4. Inflation will continue to decline

Although following the beat of scheduled increases in energy rates and wage adjustments

We expect the inflation rate (official CABA index, Ciudad de Buenos Aires) to decline to 20.8% in 2017 and 12.9% in 2018 after reaching 41% last year (see Figure 4.2), in line with the consensus of analyst expectations that estimate falling inflation, although still above BCRA targets. Although the trend in inflation has clearly been decreasing since 2H16 and the latest record for December was 1.2% MoM, we have raised the projection for both years by around 1 pp in relation to our previous publication due to the downward resistance that core inflation is showing and already programmed adjustments to energy and fuel prices. According to the increases in tariffs, fuels, tolls and prices for health and education services announced for the year, we estimate that the incidence of the regulated price increase in CABA inflation for 2017 will be 4.4 percentage points. This implies that core inflation, which isolates the impact of regulated and seasonal prices on the general level of inflation, should continue to decline gradually in 2017 to average 1.3% per month so as to reach our forecast of 20.8% for the year in total. The first data from January point in this direction, which means substantial progress compared to the 1.7% monthly average recorded in the second half of 2016.

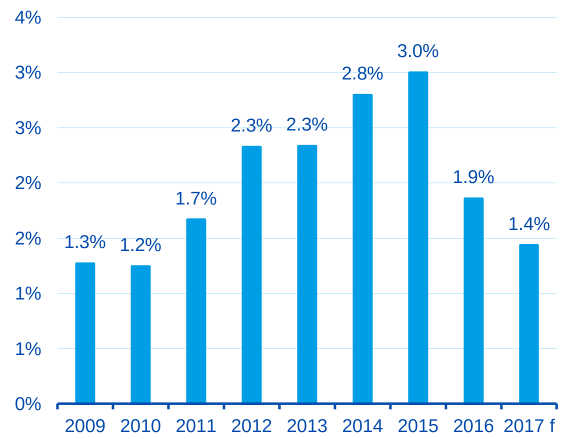
On the other hand, the impact of tariff increases on the CPI of INDEC, which includes Greater Buenos Aires (AMBA), will only be 3.5 pp lower than in CABA, due to the lower share of expenditure on electric energy and water and sanitation in the Buenos Aires metropolitan area. With a similar evolution of core inflation, but a different share in the regulated and core index, we estimate an increase in the INDEC CPI of 18.2% for 2017.

Our forecasts are based on the reduction in Central Bank financing to the Treasury of 0.5% of GDP (see Figure 4.1), the BCRA's policy of positive interest rates in real terms, downward expectations and the relative exchange rate stability will facilitate the convergence of inflation towards lower levels which will continue to gradually decline to about 1% per month in 2018. In this context, the main upside risks could stem from a negative impact of rate increases on inflation expectations or potential second round effects of increases in regulated prices on retail margins.

Given that a large part of these regulated price increases in 2017 will be concentrated between February and April, this could raise the floor of wage demands, making it difficult for the labour negotiations which will really get under way from March. In our baseline scenario, we estimate wage increases for 2017 to be agreed upon based on expected inflation rather than past inflation, although they will exceed the 1-2 pp of this year's average inflation. This scenario contemplates the fact that unemployment will fall slowly in 2017 and that the Income Tax adjustments will improve in-the-pocket salaries, thus contributing to a tempering of trade union wage demands. However, the negotiation process is just beginning and it is too early to say with certainty that the negotiations will converge on our central scenario.

Figure 4.1

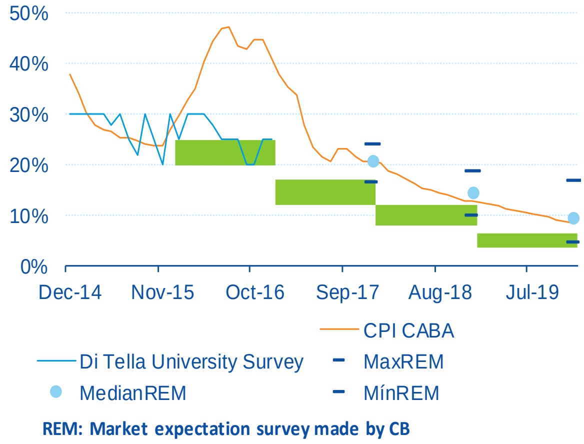
BC financing to the Treasury in % of GDP



Source: BBVA Research

Figure 4.2

Inflation, expectations and BCRA targets



Source: BBVA Research

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This report has been produced by the Argentina Unit

Chief Economist for Argentina
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

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

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

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

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
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

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