Argentina: a radical change

François Faure / Sylvain Bersinger

Argentina's economic policy has taken a more liberal turn since Mauricio Macri took power in November 2015. The new government's first measures were mainly designed to shore up the country's external liquidity and bolster its image in the eyes of the international financial community. This change of direction occurs at a time when the country has entered recession, inflation remains stubbornly high and the clean-up of public finances is only just getting underway. In the medium term, recent reforms could prove to be an effective way to attract non-resident and resident investment.

Argentina has undergone an economic "big bang" since Mauricio Macri took the helm in November 2015. The official exchange rate – which was notoriously overvalued – was abruptly devalued to eliminate the spread with the parallel exchange rate, and currency controls were eased. Export taxes on most agricultural products have been removed and tariffs on natural gas, water and transportation have been raised drastically. After the settlement of arrears with holdouts – the creditors who did not take part in the debt restructuring of 2005 and 2010 –, the country successfully taped the international bond market. These energetic measures were launched even though the economy had entered recession, weakened by low commodity prices, Brazil's recession and surging inflation, which ended up eroding household consumption, the main growth engine.

In the medium term, these reforms should bolster the country's economic credibility, secure access to global markets and reduce structural inflation pertaining to money creation, which should eventually allow the country swing back into a more stable and better balanced growth. We should not assume that these reforms will be successful, however, given the deterioration in public finances and the strong opposition to fiscal consolidation measures (for instance the huge increases in tariffs on gas and electricity have been challenged before the courts). Moreover, even if the popularity rating of the new government remains high, the shock therapy may generate a strong popular discontent if high inflation and surging unemployment persist.

Exchange rate USD/ARS

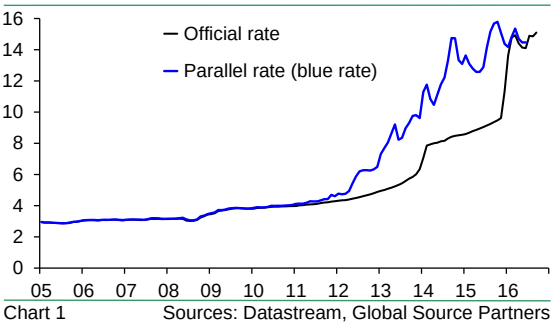


Chart 1 Sources: Datastream, Global Source Partners

Successful return to international markets

Mr. Macri's top priority was to normalise Argentina's relations with the rest of the world. Since the beginning of the decade, disputes have broken out with numerous trading partners: the European Union and the United States faced severe import restrictions, and the EU filed suit with the World Trade Organisation in 2012. The lawsuit was triggered by the 2012 nationalisation of YFP (*Yacimientos Petroloferos Fiscales*), a company previously owned by the Spanish oil company Repsol. There were also growing tensions with the other Mercosur countries, notably Uruguay, on both economic and environmental issues. Lastly, disagreements with the multilateral institutions persisted under the Kirchner administration, notably with the International Monetary Fund after it questioned the reliability of Argentina's inflation and GDP statistics. As a result, Argentina was virtually locked out of international markets.

The main breakthrough that improved relations with the rest of the world occurred when the Macri government reached a settlement with holdout bondholders. Two sovereign debt restructuring agreements reached in 2005 and 2010, which reduced the debt by about 70%, were accepted by 93% of creditors. Yet activist hedge funds filed suit to be repaid at full value for bonds purchased at a very steep discount on the secondary market. The bond issue was governed by New York law, and Judge Thomas Griesa ruled in favour of the hedge funds. The Argentine government refused to pay, not only on principle but also because it would have had to repay in full all its creditors, both renegotiated bondholders and holdouts. A court injunction prevented Argentina from repaying its renegotiated bondholders, and the country was categorised as being in selective default as of 30 July 2014.

