Argentina Economic Outlook

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01
Brexit **triggered a substantial increase in global financial volatility, prompting central banks to adjust their monetary policies to this new scenario**

02
While Argentina's GDP will fall 1% this year, the change in economic policies is expected to have an impact in 2017, with growth of 3.2% YoY

03
Inflation is falling more slowly than expected but the restrictive monetary policy maintains expectations anchored at 22%

04
Gradual devaluation of the peso in 2H16 due to seasonal factors and the cut in interest rates, although the Central Bank will deal swiftly with any sudden movements

Index

1 Editorial

The revised national accounts data finally published by the INDEC confirmed that the economy was in recession following three successive quarters of falls in GDP. Taking this into account, we have reviewed our estimate of GDP contraction to -1% in 2016 (-0.4% previously). According to the latest public opinion polls, however, consumers are optimistic about future economic outlook. We expect private consumption to stop falling in the second half of the year as salary increases come into effect and also due to higher pension payments after the enactment of the law updating some pensions by inflation. Nonetheless, in our opinion the biggest driver will be investment.

In the first half of 2016, inflation reached 47.1% year-on-year to June (measured using the City of Buenos Aires (CABA) index) due to the depreciation of the exchange rate and the tariffs hike. Although the government managed to mitigate the impact of this sharp adjustment in relative prices through its monetary and exchange rate policy, inflation remains above expectations and is proving difficult to bring down. We have adjusted our forecast for CPI CABA for December 2016 upwards to 44% YoY. Both analysts' and public expectations are still anchored downwards however, in line with our estimate of 19.5% YoY inflation in December 2017, showing credibility in the Central Bank's policy.

Due to the inflationary and exchange rate pressures, the Central Bank applied a sharp rise in the Lebac interest rate from 30% to 38% in early March, and managed to stabilise the demand for pesos. Throughout May and June, the gradual fall in core inflation and the peso's revaluation pushed the Lebac rate down by almost 800 bp. Monetary policy remains restrictive, however, with inflation forecasts around 22% for the next 12 months, making the current real interest rate significantly positive. According to our estimates, the rate will continue to fall until it reaches 25% at year end, in line with the disinflationary trend expected by analysts' consensus.

Most of the announced fiscal measures will push up public spending, putting pressure on the objective of meeting the primary deficit reduction targets from 2017 on. The government will be able to reach its target deficit of 4.8% of GDP in 2016 through the curb on spending of the early months of the year and the upward revision of nominal GDP. Although the tax amnesty is likely to be successful (in view of international pressures to combat tax havens), tax revenue is unlikely to rise strongly in subsequent years through this initiative unless the government takes major steps to lower informality and actually increase the base for tax revenue.

In the external sector, there was a substantial change in the capital account since financial loans, portfolio investment inflows and debt placements in international markets began to grow, prompting an incipient rise in reserves. This flow will lose impetus during the rest of the year as the gradual lowering of interest rates will make Argentina a less compelling location for portfolio investments. In this sense, pressure on the currency to revalue will wane, allowing the exchange rate to accompany the rise in domestic prices to a greater degree than in the first half of the year. From statements made by the Governor of the Central Bank, it may be surmised that the monetary authority will continue to attempt to avoid an excessive revaluation of the peso while also averting sudden devaluations.

Certain external risks, such as Brexit, have faded in importance, while internally there are no serious concerns regarding governability. Argentineans have placed their hopes of recovery in GDP and lower inflation towards early 2017, but if these hopes are unfulfilled, the social climate and confidence could be dealt a blow and thus delay the take-off of the economy in 2017. It is crucial for the government to begin to show clear results in terms of investment growth, in order to boost job creation and pave the way to bringing down poverty levels.

2 Global environment: central banks check Brexit effects

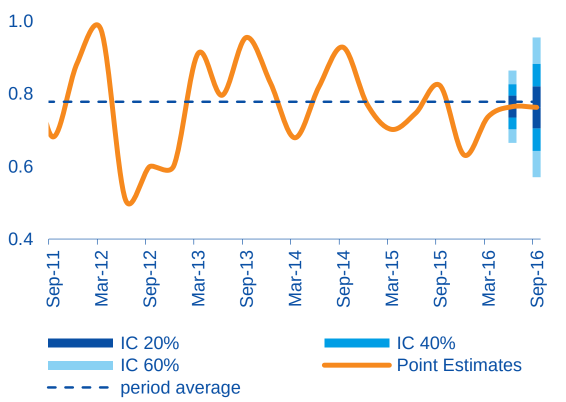
In the past three months the global economy continued the moderate trend of previous quarters, with growth rates of around 3% (Figure 1), well below the pre-crisis rates. Within this average, the developed economies show no signs of recovery, whereas we are starting to see some improvement in emerging economies, especially in Asia. As a result, globally-aggregated data has either improved somewhat or slowed down their decline.

