BBVA Research

Argentina Economic Outlook

3Q19

July 18, 2019

Creating Opportunities

Key points (I)

- Global growth will stabilize at lower levels than in previous years. Additional measures to stimulate activity, primarily of a monetary nature, will compensate for the effects of increased trade tension.
- Strong polarization of the political scene of Argentina. The announcements of the candidates for the two parties with "real" chances of winning the elections were well received by the markets. Our baseline scenario assumes that current economic policies will continue after the elections.
- The exchange rate stability achieved with the possibility of intervention by the CB within the reference zone allowed for an increase in the supply of foreign currency coming from agricultural exports, with some recovery in the price of soybeans and corn, while demand remained contained.
- We assume extreme monetary tightness will continue given its central role in keeping exchange rate volatility under control. We expect some monetary easing after the elections but real rates to remain at high levels.
- Exchange rate stability and sustained monetary tightness began to moderate inflation expectations. We maintain a 40% forecast for inflation in 2019 and a 30% forecast for 2020, incorporating the "pause" in utility rates adjustment for the remainder of 2019 and a continuation of contractionary monetary policy.

Key points (II)

- Consumption and investment reflected the impact of the drop in real wages, the exchange rate instability and the very contractive monetary policy. This hurt economic activity, which will fall by 1.2% in 2019 but begin to recover as the effects of the agricultural season and wage negotiations materialize. We expect GDP growth to reach 2.5% in 2020 once the turbulence of an electoral year is over.

- There will be a strong correction in the external sector from the deficit of 5.1% of GDP in 2018 to a deficit of 2.3% this year, due to the trade surplus and the lower tourism deficit, which is partially compensated by greater interest payments, which account for more than 4 pp of GDP. The outlook will remain almost unchanged in 2020.

- The fiscal deficit in 2019 will reach 0.5% of GDP and the fiscal targets of the IMF Stand by agreement will be met once considering the spending “adjustors”. We expect a primary surplus of 1% of GDP in 2020, which will mean a major effort to maintain tax revenue trends.

- The agreement with the EU is a great opportunity for increasing the global integration of the Mercosur countries and will promote greater intra-Mercosur exchange once existing non-tariff barriers are reduced. In addition, the agreement will strengthen political dialog and enhance cooperation in areas such as migration, the digital economy, research and education, human rights, environmental protection, etc.

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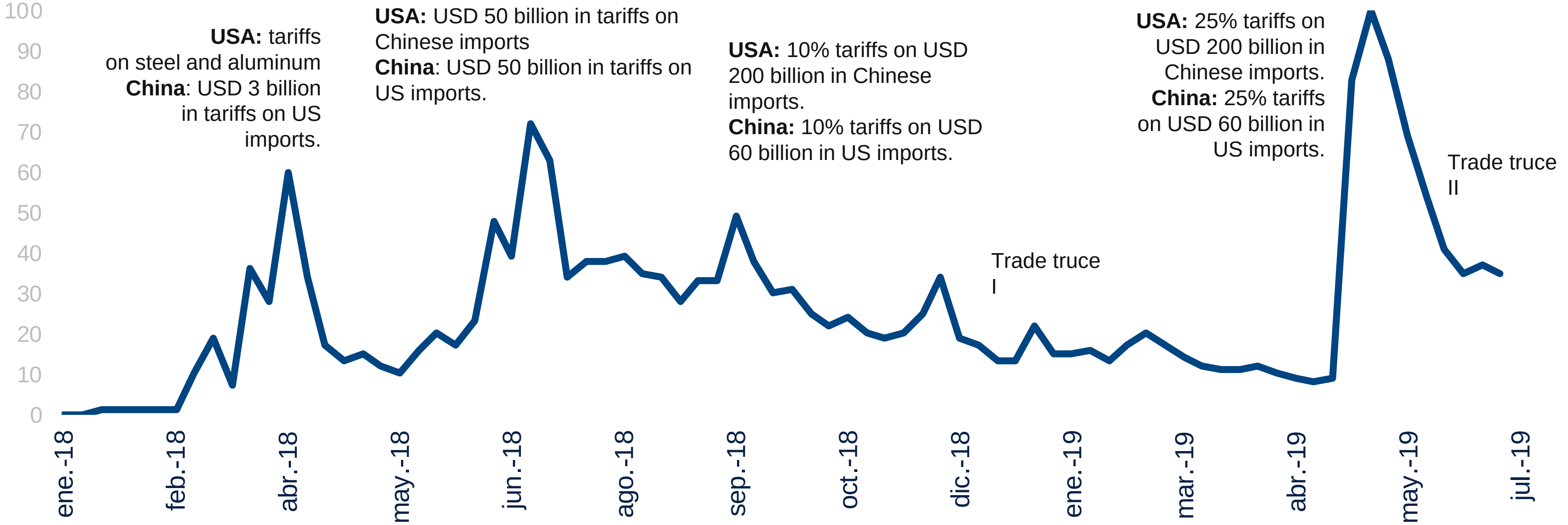
01

Global environment: growth will ease amid new stimulus measures and increased trade tensions

Growing protectionism keeps uncertainty high, even after the recent truce between the USA and China

TRADE WAR INDEX: GOOGLE SEARCHES OF THE TERM "TRADE WAR" (INDEX FROM 0 TO 100)

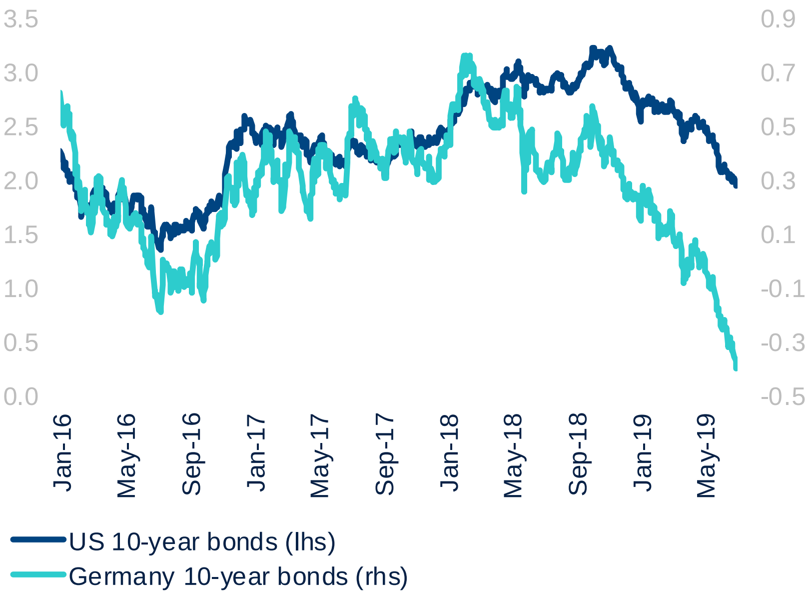


Source: BBVA Research, Google Trends

There is a movement toward safe haven investments on financial markets

SOVEREIGN DEBT YIELDS

(%)

