

Argentina: On Borrowed Time

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INSTITUTE OF
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- Monetary policy has remained tight while fiscal consolidation has been postponed.
- Increased external capital market access is helping finance the macro policy mix.
- The government hopes for a turnaround in the economy ahead of the 2017 mid-term elections as broader political support to pass pro-market reforms is needed.
- We project a modest rebound in activity and a sharp drop in inflation next year.
- Higher dollar borrowing costs from the expected policy shift by the Trump administration intensify the urgency of a forceful fiscal adjustment.

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BINDING POLITICAL CONSTRAINTS

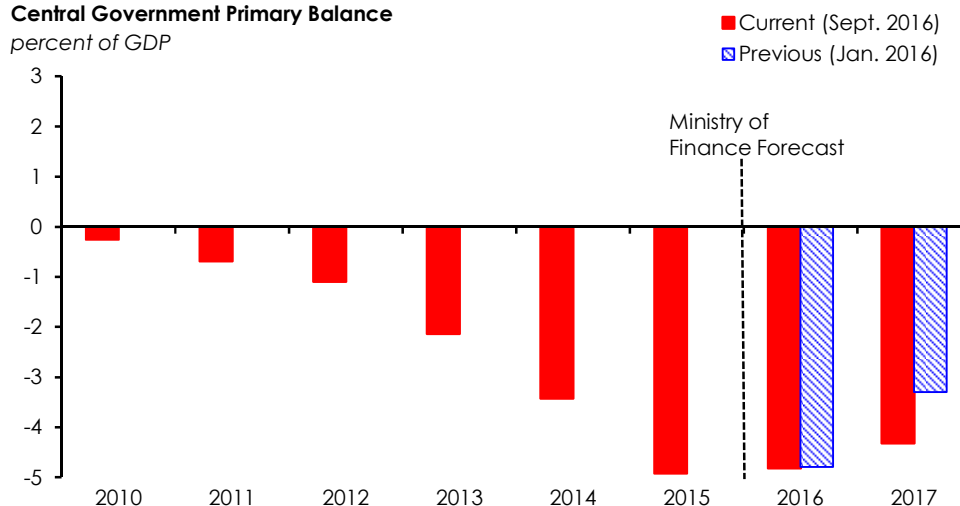
After forceful monetary and FX policy corrections early in the year, the government has adopted a more gradual policy approach amid fragile political and social conditions. The main goal is to win next year's mid-term elections supported by a buoyant economy. As a result, fiscal consolidation has been postponed, but this has not dampened strong foreign demand for Argentine debt following the settlement with holdout creditors (Chart 1). Inflation is on a downward trend following a spike at the beginning of the year, which has prompted the central bank to cut rates more recently. We project a modest recovery in activity in 2017 after a contraction this year, on the back of continued fiscal support, a stronger agricultural sector, and some growth revival in Brazil. Sustained growth, however, would require implementing productivity-enhancing reforms and overhauling public finances, particularly against a more volatile global backdrop. If Trump's policy shift induces further increases in external borrowing costs, fiscal adjustment will become more urgent. Addressing the fiscal imbalance would boost inflation-fighting efforts, lift confidence and reduce the country's exposure to swings in market sentiment.

**Inflation is on a
downward trend**

Chart 1

Central Government Primary Balance

percent of GDP



Source: IIF, Ministry of Finance.

GRADUAL FISCAL CONSOLIDATION

The initial policy corrections took a toll on the government's political capital in 2016H1. A temporary spike in inflation eroded household purchasing power, tighter monetary policy weighed on growth, and involvement of the judiciary that watered down and delayed public utility tariff hikes also weakened public support (Chart 2). As a result, the administration has shifted its policy strategy ahead of next year's midterm elections, when one-third of the Senate and half of the Lower House seats will be up for grabs.

With the aim of boosting short-term growth and minimizing social tension, the government has maintained a fiscal stimulus by increasing pension and unemployment benefits, boosting transfers to provincial administrations, expanding social subsidies, and lowering taxes on small and medium-sized enterprises. The pace of removal of subsidies to the private sector, which have been used to keep utility tariffs low, has also been slowed compared to original plans. Thus, the primary fiscal deficit is estimated at 4.8% of GDP in 2016, broadly unchanged from the previous year's imbalance. The authorities now target a primary fiscal deficit of 4.2% of GDP in 2017, above their initial goal of 3.3%.

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TAPPING THE MARKETS

The deal with holdout creditors, the global search for yield, low external debt, and improved policies have bolstered non-residents' relative appetite for Argentine securities, driving down borrowing costs and allowing the government to delay the fiscal adjustment (Chart 3). The public sector has issued about \$47 billion (8% of GDP) in bonds so far this year, leading to a rise in public debt to 51% of GDP in 2016Q3 from 44%, prior to the peso depreciation in December. This includes placements of peso securities such as a 10-year peso bond issued under local law at a fixed annual rate of 15.5%, which was mostly subscribed by foreign investors (Table 1). The authorities have met financing needs for 2016 and have started to cover estimated total borrowing requirements of 10% of GDP next year.

