Argentina

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Financial market tensions have eased following significantly tighter economic policies under the guidance of an IMF programme. Tighter policy has come with the price of a recession. The main near-term uncertainty relates to what extent government balances can be improved in a pre-election environment.

Country Risk Analysis

Summary

2018 was largely a lost year for Argentina. Following a credit fuelled economic boom in 2017 a full-fledged currency crisis brought growth to a sudden halt in the spring. The crisis was due to a mix of factors, including a severe draught, deteriorating global investor sentiment and weak underlying institutional structures. The currency lost about half of its value versus the US dollar, inflation quickly soared and interest rates rose. As a result, real GDP which was expected to grow around 3% at the start of the year instead turned out to contract around 2.5%.

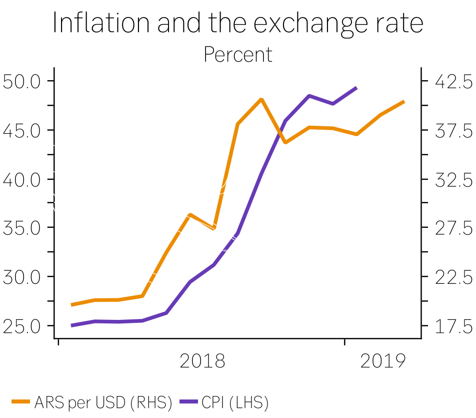
Faced with the precarious situation, economic policy had to shift from a gradual fiscal tightening, inflation targeting and a floating exchange rate to a significant fiscal belt-tightening and monetary base targeting. As foreign capital dried out, the authorities also had to switch from using external borrowing and central bank loans to fund budget deficits to IMF financing. The IMF funds will largely cover the government's financing needs for this year. In 2020, however, the authorities will have to turn to financial markets for complementary financing.

If 2018 was a lost year, 2019 may be a turn-around year. The economy is expected to start growing in the second half of the year, inflation should moderate and the current account balances are expected to improve. The outlook, however, is clouded by uncertainty related to the outcome of the October elections. We believe and assume that economic policy will largely follow the outlines of the IMF programme but this is far from certain.

Recent economic developments

Economy in full recession. Economic growth rates in Argentina have been more volatile and lower than average among risk class peers over the past decade. Following a credit fuelled economic boom in 2017, a currency crisis exploding in April 2018 halted economic activity abruptly. The crisis was due to a mix of several factors. First the country suffered the worst draught since 2009. Then, as the authorities were facing large maturities of central bank bonds, global investor sentiment turned sour causing a reversal of portfolio flows and a sharp depreciation of the peso. The depreciation and sudden stop in capital flows subsequently triggered an economic contraction. At the start of 2018 most forecasters expected real GDP to grow around 3%. It now appears likely that, instead, the economy contracted roughly 2.5%.

Exchange rate stabilizes after losing 50%. When financial market confidence evaporated, the value of the peso plunged. Although modest compared to the devaluation in 2001**, t**he peso depreciation against the US dollar last year was the deepest in the world. Following the introduction of a new monetary policy regime (see below) the currency stabilized in late 2018 but is still about 50% weaker than one year ago. The decline was less in real effective terms.



Source: Macrobond

Inflation took off again. The weakening of the peso rapidly feed through to higher inflation. As a consequence, instead of moderating as expected in early 2018, the inflation rate rose roughly doubled to about 49% in January 2019. Achieving disinflation looks challenging, particularly given that 2019 is an election year, but consensus inflation forecasts for the current year are at about 29%.

Depreciation is gradually adjusting external balances. The depreciation appears to have led to the traditional J-curve shaped improvement in the current account balances. Initially the deficit rose due to high external debt repayment flows and to the relatively closed nature of the economy, with a large chunk of exports being prized in US dollars. Towards the end of 2018, however, import compression increased and helped limit the current account deficit to about 5% of GDP.