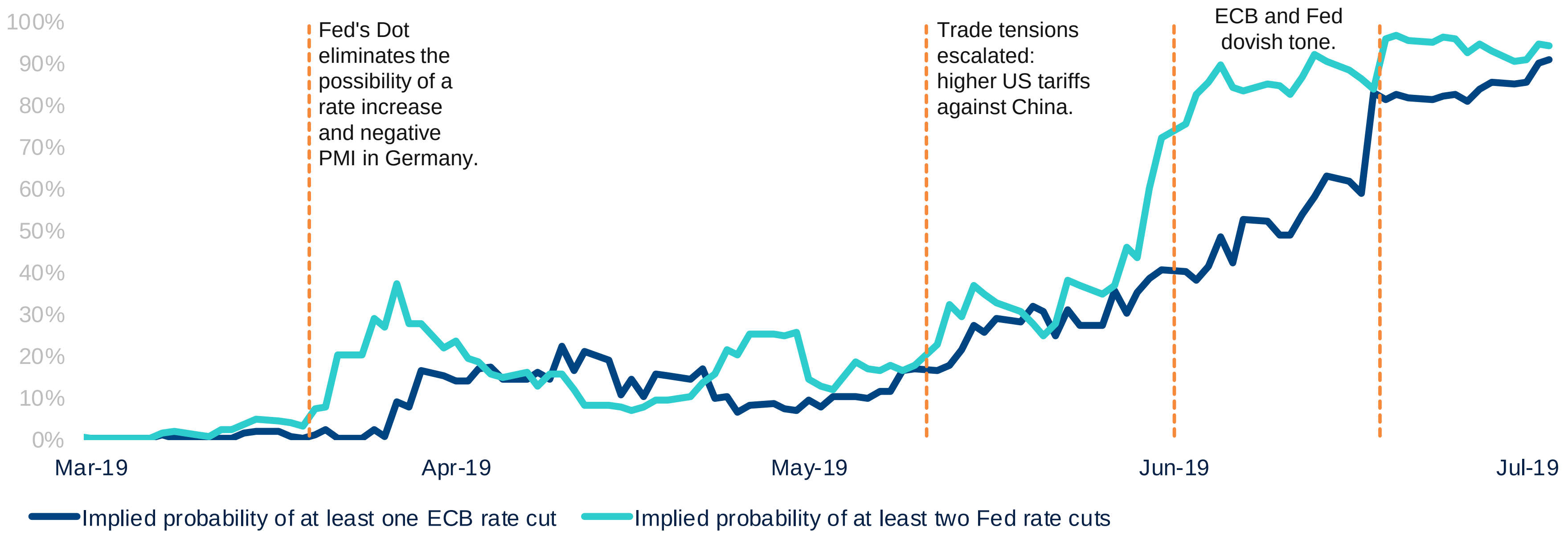


- **Very low sovereign debt yields** due to trade tensions and growth risks.
- The shift of the Fed and the ECB prompted a **search for profitability** and earnings in peripheral markets...
- **...without generating a generalized risk appetite.**

Source: BBVA Research and Bloomberg

In an environment of persistent uncertainty and low inflation, central banks change their position and consider additional stimuli

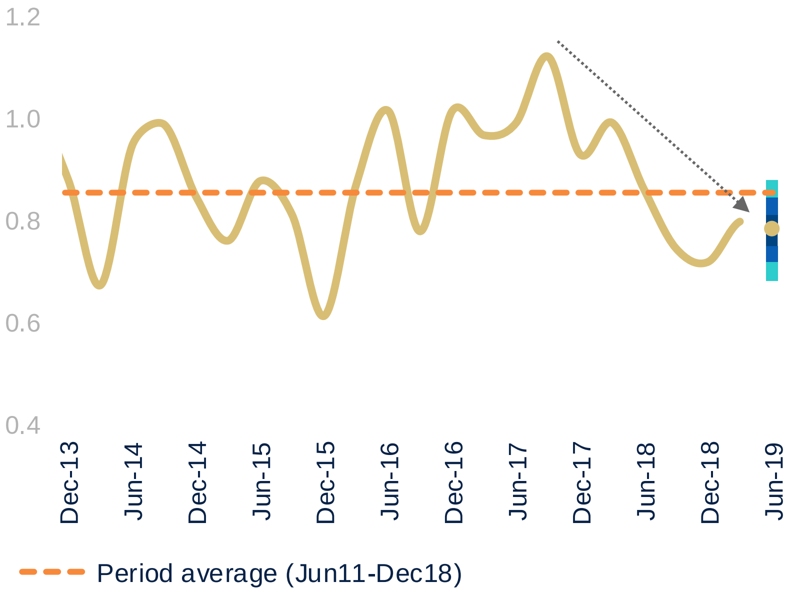
PROBABILITY OF INTEREST RATE CUTS BY THE FED AND THE ECB ACCORDING TO FINANCIAL MARKETS (%)



Source: BBVA Research and Bloomberg

Global growth continues on a smooth downward path, despite the first-quarter rebound

WORLD GDP GROWTH
(FORECASTS BASED ON THE BBVA-GAIN MODEL; % Q/Q)



Source: BBVA Research

- **Low growth** since mid-2018.
- Particularly weak performance in **exports and manufacturing**.
- Growth in 1Q19 was higher than forecast and no changes are expected for 2Q19.
- The trade war is having a particularly negative effect on China; however, the US and other countries will also be affected.
- Data shows that trade tensions are already reducing growth.

Looking ahead, additional expansionary measures are expected to offset the effect of trade tensions