Brexit brought with it a substantial increase in financial volatility, common to most asset classes. Its effect, however, was transient and non-systemic (Figure 2), partly thanks to the response of the central banks, which either delayed the process of normalising interest rates (the US Federal Reserve) or remained ready to strengthen stimulus measures (ECB, BoE and BoJ). In particular, the US Federal Reserve's response was crucial to how emerging markets weathered the storm. The search for yield in an environment of very low interest rates and the relief produced by the Federal Reserve's delaying its action on financing conditions encouraged the redirection of capital flows to the emerging bloc, which in July received the largest inflow of foreign capital since 2013.

In the US, the poor data for the first and second quarters still do not show the expected degree of recovery. This factor, coupled with the uncertainty surrounding the elections in the second half of the year and global risks (Brexit and other risks in Europe, and in China in the longer term), leads us to reduce our growth forecast for 2016-17 from around 2.5% to around 2%. In addition, in its latest meetings the US Federal Reserve expressed increased doubts about the US economy's potential for long-term growth in productivity and GDP, and this, coupled with the risks of the global economy, led it to put its rate normalisation process on hold. In this context, we now expect the Federal Reserve to announce one additional rate hike this year (probably in December) and two in 2017.

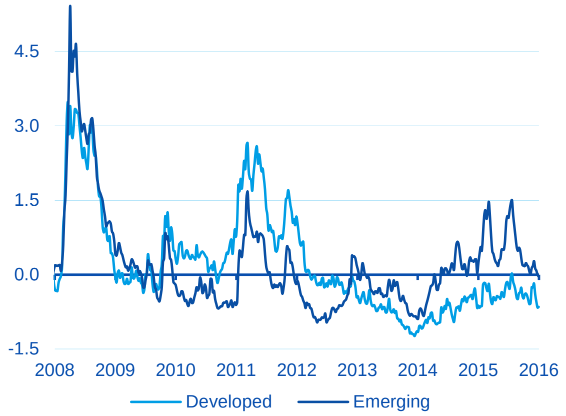
In China, fears of a sharp slowdown in the economy have partly dissipated following the stabilisation of GDP growth at 6.7% in the second quarter, although there are less encouraging signals coming from weak investment, especially by the private sector. However, we are maintaining our forecast of a slowdown in growth to 6.4% in 2016 (from 6.9% in 2015) and to 5.8% in 2017. Short-term risks persist regarding financial stability, the depreciation of the renminbi and capital outflows, as well as the property market and corporate indebtedness, while long-term questions remain about growth prospects due to the slow progress of structural reforms in some key areas, particularly in public companies.

Figure 2.1
Global GDP, % QoQ. 2Q and 3Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalised values)



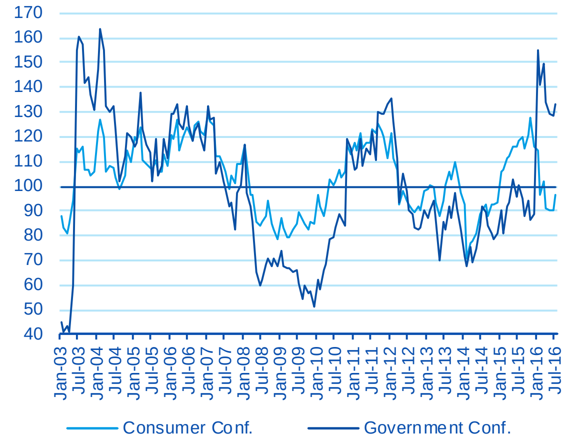
Source: BBVA Research

3 Because of the recessive tone in the first half of the year, GDP will fall 1% in 2016 but from 2017 on the economy will grow by 3%

The revised public accounts data finally published by the INDEC in late June confirmed that the economy was in a recession following three successive quarters of falls in GDP (beginning in 2Q15). The contraction in the first quarter (0.7 QoQ, seasonally adjusted) was higher than expected, while economic indicators for 2Q16 also suggest that the fall in activity will be higher than was estimated 3 months ago (-1.1% QoQ). Our current estimate is that GDP would have contracted by 1% YoY in the first half of the year mainly due to the slump in confidence (Figure 3.1) and in household disposable income due to the rise in inflation and tariffs, coupled with a more contractionary monetary policy than in 1Q16 and the negative shock of the excess rainfall and flooding which hit the agricultural sector mid-harvest.

