ARGENTINA

STILL UNDER EMERGENCY MEASURES

The health crisis has slammed an economy that was already suffering from more than two years of recession. GDP will probably contract by more than 10% in 2020. With the technical rebound that began in late Q2 and the signing of a public debt restructuring agreement, the country should manage to pull out of recession in the second half. Yet financial instability persists with the erosion of foreign reserves, the stark disconnection between official and parallel exchange rates and expectations of surging inflation. The authorities have tightened forex controls again. IMF support is essential for financial stability but might not suffice for a sustainable recovery.

DEBT RESTRUCTURING: LOOSENING THE NOOSE

In early August, the Argentine government finally reached a swap agreement in principle on its USD 66 bn in international bonds with the major bondholder committees, agreement which has been validated in early September by virtually all of its private creditors (the swap participation rate was 93.5%). Of the 12 tranches of eligible bonds, bondholders accepted a steep haircut on the coupon rate (which was cut from 7% to 3% on average) while extending the repayment schedule. In exchange, the State had to accept a marginal reduction in the face value of its debt (debt principal repayments are practically unchanged[1]). The same conditions were applied to USD domestic bonds, which are essentially held by local creditors. For the repayment schedule as a whole (through 2050 for the most part), the debt burden was reduced by USD 37.7 bn compared to the initial schedule. This gives the country a vital breath of fresh air given the deterioration in the economic and social situation.

DOUBTS ABOUT ARGENTINA'S CAPACITY TO REBOUND

As the entire country was under lockdown restrictions starting in late March, the economy contracted violently by 16.5% q/q in Q2 (-21% y/y). As in most countries, the economy then rebounded after bottoming out in April. In June, however, the INDEC monthly index of activity was still 15% below the January-February level, and industrial output continued to lag by 7% in July. The construction activity index was the only indicator that returned to pre-lockdown levels, although it is still 13% below the 2019 average (see chart 1).

The recent and very relative rebound in activity indexes was counterbalanced by a very sharp downturn in consumer confidence. This reflects persistently high inflationary pressures (1.9% a month on average in May-July) fuelled by the peso's depreciation, which has fallen 2.5% a month on average since March. In the formal sector, real wages continued to contract (-4.6% year-on-year in the private sector and -8.5% in the public sector in H1 2020). Since 2017, the purchasing power of private sector wages has fallen by 22% and public sector wages by 26%. GDP will probably contract by more than 10% over the full year despite the automatic rebound in activity after the economy reopens in H2, the increase in central government primary spending by about 5% of GDP since the end of 2019 and monetary easing (see below).

In 2021, there are reasons to doubt the economy's capacity to rebound despite the relief provided by the debt restructuring agreement, even assuming the country manages to reschedule its debt repayments with the IMF, which are normally due starting from 2021. External conditions will remain depressed, especially agricultural commodity prices, which

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	-2.5	-2.1	-11.0	8.5
Inflation (CPI, year average, %)	33.8	53.5	44.0	50.0
Gen. Gov. balance / GDP (%)	-5.0	-3.8	-9.2	-5.7
Gen. Gov. debt / GDP (%)	86.1	89.6	93.0	85.0
Current account balance / GDP (%)	-5.3	-0.8	2.3	1.0
External debt / GDP (%)	53.5	62.2	68.0	60.0
Forex reserves (USD bn)	64.0	45.0	41.0	47.0
Forex reserves, in months of imports	8.9	7.8	9.0	9.2
Exchange rate USDARS (year end)	38	60	80	120

TABLE 1 e: ESTIMATES AND FORECAST SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

PARTIAL CATCHING UP

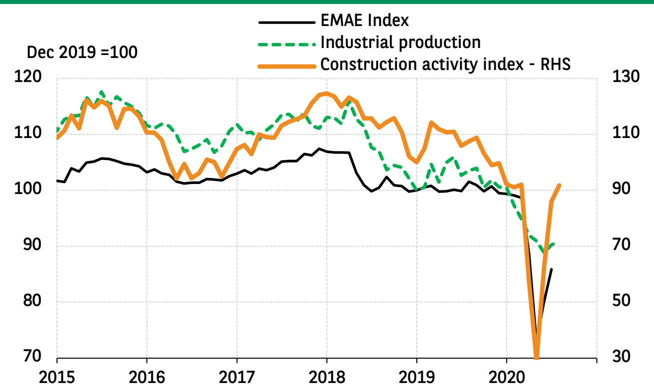

CHART 1 SOURCE: INDEC, ISAC, DATASTREAM

will limit an export-driven recovery. Looking beyond the international situation, Argentina's economy is still mired in a vicious circle, caught between currency depreciation and inflation, which the previous

1 In net present value (NPV), and compared with the initial debt repayment schedule, the State has obviously benefited from a debt reduction thanks to lower coupon rates, a rescheduling of repayments and a discount rate significantly higher than the coupon rates because of the increased in the risk premium. All these parameters are the terms of the bargaining between The State and bondholders. The result is a NPV value of the debt that satisfies the two parties. The resulting NPV rate is about 55% i.e. a haircut rate (in NPV terms) of 45%.

government failed to halt despite its policy of eliminating forex controls, lowering export taxes and deregulating water and energy utility rates. This vicious circle has stretched public finances, both directly (due to the need to regularly raise social welfare benefits) and indirectly (through the high cost of sterilising capital inflows for the central bank). It also prevented monetary policy's countercyclical leverage from functioning properly, precisely because inflation expectations were anchored to the evolution of the nominal exchange rate.