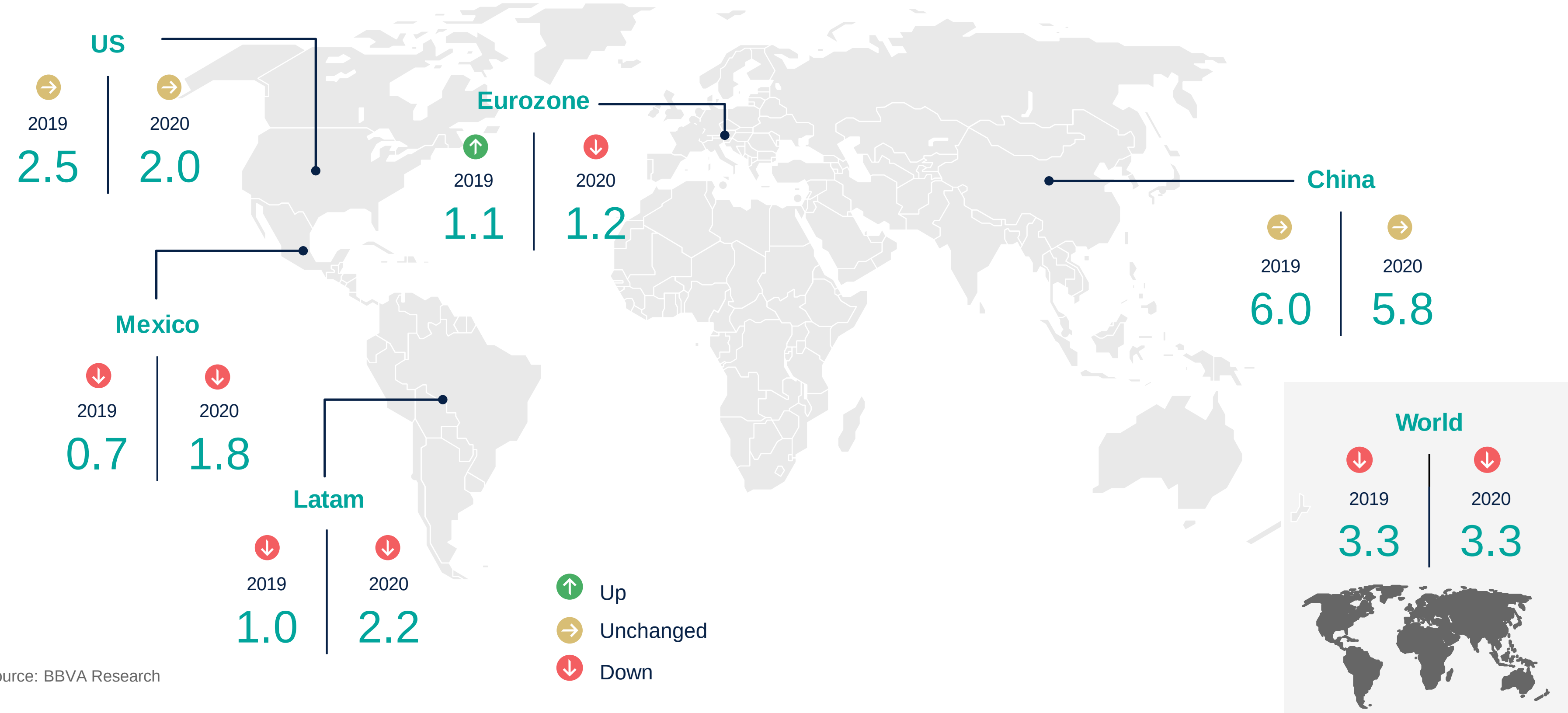
Trade tensions high

- Protectionism has already caused irreversible damage.
- The strategic rivalry between the US and China will not disappear.
- Uncertainty will continue to weigh on investment decisions.

New stimulus measures

- Fed and ECB: short-term rate cuts.
- China: additional stimuli.
- The new measures will keep financial tensions limited.
- The drop in the oil price will provide support.

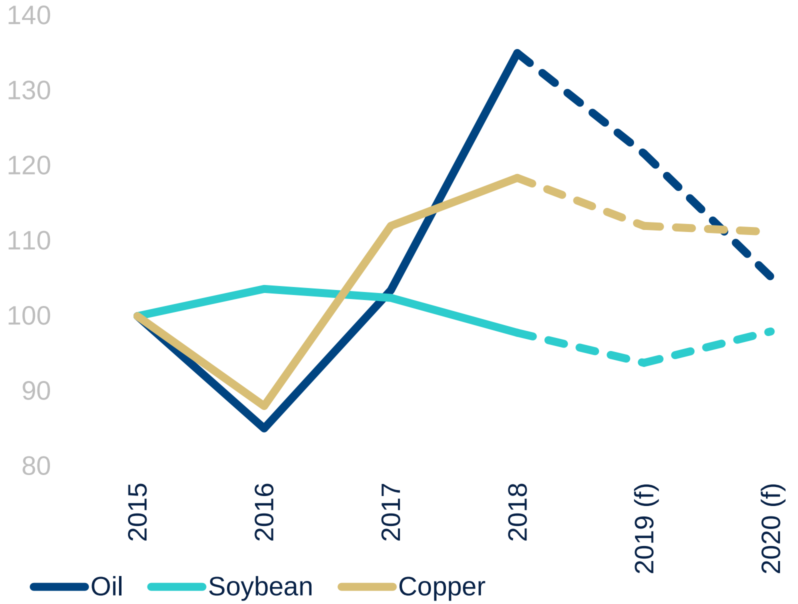
Global growth will stabilize at relatively lower levels



Source: BBVA Research

A more negative global environment weighs on raw material prices

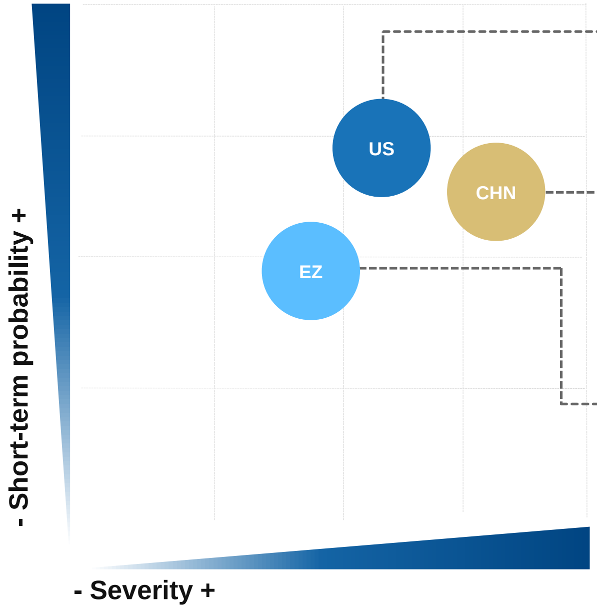
RAW MATERIALS: AVERAGE ANNUAL PRICES
(INDEX: 2015 AVERAGE = 100)



(f) Forecasts.
Source: BBVA Research

- Uncertainty and weak global growth will negatively affect prices.
- Increased US production will help limit oil prices, despite supply cuts and geopolitical tensions.
- Soybean forecasts revised downward but price increases are still expected.
- Stable outlook for copper; demand for electric automobiles will provide medium- and long-term support.

Global risks: rising on account of increased protectionism, mainly due to the potential impact on China



Source: BBVA Research

- Economic downturn: very high
- Protectionism: higher

- Protectionism: higher
- Disorderly deleveraging: relatively higher

- Growth issues: relatively high
  - *Brexit*
  - Italy
- Protectionism: still limited but growing.

Financial vulnerabilities may increase risk severity

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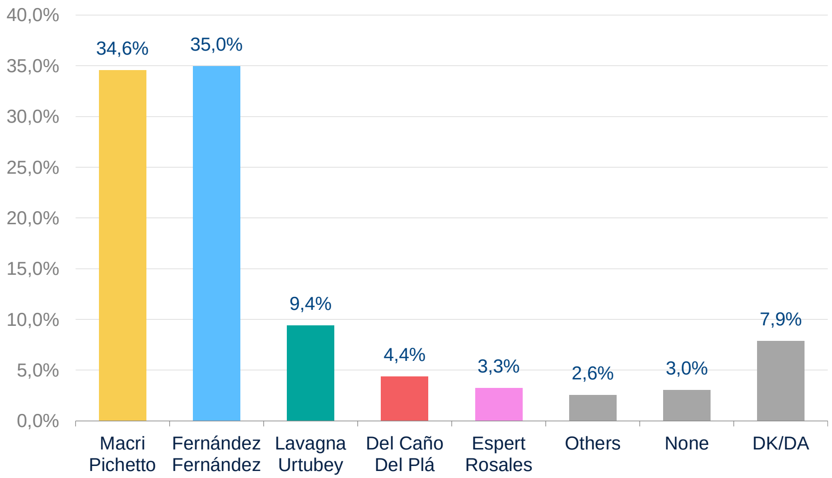
02

Argentina: reduced financial tensions bode well for a better second half of the year