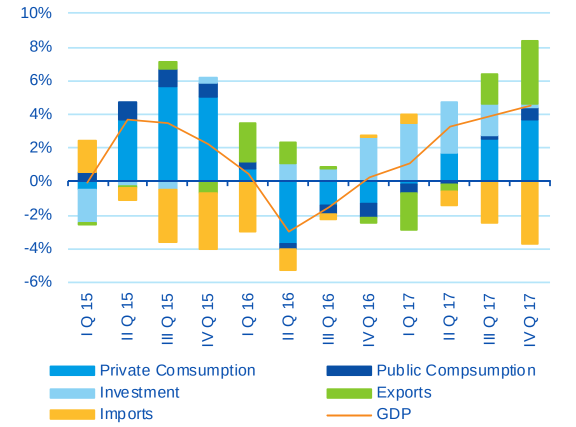
According to the latest public opinion polls, however, consumers are optimistic about future economic outlook. We expect private consumption to stop falling in the second half of the year as adjustments in relative prices are completed and salary increases are materialised, and also due to higher retirement assets through the coming into force of the Historical Retirees Reparations Act. Investment (Figure 3.2) will be the most important driver, as we have said before. Here a number of green shoots are apparent, mainly in the agricultural and fishing sector: purchase of equipment, the retention of calf-bearing cows to increase livestock, and the wheat, corn and sunflower sowing plans, with a planned 2.5 million hectare increase in surface area (Figure 3.3). The real estate sector is on the up, as shown by the 13.8% increase in sales signed in the first 6 months of the year in the Federal Capital, or 15.3% YoY, and a spike in building permits, which now stand at all-time highs. Another driver is the ambitious Transport infrastructure programme announced by the government, aimed at recovery in the building sector (according to the ISAC, this sector fell off 12% YoY in the first half of the year). Investments for electricity generation tenders, both of renewable and conventional energy sources, are also beginning to be built.

Figure 3.1
Consumer Confidence Index and Government Confidence (Base 100: historical average)



Source: Universidad T. di Tella and BBVA Research

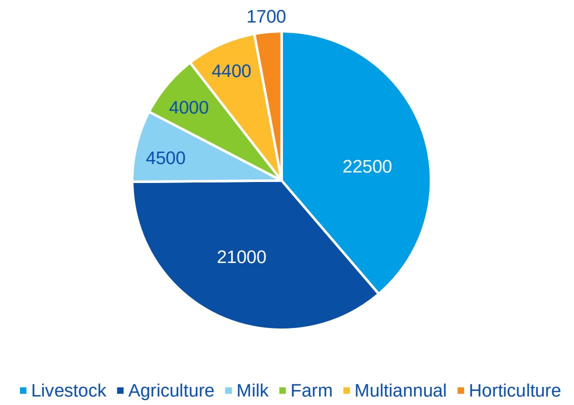
Figure 3.2
GDP (change % real YoY) and contributions to growth by component



Source: BBVA Research based on INDEC data

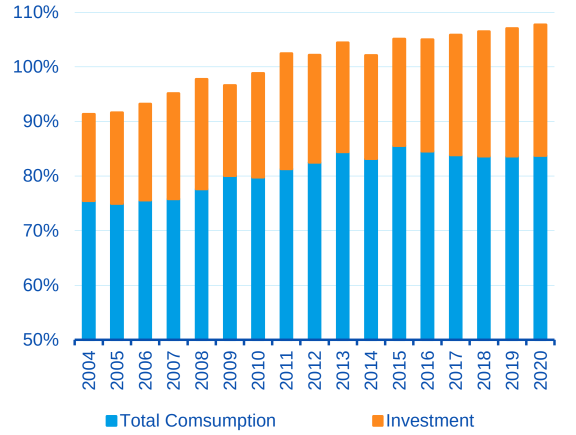
This means that the economy will begin to slowly recover from 3Q16 on, but in the yearly average it will contract 1% due to the recession in the first six months. The drive in investment started in late 2016 will be maintained into 2017, and we estimate growth of 3.2% for next year. In subsequent years, the economy would be able to regain growth rates in the region of 3% which match its long-term potential, provided monetary and fiscal imbalances are reduced and the government maintains a level playing field in order to extend the planning horizon and draw investment. The economy is expected to be rebalanced over the next 5 years. Total consumption (public and private), which rose by 10 pp of GDP between 2004 and 2015, would fall, while investment would need to continue to play a more important role, up to levels of 24%, which are more in keeping with historical highs (Figure 3.4). For sustainable mid-term growth, output will need to rise, and this can only be achieved through a higher capital expenditure per employee.