In keeping with his campaign promise, Mr. Macri brought this legal deadlock to an end in March 2016 by agreeing to pay the hedge funds and other holdouts a total of about USD 4.6 bn. As a result, Argentina was able to rejoin the international markets. In April 2016, the state issued USD 16.5 bn in international bonds. Thanks to strong demand, bond yields were slightly lower than initially expected (7.5% for 10-year bonds, vs. expectations of 8%). This successful return to the international markets bolsters Mr. Macri's strategy and reflects investors' renewed confidence.

The huge inflationary shock earlier this year is winding down…

Official inflation, which has been higher than 10% since 2012, surged to 16% in 2015 despite price controls. According to the IMF and private estimates, inflation would have reached about 30% over the period. The main factor fuelling inflation was a major expansion of money supply. In 2012, BCRA (Banco Central de la Republica Argentina) eliminated its inflation target and financed the public deficit via money creation. Between 2007 and 2015, money creation increased twice as fast as GDP.

Inflation rates

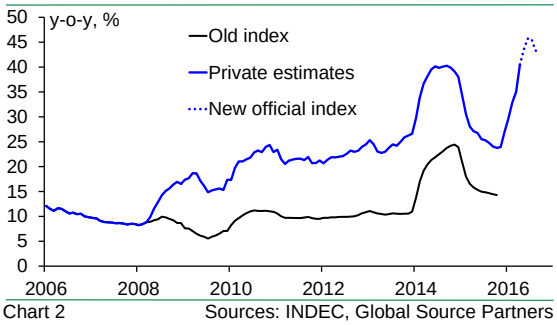


Chart 2 Sources: INDEC, Global Source Partners

One of the new president's main commitments is to bring inflation under control. So far, the first eight months of his administration have been disappointing. The recently revised consumer price index – which closely tracks variations in the index for Greater Buenos Aires – accelerated from 24% in November 2015 to 43.7% in September 2016. The sharp devaluation of the peso drove up prices of imported goods. The elimination of natural gas and electricity subsidies also led to big increases in energy prices[1]. Yet this effect has begun to wind down: the Buenos Aires consumer price index has slowed sharply, dropping from 6.5% m/m in April to about 2% since July[2]. One positive point is that disinflation has gone hand in hand with a net slowdown in the aggregates of money supply growth, which lost 10 percentage points on average between December 2015 and September 2016.

The inflation target announced by the Macri government (1% a month in 2017) is not completely out of reach once public utility prices have been adjusted (notably energy prices). Yet this means that nominal wages and pensions would have to be partially indexed to past inflation, which would be hard to achieve. Indeed, the government inherited a deteriorated economic situation. It risks losing ground in the 2017 general elections if people are asked to make too many sacrifices (via higher energy prices, for example), even though the reforms might pay off in the medium term, by improving the potential growth rate and creating a more stable macroeconomic environment.

… and the recession could be brief

The economy would experience a recession of about -2% in 2016, vs. +2.4% in 2015, due to a very poor H1 performance, notably in Q2 marked by a sharp downturn in activity indicators in industry and construction. Real GDP was already down 1.5% year-on-year in H1.

Economic activity indicators

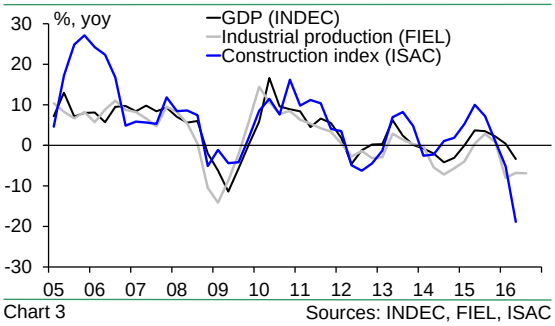


Chart 3 Sources: INDEC, FIEL, ISAC

Total exports held up well (+5.4%), buoyed by a rebound in unprocessed and processed agricultural exports (see below). Yet foreign demand is weakening due to Brazil's recession and the economic slowdown in Latin America in general. Exports of industrial goods continued to contract, down 11% in volume after a 2015 decline of 20%.