Granted, over the past 12 months BCRA has managed to drastically reduce its key rates, from 85% to 32% (over the same period the inflation rate only fell from 53% to 42%). Yet monetary easing occurred in an emergency situation characterised not only by the country's default on its debt and tighter forex controls, but also by the de facto abandon of exchange rate stability. Still negligible in August 2019, the gap between the official USD exchange rate and the parallel rate (the blue chip swap rate) rose to nearly 80% just a year later (see chart 2).

Normally, for a country that benefited from controlled inflation and financial stability prior to the health crisis, the 2021 rebound should be as strong as the 2020 shock was abrupt. For Argentina, however, nothing could be less certain, even with IMF support.

INFLATION IS EXPECTED TO SURGE AGAIN

First, despite the size of the recession over the past two and a half years, inflation is not under control. According to BCRA surveys, in August, year-on-year consumer price inflation from a 12-month horizon was expected to rise to 51.2%, compared to 40.7% for the most recently known month (August). The main cause is still the vicious circle between wages and the exchange rate, and these dynamics are all the stronger given the large gap between the official and parallel exchange rates[2].

Yet many local analysts also point out the excessive growth of the monetary base, which rose 35% in Jan-Aug. 2020 vs 30% in full-year 2019. This is due to monetary financing of the primary deficit, which amounted to 4.7% of GDP cumulated over 12 months in July, vs 0.5% in December 2019. As a result, BCRA transfers to the Treasury (direct advances and book profits drawn from the revaluation of foreign reserves) have amounted to nearly 6% of GDP since the beginning of the year.

So far, the exceptional situation created by the Covid-19 pandemic justifies exceptional financing at no cost for the State[3]. But this can only be a temporary solution.

In 2021, the government wants to limit its fiscal effort by reducing the primary deficit to 4.5% of GDP (excluding exceptional spending linked to the Covid-19 crisis, primary spending should increase by 7.6% in real terms).

Yet it seems unlikely that the IMF would authorise the continuation of direct financing by the central bank. Inflation originating from money supply growth could ease with the resumption of classic financing via borrowing. In the meantime, however, there is reason to fear that the current surge in money supply growth will have persistent effects at least through the beginning of 2021.

LACK OF FINANCIAL STABILISATION

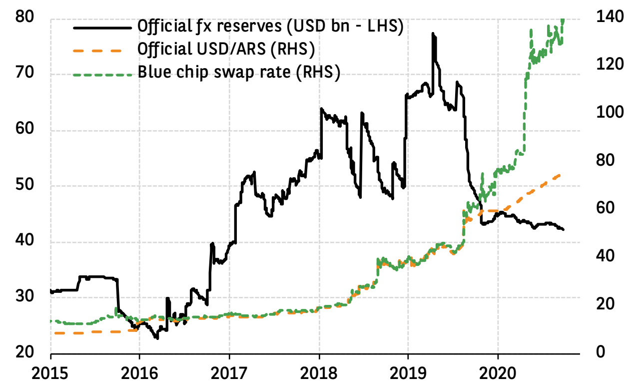

CHART 2 SOURCE: BCRA, DATASTREAM

A PERSISTENT SQUEEZE ON EXTERNAL LIQUIDITY

Persistent pressure on external liquidity is the second negative factor for the recovery. The current account deficit has narrowed sharply to only USD 0.9 bn in Q1 (cumulative over 4 quarters), and should give way to a surplus (the trade surplus was nearly USD 20 bn in July, cumulative over 12 months). Yet the central bank's foreign reserves have continued to erode, to USD 42.6 bn in early September, down from USD 45 bn at year-end 2019. Resident purchases of USD had declined sharply with the implementation of forex controls, but they have picked up again since March. In mid-September, the central bank had to introduce new forex control measures[4], including temporary restrictions on the repayment of USD debt by domestic companies[5].

An agreement with the IMF is thus vital to bolster external liquidity and to provide guarantees concerning improvements in the country's solvency, which will remain very fragile since the state was unable to obtain a reduction in its debt. Yet IMF financial support will not suffice to fuel a sustainable recovery from the crisis. The Argentine government and the IMF must strike the right balance between fiscal consolidation and monetary and exchange rate policy goals, one that reassures private creditors without stifling hopes for a recovery.

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2 Econometric estimations show that the pass-through between the exchange rate and inflation is 0.2 when the gap is lower than 40% but 0.4 when it is above 40%.
3 Central bank's advances (Adelantos transitorios) do not bear interests.
4 All debit and credit card expenditures are included in the USD 200 monthly limit on USD transactions. New 35% income tax advance on any fx purchases (on top of the existing 30% mandatory PAIS tax introduced in Dec. 2019). Prohibition on USD purchases by individuals receiving state benefits and grants. Non-residents are prohibited from selling securities with settlement in USD in the local market unless the position is held for at least one year.
5 Companies with over USD 1 mn of USD-denominated debt monthly maturities between October 15, 2020 and March 31, 2021 will be allowed to settle only the equivalent of 40% of their debt service and will have to send a repayment plan for the remaining 60% by October 1.