

A scenic landscape of snow-capped mountains and a lake in Argentina. The image shows a clear blue sky with some light clouds, a range of rugged mountains with significant snow cover, and a calm lake in the foreground that perfectly reflects the mountains and sky. The foreground is a grassy slope. A red rectangular overlay is positioned in the lower-left quadrant, containing the text.

Argentina

AAEP - November 2016

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HSBC, UBA, CEDES

Decoupling?

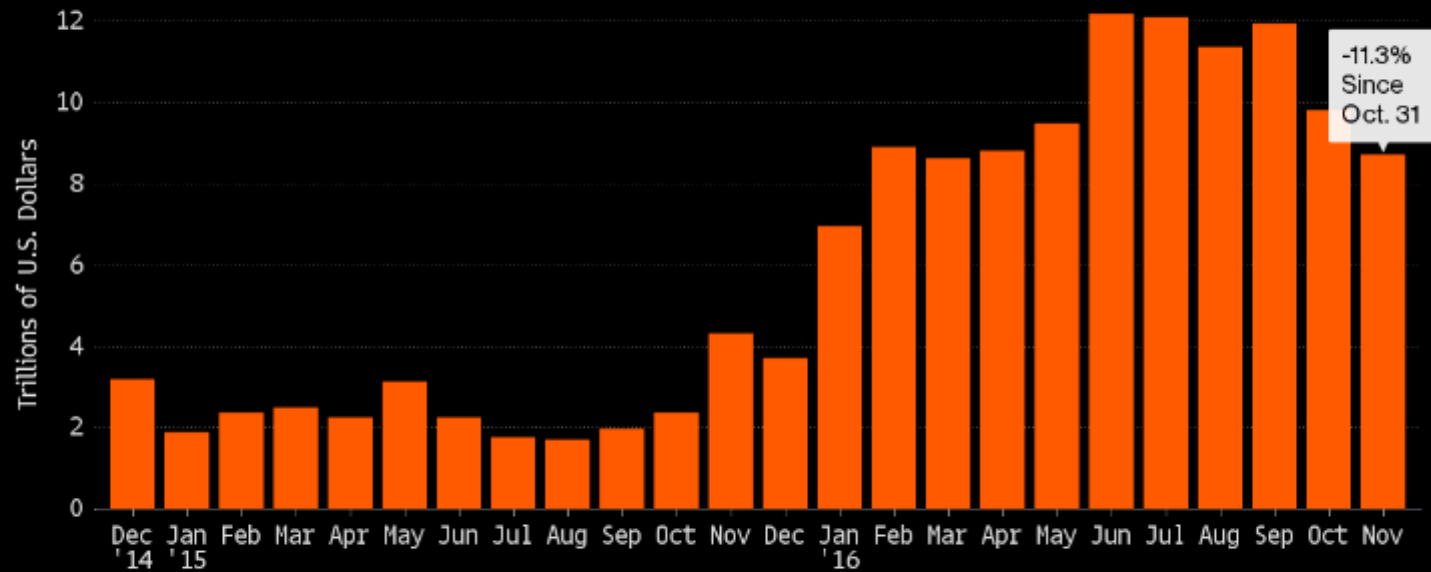
		PROPAGATION	
		Financial	Real
SHOCK	Financial	Contagio	Cost of Capital
	Real		Commodities

Decoupling?

Much Less of Less Than Zero

Worldwide debt with negative yields plunged following Donald Trump's upset win

Market Value of Negative-Yielding Debt*



Source: Bloomberg

*Includes all such bonds in the Bloomberg Barclays Global Aggregate Index as of the end of each month except the last one, which is as of Nov. 11

Bloomberg

A horizontal band with a red tint, containing a background image of a person's face and a window with bars.

Argentina

Impressive pace of reform at the onset

- Sharp currency depreciation
- Liberalization of the capital account
- Reduced tax on exports
- Replenishing liquid central bank reserves
- Significant reduction of the monetary overhang inherited from financial repression
- Steps towards inflation targeting regime
- Settlement and payment to a majority of holdouts. Out of default.
- Electricity, gas, water and transportation tariffs increased
- Rebuilding public statistics bureau
- Significant realignment in foreign affairs policy

