ARGENTINA

TIME IS RUNNING OUT

Looking beyond the strong recovery in 2021, the Argentine economy remains fragile. Production in primary and secondary sectors has returned to its pre-pandemic levels. However, the economy remains constrained by high though largely repressed inflation, which is hitting household consumption and services. Since December 2021, a new wave of Covid-19 infections has introduced additional uncertainty. The mid-term elections have weakened the government coalition, which is still negotiating with the IMF. Monetary policy is tightening and the normalisation of budget deficit financing will require a slowdown in expenditures, although a drastic consolidation is unlikely. However, time is running out. Despite the jump in prices for agricultural raw materials, the divergence between the market exchange rate and the official rate has widened. Moreover, the central bank's forex reserves have only just stabilised due to capital outflows, notably from residents. Above all, very large repayments fall due in March.

COALITION WEAKENED IN ITS NEGOTIATIONS WITH THE IMF

President Alberto Fernandez's *Frente de Todos* (FdT) centre-left coalition lost out in the partial mid-term legislative elections in November 2021. Its position in the Chamber of Deputies was weakened, with its seat count dropping from 120 to 118 (of 257 in total). More importantly, FdT lost its Senate majority, as it was left with only 34 of the 40 seats it previously held (out of 72). The Fernandez government was punished for dissent within the Peronist camp itself. It has been accused of excessively radical management of the pandemic (tainted with scandals), with long lockdown periods in the capital and surrounding region, as well as of an inability to control inflation.

The negotiations with the IMF are dragging on. They are designed to allow the country to reschedule its debt to the IMF under an Extended Fund Facility (EFF). The electoral setback can only strengthen the government's bid to limit the IMF's conditions. After technical meetings in early December 2021, the IMF team indicated that the fiscal consolidation needed to be gradual, sustainable and to allow investment in infrastructure and technology and targeted social spending. Therefore, there will not be drastic improvement in the fiscal position. The declaration also stressed the need for a multi-pronged strategy to control inflation. This must combine a reduction in the monetary financing of the budget deficit, an appropriate monetary policy with positive real interest rates and, in much vaguer terms, coordination between wages and prices. Inflation is responsible for fuelling financial instability, providing a structural brake on growth and exacerbating the poverty that affects 40% of the population.

A FRAGILE RECOVERY AND REPRESSED INFLATION

The economic recovery continued in H2 2021, but remains fragile. Real GDP jumped 4.1% q/q in Q3 vs. -0.9% in Q2, but then fell again in October (it still remains 2% above its pre-pandemic level). The recovery of the construction sector was strong and explains the sharp increase in investment, the most dynamic component of demand (13% higher than in 2019). However, industrial production has been weakening since July 2021, even though it is 8% higher than its pre-pandemic level (see chart). Most service sectors, with the exception of healthcare and education, have not returned to their end-2019 levels, still less the levels at the end of 2017 when the recession in the country began.

In Q3, household consumption was still 5% below its level in Q4 2019, with real wages falling by 6% over the period in the private sector and 9.5% in the public sector. Public consumption has partly offset the weakness of private consumption, particularly since mid-2021.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	-2.0	-9.9	8.0	1.5	2.0
Inflation (official, annual average, %)	53.5	42.0	48.4	59.3	43.0
Fiscal balance/ GDP (%)	-4.7	-8.9	-5.0	-4.5	-4.0
Public debt/ GDP (%)	90.1	104.3	85.4	80.1	78.2
Current account balance / GDP (%)	-0.8	0.9	1.3	0.8	0.5
External debt / GDP (%)	62.7	69.9	58.6	51.5	49.5
Forex reserves (USD bn)	44.8	39.4	39.6	43.3	47.8
Forex reserves, in months of imports	8.1	9.1	7.2	7.6	8.0

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

ACTIVITY INDICATORS

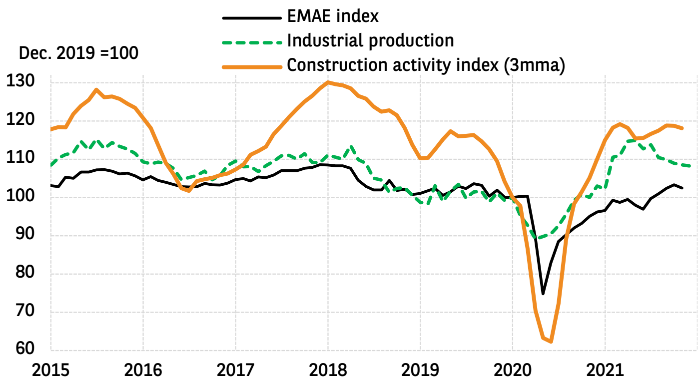

CHART 1 SOURCE: INDEC, ISAC

The latest wave of Covid-19 infections has introduced additional uncertainty in the recovery. Since mid-December the number of new cases has risen steeply as the Omicron variant has taken hold. Argentina is by far the worst hit country in Latin America, with more than 100,000 cases per day at mid-January, a rate of 2,500 per million people (against an average of 680 for the major Latin American countries).

This upsurge in the pandemic coincided with the mid-October removal of restrictions on foreign tourists for the summer season. For the time being, deaths remain very low and the number of people in intensive care is lower than in previous waves.