Foreign exchange reserves have been replenished. Reserves that were lost in trying to milden the exchange rate depreciation has subsequently been re-filled by IMF funds. Moreover, the extent that reserves can be used to affect the exchange rate is now strictly regulated in the IMF agreement. In early 2019, most interventions have been aimed at preventing excessive appreciation. At about USD 67 bn reserves are equivalent to about 11 months of imports.

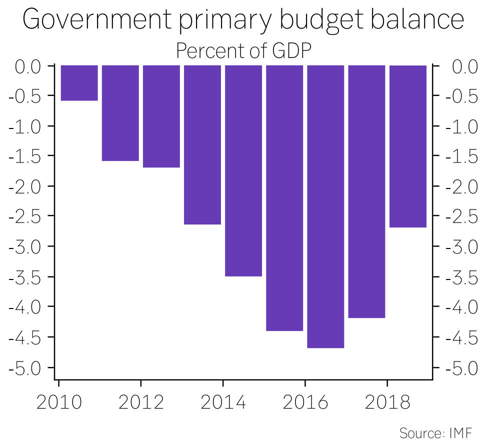
Economic policies

Revised IMF programme. The country's IMF programme, originally agreed on in June 2018, was adjusted and augmented in October giving access to USD 56.3 bn over a three-year period. The programme is designed to cover the external financing needs for 2019 and assume that a moderate portion of local debt is rolled-over during the year. This appears reasonably realistic. New external financing will become necessary in 2020 as IMF disbursements will be smaller and repayments are due. Fairly strict implementation of the IMF programme will probably be required to maintain the interest of picky foreign investors.

Significant monetary tightening. In order to contain the pass-through from the peso's depreciation to inflation, the central bank (BCRA) temporarily abandoned its inflation target and adopted a strict quantitative monetary policy in September 2018. In connection with this, interest rates were hiked to more than 70%. The have subsequently come down to around 50%.The new policy target through June this year is zero nominal growth of the monetary base. Thereafter, the increase in the monetary base will be limited to 1% a month. At the same time, BCRA is restricted from intervening in the FX market as long as the currency fluctuates within a rather broad band (20%). The upper and lower limits of the band rise 2% a month which is lower than actual inflation.

So far, new policy regime proving is successful. Initially, the new monetary policy framework has been successful. The peso has stabilised, interest rates are declining, although still high, and inflation is showing signs of moderating.

Fiscal tightening is progressing. In addition to tight monetary policy, the IMF funded economic strategy is focussed on a front-loaded fiscal consolidation with one of the central targets being a balanced primary budget in 2019. Is this realistic? Argentina's previous experiences with fiscal adjustment under the auspices of the IMF have been mixed but show that a similar adjustment is not unrealistic. In the 2003 programme, Argentina systematically over achieved fiscal targets and reached a primary surplus of 5%.



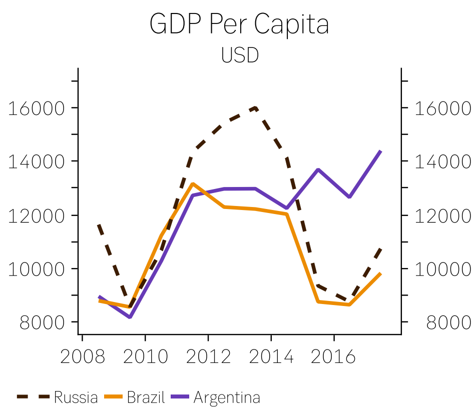
This time around, a significant cut to expenditures is in the works, mainly through further reductions in energy subsidies, reductions in the public sector wage bill and a reduction of transfers to provinces and to state-owned enterprises. An early check-point in this strategy was to reduce the primary fiscal deficit to 2.7% of GDP in 2018. This can be ticked off. A balanced primary budget target for 2019 is not unrealistic but most observers agree that it is subject to significant risk.

Government debt has risen rapidly from low levels. Around 75% of the government debt is denominated in foreign currency which makes public finances vulnerable to exchange rate fluctuations. This was evident last year when the depreciation contributed to a rise in government debt to 78% of GDP from 57% in 2017. A mitigating factor is that nearly half of the debt is owed to government entities, reducing its rollover risk. The rise in debt and interest rates naturally has pushed the interest rate burden higher too. Argentina has as poor debt repayment record with two defaults since 2001.