However, high inflation erodes household purchasing power and, in turn, private consumption, which declined 1.5% in H1 2016 (including a Q2 decline of 3%) and the unemployment rate exceeds 9%. Labour unions are demanding big wage increases to keep pace with inflation, but prices are likely to rise faster than wages given the increase in natural gas and electricity prices. Mr. Macri's campaign platform included eliminating subsidies and letting the laws of supply and demand determine prices. Although these reforms might be beneficial in the medium term, they will inevitably cut into consumption in the short term.

Most importantly, investment contracted sharply, down 4.2%. Investment as a share of GDP is now only 19%, down from 21% at the beginning of the decade. The change of government resulted in a freeze on public investment, triggering the collapse of activity in the construction sector. Foreign direct investment has also slowed sharply. Even though the key 35-day Lebac rate was lowered from 38% to 27.5% in April, real interest rates are still very high for companies and households, especially in the light of the recent slowdown in inflation.

Encouraging signs over the summer months (increase in domestic car purchases and cement sales) have raised hopes for a rather quick end to the recession and a strong rebound in 2017, buoyed by 1/ the consolidation of commodity prices, 2/ slowing inflation, which paves the way for lower real interest rates, 3/ mild fiscal tightening, 4/ a gradual upturn in FDI and 5/ capital repatriation by residents benefiting from tax amnesty (see below).

Commodity prices

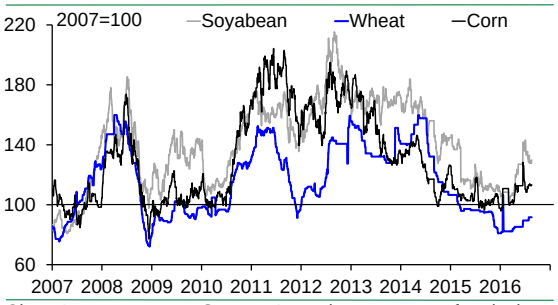


Chart 4 Source: Argentina secretary of agriculture

Even so, the potential growth rate could be set back by structural weaknesses, such as the lack of infrastructure investment (notably in transport and energy) and the poor ranking of Argentina's business climate. Mr. Macri has pledged to improve these weak points.

External accounts: liquidity has stabilised, but competitiveness has eroded

External liquidity has become a growing concern in recent years. The Kirchner government implemented numerous currency controls to limit capital flight. Export companies had to convert their foreign currency income

into pesos in the domestic market; there were limitations on foreign currency purchases by residents; import taxes were raised and certain imports required written authorisation. All these measures proved to be fairly ineffective in limiting capital flight by residents, which the IIF estimates at nearly USD 6 bn a year between 2011 and 2015. Foreign reserves plunged from nearly USD 49.7 bn at year-end 2010 to USD 23 bn at year-end 2015.

In December 2015, the new government lifted or sharply scaled back most of these currency controls, and the central bank stopped using its reserves to stabilise the peso. As of the first months of 2016, this move cut short the outflow of foreign reserves, which began swelling again, to USD 29 bn by the end of September. Now that capital controls have been lifted, direct investment should begin to pick up again.