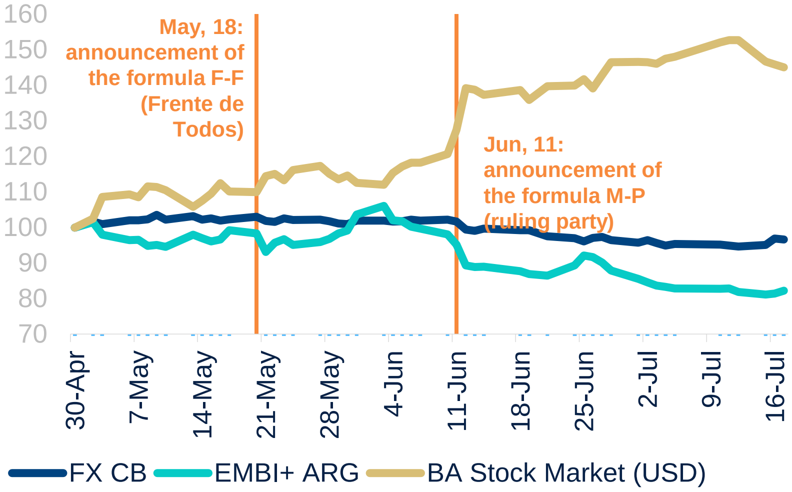
Political polarization deepens while climate improves

AVERAGE INTENTION TO VOTE BY POLITICAL CANDIDATE (VARIOUS SURVEYS) JULY 2019
(%)



Source: BBVA Research

MARKET INDICATORS
(BASE 04/30/19=100)



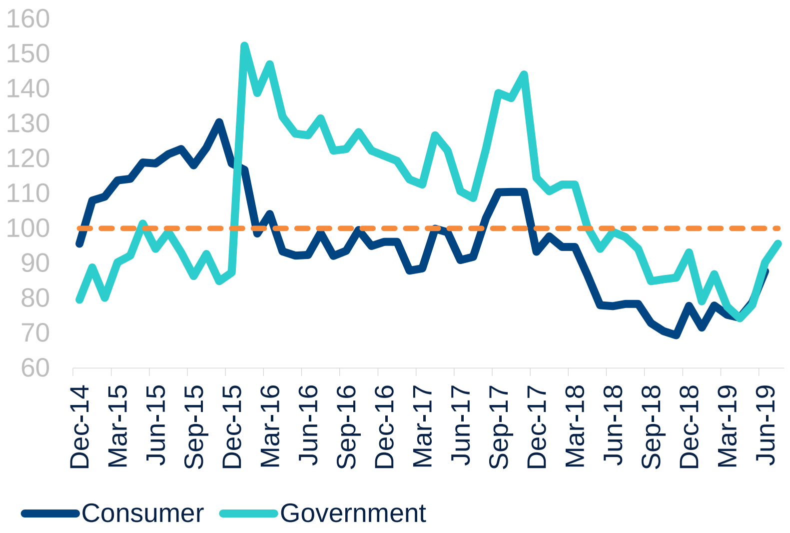
Source: HAVER, BCBA, BCRA and BBVA Research

The breaking off of the Alternativa Federal party exacerbated the polarization. Senator Pichetto from this alliance agreed to run for VP of the ruling party, which showed greater openness to other political alliances.

The announcements of the ruling party candidates and of Cristina Fernández's VP candidature de-stressed the market, enabling a financial boost that, in turn, favors the ruling party.

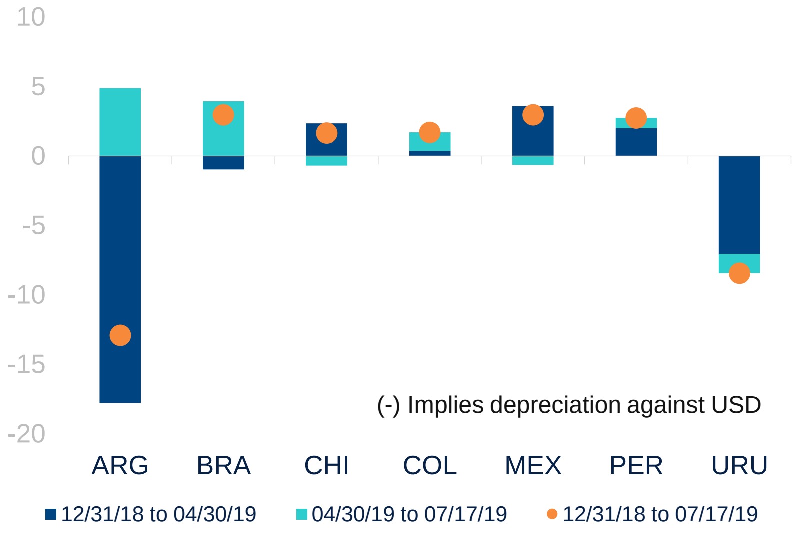
Confidence recovers as the peso stabilizes

CONFIDENCE
(BASE = HISTORICAL AVERAGE)



Source: UTDT and BBVA Research

REGIONAL EXCHANGE RATES
(BASE 04/30/19=100)



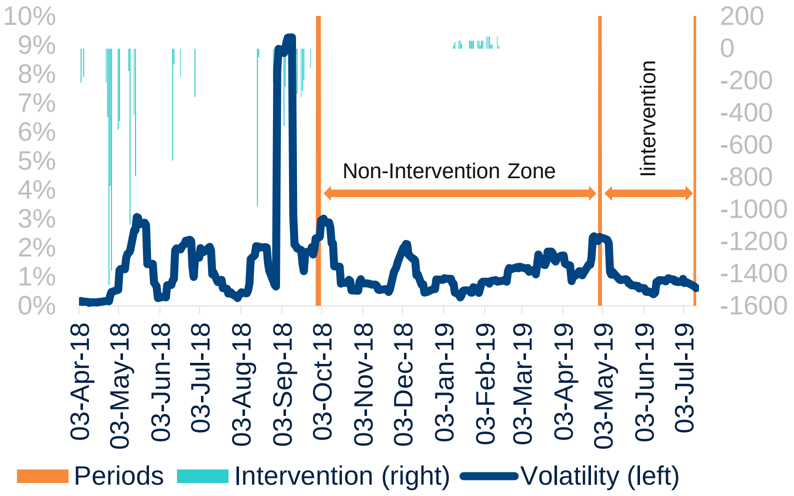
Source: HAVER and BBVA Research

In recent months, an upturn in perceptions of the economy and a more moderate boost to household finances have triggered consumer confidence.

Since the end of April, the region's currencies have recovered some of their value against the USD, with Argentina in the lead.

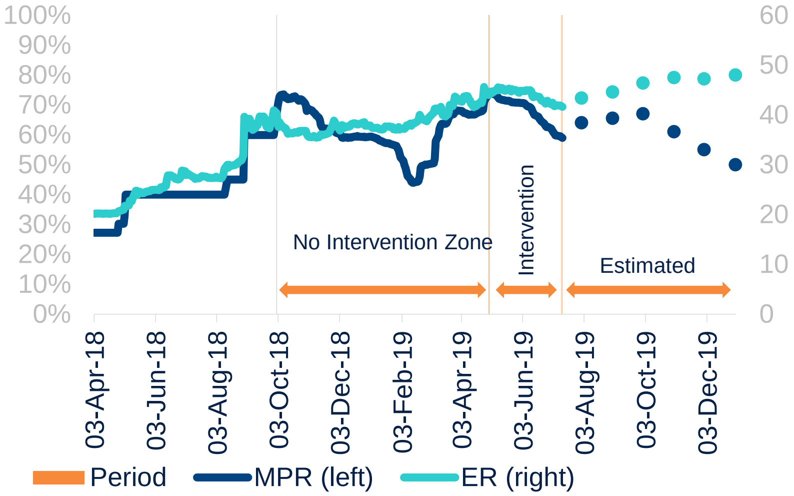
The BCRA's capacity to intervene allowed a *currency truce*

