoming out in Q3. Actually, exports were also losing momentum.

Argentina's economy will not escape recession this year. The drought and water stress during the last months of the austral summer season will trigger a dramatic drop-off in farm production (down 21% for soybeans, 45% for wheat and 11% for maize). *La Nina* undoubtedly had its effect on rainfall, but climate change is also to blame, the only factor that explains the persistence of the drought (the third consecutive year) and this year's exceptional intensity. The farm sector is also

ARGENTINA: ACTIVITY INDICATORS

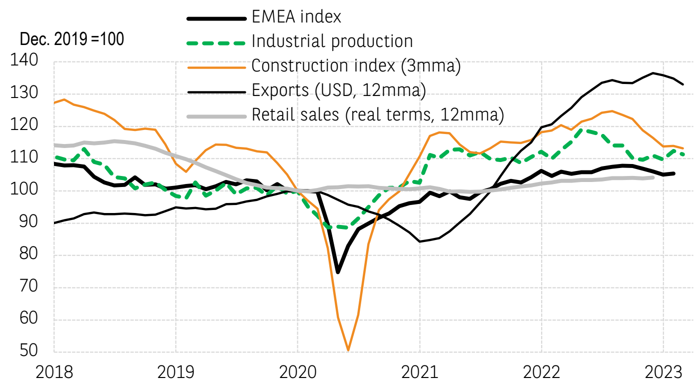


CHART 1 SOURCE: INDEC, BNP PARIBAS

having to face up to an outbreak of avian influenza since mid-February 2023.

Taking solely into account the three biggest crops, the farm sector's negative contribution can be roughly estimated at 1.5 percentage points of GDP at the least. At the same time, non-farm GDP will be hit by the slowdown in world growth, the erosion of household purchasing power in Argentina and the rise in domestic interest rates. The BCRA raised its key central bank rate from 38% in early 2022 to 78% on 27 March 2023. All in all, total GDP could contract by 3%, while inflation barely levels off at an average annual rate of 100%, or a monthly inflation rate of between 5% and 6%. Price inflation will remain very high despite the recession because of expectations of currency depreciation, which is likely to hold at the current pace (-5.3% a month against the USD since the beginning of the year, compared to -4.4% in 2022) as long as the balance of payments remains under fierce pressure.

FOREIGN RESERVES UNDER PRESSURE

Despite currency controls, the central bank's reserves are eroding, from USD 44.6bn at year-end 2022 to USD37.6 bn at 31 March 2023. The cumulative 12-month current account balance swung into a deficit in Q3 2022 as the trade surplus narrowed sharply (from USD 14bn at year-end 2022 to USD 5.4bn in February 2023, according to customs data). In addition, non-resident capital outflows picked up again recently, after the BCRA sold a little more than USD2 bn to the private sector since the beginning of the year. The surplus demand for dollars is showing no signs of abating, with the spread between the blue chip swap rate and the official exchange rate holding at 90%.

The favourable conclusion of the fourth review of the EFF arrangement will pave the way for the disbursement of the equivalent of USD 5.3bn. Yet over half of this amount will be used to repay international financial institutions, primarily the IMF. The rebuilding of foreign reserves will be temporary at best, even if imports were to contract. Prices for the main grains are trending downwards, while export volumes will decline due to smaller harvests. The economists at JP Morgan estimate the decline in exports of the three main crops at USD 15bn in value terms, or 2.4% of GDP.

To try to reduce the surplus demand for dollars reflected in the persistently high spread between the parallel and official exchange rates, in mid-March the government announced that it would require public institutions to: 1/sell certain domestic-law foreign-currency bonds to the Treasury, and to use 70% of the proceeds to purchase long-term bonds denominated in pesos (for an estimated total of USD 15bn) and 2/to exchange their international bonds into domestic bonds in pesos, whose pay-out would be indexed either to inflation or forex trends at maturity.

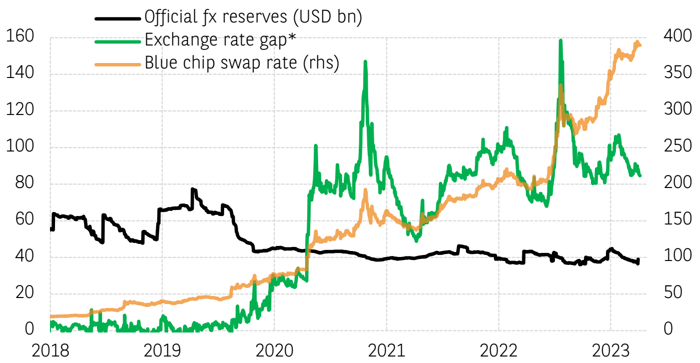
These measures are a way for the government to make advanced payments on the Treasury's upcoming debt servicing needs in foreign currency without dipping into the foreign reserve. In January, Sergio Massa already announced that the BCRA would purchase USD 1bn in sovereign debt securities denominated in foreign currency on the Treasury's behalf. Although following each review of the EFF arrangement, the IMF refinances the amounts that the Argentina must reimburse quarterly, the economy minister is seeking to avoid wasting foreign reserves and to respect the IMF targets set for the end of each quarter. So far, however, we can see that the Argentine authorities have had to painfully claw back all of the ground that was quasi-systematically lost after each review. Note that Argentina's foreign currency sovereign debt repayments (international bonds and loans + domestic debt in foreign currencies) amount to USD 35bn in 2023.

FISCAL EFFORTS ARE NOT ENOUGH

In addition to the squeeze on external liquidity, Argentina is also having trouble rolling over domestic debt in pesos. The cumulative 12-month primary deficit was still small at 2.2% of GDP through February 2023 (4.3% for the total deficit), thanks to fiscal efforts. Primary spending was cut from 29% of GDP at year-end 2021 to 27% at year-end 2022. In January-February, however, the primary deficit swelled to 0.3% of GDP, which is already above the IMF's Q1 2023 target.

On 9 March, Sergio Massa offered public and private creditors the possibility of exchanging peso-denominated debt securities maturing through Q2 2023 for new notes due in 2024 and 2025. Second-quarter maturities indeed amounted to 5% of GDP, a little less than half of the full-year total. The participation rate was very disappointing at only 57.3%. Although the operation helps ease the domestic debt servicing charge by the equivalent of 2.6% of GDP, the participation rate of private creditors was very low. Moreover, domestic debt securities indexed either to the exchange rate or inflation now account for 93% of total domestic debt. Private creditors clearly felt that indexation guarantees were insufficient for them to accept the risk of further debt restructuring. At the same time, sterilisation costs for the central bank soared from 3% of GDP at year-end 2021 to nearly 8% at year-end 2022, despite the halting of direct central bank advances to the Treasury (i.e. direct monetary financing of the budget deficit) since August 2022, and the absence of net financing flows from the rest of the world. In case of domestic debt restructuring, the banking sector will be the first to be hit since public securities (excluding Leliq and Noliq, the BCRA's sterilisation instruments) account for 23% of the sector's total assets.

ARGENTINA: EXCHANGE RATE AND OFFICIAL FX RESERVES



* gap between the 'Blue rate' and the official exchange rate USD/ARG

CHART 2 SOURCE: BCRA, BNP PARIBAS

François Faure
francois.faure@bnpparibas.com