Official foreign exchange reserves

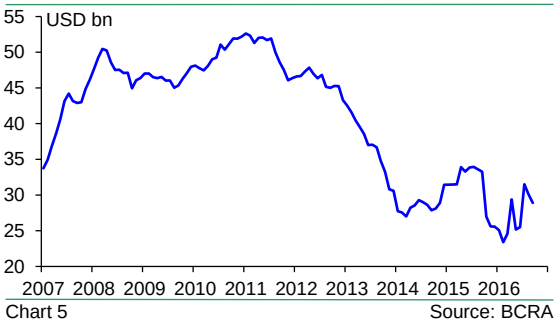


Chart 5 Source: BCRA

These changes were necessary in the light of the swelling current account deficit, which rose to nearly USD 16 bn in 2015 (2.7% of GDP). After reporting a trade surplus since the beginning of the decade, Argentina swung into a trade deficit. Exports plunged 17% in 2015 due to the decline in agricultural prices (unprocessed and processed agricultural products accounted for 62% of total exports in 2015) and the recession in Brazil, Argentina's leading trading partner. Yet the trade deficit has narrowed since the beginning of the year, thanks to the rebound in agricultural exports, both in value and in volume. On the one hand, soya and corn prices picked up, and on the other, with the elimination of export taxes and the peso's massive devaluation, exporters managed to sell production that they had been keeping as inventory.

Trade and current account balance

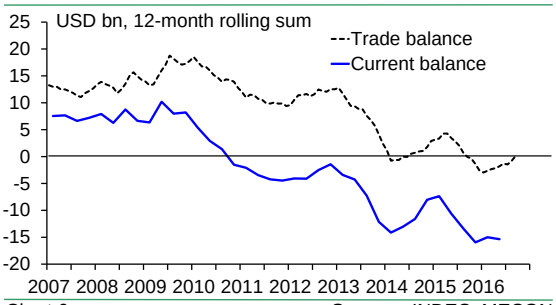


Chart 6 Sources: INDEC, MECON

Yet external competitiveness is still a weak point. Industrial competitiveness has deteriorated through 2015: prices of Argentina's non-farm industrial exports declined less than those of its competitors in the developed world. Despite devaluation, competitiveness probably did not improve since the real exchange rate continued to appreciate. The elimination of trade barriers is also expected to favour imports of finished products.

Export price competitiveness

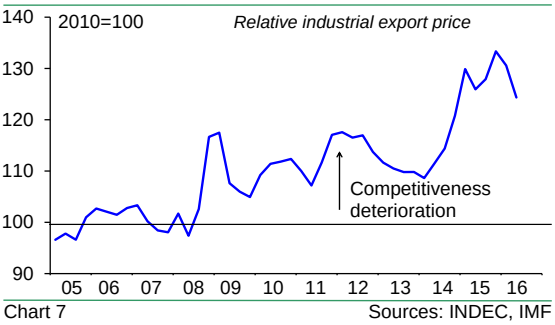


Chart 7 Sources: INDEC, IMF

It will take time to build up the industrial export base, which will require imports of machinery and capital goods. Moreover, the energy deficit will remain high

structurally as long as investments in this sector are not fully effective. As a result, the trade balance will continue to be volatile, and will depend largely on commodity prices. The country is unlikely to return to the double-digit trade surpluses (in USD billions) observed between 2002 and 2012.

Renewed access to world financial markets should facilitate the financing of the current account deficit in the years ahead. Yet it would be best if this financing did not generate debt. In the first six months of the year, net FDI inflows amounted to only USD 2.8 bn, compared to nearly USD 5 bn in H2 2015. Yet tax amnesty, which took effect in August 2016 (see below), could trigger massive capital repatriation (up to USD 24 bn if successful). This would more than offset the increase in external debt servicing charges on newly issued international bonds. Yet the success of tax amnesty must first be confirmed. More specifically, it will take time for the Macri reforms to have a sufficient impact on FDI inflows for foreign investors to consider Argentina to be a safe place to invest in the long term.

Public finance consolidation still lies ahead

Public finances have deteriorated significantly in recent years and are a bigger source of concern than the external accounts. From 2003 to 2011, strong economic growth helped improve public statistics. During this period, high export taxes generated large fiscal revenues due to the increase in agricultural prices. Starting in 2011, however, public finances began to deteriorate under the double impact of slower growth and higher spending, mainly with the approach of the presidential election. The federal government's "adjusted" primary deficit[3] has widened since the mid-2000s, to 4.1% in 2015. Last year, the total "adjusted" deficit reached 6.1% of GDP, and even 7.1% including provincial government budgets. Worse, the federal deficit has been largely financed through foreign reserves and central bank loans in recent years (in addition to the transfer of profits).