EXCHANGE RATE VOLATILITY AND BCRA INTERVENTION
(STANDARD DEVIATION % 10 DAYS AND USD MILLIONS)



Source: INDEC, BCRA and BBVA Research

REFERENCE EXCHANGE RATE (ER) AND MONETARY POLICY RATE (MPR)
(ARS/USD AND %)



Source: INDEC, BCRA and BBVA Research

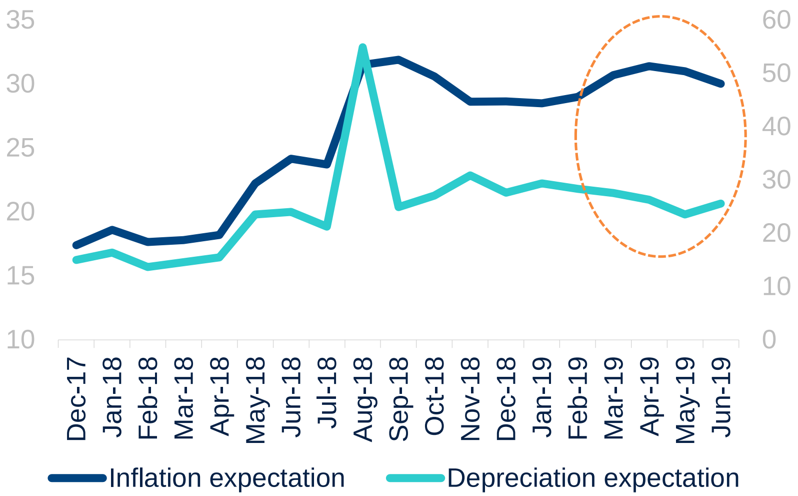
After the announcement of greater capacity to intervene, FX rate volatility declined without the need for the BCRA to intervene.

We expect volatility to return in step with the electoral process, but the BCRA will maintain a strong monetary tightening and will use its foreign exchange tools until political uncertainty dissipates.

Reduced exchange rate volatility and maintenance of contractionary monetary policy lower inflation and expectations

DEVALUATION EXPECTATIONS AND INFLATION EXPECTATIONS

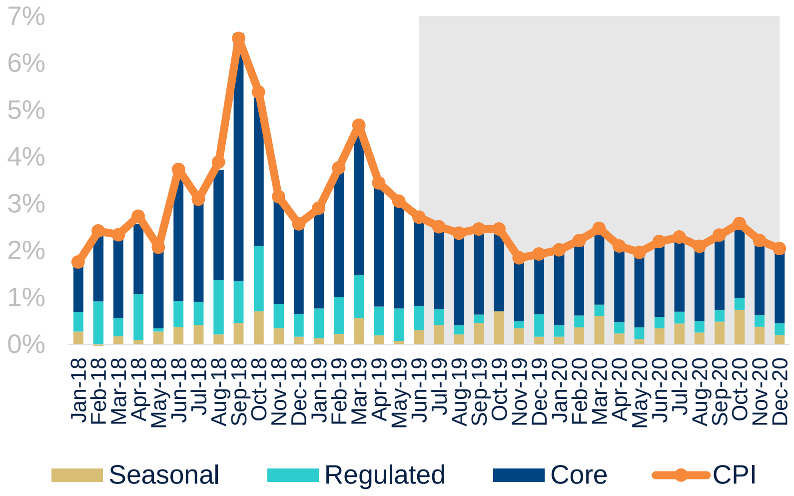
(IN %, 12-MONTH VARIATIONS)



Source: REM BCRA and BBVA Research

INFLATION AND CONTRIBUTION BY COMPONENT

(IN %, 12-MONTH VARIATIONS)



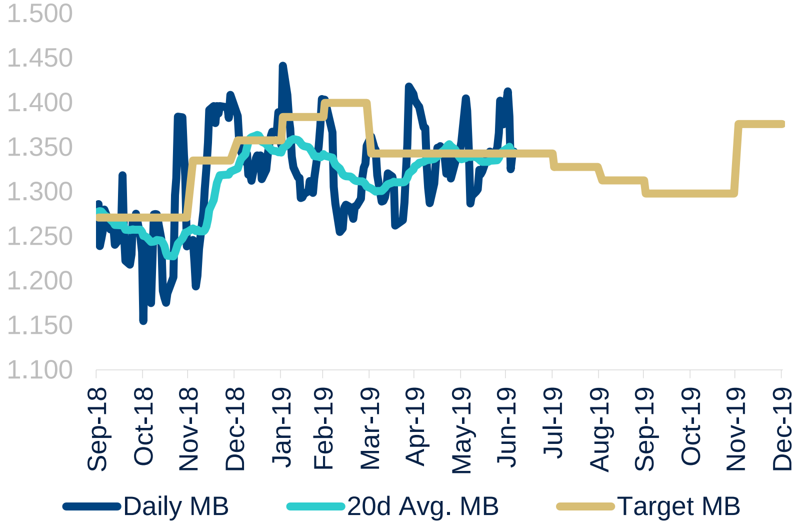
Source: INDEC and BBVA Research

Lower depreciation expectations tamed inflation expectations. In 1H19, inflation reached 22% but until June has been declining for three months in a row.

Based on a continuing of current FX and monetary policy, we have kept our inflation estimate at 40% for 2019 and 30% for 2020.

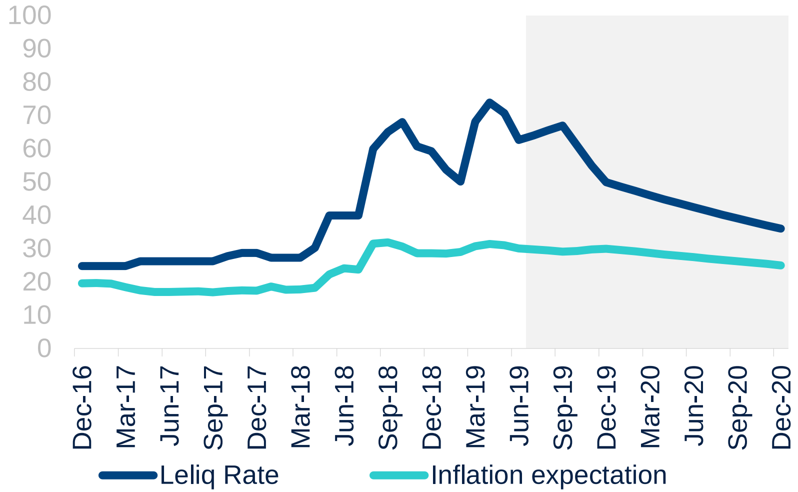
Maintaining monetary tightness is key to further moderating volatility

MONETARY BASE AND 7-DAY LIQUIDITY NOTES (LELIQ)
($ BILLIONS)



Source: BCRA and BBVA Research

LELIQ RATE AND FORECAST INFLATION OVER 12 MONTHS
(%)



