Argentina Watch

Group Economics
Emerging Markets Research

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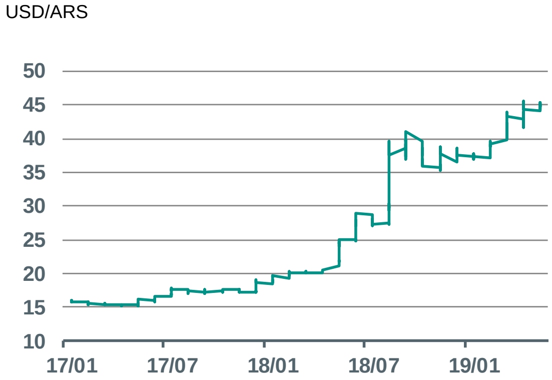
Walking the edge

- **Fears of market-unfriendly election outcome leads to renewed peso weakness and higher spreads**
- **Economic recession continues, weakening president Macri's chances**
- **Difficult to escape the vicious circle of political and economic uncertainty before the elections**
- **Largest IMF programme in history further dents his popularity, but helps prevent another debt crisis**

Politics dominate the scene

Markets panicked once again recently due to fears that former president Christina Fernandez might run and win the presidential elections scheduled for October 2019 (first round on 27 October, second round on 24 November). On top of this, sentiment was hit by rising tensions between the US and China. Christina Fernandez's announcement that she will run for vice president instead, while her namesake Alberto Fernandez will run for president, brought only more confusion. So far this year, the peso has lost 17% of its value versus USD, after a loss of 50% last year. CDS spreads jumped back over 1000 and the policy rate surged above 70. Half of the twelve quarters in president Macri's first three years in office have shown negative growth and economic prospects remain bleak. While the dovish policy shift from the world's main central banks is generally supportive for EM currencies, uncertainties remain high and risk aversion could flare up easily. Market turmoil is diminishing the prospects of an eventual recovery in Argentina and could hence further undermine Macri's re-election chances. This, in turn, is leading to more uncertainty and keeping the country trapped in a vicious circle.

The peso continues to fall…



Source: Bloomberg

…while CDS spreads surge

Source: Bloomberg

Group Economics: 'Enabling smart decisions'

Growth forecast revised downward

The economy remains in a severe recession and recent economic data do not yet point to an end. After a promising 2017 and a good start to 2018, the economy eventually shrank by 2.4% in 2018, driven down by a fall in both consumption (-2.6%) and investments (-4.6%). Exports were almost flat, but as imports shrank by 4.2%, the overall contribution of the external sector to growth was positive. We expect the recession to continue, at least in the first half of 2019. The first quarter GDP figures won't be published until 19 June, but the monthly GDP is a good proxy and points to a fall of 5.7% yoy in Q1 after a decline of 6.2% yoy in Q4 2018. Industrial production growth remains strongly negative, dropping 13.4% yoy in March, and retail sales continue to fall as well. With inflation outpacing wages, unemployment rising and credit growth contracting strongly in real terms, consumer spending is also continuing to fall. Imbalances like the current account deficit and the fiscal deficit are only slowly declining and both public and foreign debt levels remain too high for comfort.

Economic growth: more bust than boom

Economic activity index, % yoy

Source: Bloomberg

With the need to stick to a very restrictive economic policy, it appears increasingly difficult to break out of the vicious circle of political uncertainty, pressure on the peso, high inflation and high interest rates. After a decline of 2.4% last year, we now expect the economy to shrink by at least 1.5% this year, instead of -1%, with risks still tilted to the downside. After the elections, political uncertainty will diminish. However, assuming that adherence to the extremely tight monetary and fiscal policy continues. the upturn will remain limited. We now expect economic growth to pick up to 2% in 2020, instead of our earlier estimate of 3%.

Looking from Kirchner-Fernandez…

During the twelve years of the Kirchner-Fernandez episode, the economy went through many boom and bust periods but still grew by 4.2% a year on average, while the unemployment rate fell from around 20% at the start of 2014 to around 7% in 2015. Since 2012, however, the economy barely grew on average and after the collapse of commodity prices in 2014 the economic situation became increasingly difficult. Measures to protect the domestic economy led to a scarcity of everything. Currency restrictions spawned a flourishing black market and drove the already sky-high inflation even higher. The country also clashed with creditors, who rejected a debt cancellation agreement reached in 2005 and 2010. As a result, the credit rating agencies judged Argentina to be in default and the country was cut off from the international capital market.

… to Macri…

The close election victory of Mauricio Macri – of the non-Peronist right-wing Propuesta Republicana (Pro) party – in December 2015 brought an end to twelve years of left-wing Peronist rule. In his first years in office, Macri did reasonably well navigating between implementing reforms and maintaining social support. The peso was sharply devalued, most of the capital controls were abolished in steps and, finally, the exchange rate was allowed to float. In addition, the subsidies on gas, water and electricity were lowered or abolished and trade restrictions were reduced. Overall GDP growth turned positive in 2017 and mid-term legislative elections in October 2017 strengthened Macri's position. But this period was short-lived. Macroeconomic imbalances remained high. The primary fiscal deficit still stood at 3% of GDP end-2017 and government debt levels as well as the current account deficit went up again .