Banking sector has limited impact on country risk. The banking sector is small compared to the size of the economy, thus constituting a relatively limited contingent liability for the government. The IMF's financial soundness indicators reflect a well-capitalized sector. Weakening economic activity has led to slower lending growth while credit quality has deteriorated modestly. The sharp peso depreciation does not appear to have affected the public's confidence in the sector.

Structural features

Incomes are high, institutional quality is low. Incomes per capita and social development indicators are clearly better than country risk peers. A structural weakness however is the poor quality of institutions that has plagued the economy for decades. Together with political polarisation this has been reflected in years of unpredictable macroeconomic policy making. It has also been a factor behind the country's weak debt repayment record. An important institutional improvement in the past year has been increasingly reliable official statistics.



Source: World Bank

Political situation

Election year raises uncertainty. History puts Argentina among the Latin American economies which during periods have been subject to what some refer to as "pendulum politics", repeatedly swinging from one extreme political approach to another. This volatility has also been reflected in the economy, with the government having entered into 11 IMF programmes since the 1980s. Presidential elections are due in October. Support for the Macri government has fallen (34% approval rate in January) and the lack of majority in parliament has made it challenging to deliver the policy adjustments agreed on in the IMF programme. Political polarisation is high. With Macri only holding a very narrow lead in the opinion polls, the outcome is highly uncertain.

Outlook

Economic recovery in the second half of 2019. The economy is expected to start growing again towards mid-2019 as consumers should slowly be regaining some purchasing power that was lost due to high inflation. Exports will be boosted by a rapidly recovering agriculture sector following last year's drought. This together with weak domestic demand is expected to contribute to improving external balances. The current account deficit should be less than half compared to 2018. A negative output gap should reduce inflation rates. Despite the recovery later in the year, we expect a contraction of real GDP by almost 1.5% in 2019.

Uncertainty is high. Downside risks to our main scenario are very high. A key risk relates to the country's capacity to meet its financing needs beyond 2019. For example, if global financial conditions turn tighter than expected or if uncertainty relating to the election outcome sparks financial market turbulence, this would rapidly make financing conditions more challenging.

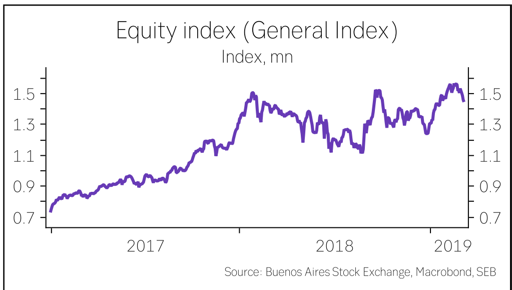
Risks that consolidation and hence debt reduction will come to a halt. A period of sustained fiscal consolidation is crucial in order to reduce the government debt and meet the expectations of financial market participants. The government aims to run a 1% primary budget surplus in 2020, but the road to get there partly depends on the outcome of the elections. Would a possible new administration be as committed to the IMF programme as Macro government? Irrespective of the political outcome, risks relate to economic growth disappointing, leading to lower than expected revenues.

