

# Argentina

## A high-risk election year

*Calm has returned to Argentina's financial markets since the end of September 2018. The peso has levelled off after depreciating 50% against the dollar in the first 9 months of the year. The central bank finally managed to loosen its grip after raising its key policy rate by 70%. Restored calm can largely be attributed to IMF support, but it comes at a high cost: a strictly quantitative monetary policy and the balancing of the primary deficit as of 2019. The economy slid into recession in Q2 2018 and is likely to remain there through mid-2019. So far, the recession has not eroded the country's fiscal performance, the trade balance has swung back into positive territory and inflation has peaked. Yet will that be enough to restore confidence before October's elections?*

### ■ Financial tensions ease...

Since the end of September 2018, financial tensions have eased in Argentina. After depreciating by nearly 50% against the dollar in the first 9 months of the year, the peso has levelled off and is now fluctuating at between ARS36 and ARS38 to the dollar. The 7-day liquidity bill rate (Leliq), the central bank's new benchmark interest rate<sup>1</sup>, eased from 73.5% to 61%. Yet investors are still wary, and the risk premium on 5-year CDS rose to 750bp in mid-January, a 150bp increase since October.

The first signs of financial stability can be attributed to the 26 October announcement of the revision of the IMF's standby credit facility, which was extended from USD 50 bn to USD 56 bn in October, and the 19 December conclusion of the second review of the standby agreement and the disbursement of USD 7.6 bn, which helped shore up the central bank's foreign reserves (to USD 66 bn at end December, from USD 51 bn at end November). Financial stability can also be attributed to a very restrictive monetary policy, the cost of which was a severe recession.

### ■ ...thanks to very tight monetary policy

Faced with a self-feeding dynamics between the peso's depreciation and inflation, the monetary authorities have pursued a very strict quantitative monetary policy since September. The central bank (BCRA) temporarily abandoned its inflation target and will target zero nominal growth of the monetary base through June 2019 (with the exception of seasonal increases in December and June). Thereafter, the increase in the monetary base will be limited to 1% a month in H2 2019. At the same time, BCRA is not authorised to intervene to support (or weaken) the peso as long as the currency fluctuate within a rather broad band (20%). In contrast, the upper and lower limits are following a growth rate of 2% a month. This is much lower than observed inflation, which averaged 4.3% over the past 6 months, and is even lower than inflation expectations, which averaged 2.5% in Q1 2019 according to the BCRA's December survey. The BCRA is allowed to intervene when the peso trades outside of these fluctuation bands, although it cannot sterilise its interventions.

<sup>1</sup> Since mid-2018, the Leliq has massively replaced the Lebac, the BCRA's sterilisation instrument, the cost of which had placed too much of a burden on public finances (see "Argentina: a touchy transition" Conjoncture, BNP Paribas - September 2018). The Leliq became the benchmark policy rate on 8 August 2018.

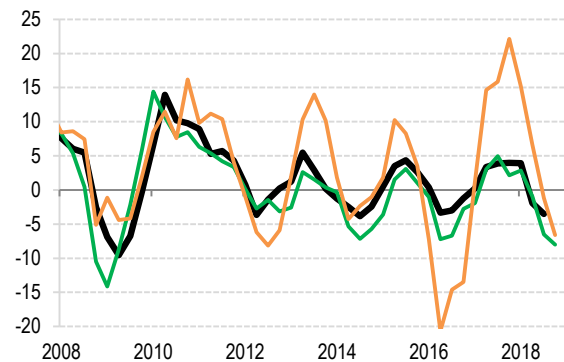
### 1-Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	2.9	-2.5	-1.5	2.5
Inflation (official, annual average, %)	25.2	33.8	37.0	18.0
Fiscal balance/ GDP (%)	-6.0	-5.2	-3.7	-3.0
Public debt/ GDP (%)	57.1	78.0	83.0	87.0
Current account balance / GDP (%)	-4.9	-5.2	-3.0	-2.5
External debt / GDP (%)	37.2	54.7	56.9	51.5
Forex reserves (USD bn)	55	66	60	65
Forex reserves, in months of imports	6.2	7.0	7.3	6.5
Exchange rate USDARS (year end)	18.6	38.5	55.6	57.5

e: BNP Paribas Group Economic Research estimates and forecasts

### 2- Hard time

— Real GDP (yoy %) — Construction activity (yoy %)  
— Industrial production (yoy %)



Source: INDEC, FIEL

This framework brings to mind a currency board, albeit a more restrictive variant as far as the monetary rule is concerned<sup>2</sup>. The strategy consists of anchoring inflation expectations thanks to a real appreciation of the exchange rate, which is justified *ex post* by the improvement in the ratio between foreign reserves and the monetary base.

<sup>2</sup> A currency board arrangement does not impose absolute stability but rather relative stability of the monetary base through a constant ratio between the monetary base and foreign reserves. Ordinarily, however, the forex fluctuation band is much narrower.