Government debt surging again and ..

Source: EIU

…current account deficit widening

Source: EIU

… and to a new IMF agreement

When the Fed started to hike interest rates in 2018 and the global tide turned less favourable, the gradual reform approach proved to be too slow and insufficient to reverse years of economic mismanagement during the Kirchner-Fernandez era. Argentina and Turkey were among the worst performers when general dollar strength, the fear of higher US interest rates and US-China tensions led to EM currency weakness in 2018. The very unpopular IMF had to come to the rescue with an unprecedented SDR 41 bn (equivalent to USD 56 bn) Standby Agreement. This boosted foreign reserve levels and helped to stabilise the currency. However, as both monetary and fiscal policy were severely tightened, the economy once again entered into a recession. The situation was further aggravated by a severe drought that hampered agricultural output. All in all, Argentina experienced a contraction of economic growth in three out of the four years of Macri's government. The government has taken a likely unavoidable gamble by going to the unpopular IMF for help. Now, a year later, this has not brought the hoped-for stability, nor has it helped improve the odds of president Macri.

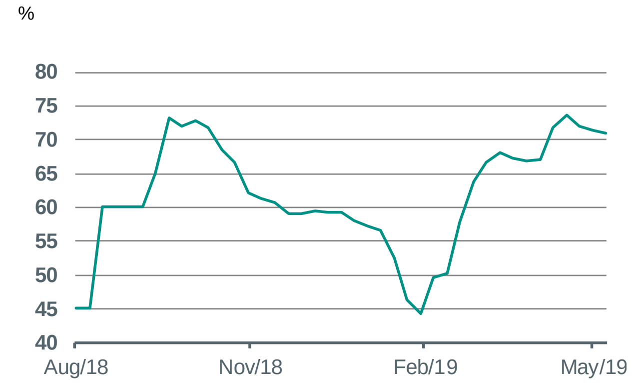
After IMF agreement inflation continues to rise

After the IMF programme was implemented, the currency initially stabilised, inflation stabilised as well and real interest rates fell from around 25% in August to almost 0% in February. However given renewed turmoil, the main policy rate has now risen back up above 70%, while inflation has increased to over 50%. Since the IMF programme, the central bank of Argentina (BCRA) no longer sets the interest rate, but strictly controls the monetary base and more and more the exchange rate as well. Initially, FX intervention was only allowed if the peso moved outside a bandwidth of ARS/USD 39.8 to 51.5. However, as inflation continued to rise, the BCRA – in agreement with the IMF – is now also allowed to intervene when the currency moves within this band. In another surprising move the government went back to implementing price controls on certain goods.

Inflation moving up again…

Source: Bloomberg

…as are interest rates



Source: Bloomberg

While the fiscal situation has improved, the debt level remains worrisome

Although FX weakness is seen as the most important driver behind the current rise in inflation, higher administered prices and tax measures also play a role. To limit the social costs of the recession and improve the approval ratings in the run-up to the elections, the government announced in April that it will refrain from further tariff increases for public utilities like electricity, gas and transport. The big question is whether there is sufficient fiscal leeway under the IMF programme to do this. Under the deal, the government agreed to balance its primary budget in 2019, although a deficit of 0.5% is deemed acceptable. In another surprising move, president Macri raised tariffs on merchandise imports. This might improve government revenues, but could also harm investments, for example in the important automotive sector. The soybean imports used in the processing industry are now also part of the new tariff regime. So far, the government seems on track to reach the fiscal target. In the first quarter, the primary balance even showed a small surplus of 0.1%. But with the recently announced measures, a (small) deficit for the year as a whole seems more likely. The government debt levels are not only impacted by the fiscal balance but by currency weakness as well. Contrary to most other emerging countries, over half of Argentina's debt is still financed externally. The government debt-to-GDP ratio jumped from slightly less than 60% of GDP end-2017 to around 90% end-2018. While the IMF programme should be sufficient to cover Argentina's financing needs, continuous market turmoil and subsequent capital outflows could still spoil the party. Although it is not our base case scenario, the risk of a renewed default cannot be ruled out.

Key forecasts for the economy of Argentina

	2016	2017	2018e	2019e	2020e
GDP (% yoy)	-1.8	2.9	-2.4	-1.5	2.0
CPI inflation (% yoy)	41.4	26.5	34.3	45.0	35.0
Budget balance (% GDP)	-5.8	-6.0	-5.7	-4.0	-2.5
Government debt (% GDP)	54	57	92	86	86
Current account (% GDP)	-2.7	-5.0	-6.0	-2.0	-1.0
Gross fixed investment (% GDP)	14.6	14.8	14.9	14.9	15.3
Gross national savings (% GDP)	12.8	11.0	9.6	12.5	14.2
USD/ARS (eop)	15.9	18.6	37.6	42.1	46.6
EUR/ARS (eop)	16.8	22.3	43.1	48.9	58.3

Economic growth, budget balance, current account balance for 2016 and 2017 are rounded figures

Source: EIU, ABN AMRO Group Economics