Federal government budget balances

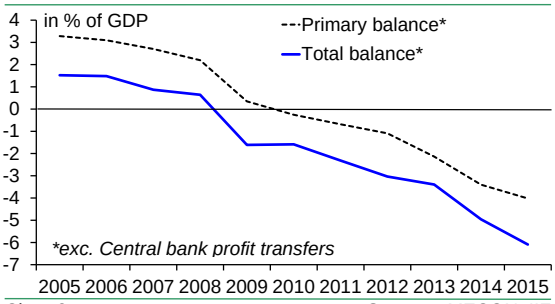


Chart 8 Sources: MECON, IIF

Thanks to the recession, the "adjusted" primary deficit should continue to widen towards 5% in 2016. But this trend also shows how the government does not want to stifle the fledgling recovery by tightening fiscal policy too abruptly. In his 2017 budget proposal, finance minister Alfonso Prat-Gay calls for the primary deficit to be reduced to 4.2%, compared to the previous target of 3.3%, based on a relatively optimistic but feasible growth forecast of 3.3%. Although the authorities seem to be firmly determined to make gradual improvements, the reforms have completely changed public finance management in recent months.

Mr. Macri's gradual fiscal adjustment strategy is based on cutting spending rather than raising taxes. Primary spending is expected to be trimmed from 24.5% of GDP in 2015, to 23.5% in 2017. But spending displays considerable inertia as showed by the resistance to subsidies cuts, which accounted for 3.4% of GDP in 2015. Indeed, the elimination of subsidies has been the main target of the government. In April, natural gas and electricity subsidies were eliminated but were then partially reinstated in August for individuals following the Supreme Court's ruling in favour of public hearings. In early October, the government has had to propose a new schedule of increases in gas tariffs for individuals (up to 2019) and social tariffs to protect the poorest households have been confirmed. Finally, in 2016, subsidies will probably remain stable (in percentage of GDP) and are expected to decrease by only 0.5% of GDP in the draft budget for 2017.

A tax amnesty law was introduced in June 2016[4]. Using an optimistic scenario, tax amnesty should generate USD 2.3 billion in fiscal revenue (0.5% of GDP), and by the end of amnesty in March 2017, a total of USD 6 bn in new sources of financing for the Treasury (1.1% of GDP). The government intends to use this one-off revenue to repay pension holders that did not receive their full pensions in previous years. Although the potential revenues from tax amnesty have already been allocated, they could still have a major impact on confidence.

The fiscal deficit will remain large but the financing plan has already improved. Thanks to renewed access to international markets, the deficit will be increasingly financed via bond issues. This year, international issues were a big success and domestic issues are proceeding smoothly. As a result, central bank financing should drop off sharply this year to 20% (excluding the repayment of holdouts), compared to 45% in 2015.

Government reforms and the settlement of arrears seem to have restored the rating agencies' confidence. But public finances remain fragile. In the short term, not only the fiscal deficit will be large but financing might not be as easy as it was in 2016, the year of change. The government might not be able to call on the market as much as it has this year, while financing by the central bank financing are likely to contract further. Moreover, the federal government should have increased by about 14 percentage points between year-end 2011 and end-2016 to reach about 52% of GDP. The average maturity is relatively long (7.8 years in March 2016) but the share of fx-denominated or fx-indexed debt is very high (72%). As a consequence, stress tests show a huge vulnerability of the debt-to-GDP ratio to exchange rate shocks.