Table 1
Govt. Debt Issuance in 2016

| \$ billion | |
|-------------------------|-------------|
| Federal | |
| Global Markets: | 24.8 |
| Local Markets: | 14.7 |
| -Bonds | 8.0 |
| -Bills and Notes | 6.7 |
| State and Local* | 7.1 |
| Total | 46.6 |

Source: IIF based on official sources. (*): Global issues only.

Chart 2
Confidence in the Government and Real Wages
index (June 2013=100) scale (1-5, 5=highest)

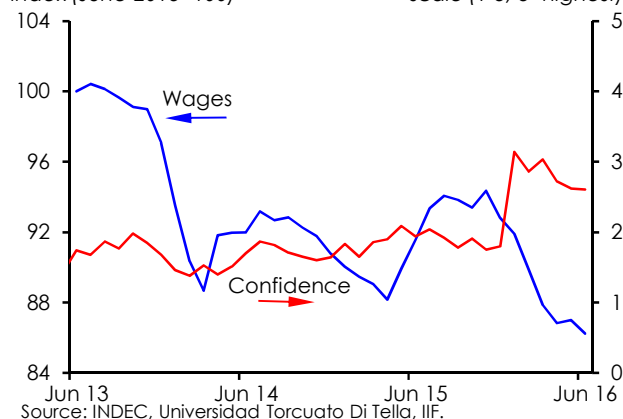
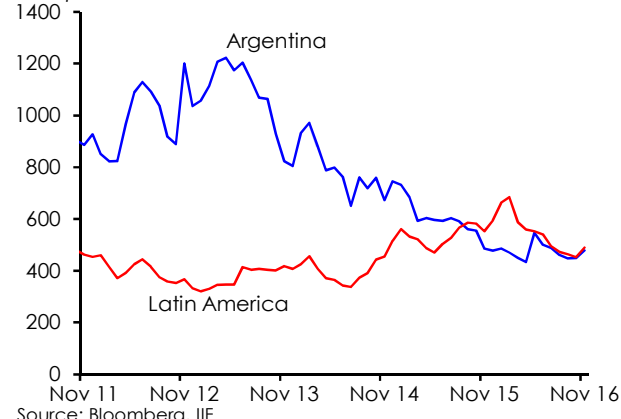
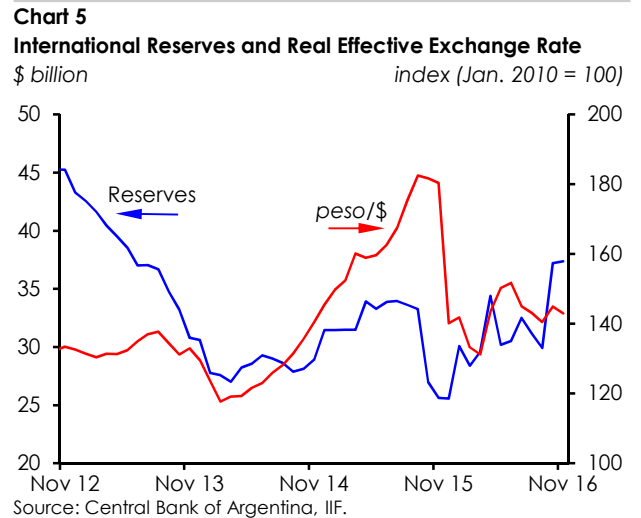
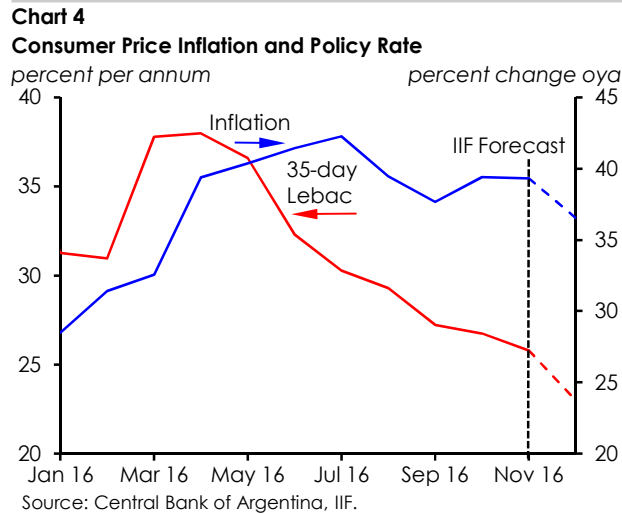


Chart 3
EMBI Spreads
basis points





MONETARY POLICY AT WORK

Monetary policy has led the administration's macro adjustment efforts. Significant tightening at the beginning of the year helped mitigate the *pass through* from the FX realignment to inflation. Twelve-month inflation declined to 38% in October from 43% in July 2016, allowing for some monetary easing thereafter. The 35-day Lebac interest rate, which is currently used as the policy rate, declined to 25% in November from 38% in April (Chart 4). With the aim of further consolidating monetary policy credibility, the central bank has launched an inflation targeting framework to begin operating in January 2017, relying on the seven-day repo interest rate as the main policy instrument (Table 2).

