1. Editorial

The most recent indicators confirm GDP s.a. growth of about 0.6% QoQ that our nowcasting models estimated for the last quarter of 2016, but the slower exit from the recession of 2016 has led us to revise GDP growth in 2017 downward (from 3.2% to 2.8%), maintaining our growth estimates of 3% for 2018. Investment will continue to be the main driver of expansion this year, although we have revised the expected increase downward from 11.1% to 9% YoY since the launch of announced investments has been slower than anticipated. However, considering the ambitious public infrastructure investment plan and private investment in agriculture and renewable energies being encouraged by regulatory changes, the recovery will be significant compared to 2016 when investment is estimated to have contracted 4% YoY.

We expect the inflation rate (CABA index) to decline to 20.8% in 2017 and 12.9% in 2018 after reaching 41% last year. Although the trend in inflation has clearly been decreasing since 2H16, we have raised our forecasts in relation to our previous Outlook due to the downward stickiness shown by core inflation and scheduled adjustments to energy prices. The reduction in Central Bank financing to the Treasury of 0.5% of GDP, the BCRA's positive interest rate policy in real terms, falling inflation expectations and relative exchange rate stability will contribute to the convergence of inflation towards lower levels. The main upside risks could come from potential second-round effects of increases in regulated prices or their negative impact on inflation expectations and wage negotiations.

The BCRA has set ambitious inflation targets (12-17% YoY in 2017) that it will seek to achieve by maintaining positive real interest rates. The challenges of monetary policy are not trivial as a strong reduction in inflation needs to be achieved in a context of very gradual consolidation of public accounts and reduction of fiscal dominance. Having overcome most legal obstacles, we expect the reduction of subsidies to energy and transport sectors to continue at a faster pace in 2017. However, social security expenditures will continue to grow as a result of the Pensioners Reparation Programme as will investment in public works, with the result that in 2017 primary spending will decline by only around 2% of GDP while fiscal revenues will fall by 1.7% of GDP due to the approved tax cuts. The primary deficit will thus only be reduced to 4.2%, which will not translate in the same proportion to the total result (4.7% of GDP) due to the increase in the interest burden on the debt. Financial needs will amount to USD 40 billion of which debt placements in the domestic market of USD 14 billion are projected in both pesos and dollars. The government issued USD 7 billion in debt in international markets in January on favourable terms and is also negotiating a USD 6 billion repo loan with international banks, thus virtually covering all the financial needs in US dollars for the year.

The current account deficit will deteriorate slightly to 2.8% of GDP in 2017 as the trade balance will record a deficit of USD 200 million in 2017 due to a slight decline in the terms of trade and slower growth in export volumes than in imports. In a context of removal of practically all foreign exchange market restrictions, positive real interest rates, private investment flows and public debt issues, we expect capital inflows to outstrip the current account deficit in 2017. The resulting accumulation of international reserves will continue to pressure the exchange rate downward during the year, although we cannot rule out episodes of short-term volatility that could occur as a result of the local electoral cycles or international financial tensions. The relative uncertainty regarding the future of global trade agreements, the expected increase in international interest rates and the moderate deterioration in the terms of trade highlight the fact that the appreciation of the real exchange rate, which we expect to continue, has become an important challenge for Argentina. To counterbalance this problem, the country will need to improve its competitiveness and enhance the dynamism of its exports by other means such as investment in infrastructure, the reduction of the tax burden, or the improvement of labour productivity.

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