A resilient banking sector faces headwinds

Argentina's banking sector is still relatively conservative with a loan/GDP ratio of 15% and an overall loan/deposit ratio of 88% in 2015. According to BIS estimates, household and corporate debt was very mild at 6.1% and 12.7% of GDP, respectively, in March 2016. Banks have satisfactory levels of capitalisation, with a Tier 1 capital adequacy ratio of 14.9% in Q1 2016. The doubtful loan ratio is also low at 2% in early 2016. The net external position of bank deposits (foreign assets minus foreign liabilities) generally strikes an equilibrium, and foreign currency loans account for only about 15% of total loans outstanding. The banking sector is not a particularly big user of securitisation or derivatives for transferring risks off balance sheet. Consequently, at first sight the banking sector as a whole does not seem to be especially vulnerable to credit and market risk.

Bank credit to the private sector

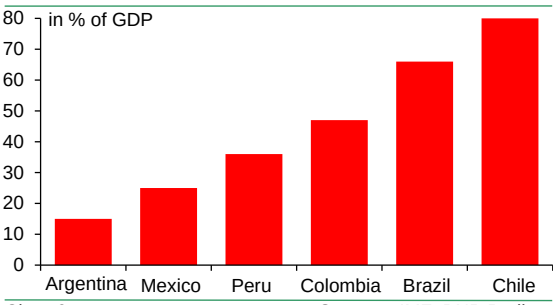


Chart 9 Sources: IMF, BNP Paribas

The biggest threats facing the banks are: 1) an increase in non-performing loans due to the recession and volatile commodity prices (in the non-financial, private sector, debt is relatively high at 60% of exports of goods and services), and 2) exposure to sovereign risk, since federal and local government commitments account for 40% of total commitments.

The banking sector also faces several constraints. Banks are still required to lend to SMEs at real negative interest rates, while fees and commissions are capped. Consequently, the public banks have lower profit margins and capitalisation ratios than private banks. These restraints should be gradually lifted by Federico Sturzenegger, the new central bank governor named by Mr. Macri in December 2015.

High inflation is another constraint that makes it harder to estimate risk, and which increases costs and operating expenses. As a result, lending is mainly short

term (about 1 year according to the IMF) and generally in fixed rate instruments. Lending rates are high, even though they have begun to decline in keeping with cautious monetary easing. The average lending rate was 30% in August 2016, down from 38.7% in April.

Lastly, the main source of financing is still deposits, which accounted for about 80% of total financing according to the IMF. In the past, this has resulted in outbreaks of panic and bank runs (mainly during the 2001 crisis). As the IMF points out, liquidity demand tends to be less stable in Argentina than in other countries.

If the macroeconomic situation is successfully stabilised, then the banking sector is likely to experience a period of growth. The normalisation of relations with external creditors has enabled local banks to rejoin the international financial markets. Encouraged by deregulation and reforms, foreign banks are also likely to invest in Argentina. Vast opportunities exist for the banks to expand their business. Argentina's loan penetration rate is low, and only a third of the Latin American average. Banks are well capitalised and could step up loan production. Deposits could also swell if macroeconomic stability is ensured. According to a Fed study[5], Argentina is one of the countries where the dollar is hoarded most by households. Total dollar hoarding is estimated at USD 50 bn. Inflation and exchange rates need to level off in order to reduce real interest rates and expand lending.

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Argentina has been steering towards a major turning point over the past year, after a decade marked by the Kirchners' strong economic interventionism. Mauricio Macri's new economic policy has a resolutely liberal bent that clearly contrasts with his predecessor's policies. Of course, it is still too early to try to assess the reforms that have been undertaken. Macri's first measures, which some compared to a kind of shock therapy, consisted mainly of rebuilding external liquidity and shoring up the country's image in the eyes of the international financial community. Although it will take a while to clean up public finances and bring inflation under control, the measures implemented so far could have a negative short-term impact, like cutbacks in subsidies, which have fuelled higher inflation and social discontent. But the government's gamble will have paid off if it successfully manages to attract foreign companies and, above all, to convince Argentine companies to begin investing in the economy again.