Table 2
Inflation Targets

| | percent change oya |
|-------------|--------------------|
| 2017 | 12-17% |
| 2018 | 8-12% |
| 2019 | 5±1.5% |

Source: Central Bank of Argentina.

Monetary restraint has helped stabilize the exchange rate market. The peso has steadily strengthened this year, although depreciation pressures have resumed recently following the election of Donald Trump. Foreign reserves rose to \$37 billion in November from \$26 billion in December 2015 (Chart 5), reflecting increased portfolio debt inflows. A tax amnesty program, which has attracted about \$8 billion thus far this year in undeclared cash holdings, has also helped prop up the peso.

MAKING PROGRESS

We project the economy to grow 1.8% next year, revised down from a previous forecast of 2.8%, following an estimated contraction of 2.4% in 2016 on the back of a recovery in household purchasing power due to declining inflation, unabated public spending, stronger credit growth, and higher agricultural output. High-frequency indicators suggest that the worst of the recession is over as improved macro conditions gradually permeate the economy (Chart 6). We forecast inflation to decline to 20% next year from 37% in 2016 driven by tight monetary policy. Next year's wage negotiations will be the first major credibility test for the

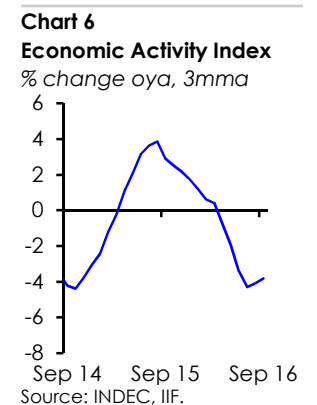


Table 3

Macroeconomic Outlook

| percent of GDP | 2014 | 2015 | 2016f | 2017f |
|--------------------------------|------|------|-------|-------|
| Real GDP Growth (% oya) | -2.5 | 2.3 | -2.4 | 1.8 |
| Inflation (% oya; eop) | 40.6 | 27.2 | 37.4 | 20.6 |
| Exchange Rate (peso/\$, eop) | 8.6 | 12.9 | 16.0 | 18.0 |
| Current Account | -1.4 | -2.6 | -3.0 | -3.3 |
| Net FDI | 0.3 | 1.1 | 1.5 | 1.6 |
| Int. Reserves ex. Gold (\$ bn) | 29.0 | 23.4 | 31.3 | 38.9 |
| Central Gov. Balance | -5.1 | -6.6 | -7.0 | -6.9 |
| Total External Debt | 28.6 | 27.1 | 35.5 | 35.9 |

Source: IIF.

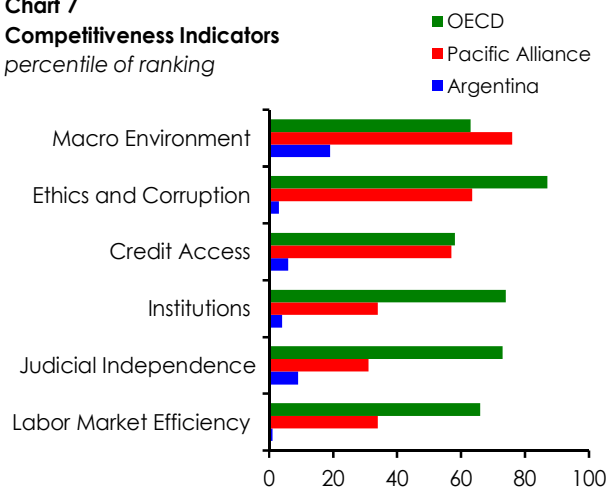
central bank’s anti-inflation strategy as reputation takes time to build and high inflation has eroded real income this year (Table 3).

CHALLENGES AHEAD

Ample availability of external financing has allowed authorities to put fiscal consolidation on hold to maintain political and social support, which is crucial to ensure the sustainability of private sector-led growth policies. While a positive result in the mid-term elections would help the government regain momentum, passing productivity-enhancing reforms in Congress (e.g. reforming the tax system, improving regulatory frameworks to increase market competition, reducing labor costs, and overhauling fiscal and monetary institutions) would still require consensus with other political forces (Chart 7). While this could be difficult to achieve, the government has been able to work out several initiatives with pragmatic factions of the Peronist party this year.

Notwithstanding political and social constraints, a continued sizable fiscal deficit this year could become a drag on growth in the coming years, particularly against a backdrop of heightened global financial volatility. While direct trade linkages with the U.S. economy have declined in recent years, the expected Trump fiscal stimulus policies could translate into a protracted period of higher external borrowing costs, putting the government’s policy strategy of heavy reliance on global capital markets to finance a gradual fiscal adjustment at risk. Nonetheless, sustaining robust growth will require confidence-enhancing fiscal consolidation, including setting a credible multi-year timeframe for balancing the budget. This would help further reduce borrowing costs, bolster private sector investment and achieve a meaningful reduction in inflation, lifting trend growth. Dispelling the risk of chronic fiscal deficits is a major undertaking as periods of progressive and systematic fiscal consolidation are very rare in Argentina.

Chart 7
Competitiveness Indicators
percentile of ranking



Source: 2015-2016 World Economic Forum Competitiveness Index .

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