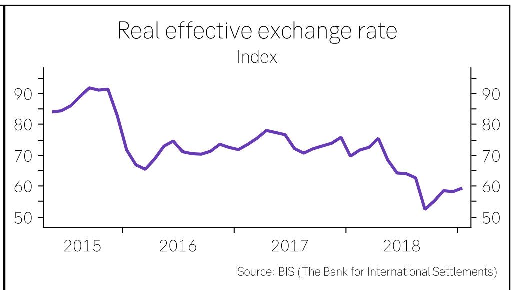
Argentina: Key Economic Indicators

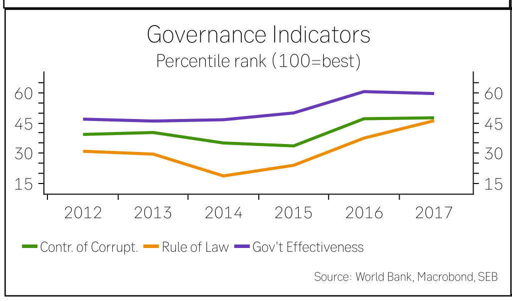
Macroeconomic	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP real (chg)	-2.5%	2.7%	-1.8%	2.9%	-2.5%	-1.4%	3.3%	3.0%
GDP (USD bn)	563.7	644.0	554.2	636.8	541.5	517.8	548.7	575.5
GDP/capita (USD)	13 098	14 815	12 624	14 368	12 105	11 468	12 043	12 520
Investments/GDP	3%	2%	2%	1%	1%	1%	1%	1%
Trade/GDP	23%	18%	20%	19%	24%	27%	27%	28%
Oil production, bpd ('000)	6181	6099	6916	7124	7416	7720	8028	8350
Money & Prices								
CPI inflation	42%	26%	39%	25%	28%	22%	17%	12%
Money, M2 (chg)	22.5%	34.0%	23.3%	28.7%	30.9%	24.1%	20.7%	15.1%
Interest rates	12%	20%	33%	28%	38%	32%	23%	15%
Stock prices, index ave.	384698	471601	620335	978488	1E+06	1E+06	2E+06	1714180
Exchange Rate (USD)	8.1	9.2	14.8	16.6	25.4	32.4	36.8	40.4
Government Finances								
Budget balance/GDP	-4.0%	-6.6%	-6.6%	-6.8%	-5.7%	-3.7%	-2.5%	-2.6%
Govt debt/GDP	36%	52%	53%	57%	78%	68%	65%	62%
Balance of Payments (USD bn)								
Current account	-9.2	-17.6	-14.7	-31.3	-34.2	-13.5	-13.6	-18.1
(% of GDP)	-1.6	-2.7	-2.7	-4.9	-5.0	-2.6	-2.5	-3.1
Exports of goods	68.4	56.8	57.9	58.4	60.4	66.6	74.1	81.4
Imports of goods	62.9	57.6	53.5	64.0	69.1	70.8	76.2	81.4
Other current acct flows	-14.7	-16.8	-19.1	-25.8	-25.5	-9.3	-11.5	-18.1
Net FDI	3.1	10.9	1.5	10.4	14.6	19.2	22.0	24.6
Loan repayments	-9.7	-10.8	-12.1	-11.8	-17.6	-21.4	-25.0	-28.5
Net other capital flows	9.0	19.7	26.6	51.4	48.3	18.0	19.3	24.6
Chg in intl reserves	-6.8	2.1	1.3	18.6	11.1	2.3	2.6	2.6
External Debt & Liquidity (USD bn)								
Reserves	28.9	31.0	32.3	51.0	62.1	64.4	67.0	69.7
in months of imports	6	7	7	10	11	15	13	12
Gross external debt (% of GDP)	28%	26%	32%	34%	54%	57%	53%	49%
Gross External Debt	158.4	166.8	178.5	214.0	291.0	295.0	291.0	280.0
o/w short term debt	31.5	47.8	51.9	47.9	50.2	52.6	55.0	57.4

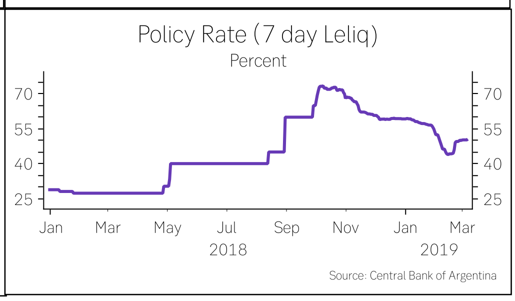
Type of government:	Parliamentary democracy
Next elections	Presidential and legislative in October 2019
Other:	
Latest PC deal	2010
Recent IMF programs	3-year SBA agreed in June 2018

Sources: Oxford Economics, IMF and SEB estimates.









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