28 October 2016

francois.faure@*bnpparibas.com*

NOTES

[1] On April 1st, in the Buenos Aires metropolitan area, electricity tariffs were raised by an average of 250% and those on natural gas, water and transportation by a 100%-300% range. Increases in gas and electricity tariffs have been challenged before the courts, leading the government to suspend gas tariffs temporarily (until early October) and to propose an extension of the schedule for the elimination of gas subsidies over four years (i.e. up to 2019) versus two previously. To reduce the impact on low-income households, the government introduced special social welfare rates that should benefit to 20% of the consumers. Moreover, households that managed to reduce consumption were granted discounts.

[2] In August and September, the increase was less than 2% due to the suspension of April's natural gas price increase, following the Supreme Court's ruling. Core inflation is about 1.5%.

[3] I.e. the balance excluding interest charges and central bank profits transferred to the State budget. This is the official deficit target.

[4] Tax amnesty allows savings held abroad to be repatriated without justifying their origin. Individuals and companies can declare these assets and pay a special tax (from 0% to 10% depending on the amount), or invest in sovereign bonds or mutual funds with specific investment targets. Resident assets held abroad are estimated at between USD 250 bn and USD 500 bn, according to INDEC and CEFIDAR studies. Yet even using optimistic assumptions, the total amount of assets eligible for tax amnesty is estimated at USD 60 bn.

[5] "Crisis and Calm: Demand for U.S. Currency at Home and Abroad from the Fall of the Berlin Wall to 2011" Ruth Judson, Board of Governors of the Federal Reserve System, 2012.

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GROUP ECONOMIC RESEARCH

William DE VIJLDER Chief Economist	+33(0)1 55 77 47 31	william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

Jean-Luc PROUTAT Head	+33.(0)1.58.16.73.32	jean-luc.proutat@bnpparibas.com
Alexandra ESTIOT Works coordination - United States - United Kingdom - Globalisation	+33.(0)1.58.16.81.69	alexandra.estiot@bnpparibas.com
Hélène BAUDCHON France (short-term outlook and forecasts) - Labour markets	+33.(0)1.58.16.03.63	helene.baudchon@bnpparibas.com
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BANKING ECONOMICS

Laurent QUIGNON Head	+33.(0)1.42.98.56.54	laurent.quignon@bnpparibas.com
Céline CHOULET	+33.(0)1.43.16.95.54	celine.choulet@bnpparibas.com
Thomas HUMBLOT	+33.(0)1.40.14.30.77	thomas.humblot@bnpparibas.com
Laurent NAHMIAS	+33.(0)1.42.98.44.24	laurent.nahmias@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François FAURE Head	+33.(0)1 42 98 79 82	francois.faure@bnpparibas.com
Christine PELTIER Deputy Head - Greater China, Vietnam - Methodology	+33.(0)1.42.98.56.27	christine.peltier@bnpparibas.com
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Pascal DEVAUX Middle East, Balkan countries - Scoring	+33.(0)1.43.16.95.51	pascal.devaux@bnpparibas.com
Anna DORBEC CIS, Central European countries	+33.(0)1.42.98.48.45	anna.dorbec@bnpparibas.com
Hélène DROUOT Asia	+33.(0)1.42.98.33.00	helene.drouot@bnpparibas.com
Johanna MELKA Asia, Russia	+33.(0)1.58.16.05.84	johanna.melka@bnpparibas.com
Alexandra WENTZINGER South America, Caribbean countries	+33.(0)1.42 98 74 26	alexandra.wentzinger@bnpparibas.com

Michel BERNARDINI Public Relation Officer	+33.(0)1.42.98.05.71	michel.bernardini@bnpparibas.com



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Prepared by Economic Research – BNP PARIBAS
Registered Office: 16 boulevard des Italiens – 75009 PARIS
Tel: +33 (0) 1.42.98.12.34 – Internet : www.group.bnpparibas.com
Publisher: Jean Lemierre. Editor: William De Vijlder
Printed in France by: Ateliers J. Hiver SA – November 2016
ISSN 0224-3288 – Copyright BNP Paribas

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