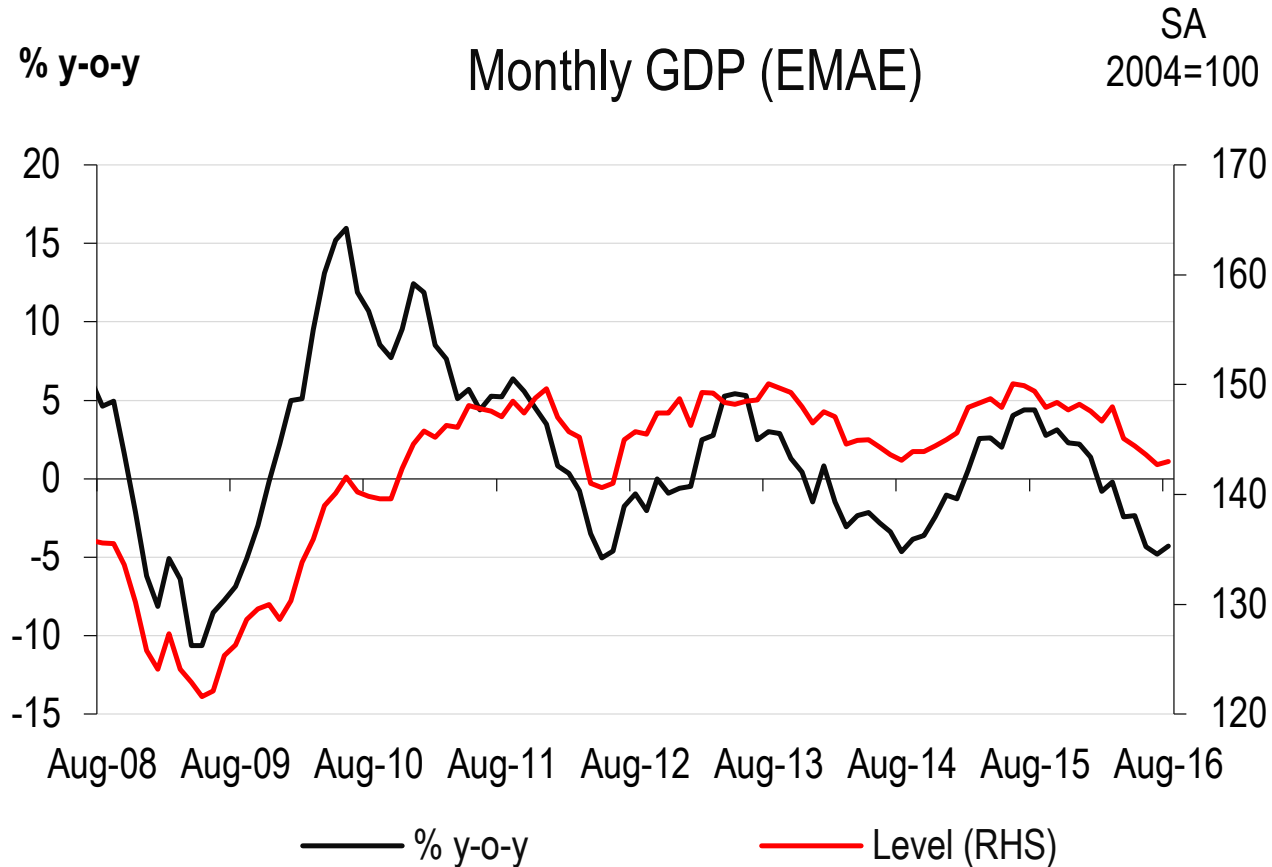
But...

- Initial ARS depreciation partially reverted by inflation
- Import restrictions still in place
- Sterilization is costly
- Renew issuance at a dear cost and in some cases to finance current expenditures
- Fiscal consolidation practically nil
- Partial reversal on tariff adjustment
- Recession is deeper and longer than anticipated
- President Macri approval ratings suffering