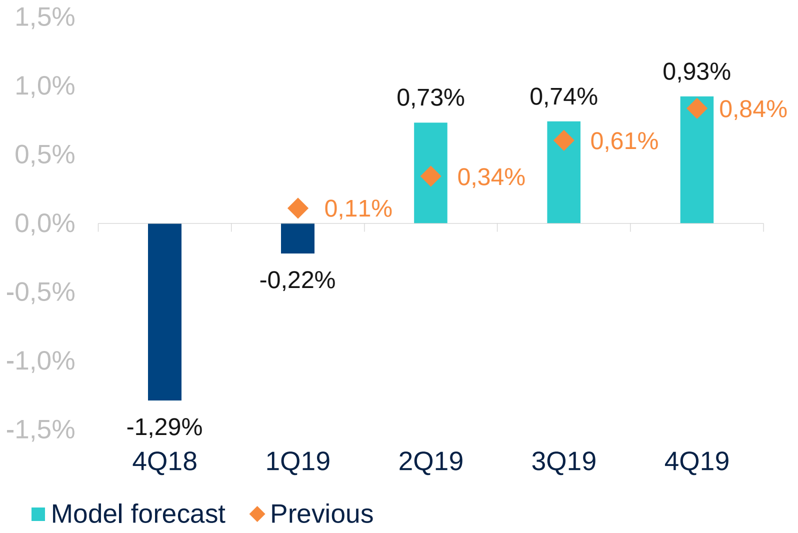
Source: BCRA and BBVA Research

The reserve requirement of term deposits in pesos (freeing up USD 45 bn) was reduced by 3 pp and will be offset by reducing the monetary base target between August and October to neutralize the effect.

Once political uncertainty clears and the demand for money recovers from the current lows, interest rates could fall, but would still be positive in relation to inflation expectations.

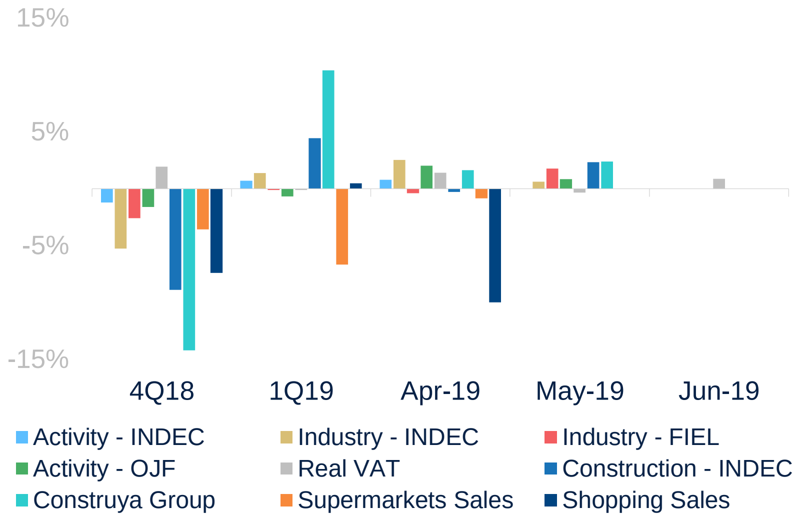
Activity curbed by monetary restrictions, despite the agricultural boost and exchange rate stability

REAL GDP: MICA MODEL FORECASTS
(% VAR. Q/Q, SEASONALLY ADJUSTED)



Source: INDEC, IERIC, BCRA and BBVA Research

ACTIVITY INDICATORS
(VAR. %, SEASONALLY ADJUSTED Q/Q AND M/M FOR APR-MAY-JUN)



Source: BBVA Research based on data from INDEC, the Ministry of Finance, FIEL, OJF and Grupo Construya

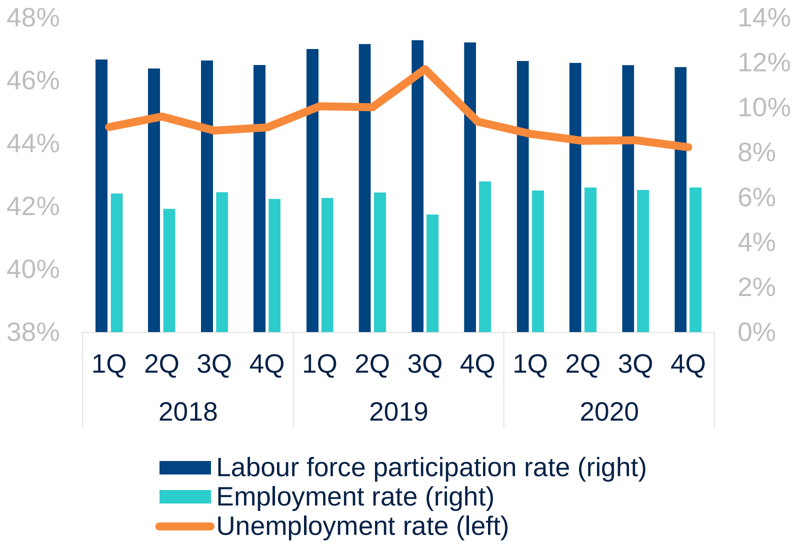
Quarterly growth in 1Q19 was slightly negative due to high interest rates and increased FX rate uncertainty in March. However, we estimate 0.8% q/q growth in 2Q19 driven by agricultural activity.

Activity shows a slight recovery in 2019. Although consumption remains subdued, most indicators grew in the first semester and remain in positive territory, driven by agriculture and *Vaca Muerta* oil production.

As a result, unemployment has increased and wages have not recovered

EVOLUTION OF LABOR INDICATORS

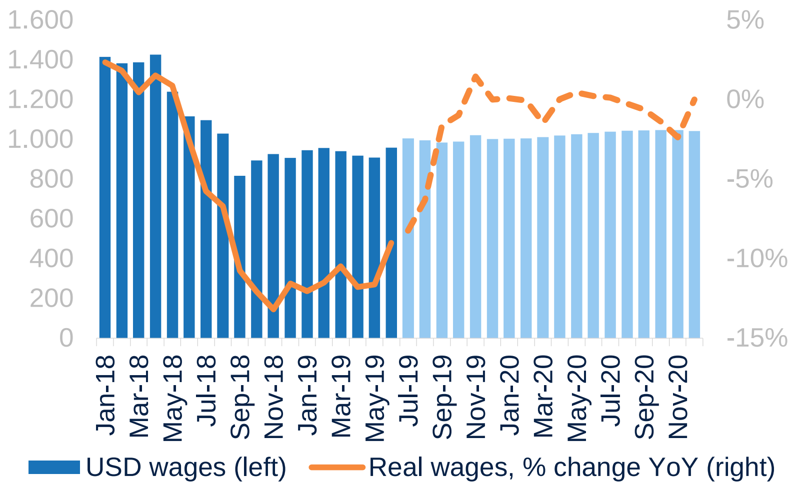
(%)



Source: BBVA Research based on data from INDEC

WAGES AND PURCHASING POWER

(WAGES MEASURED IN USD; REAL SALARY VARIATION IN %)