Figure 3.3
Estimated investments in the Agricultural and Fishing Sector 2016/2017 (USD million)



Source: BBVA Research and Sociedad Rural Argentina

Figure 3.4
Role of Consumption and Investment (% of GDP)



Source: BBVA Research based on INDEC data

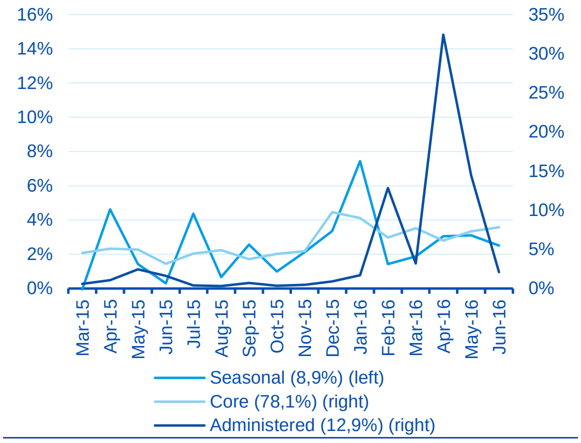
4 Inflation continues to fall at a slow pace, but expectations remain well anchored at 22% for 2017

In the first half of 2016, inflation measured by the CABA index went as high as 47.1% YoY in June, even higher than the levels reached immediately after devaluation in January 2014. This sharp increase in inflation, against the June 2015 figure of 24.9%, is not only the result of ending the exchange rate peg but also stems from a substantial increase in energy and transport tariffs, which had practically not been adjusted since 2002. Hence, regulated prices rose 88.8% YoY at June 2016, while core inflation reached 41% YoY as the pass-through was much lower than in 2014 (only 38% of a devaluation of 56%, versus 89% in 2014).

Although the government managed to mitigate the impact of this sharp adjustment in relative prices through its monetary and currency policy, inflation remains above expectations and is proving difficult to bring down. Headline inflation fell 3.2% m/m in June, having held an average of 5.8% m/m in April-May and 4.8% in 1Q16, but core inflation has not shown a clear downward trend. Although its monthly average went down from 3.5% 1Q16 to 3.1% in April-May, it rose again to 3.6% in June (Figure 4.1). It is difficult to tell if this is due to second round effects of the tariffs hike or the exchange rate devaluation of almost 10% in the second fortnight of June, but clearly it shows that there is still a significant degree of inflation inertia. The two inflation figures published by INDEC in the Buenos Aires Metropolitan Area confirm that although monthly inflation fell from 4.2% in May to 3.1% in June, core inflation rose from 2.7% to 3%.

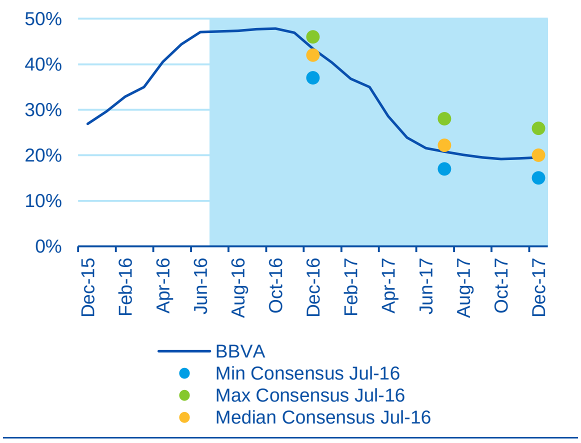
Based on the data observed in the first half of the year and taking into account our estimates of moderate devaluation of the peso and recovery in activity in the second half of the year, we have revised our estimate for CPI CABA for December 2016 upward to 44.1% YoY. This implies a more gradual fall in inflation in 2H16 towards slightly higher levels of 1.6% m/m in 4Q16. Although inflation remains resilient (as indicated in our estimates, in fact), both analysts' and the public's inflation expectations are anchored downward (Figure 4.2), demonstrating the credibility of the Central Bank's policy. We have maintained our inflation forecasts of 19.5% for 2017, including a 2 pp increase in CPI due to the impact of a further adjustment of around 100% in energy prices.