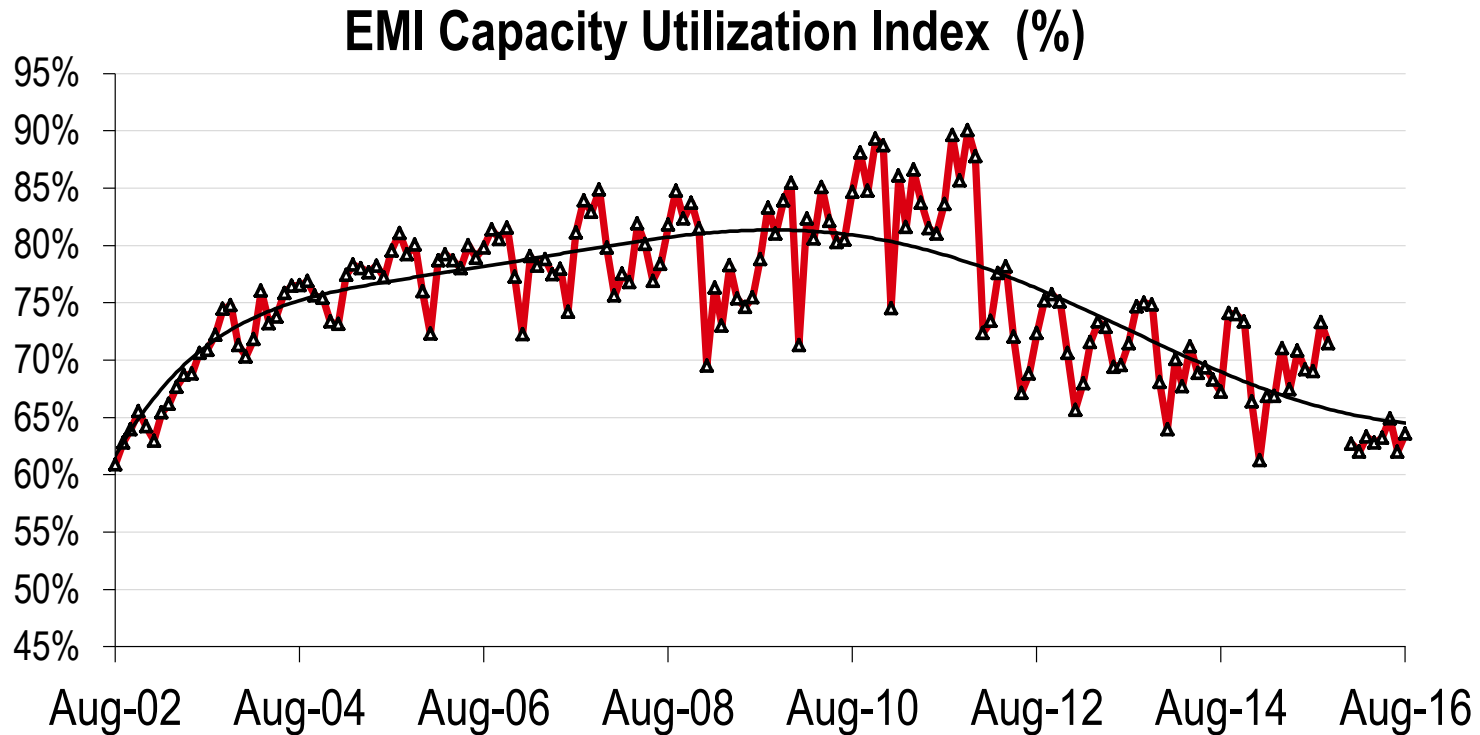
...and challenges

- Recession
- High Inflation → tight monetary policy to continue
- Backward looking wage negotiations → inertia
- Fiscal gradualism or fiscal profligacy?
- Large financing needs: dependence on external debt markets –but wait for tax amnesty
- Sterilization and local debt issuance risk crowding out the private sector
- Support for President Macri has diminished. With no majority in Congress, he needs public support → macro will be a key factor for elections