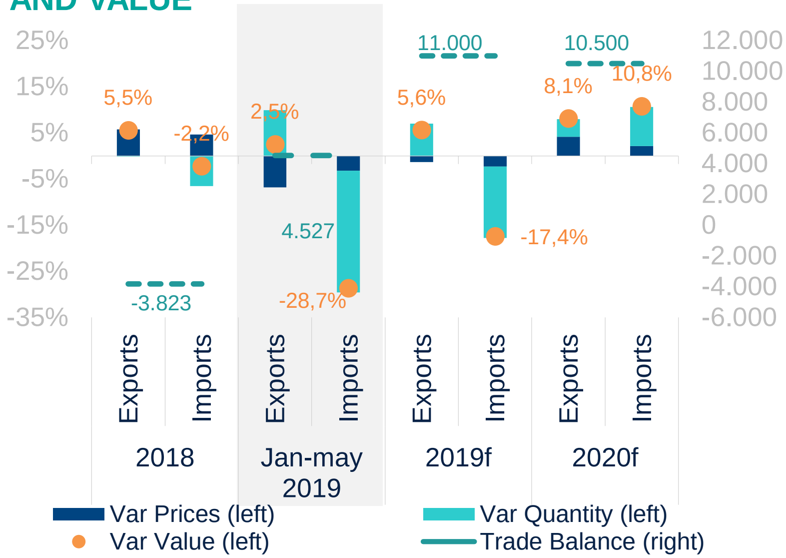
Source: BBVA Research based on data from INDEC

Since the crisis deepened in April 2018, more than 220,000 private sector jobs have been lost. In contrast, public employment grew slightly during the same period (+19,000 jobs) while the collapse of real wages has a restraining effect.

The large fall in real wages of 2018 had a strong negative carry-over effect on 2019 that will not enable their full recovery. However, FX stability, declining inflation and wage bargaining anchored to the CPI cushion the fall.

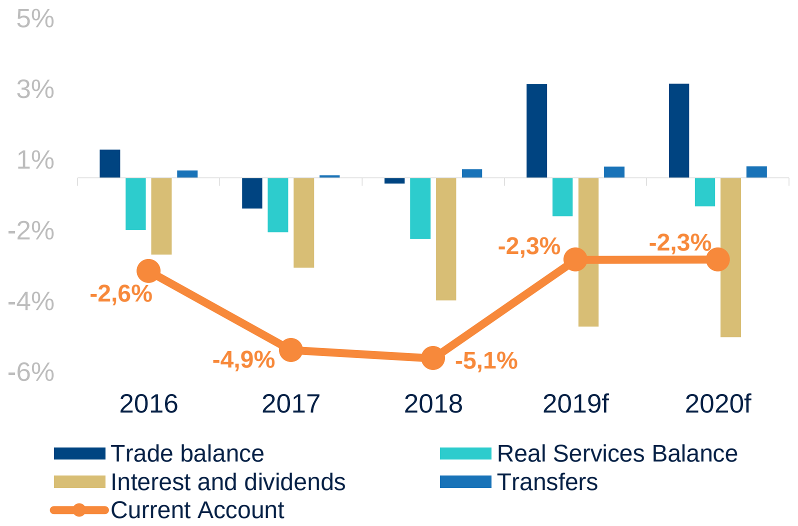
Adjustment in the external sector is driven by the exchange of goods and services

TRADE BALANCE: BALANCE IN MILLIONS OF DOLLARS AND VARIATION (%) IN PRICE, QUANTITY AND VALUE



Source: BBVA Research based on data from INDEC

CURRENT ACCOUNT AND ITS COMPONENTS (AS A % OF GDP)



Source: BBVA Research based on data from INDEC

The sharp fall in imports for 2019 due to devaluation and the drop in GDP and the recovery of exports, will set up a trade surplus of USD11 bn. In 2020, imports will recover due to increased activity but exports will also grow, resulting in a balance of USD 10.5 bn.

The current account will improve strongly from the trade surplus and adjustment to the tourism account. The current account result will be -2.3% in 2019 and 2020, and will not improve further because interest payments remain a burden as debt and dividends grow.

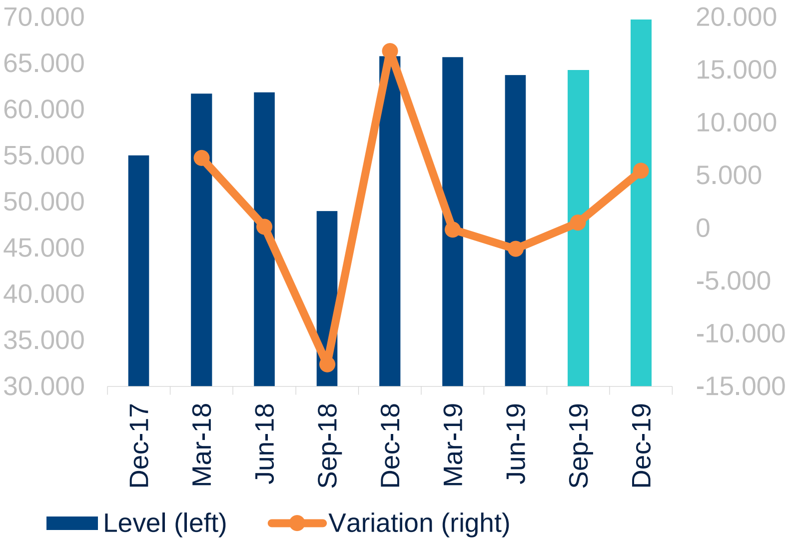
International reserves would grow to a limited extent in 2019 with an improved private sector performance

EXCHANGE RATE BALANCE AND RESERVES (MILLION USD)

Millions of Dollars	Observed 2018	Accumulated May-2019	Forecast 2019	
PRIVATE SECTOR	-44.865	-9.238	-17.995	
Current Account	-4.450	4.855	10.290	
Trade Balance	8.323	9.063	19.236	14.759
Real Services Balance	-9.460	-2.675	-5.614	
Interest + others transferences	-2.109	-899	-2.112	
Dividends	-1.204	-635	-1.220	
Capital Account	-40.415	-14.093	-28.285	
Direct Investment	2.424	1.539	3.032	
Short Term Investment	-6.184	-1.291	-4.039	
Loans + Credit lines	-456	-1.036	-2.935	14.000
Dollarisation of Portfolios	-27.230	-9.532	-18.695	
Bonds trading + others	-8.969	-3.773	-5.649	
PUBLIC SECTOR	46.816	2.518	9.949	
Current Account (interests)	-6.879	-3.662	-9.477	-36.868
Capital Acccount	53.696	6.180	19.426	
Others net movements	2.661	2.942	5.688	
Concept not informed by client (net)*	6.761	2.804	6.307	
CURRENT ACCOUNT	-11.329	1.193	813	
CAPITAL ACCOUNT	15.942	-4.971	-3.171	
Variation of international Reserves	*10.751*	*-902*	*3.949*	
International Reserves	65.806	64.903	69.754	

(*) Concept that is not taken into account to determine the capital account but for the variation of reserves

INTERNATIONAL RESERVES, LEVEL AND VARIATION (MILLION USD)

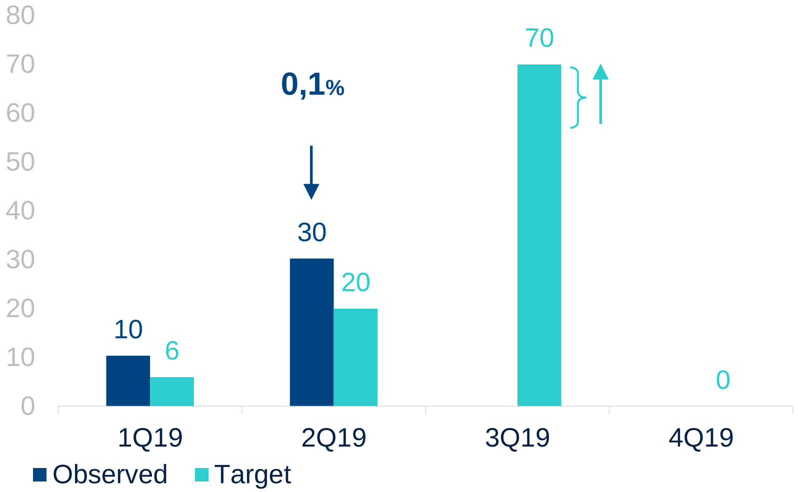


Source: BCRA and BBVA Research

External adjustment alone (balance of goods and services) would generate some USD 14.7 bn more than in 2018 on the **current account.** Meanwhile, on the **capital account** side, lower portfolio dollarization and less short-term investment withdrawals represent additional USD 14 bn. However, the public sector will have less income (loans) in 2019 and higher interest payments.