Figure 4.1
Core Inflation CABA and components (% m/m)



Source: BBVA Research and GCBA

Figure 4.2
Estimated inflation BBVA Research vs. REM (% YoY)



Source: BBVA Research, GCBA and Central Bank of Argentina Expectations Survey

5 Monetary policy remains restrictive, despite the cut in Lebac interest rates

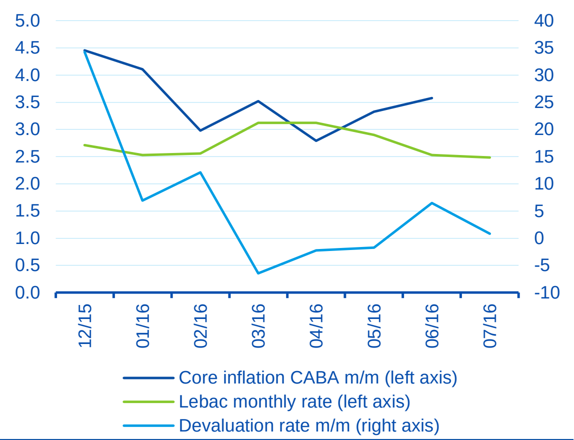
In the second quarter of 2016, the priority in monetary policy was to use interest rates to apply a restrictive approach; not the same policy as in the first quarter, in which the Central Bank's main task had been to absorb the "monetary hangover" of 2015 from the placement of Lebac treasury bills.

Due to the inflationary and exchange pressures, the Central Bank applied a sharp rise in the Lebac interest rate from 30% to 38% in early March, and managed to stabilise the demand for pesos, create an incentive for portfolio investments and put downward pressure on the exchange rate. Throughout May and June, the gradual fall in core inflation and the revaluation of the peso pushed the Lebac rate down by almost 800 bp, bringing it once again to 30% in late June. (Figure 5.1).

Despite this reduction, the restrictive tone in monetary policy is being maintained, with inflation expectations in the region of 22% for the next 12 months, making the current real interest rate significantly positive. According to our estimates, after the Central Bank's recent pause until early July, the rate will continue to fall until it reaches 25% at year end, in line with the deflation trend put forward by analysts' consensus (Figure 5.2).

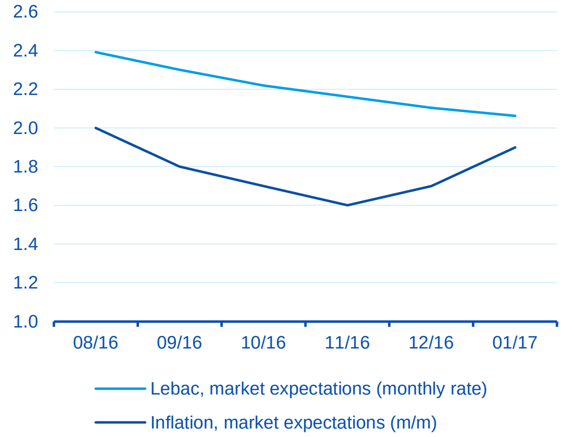
Deposits and loans interest rates have followed a similar pattern as the Lebac rate, albeit with some lag and lower volatility. The Badlar deposits rate, which had reached a high of 30% in May, stood at an average of 26% during July, and we expect it to follow the Lebac rate until it reaches 25% at year end. There is still ample liquidity in the financial system as demand for lending remains stagnant. Lending to the private sector in pesos rose by only 3% between July 2016 and December 2015, while deposits in pesos climbed 11.2% during the same period.

Figure 5.1
Lebac Rate (% monthly rate), Devaluation and Inflation (% m/m)



Source: BBVA Research, Central Bank of Argentina and GCBA

Figure 5.2
Central Bank market expectations survey: 35-day LEBAC rate vs. Inflation



Source: BBVA Research and REM Central Bank of Argentina July 2016

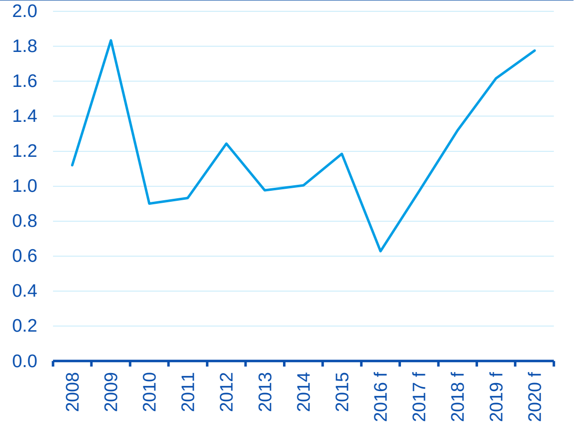
6 It will be difficult to meet fiscal targets in view of announced measures, barring extraordinary income from tax amnesty

