

SITUACIÓN ARGENTINA: EXECUTIVE SUMMARY Second Quarter 2008

In 2008, we expect the Argentinian economy to grow by 7.5%, still significantly above its long term potential, but 1.2 pp below the 2007 level. Demand indicators from the first quarter of the year do not show clear signs of a slowdown from the end of 2007, but some indicators on the supply side do point to this, especially those impacted by the strikes in the agricultural sector. This should also have a partial effect on the economic activity indicators of the first quarter, but we think that no impact will be seen on the year overall, unless the action becomes more intense. The soya harvest and industrial use of soya could continue beyond the second quarter, due to some bottlenecks in transport and ports, affecting the seasonal data, but not the annual total.

The restrictions on energy supply which could arise in the event of a very severe winter will be temporarily alleviated by the higher imports of oil and gas that the trade surplus allows. As in 2007, manufacturing industry should adapt its seasonal production patterns to the availability of energy, accumulating inventories in periods when climate conditions are more favourable.

In the external sector, imports will continue to grow faster than exports, although capital goods imports will grow at a slower pace, as investment in the agricultural sector falls due to the imposition of the sliding scale tax system. But investment will continue to be the most dynamic segment of demand, thanks to the recovery of the construction sector. In addition, private consumption will drive most of the growth, with public spending slowing down.

In a context of a slight deceleration in growth, we expect the unemployment rate to continue to fall to 6.5% at the end of 2008, although at a slower pace than at the start of the recovery, as it is now moving close to the record low for unemployment in Argentina. Registered private salaries will have an average nominal increase of around 20.0% in the year, in line with the official target and with the first collective agreements that have been announced (Truckers, Bankers, Retail, among others).

The upside pressure on the consumer price index does not only reflect external factors, such as the high prices of raw materials, but also internal factors, mainly a rise in internal spending of above 9% per year, well ahead of potential GDP growth, which we estimate to be about 3.2% per year.

The public finances also reflect the solidity of the economic growth, with rises in VAT and Social Security collection of close to 35% in the first quarter. But the most substantial impact on the health of public finances has come from the rise in the international prices for agricultural raw materials. In 2007, export taxes accounted for 78% of the primary figure, and this allowed an 83% rise in subsidies without a deterioration in the fiscal surplus. However, this is also the main risk factor for Argentina, as a fall of 30% in the prices of these raw materials from our base case scenario would result in a reduction of the budget surplus by about 1.3% of GDP. Although the increase in public spending has slowed from 44% in 2007 to 35% now,

this is not enough to protect the economy in the event of a deterioration in the terms of trade. The situation would be even more difficult if the impact of the subsidies to the energy and transport sectors is noted, and in 2008 these subsidies will be joined by new subsidies to small agricultural producers, to compensate for the rise in taxes.

The boom in agricultural raw material prices is also a key factor in explaining the solidity of the external accounts of Argentina. Even assuming a slight moderation in these prices, as we are beginning to see, compared to the high levels of the first quarter, the terms of trade should improve by 14% in 2008, with exports reaching a record level of US\$74 billion. The trade surplus will be close to US\$14 billion, similar to the level seen in the period immediately following the crisis of 2001, when imports collapsed. However, this apparent strength in the external accounts masks some very different dynamics in real terms, as the significant rise in imports which has accompanied the economic recovery has led to a fall in the trade balance in constant prices of 74% from 2002 to 2007. If the expected moderation in raw material prices continues in 2009, the deterioration in the terms of trade would lead to a fall in the trade surplus to one third of the forecast for 2008, and to the disappearance of the current account surplus.

In the first months of the year, there have been no changes to the course of the monetary policy set by the Central Bank, which is focused on its main priorities: maintaining the nominal exchange rate, accumulating international reserves, and meeting its monetary targets.

In terms of monetary demand, the relation between monetary aggregates and GDP is tending to stabilise, in other words, the stage of the economy in which there was rapid money supply growth is now over, reducing the freedom to act of current monetary policy.

Lending continues to rise at almost twice the rate of deposits, from the very low levels post-convertibility. Until now, deposits have been the main source of funding for the loans, but in the future (see the special analysis in the Financial System chapter), lending growth will require other sources of funding, such as an additional reduction by banks of public risk, and access to internal and external financing sources which have until now been almost absent.

In our scenario of a continued large external surplus, the Central Bank will have to intervene actively in the foreign exchange market to moderate the pressure on the peso to appreciate. Reflecting this policy, the nominal exchange rate should be around \$3.23/US\$ at the end of the year. But the real exchange rate to the dollar will continue to appreciate over the course of the year, reflecting the spread between inflation in Argentina and inflation in the US, although our econometric analysis indicates that the bilateral exchange rate is reaching its equilibrium level. It is likely that the peso will continue to appreciate in real terms to the dollar, both because of the impact of the improved relative productivity of Argentina, and because of the rise in export prices. For the multilateral exchange rate, which is more relevant than the bilateral rate when valuing the equilibrium exchange rate, the peso is still at a very depreciated level and the room for appreciation is larger. However, in a

scenario of risk, with an exit of capital, a greater intervention would be needed from the BCRA, including losing its reserves, in order to avoid a depreciation of the currency.

Finally, the interest rate that banks pay on deposits continues to be negative in real terms, reflecting partly a real exchange rate which is still above its equilibrium level. As this becomes increasingly negative, as indicated by the rise in inflation expectations in the private sector, the positive output gap will widen, with the corresponding increase in inflationary pressure.