7. The rapid deterioration in the balance of trade highlights the vulnerability to a shift in global conditions

The greater buoyancy of domestic demand in conjunction with the real appreciation of the peso contributed to a sharp pick-up in imports over 2017, which grew 19.7% in the year, while exports have still failed to show clear signs of recovery (+0.9% YoY). The net result was a trade deficit of USD 8.471 bn, which makes a stark contrast with a surplus of USD 1.969 bn in 2016. With the exception of fuels, due to more clement weather and the rise in energy rates, all import items posted surging rates of volume growth on aggregate for the year, particularly items such as Parts and accessories for capital goods (+19.2% YoY) and motor vehicles (+39.9%). In this last case, the vigour of motor vehicle sales in Argentina, particularly models manufactured in Brazil in combination with the stagnation of Brazilian demand, was instrumental in the deficit on the industry's balance of trade racing ahead.

Bearing in mind these trends, we estimate that the balance of trade will reach a deficit of USD 11.2 bn in 2018, even taking into account something of a fall in the elasticity of imports to GDP in the coming year following the readjustment in 2017. We can also expect more vigour from export volumes, from both greater demand from Brazil for industrial products and a lower level of withholding of both primary products and agriculture and livestock manufactures following on from the decrease in withholding of soybean exports and the recent peso depreciation. We forecast that, with the economy growing at close to its potential rate of 3% in the next few years, imports of inputs and capital goods will continue rising at a sustained clip, however reforms to boost the competitiveness of exports will eventually stabilise the trade deficit at around 1.7% of GDP from 2019.

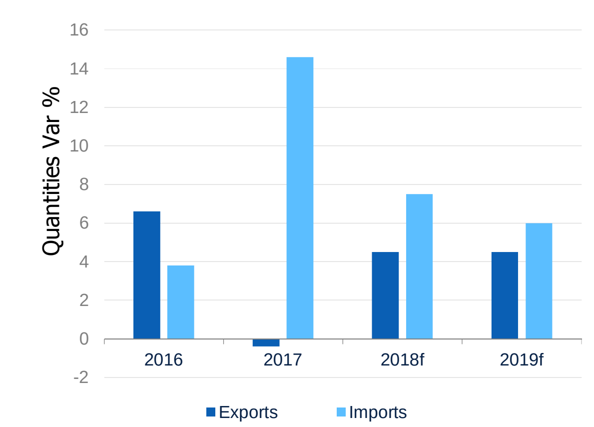
Other items in the current account such as real services should see their negative balances shrink very slowly, especially tourism, since the real exchange rate will remain relatively strong compared to Argentina's key trading partners. Despite the reduction of over 100 bp in country risk in 2017, interest paid abroad will hold at over 2% of GDP in 2018 and 2019, as the closing up of the fiscal deficit is going only slowly and companies will continue to raise money for their expansion plans via external debt issuance. Thus the current account deficit will remain high in the next few years up to 2020, averaging some 5% of GDP.

The funding of this deficit has been plentiful, leading to a rise in reserves of 2.7% of GDP in 2017 while keeping the surplus supply of dollars in the local market. We estimate that, beyond occasional bouts of volatility such as those seen following the changes in monetary policy, this situation should continue to predominate in 2018 and 2019, giving rise to an exchange rate depreciation below the rate of inflation in the next two years. The monetary policy we foresee for 2018, though looser than in late 2017, will keep interest rates above expected inflation, underpinning the attractiveness of investments in pesos for both residents and non-residents.

The surprise 8% exchange rate depreciation in the second half of December 2017 was a foretaste of the relaxation of inflation targets and less contractive monetary policy looking ahead, although in any case the monthly average for December came in at barely over our estimate of ARS17.6/USD. As regards this aspect, we have raised our exchange rate forecasts for 2018 onwards slightly, assuming a marginally bigger depreciation than before and reaching ARS20.2/USD at the end of the year and ARS22.4/USD at the end of 2019. The chairman of the central bank has once again stressed the role of the floating exchange rate system in containing external shocks and the low level of *pass-through* to inflation of the recent bouts of volatility, for which reason we can expect very little intervention by the central bank in the forex market. In spite of this, and given that it is standing by its goal of building up foreign exchange to a level of 15% of GDP, in 2018 we will probably continue to see the central bank directly acquiring foreign currency from Treasury bond placements and reducing the downward pressure on the exchange rate that would prevail if this flow were to be dumped directly onto the forex market.

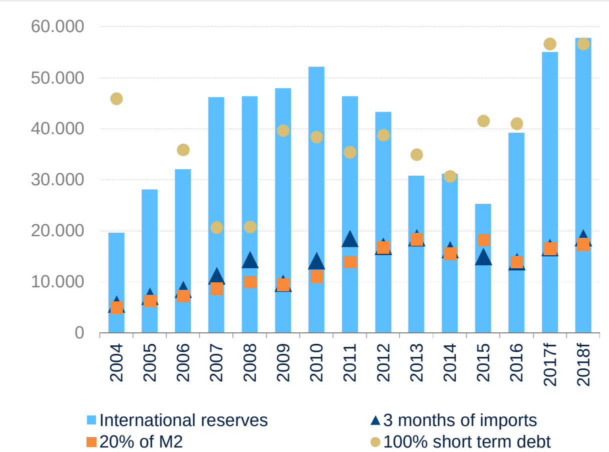
Nevertheless, the current level of reserves of close to 9% of GDP is still relatively low in comparison with the other countries in the region, illustrating how vulnerable Argentina is to an external shock that reduces available funding as a portion of the inflow of capital to the country has been used to build up the private sector's external assets (building up reserves of dollars). It is crucial for the reforms that the government is pushing through to start bearing fruit in terms of improving productivity so that the financing of the current account is mostly channelled via foreign direct investment rather than through portfolio investments that are subject to sudden stops.

Figure 7.1 Balance of trade: import and export volume growth (% var. YoY)



Source: INDEC and BBVA Research

Figure 7.2 Ratios of reserves



Source: INDEC, BCRA, Haver and BBVA Research

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