Recession lasting through 3Q-2016

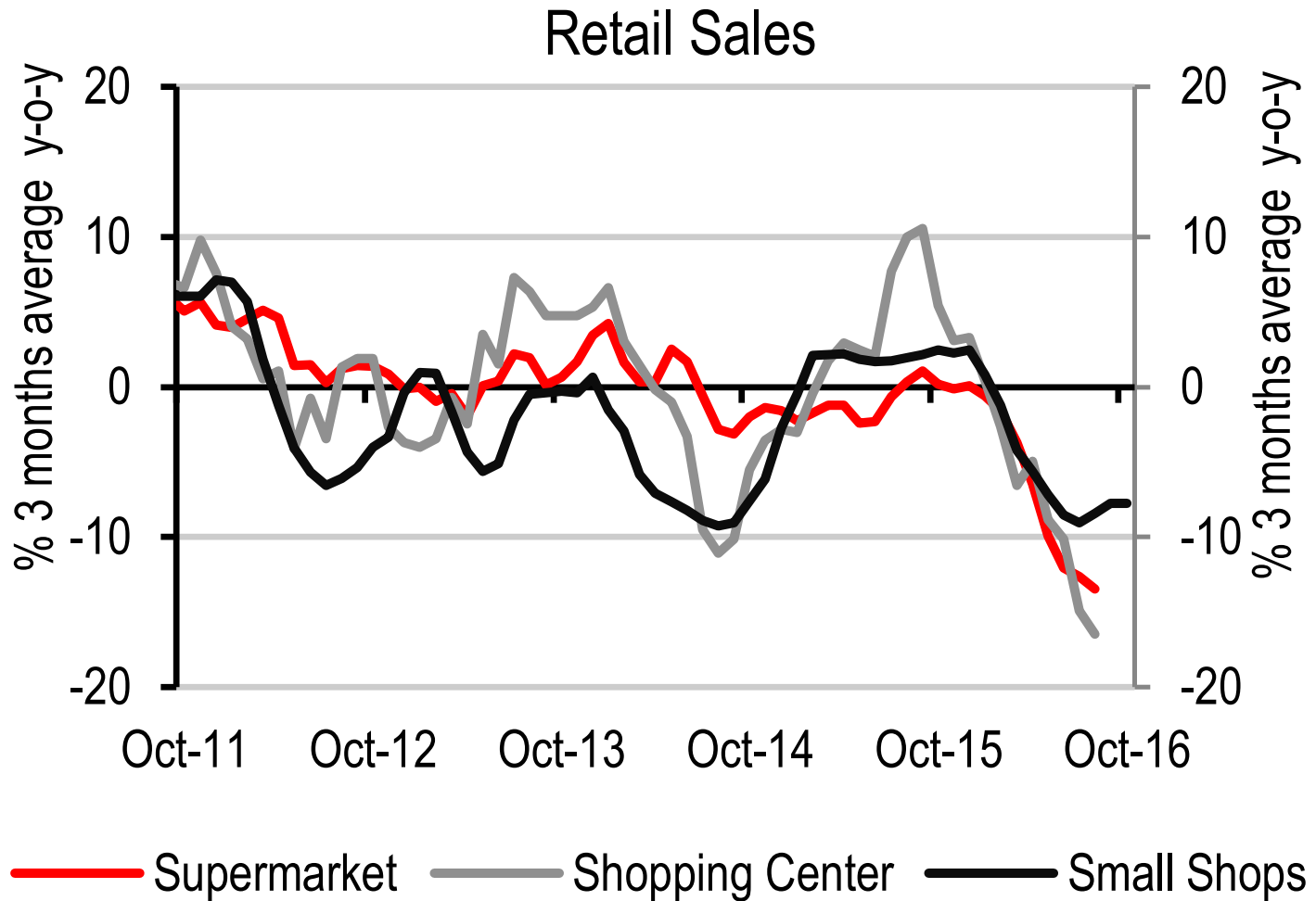


Lots of spare capacity to use before investing