During the first 6 months of the year, the primary deficit grew by 27.5%, tantamount to a15% fall in real terms. Tax revenue also increased less than inflation (26.8%), largely due to the elimination/reduction of withholdings on exports and adjustments in the minimum tax-free amount for Income Tax, while the government also no longer collected 35% in Income Tax from the buying of currencies and tourism expenses which had been implemented due to the “currency clamp”. Primary expenditure increased 27% YoY in the same period underpinned largely by Social Security Benefits (+38.9%), while Capital Expenditure and Other Current Expenses contracted. Private sector transfers began to slow in the first quarter due to the reduction in energy grants. The positive effect of this cut in subsidies is now beginning to fade, however, and this effect could be heightened after a ruling to freeze increases in gas and electricity bills. In any case, the annualised primary deficit in 1H16 ($121.2 billion) is considerably lower than the target of $350 billion which the government announced in its Financial Plan.

It is important to bear in mind, however, that seasonally the deficit is always larger in the second half of the year, and also that the government's recent announcements would mainly have an expansionary fiscal impact. Hence, the target may ultimately prove elusive, although the government will almost certainly reach the agreed deficit of 4.8% of GDP, given the upward revision in nominal GDP in the new series published by INDEC. Particularly important factors expected to have an impact beyond 2016 are the gradual devolution to Argentina’s provinces of part of the Federal “Co-participation” formerly assigned to maintain the Social Security system, debt payments to retirees and higher retirements (Historical Redress Act) and legal barriers to tariff increases; in fact these factors stand in the way of targets being reached in 2017, unless activity or elasticity in tax revenue recovers strongly (Figure 6.1).

The government has estimated an annual cost in the region of 1% of GDP from regularising contingent social security debts; which would be partly funded from funds from the tax amnesty (money held abroad). They tax amnesty is likely to be successful (in view of international pressure to combat tax havens and because the fiscal exchange treaties signed by Argentina come into force in 2017); while approximately USD 50 billion of the USD 240 billion which Argentinian residents are estimated to hold abroad are expected to be declared. Nonetheless, tax revenue would only increase by USD 5 billion, which would only suffice to cover the increase in retirements for the first year. Argentina's fiscal structure is such that much of the income on financial assets (public securities, interests on term deposits) are not included in income tax. In subsequent years therefore, tax revenue would not be expected to increase sharply as a result of the tax amnesty unless the government takes major steps to address the problem of the “informal economy” and actually increase the base for tax revenue. For this to happen, important incentives would need to be set in motion following the amnesty in order to regularise future tax revenue whether by reducing rates for taxpayers who play by the rules, simplifying the system for small companies or higher fines for tax evasion.

Figure 6.1
Elasticity of Tax Revenue (increase from each pp of growth in GDP)



Source: BBVA Research and Ministry of Finance

Table 6.1
National public sector debt maturities 2017 (bonds + international bodies) (USD billion)

	Debt in		
	Pesos	**Dollars**	**Total 1/**
Capital	11.1	12.2	**23.4**
Interest	3.5	5.3	**8.8**
Total 1/	**14.6**	**17.5**	**32.2**

1/ Does not include Treasury Bill debt maturities or debts with Banco Nación and Banco Central
Source: BBVA Research and Secretary of Finance

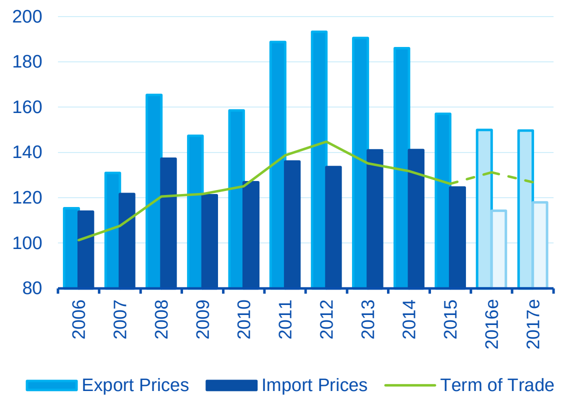
The Treasury is being funded as was announced: a total contribution of $ 160 billion by the Central Bank during the year and no new net placements of sovereign debt abroad following the hold-outs agreement. On the local market, however, Argentina has continued to issue LETES (Treasury bills) in dollars and public securities in pesos which can be adjusted by Badlar or CER according to Ministry of Taxation's plans. The provinces have again been very active on the international market and to date have placed USD 5.6 billion in international bonds. Argentina's EMBI index has not dropped significantly since Macri took over as President, but there is still appetite for Argentinian debt in the post-Brexit scenario, as investors remain focused on higher returns against a setting of exceptionally low interest rates in developed countries. Looking forward to 2017, although the total amount of national public sector debt maturities will be similar to 2016 (Table 6.1), greater foreign currency funding will be needed due to the Bonar 17 maturity in April (USD 7.3 billion) – here the government will have to show progress in bringing down the budget deficit so as to maintain investors' confidence and to reduce rates on new issues.