2Q19 fiscal target was met and a USD 5.4 billion disbursement was made by the IMF

CUMULATIVE PRIMARY FISCAL RESULT, OBSERVED VS. TARGET
($ BILLIONS)



Source: Ministry of Finance and BBVA Research

ALLOCATION OF IMF DISBURSEMENTS IN 1H19
(USD BILLIONS)

	ARS	USD	Total
FMI disbursements (1)	**0**	**18.400**	**18.400**
Currency sales	**4.500**	**-4.500**	**0**
Sales to Central Bank	1.500	-1.500	0
Auctions	3.000	-3.000	0
Balance after sales	**4.500**	**13.900**	**18.400**
USES	**4.424**	**12.658**	**17.082**
Interests	**1.900**	**4.923**	**6.823**
Private and IFIs	1.900	4.923	6.823
Capital	**2.524**	**7.735**	**10.259**
IFIs (net)	0	1.502	1.502
Private	2.524	6.233	8.757
AVAILABLE FUNDS	**76**	**1.242**	**1.318**

(1) USD 7,6 billon on Dec 21,2018 and USD 10.8 billon on Apr 9, 2019.

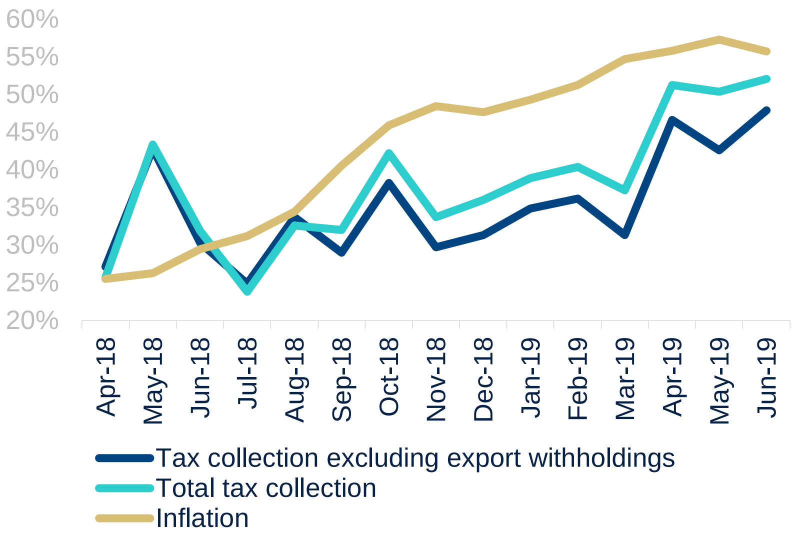
Source: Ministry of Finance and BBVA Research

The June deficit fell 88.4% y/y, as revenue of USD 44.6 bn (sales of fixed assets of public companies) allowed the 2Q19 target to be exceeded. The cumulative 3Q19 target was raised from USD 60 to 70 billion.

The IMF stated that the markets have stabilized, the fiscal and external situation is improving, the monetary policy is prudent and economic activity is slowly recovering, although it believes inflation is still high.

Despite the good performance in 2019, the 2020 fiscal target will require increased taxes or further spending adjustments

TAX REVENUE AND INFLATION
(VAR. % Y/Y)



Source: Ministry of Finance, INDEC and BBVA Research

ANNUAL FISCAL TARGETS
(% GDP)

	Total revenues	Total expenditures	Primary result
2016	19,8	24,0	-4,2
2017	18,8	22,6	-3,8
2018	17,8	20,1	-2,3
Jun-19 (last 12m)	18,5	19,7	-1,2
2019 Target			**-0,5**
2020 Target			**1,0**
pp change			
Var. 2018-2016	-1,0	-1,4	0,4
Var. 2018-2017	-1,0	-2,4	1,5
Var. 2019-2018			0,7
Var. 2020-2019			**1,5**

Source: Ministry of Finance, INDEC and BBVA Research

Tax revenue grew by 52% in June but still below inflation. Although the increase in export duties has had a positive effect, it will probably fail to neutralize the weakness of other taxes this year.

The goal of achieving the primary result target with adjustments of -0.5% of GDP will require further primary expenditure adjustments in 2019. A further reduction in the primary result, equivalent to 1.5 pp of the GDP in 2020, looks more complicated.

The EU–Mercosur agreement: an opportunity to boost trade

The trade blocs finally reached a political agreement to implement the free trade agreement, which will affect 780 million people. The treaty must still be ratified by the parliaments of both blocs' member countries, which will take time.

The agreement has great potential to create trade and increase the international integration of Mercosur countries, especially Argentina and Brazil, its two largest and most closed economies. The agreement will also promote greater intra-Mercosur exchange by stimulating the reduction of existing non-tariff barriers and reforms to increase productivity.

The EU will liberalize almost 100% of its trade in industrial goods and 81.7% in agricultural products (17.7% will have quotas and 100 agricultural products are excluded).

Mercosur will progressively liberalize 90% of its industrial products (average of 10 years), including automobiles (35% tariff), auto parts (14–18%), machinery (14–20%), chemicals (up to 18%) and pharmaceuticals (up to 14%).

Mercosur countries will establish legal guarantees to protect 357 high-quality European food and beverage products—recognized as geographical indications (GIs)—from being imitated.

According to World Bank estimates, the agreement could increase Argentina's exports to the EU by 80% by 2030.

Beyond trade, the agreement will strengthen political dialog and enhance cooperation in areas such as migration, the digital economy, research and education, human rights, environmental protection, etc.

Annual macroeconomic forecasts

	2017	2018	2019 (e)	2020 (e)
GDP (% YoY)	2,7	-2,5	-1,2	2,5
Inflation National CPI (% YoY, eop)	24,8	47,6	40	30
Exchange Rate (vs. USD, eop)	17,7	37,9	48	60
Monetary Policy Rate (%, eop)	28,8	59,3	50	36
Private Consumption (% YoY)	4	-2,4	-6,3	2,2
Public Consumption (% YoY)	2,7	-3,3	-0,1	-1,1
Investment (% YoY)	12,2	-5,7	-13,8	5
Total Fiscal Result (% GDP)	-5,9	-5	-3,8	-2,3
Current Account (% GDP)	-4,9	-5,1	-2,3	-2,3

(e) Estimate.
Source: BCRA, INDEC, Haver and BBVA Research

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