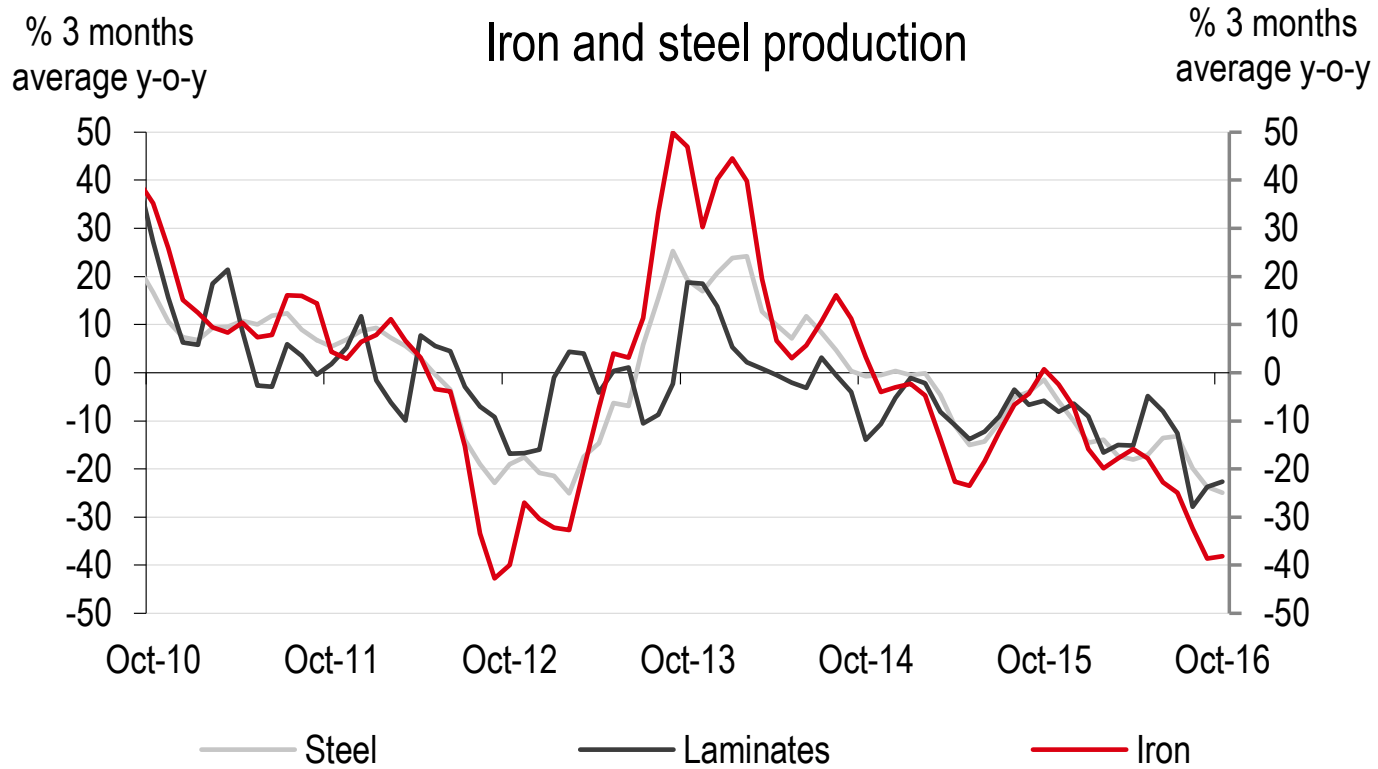


Source: INDEC

Retail sales still falling

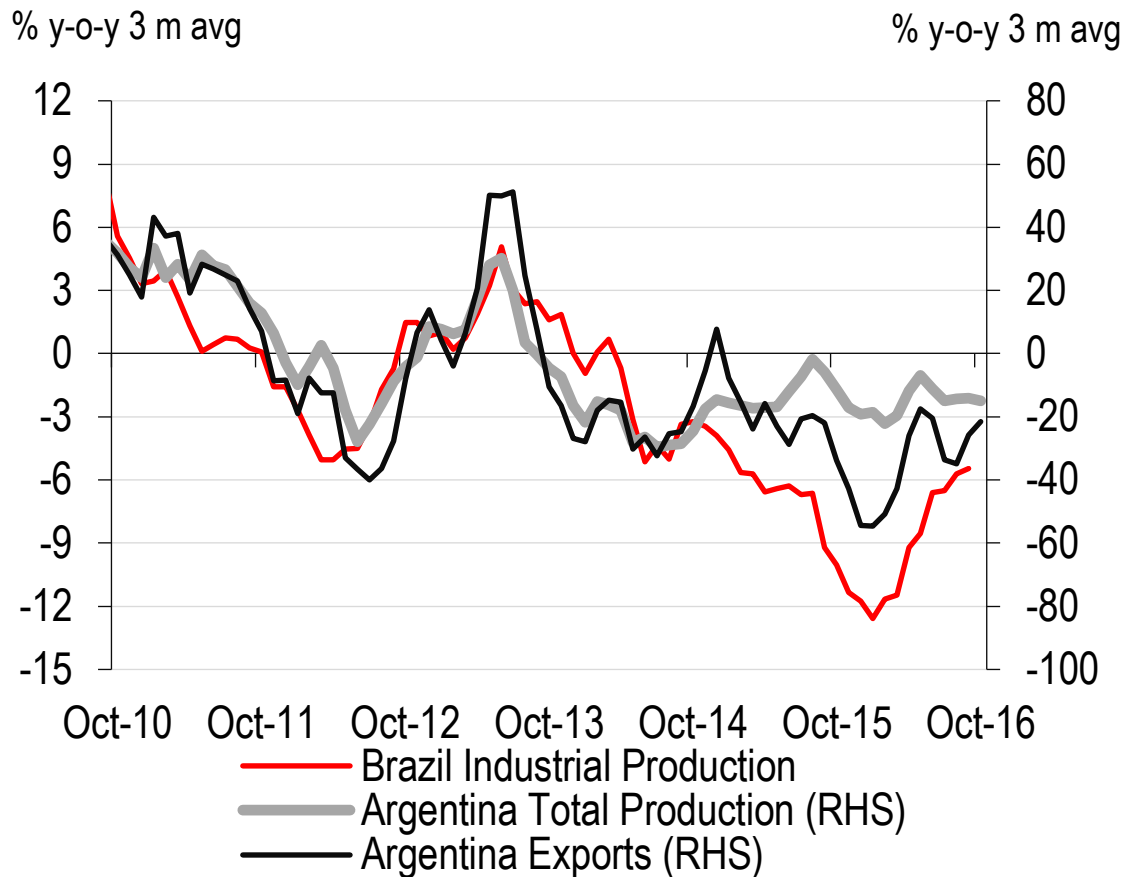


Manufacturing still contracting (1)