7 Lower than expected trade deficit due to the improved terms of trade which contain the negative impact of the energy shortage

The USD 479 million trade surplus accumulated to June shows that our estimates of a USD 3.5 billion deficit for 2016 were overly pessimistic. While we expect the trade balance to deteriorate in the second half of the year, due to the seasonality of agricultural exports and one-off extraordinary events which took place in the first half of the year and will not be repeated (e.g. payment of 2015 harvest exports retained), we believe that the final trade deficit will be brought down to only USD 900 million this year, mainly the result of sharp recovery in soy prices and lower than expected imported prices, underpinned by oil. In 2017, however, we expect the terms of exchange to deteriorate (Figure 7.1) basically because hydrocarbon prices will rise more quickly than cereals and oilseeds, which, coupled with more buoyant activity and imports, will push the deficit back up to USD 4 billion.

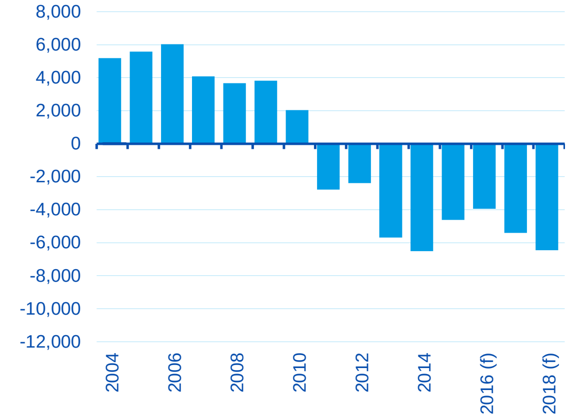
These forecasts clearly point to a structural problem in Argentina's external sector: the energy balance deficit, which will reach USD 3.9 billion in 2016. This is an improvement on the 2015 figure of USD 4.6 billion, but really it is due to lower prices paid for imported natural gas. (Figure 7.2). Even if investments began to materialise in the energy sector, Argentina would still need at least 4 or 5 years to be in a position to cover demand with local production. For the time being, therefore, the need for imports will prevail, and the deficit could even expand to over USD 7.0 billion in 2019.

Figure 7.1
Export and Import Prices and Terms of Exchange Index. Base indices 100 = 2004



Source: BBVA Research based on INDEC data

Figure 7.2
Energy trade balance (US$ million)



Source: BBVA Research based on INDEC data

There will be little improvement in the current account despite the lower trade imbalance, because the real services deficit will increase again in 2016, mainly due to tourism-related decisions taken before the devaluation. The real depreciation of the peso has been limited, so that changes in real services flows were not substantial. This means the current account deficit will increase from 2.5% of GDP in 2015 to 2.8% of GDP in 2016. It will then steadily fall from 2017 on as the adjustment of relative prices and economic recovery in Brazil begin to have a positive impact on Argentinean exports.

8 Reserves begin to increase through debt placements but will no longer put downward pressure on the exchange rate

In the external sector, the most substantial change was in the capital account; financial loans, portfolio investment inflows and debt placements in international markets began to grow, prompting an incipient rise of USD 2.29 billion in reserves in 2Q16. Assuming that the USD 1.0 billion repo which the Central Bank renewed with international banks in July is not fully cancelled by the end of the year, nor the BIS and China loans, then reserves might increase by almost USD 2.5 billion in 2016, without even taking into account possible capital inflows from the tax amnesty.

The Central Bank's policy is usually not to intervene on the exchange market, but it has now begun to make acquisitions on the market directly or via official banks, accumulating USD 2.13 billion in 2Q when cereals and oilseed export payments amounted to USD 7.38 billion from the soy and maize harvest. This flow will almost certainly drop off during the rest of the year as the gradual lowering of interest rates will make Argentina a less compelling location for portfolio investments. In turn, pressure on the currency to revalue will wane, allowing the greater rate to accompany the rise in domestic prices to a greater degree than in the first half of the year. Hence, we maintain our forecast of $15.95/USD as an average for December 2016 and of $17.45/USD for December 2017. Taking into account the recent release of practically all remaining exchange restrictions from the dollar clamp, coupled with the discouragement of capital inflows declared through the amnesty, which might be construed from statements made by the Chairman of the Central Bank, it may be surmised that the monetary authority will take further steps to try to avoid excessive nominal revaluations of the peso while also averting sudden devaluations. Although he has stressed once again that the peso’s volatility is the main priority, the Central Bank has shown greater readiness to act when the exchange rate moves beyond the $14-16/USD band for an extended period of time.