Although it is too early to evaluate the effectiveness of this monetary and forex policy, inflation has slowed sharply, with headline inflation down from a peak of 6.5% (per month) in September to 3.2% in November, and core inflation easing from 7.6% to 3.3%. The BCRA lowered its intervention rate to 60%, a minimum it intended to maintain as long as survey results did not show a decline in 12-month inflation expectations for two consecutive months (as was the case in November). Thanks to the peso's stability and the downturn in metal and then oil prices, producer prices even declined 0.6% in the month to November, compared to +16.2% in September. Although inflation expectations showed greater rigidity, they also declined.

This monetary and exchange rate strategy is not risk-free. Firstly, prohibition of sterilizing capital flows outside the fluctuation bands may trigger interest rates volatility. Even if monetary policy is credible and thus allows a decline in real interest rates, potentially high volatility of short term rates - when they get close to the limits of the corridor - can deter investment decisions that usually require good predictability of the cost of borrowing. Secondly, the fact that there exist limits on how far the exchange rate can depreciate may result in an overvaluation of the real exchange rate which may harm competitiveness. In both case, there is a potentially negative impact on growth.

In the case of Argentina, the aforementioned two risks are not major risks. Corporates are used to live under considerable financial stress and, in a through-the-cycle view, investments decisions are more constrained by macroeconomic policy instability or the business environment than interest rate volatility. On the contrary, the solvency of economic agents indebted in foreign currency (foremost of which is the state) requires the real exchange rate to remain as stable as possible. Indeed, a depreciation of the currency has a mechanical and strong impact on the debt dynamics whereas the impact of the real exchange rate on the current account balance is small<sup>3</sup>. More generally, the priority for supporting growth is to curb inflation in order to give more room of manoeuvre to monetary policy.

### ■ The price: a severe recession

Argentina's economy sank into recession in Q2 2018 with real GDP contracting at an annualised quarterly rate of 15.6%. Nothing suggests that the country recovered in Q4, and the recession could extend at least through the first part of 2019.

In Q2 and Q3 2018, the cumulative decline in real GDP is estimated at nearly 5% (-3.9% compared to the same period in 2017). The farm sector (8% of GDP in volume in 2017) largely contributed to the overall decline (-2.8% over 12 months) due to a very poor Q2 performance, which more or less levelled off in Q3. In contrast, in other economic sectors (construction, industry and services), the economy continued to contract, although at a slower pace than in Q2.

<sup>3</sup> According to the IMF, the elasticity of the current account with respect to the real exchange rate is only -0.06 compared with -0.23 for China (which is assessed as small). The very low elasticity reflects the large weight of primary products in total exports.

The only positive point is that the contribution of net exports turned positive in Q3, thanks not only to the contraction of imports but also to a rebound in exports. Yet industrial output and survey results suggest that GDP declined again in Q4. Household consumption is unlikely to rebound given the contraction in real wages (-11.3% in the year to Q3 2018 vs. +4% in Q4 2017) and the decline in employment (-1.5% year-on-year for the period September-November 2018, vs 2% at year-end 2017). Moreover, the rebound in exports will not prevent investment from declining. Lastly, fiscal policy will continue to be very restrictive given the target of balancing the primary deficit (excluding net interest charge) as of 2019.

For the moment, the recession has not had a perceptible impact on fiscal performances. To the contrary, tight control over spending has reduced the primary deficit to 2.4% in 2018 from 3.8% in 2017. Primary spending was reduced from 23.2% of GDP to 21.2%. The net interest charge, in contrast, rose from 2.2% of GDP to 2.4%. Although the net interest charge has not increased much yet, its relative weight will swell due not only to the revaluation of interest on foreign currency debt, but also to real domestic interest rates, which are much higher than before the 2018 financial shock.

Moreover, the balance of payments equilibrium is still fragile. The current account deficit may have been slashed in half, from USD 31.3 bn in 2017 to USD 15 bn in 2019. But the wait-and-see attitude of investors in the run up to October's elections is likely to reduce the capital account surplus. Net foreign direct investments and non-resident portfolio investment are bound to dry up (USD 8.8 bn and USD 13.3 bn, respectively, in Q1-Q3 2018). The balance of payments equilibrium will depend on resident capital outflows, which have been massive over the past two years (USD 20 bn in 2017 and USD 26 bn in Jan-Nov 2018). Capital outflows could slow if the exchange rate stabilises. Yet nothing is less certain with the approach of the elections. For the moment, thanks to the extension of maturities following the clearance of arrears in 2016, debt servicing on Argentina's international government bond holdings (USD 190 bn) is largely bearable (USD 8.1 bn in 2019). In contrast, debt servicing on the state's total external debt and dollar-denominated domestic debt is massive (USD 37.5 bn), which explains the size of the IMF's credit facility.

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