Even though activity fell again in Q4 2021, GDP will have posted a strong recovery over the whole year, given strong carry-over effects. In 2022, however, growth is likely to slow markedly due to: 1/ the expected acceleration of inflation and tightening of monetary policy (the BCRA has already raised its policy rate from 38% to 40%; 2/ the (temporary) shock from the expected devaluation of the official exchange rate, a necessary condition to reduce the increasing divergence between exchange rates[1] and for the gradual withdrawal of foreign exchange controls; and 3/ the normalisation of the financing of the budget deficit and a slowdown in current spending.

The monthly inflation rate fell by an average of around 4% between October 2020 and April 2021, and by 3.2% between May and December 2021. But this deceleration is temporary. Granted, the depreciation of the official exchange rate has been reduced to 1% per month since July, compared to 3% in H1 2021. But the gap between the market rate and the official rate is well above the 40% threshold at which the pass-through effect of the exchange rate on prices is amplified. Moreover, the slowdown in inflation has come at the cost of price controls (going as far as a temporary freeze between October 2021 and early January 2022), the already-broad scope of which is likely to be extended[2]. Repressed inflation is estimated at around 10 percentage points compared with 51% y/y for CPI inflation.

The expected catch-up of frozen prices and the adjustment of regulated prices have raised fears of a reacceleration in H2 2022, which could push the inflation rate to 60% y/y at mid-year or so. On top of this, there is the possible unfavourable effect of future monetary and exchange rate policies if their negative effects (devaluation of the official exchange rate, increase in the target rate of depreciation to allow the central bank to rebuild currency reserves) outweigh the positive effects (monetary tightening, closing of the gap between official and market exchange rates).

A MIXED PICTURE FOR PUBLIC FINANCES AND EXTERNAL ACCOUNTS

At first sight, the budget deficit was reduced markedly in 2021. It was only 3.1% of GDP (2.2% excluding interest payments) over the 12 months to November, compared to 8.5% and 6.5% respectively in 2020. However, the performance is less impressive when one takes account of the transfer of SDRs (1% of GDP) and exceptional revenue raised on the extraordinary tax on financial market gains (0.6% of GDP). Moreover, the interest paid by the central bank on its debt (Leliq and swaps), which in December represented around 100% of money supply (from 80% in 2020), is not included in the central government's budget. Even so, these payments represent the sterilisation cost of budget deficit monetary financing. These payments were the equivalent of 2.6% of GDP, as in 2020, despite the reduction in direct advances from the BCRA to the Treasury (from 7% of GDP in 2020 to 2.7% in 2021).

EXCHANGE RATES AND OFFICIAL FOREX RESERVES

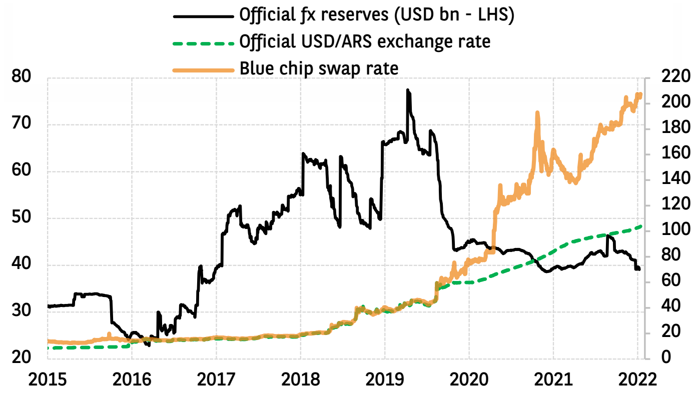

CHART 2

SOURCE: BCRA, BNP PARIBAS

In all, the budget deficit corrected for transfers from the central bank, but including sterilisation costs, was 6.4% of GDP, which gives a more accurate picture of the imbalance in the public finances. By the end of December, the 2022 budget had still not been adopted, having been rejected by the Senate. The government will need to revise it and get it passed quickly, as its adoption is a precondition for the IMF.

External liquidity remains low despite a trade surplus that has increased, and will probably exceed USD 15 billion in 2021 as a result of the very strong price increases for the main agricultural exports (+47% for soybeans, +38% for corn and +16% for wheat). The basic balance (current account balance + net direct investment) is likely to show a surplus of at least USD 10 billion. However, forex reserves, which increased to USD 46 billion after the acquisition of SDRs, have since fallen to USD 39 billion, below their end-2020 level. Net outflows of portfolio investment reached USD 5 billion over the first nine months of 2021, and net purchases of foreign currency by the non-financial private sector resumed in the second part of the year.

According to estimates from Global Source Partners, payments of interest and principal on external debt will reach around USD 25 billion in 2022 (USD 22 billion to the IMF) and USD29 billion in 2023 (USD 23 billion to the IMF). A rescheduling agreement is essential before the next major repayment date in March (when more than USD 5 billion are due to official creditors alone, consisting mainly of the IMF and the Paris Club).

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1 The market rate for the dollar against the ARS (the Blue Chip Swap Rate) is currently double the official rate. Since April it has risen much faster (4.5% per month on average compared to 1.3% for the official rate). It has moved in step with the ratio of money supply to currency reserves, which is a good proxy for exchange rates in countries experiencing very high rates of inflation.

2 On 15 October 2021, the government reached agreement with major retailers and manufacturers and/or their representatives to freeze prices on around 1,200 products until 7 January. Price controls already existed on more than 700 products under the *Precios Cuidados* programme. When the temporary freeze ends, the government hopes to negotiate an extension of the scope of *Precios Cuidados* to around 1,300 products. This would be a voluntary agreement to limit price rises to 2% per month or 6% per quarter.