9 External risks have faded but resuming economic growth is crucial to the recovery of domestic confidence

Decisive action by central banks has generally managed to calm the financial volatility triggered by Brexit. The flow of capitals returned to emerging markets from July on, but a potential further spike in financial instability in China could prompt more risk aversion in the short-term. A temporary phenomenon of this kind is unlikely to have a significant impact on Argentina, but if it were more prolonged and caused a sharp slide in commodity prices, then it would end up having a negative impact, albeit slight, on local economic activity. Looking at the region as whole, Brazil is showing certain signs of improvement, in line with our forecast that it would come out of recession in 2017. Nonetheless, increased political uncertainty by the primary Mercosur trade partner is still a risk factor for Argentina, even though it is now less likely.

On the domestic front, the main risks are conflicts possibly caused by the political and economic transition. The cut in subsidies for energy consumption and the unified exchange rate have brought about a profound change in relative prices, and one that has had a negative impact on middle sectors of the population. Despite recent protests about the rate hike, and the Judiciary’s temporary freeze on gas and electricity price hikes, the President's popularity has not been dented and in fact he has ensured that most of the important initiatives have been approved with heavy majorities in Congress. For the time being, there are no causes for concern in terms of governability. In fact, consumer confidence and confidence in the government (see Figure 3.1) rose slightly in July. Argentineans have placed their hopes in recovery in GDP and lower inflation towards early 2017, but if these hopes are unfulfilled, the social climate and confidence could be dealt a further blow and constrain the take-off of the economy in 2017. It is crucial for the government to begin to show clear results in terms of investment, so as to once again boost job creation and begin to bring down poverty levels.

10 Tables

Table 10.1
Annual macroeconomic forecasts

	2012	2013	2014	2015	2016e	2017e
GDP INDEC Baseline 2004 (% y/y)	-1.1	2.3	-2.6	2.4	-1.0	3.2
Inflation (% y/y, eop)	---	26.6	38.0	26.9	44.1	19.5
Exchange Rate (vs. USD, eop)	4.9	6.5	8.6	13.0	16.0	17.5
Interest Rate (%, eop)	15.4	20.2	20.0	27.5	25.0	15.0
Fiscal Balance (% GDP)	-2.1	-1.9	-2.7	-4.8	-4.7	-3.5
Current Account (% GDP)	-0.2	-2.0	-1.4	-2.5	-2.8	-2.7

Source: BBVA Research

Table 10.2
Quarterly macroeconomic forecasts

	GDP Indec (% y/y, avg)	Inflation CABA (% y/y, e.o.p.)	Exchange Rate (vs. USD, e.o.p.)	Badlar Interest Rate (%, e.o.p.)
Q1 14	-0.8	36.7	7.93	26.18
Q2 14	-2.0	40.2	8.13	23.02
Q3 14	-4.2	40.3	8.42	20.28
Q4 14	-3.1	38.0	8.55	19.98
Q1 15	0.0	28.0	8.78	20.80
Q2 15	3.7	25.5	9.04	20.37
Q3 15	3.5	24.0	9.37	21.15
Q4 15	2.2	26.9	11.43	27.54
Q1 16	0.5	35.0	14.96	29.72
Q2 16	-3.0	47.1	14.14	28.95
Q3 16	-1.5	48.2	15.70	25.60
Q4 16	0.3	44.1	15.95	25.00
Q1 17	1.0	35.6	16.33	22.00
Q2 17	3.3	22.2	16.63	19.36
Q3 17	3.9	19.7	17.00	17.04
Q4 17	4.6	19.5	17.45	15.00

Source: BBVA Research

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This report has been produced by the Argentina Unit:

Chief Economist for Developed Economies
Gloria Sorensen
gsorensen@bbva.com

Marcos Dal Bianco
marcos.dalbianco@bbva.com

María Celeste González
celeste.gonzalez@bbva.com

Adriana Haring
aharing@bbva.com

Jorge Lamela
jorge.lamela@bbva.com

Juan Manuel Manias
juan.manias@bbva.com

Andrea Savignone
asavignone@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research – BBVA Banco Francés
Reconquista 199, 1st floor
C1003ABC - Buenos Aires (Argentina)
Tel.: (+54) 11 4346 4000
Fax: (+54) 11 4346 4416
bbvaresearch@bbva.com
www.bbvaresearch.com