1. Summary

The Argentine economy entered its third consecutive quarter of recovery, achieving a growth 1.1% QoQ in seasonally adjusted terms in the first quarter of 2017, driven mainly by investment. This confirms our growth forecasts of 2.8% for 2017 and 3% for 2018 in a scenario where the parliamentary election results of October 2017 will not imply great changes in economic policy.We expect that the combination relatively loose fiscal policy and a relatively tight monetary policy will be maintained, but the reduction of electoral uncertainty and inflation will drive the growth of investment and employment.

After rising by an average of of 2.5% per month due to the impact of increased energy rates for 3 months, inflation fell to 1.4% in June, with core inflation at 1.5%, according to the Gretater Buenos Aires (GBA) CPI. We believe that this gradually decreasing trend in core inflation will be maintained in the coming months under a monetary policy that will remain relatively tight. Considering that energy rate increases are resumed in 4Q17, inflation as measured by INDEC's GBA CPI will reach 19.5% y/y at the end of 2017 (22.4% as measured by CABA), still above the BCRA's target of 12-17% YoY. Judging by its comparative evolution in 1S17, the new national CPI (IPC Nacional), which will be used to assess the attainment of inflation goals from July on, will not generate significant changes in the feasibility of achieving the Central Bank targets.

The Central Bank will be cautious in its reduction of the monetary policy rate (MPR) after having recognised its haste in lowering it at the beginning of 2017. In line with our inflation forecast, which points to a downward trend in the second half of the year, we estimate that the MPR will be cut gradually, reaching 21% in December 2017, maintaining a rate still high in real terms during the disinflation process. While this level of interest rates will continue to attract short-term capital inflows, it is expected that in the rest of the year the excess supply of foreign exchange will moderate. The demand for imports will begin to grow and the proximity of the elections will encourage hedging by companies and add volatility. In this context, the exchange rate will depreciate at a higher rate than in the first half of the year, but without changing the peso's medium-term trend, which is one of real appreciation.

The fiscal target of 1H17 will be easily met with the help of the fiscal amnesty, giving room for a greater seasonal expansion of spending in 4Q17, without jeopardising the annual primary deficit target of 4.2% of GDP in 2017. Achieving the primary deficit target of 3.2% of GDP in 2018 looks more ambitious as it implies a 1% of GDP reduction in spending to be achieved basically through the reduction of energy and transport subsidies since, on a path of disinflation, pensions and social subsidies will continue to increase in real terms due to their indexation to past inflation. The government has committed itself to a tax reform in 2018 but with these demanding goals, it is unlikely that the reform will involve a substantial decline in taxes in the short term.

We believe that the trade balance will continue to deteriorate gradually over the next few years basically due to the recovery of growth and investment, while a stronger expansion of exports will depend on the maturity of improvements

in transport infrastructure and productivity. The deficit in real services (largely, tourism) will remain above 1% of GDP in 2017 and 2018 reflecting the appreciation of the real exchange rate, with the current account deficit at around 3.5% of GDP. The gradual reduction of external vulnerability will depend on improving the competitiveness of exports since the economy will need to maintain a certain level of imports to continue growing. Despite the lifting of foreign exchange restrictions and a favourable business climate, foreign direct investment is still less than 2% of GDP, below the average for the region.

The parliamentary elections in October can be considered a milestone for the 2018-19 scenario. There are still no reliable polls, but the composition of forces in Congress is unlikely to change significantly and the administration will continue to need the support of opposition parties to get key laws passed. The outcome of the senatorial elections for the Province of Buenos Aires will have a significant influence on the political strength of the government and the management of economic policy. A strongly adverse result for Cambiemos (very unlikely) could increase the cost of financing and force the government into carrying out a more rapid fiscal adjustment, with a possible negative impact on the level of economic activity. On the other hand, a resounding victory would give the administration greater political capital to carry out structural reforms and improve the productivity of the economy. A substantial drop in country risk would allow for a larger deficit to be financed and for quicker progress to be made regarding the elimination of distorting taxes at national and provincial levels, boosting medium-term growth.

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