Economic Analysis

Argentina Economic Outlook. Second quarter 2019

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Gradual moderation of global growth with monetary easing

Global growth has slowed more than expected in recent months, reinforcing fears of a sharp slowdown in economic activity. In this context, the Fed and the European Central Bank (ECB) have changed their roadmap and have announced new monetary stimulus measures. Similarly, China has adopted additional expansive fiscal and monetary policies. This reaction by the economic authorities in the major economies favors a gradual moderation of world growth. However, an unforeseen loss of dynamism in the Chinese economy, a new wave of protectionist measures and the disorderly exit of the UK from the European Union, among other risks, could trigger more negative scenarios.

In Argentina, the impact of financial volatility will slow growth recovery

On the external front, economic news have been better than expected after the Federal Reserve's U-turn, indicating that it would put an end to the cycle of withdrawing monetary stimuli and raising interest rates, dispelled fears of a US recession. The pause in monetary tightening in central countries will undoubtedly favor capital flows to emerging markets. However, for the time being Argentina has not benefited from this change, as uncertainty still hangs over the country with regard to the outcome of the presidential election and the ability of the current economic program to stabilize the economy.

In this sense, the fiscal and monetary goals of the program agreed upon with the IMF have been comfortably met, releasing the expected disbursements. However, the results in terms of exchange rate stabilization and inflation reduction have been short-lived. Initial optimism about the effectiveness of the monetary-exchange rate program was marred by disappointing inflation data for January and February (2.9% and 3.8% MoM respectively), which cast doubts on whether there were grounds for such a rapid decline in the Leliq rate (more than 30 pts up to mid-February) and was reflected in an sharp depreciation of the peso. The Central Bank of Argentina (BCRA) was again forced to tighten monetary policy by deciding to outperform previous monetary base growth targets and interest rates quickly recovered to levels above 68%. Although the monetary base has fallen by 8% from year-end after eliminating all the factors that caused monetary expansion in the past, it is still growing at a year-on-year rate of 30% due mainly to the dismantling of Lebac securities during the second half of 2018. This monetary overhang should be gradually diluted and considering lags in monetary policy, the current strategy of the Central Bank should contribute to reduce the monetary factor as a cause of inflation in the coming months.

While exchange rate volatility was to be expected throughout the electoral cycle, our central scenario envisaged that they would be concentrated in 3Q and 4Q19, which would allow for a gradual lowering of interest rates in the first half of the year. In the current context of rising inflation expectations, however, rates are likely to remain high for most of the year, thereby introducing a downward bias in our growth forecasts. GDP contracted by 2.5% in 2018, with a QoQ s.a. fall slightly lower than forecasted in 4Q18, which reduces by one tenth of a percentage point the negative statistical drag for 2019 while the known 1Q19 indicators are in line with the expected recovery. However, we have slightly revised 2019 growth downward to −1.2% due to a more prolonged tight monetary policy, maintaining our view of positive quarterly growth throughout the year, albeit at a lower rate, basically driven by the tradable sectors. Only in 4Q19 will the economy be growing at 2.1% YoY with private consumption at 3.9% YoY. Once the electoral uncertainty clears and financial variables have stabilized, the economy is expected to grow 2.5% in 2020, despite the contractionary fiscal policy, as investment and private consumption recover and external demand boosts exports.

The timid growth of the economy will be insufficient to increase job creation (which contracted in 4Q18) and the supply of workers will continue to grow above demand, also possibly driven by the need to supplement family income with an "additional worker" in view of the sharp fall in real wages in 2018. Unemployment will gradually climb to around 11% in 2Q19, which may moderate wage demands during the wage negotiation process that will start in the coming months. However, considering the acceleration of inflation in the first quarter of the year, it is hard to envision a recovery of real wages on average in 2019.

The Treasury continued to outperform primary surplus targets in January and February, although revenues (especially in export taxes) have grown less than expected in the Budget. In this sense, a greater cut in expenditures (mainly capital spending) has been negotiated with the IMF to meet the zero annual primary deficit target in a context of lower fiscal income. At the same time, for seasonal reasons, the primary surplus target of 2Q19 has been relaxed, moving partially to the third quarter while keeping the annual objective unchanged. The use of IMF-agreed adjustors is likely, with 0.3% of primary deficit for social spending and 0.2% for infrastructure spending with multilateral financing. On this basis, primary deficit could reach 0.5% of GDP in 2019, even while fulfilling the commitments of the stand-by agreement with the IMF.

The financing outlook for 2019 is relatively tension-free with renewals exceeding 80% of LETES (short-term debt instruments) maturities in both pesos and dollars. However, the rollover of instruments maturing within the year is likely to be lower as the elections approach. Although financing is assured by the IMF this year, the higher depreciation rate of the peso raises doubts about debt sustainability and the possibility of returning to the markets in 2020 as reflected in the country risk index, which has grown almost 160 basis points (bp) since February lows.

Slower decline in inflation and faster adjustment in the external sector

In spite of the recession, inflation has fallen very gradually, still processing the pass through of the strong 2018 devaluation and the increase in energy and transport tariffs that continues to be required to achieve fiscal consolidation. Inflation is estimated to have averaged 3.5% per month in 1Q19, with a monthly impact of 0.9% from regulated prices and some transitory climatic impacts on the price of meat and dairy products. Considering monetary policy lags of up to 12 months, we estimate the increase in CPI will fall to an average of 1.9% per month only in the second semester, but the high inflation of recent months will be reflected in a retail price increase of 35% YoY in 2019, above the 30% previously forecast. While we continue to expect disinflation going forward, based on tight monetary policy, the decline will be slower than estimated considering the economy's higher indexation, bringing inflation to 25% in 2020.

This inflation scenario assumes that regulated price increases will fall sharply from May on and that, apart from occasional outbreaks of volatility, the exchange rate will be depreciate in line with inflation to reach ARS 49/USD by the end of the year. In fact, in the first quarter of the year, albeit with sharp changes in trajectory, the accumulated depreciation of the peso reached 14.6%, slightly above the increase in the CPI. The scenario for supply of hard currency looks more relaxed in 2Q19 with agricultural exports contributing approximately USD 4.5 billion more than the previous season after the 2018 drought. In addition, the Treasury will be able to sell a USD surplus of USD 9.8 billion at a rate of USD 60 million per day as agreed in March with the IMF. Portfolio dollarization remained contained in January–February, 35% below the same period in 2018. However, the key issue will be the size of the increase in demand for hard currency if political uncertainty increases, which could also affect export settlements. However, with a stock of assets in pesos (including the increase of fixed term deposits in the financial system) after the reduction in stock of short term peso securities due to the elimination of Lebac´s—which is 40% of what it was in 2018—it is unlikely for a sudden movement in the exchange rate to take it significantly above the upper band for an extended period of time.

Meanwhile, the adjustment of the external sector is accelerating, driven both by the improvement in exchange rate competitiveness and by the fall in the level of activity. The trade balance has remained in surplus since last October due to the sharp fall in imports and the positive balance will increase in the coming months due to the improvement in agricultural exports of corn and soybean, bringing the total for the year to around USD 11 billion. Although the terms of trade have improved only slightly for Argentina, the recovery of growth in Brazil will mean greater dynamism in the placement of industrial products. Thus, adding the fall in the tourism deficit of 47% YoY, the current account deficit will be only USD 9.5 billion (2.2% of GDP), a third of the large deficit of USD 28.5 billion of 2018. With an exchange rate that will remain depreciated in real terms and a modest growth of the economy, the trade surplus will continue to increase gradually and the tourism deficit will shrink in 2020, bringing the current account deficit to just 1.5% of GDP.

Capital inflows will come mainly from multilateral agencies—in particular the IMF with USD 22.5 billion disbursement—with low participation from foreign direct investment and private portfolio investment, but will be enough to produce an increase in the BCRA's stock of international reserves, provided that dollarization remains contained.

Balancing Risks

Except for the greater difficulties experienced by Brazil's new president, Jair Bolsonaro, in obtaining congressional approval for the planned fiscal and social security reforms, the international outlook looks more positive for Argentina, especially because of expectations of greater monetary policy loosening in the central countries.

On the other hand, at the domestic level, risks have intensified toward the end of 1Q19 due to renewed exchange market volatility and the increase in interest rates. The prolongation of such a scenario would not only call into question the possibility of lowering inflation in line with commitments, but also the speed at which growth may recover and financing prospects for 2020. An increase in the peso's depreciation rate despite high interest rates may undermine confidence in the economic program. Beyond the uncertainty produced by the electoral cycle, persistent inflation and the perception that the BCRA's capacity for intervention in the exchange market are limited by the agreement with the IMF may drive portfolio dollarization. This, in turn, feeds back into inflation expectations and may make fiscal adjustment more difficult due to the indexation of pensions and subsidies and some wage agreements. This scenario would have a negative impact not only on the level of reserves but also on confidence indicators and on economic activity, and consequently on the electoral chances of the current administration.

It is not yet known whether the opposition will face the ruling "Cambiemos" coalition as a united or divided front, or who will ultimately be its candidate. However, whatever the profile of the winner of the 2019 elections, managing the economy in 2020 will require continuing to fulfill the fiscal and monetary commitments agreed on with the IMF, in order to make accessing credit markets possible. The key question is whether the next government will have enough political capital to tackle the tax system and labor market reforms needed to improve the competitiveness and growth potential of the Argentine economy in the medium term.

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