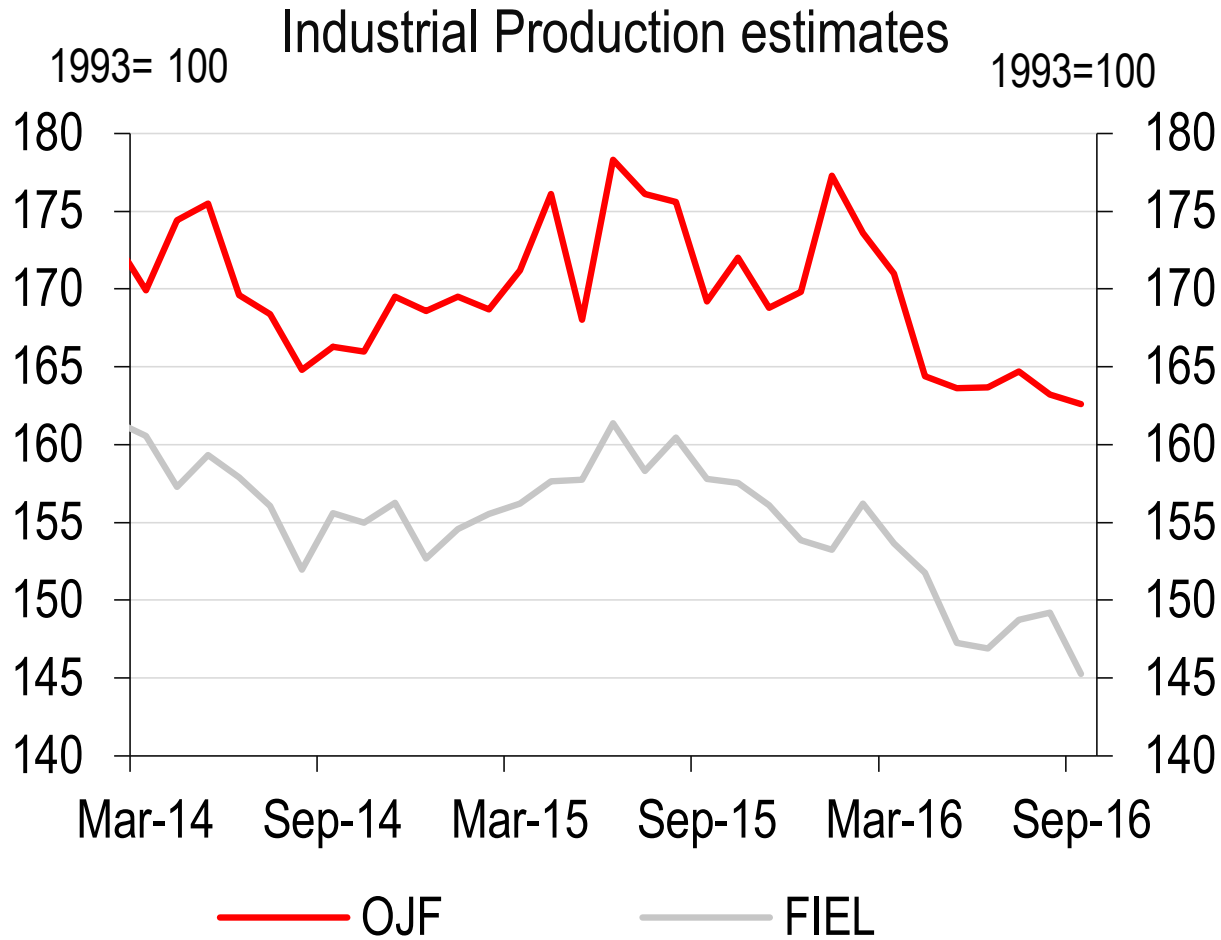


Manufacturing still contracting (2)

Automotive production

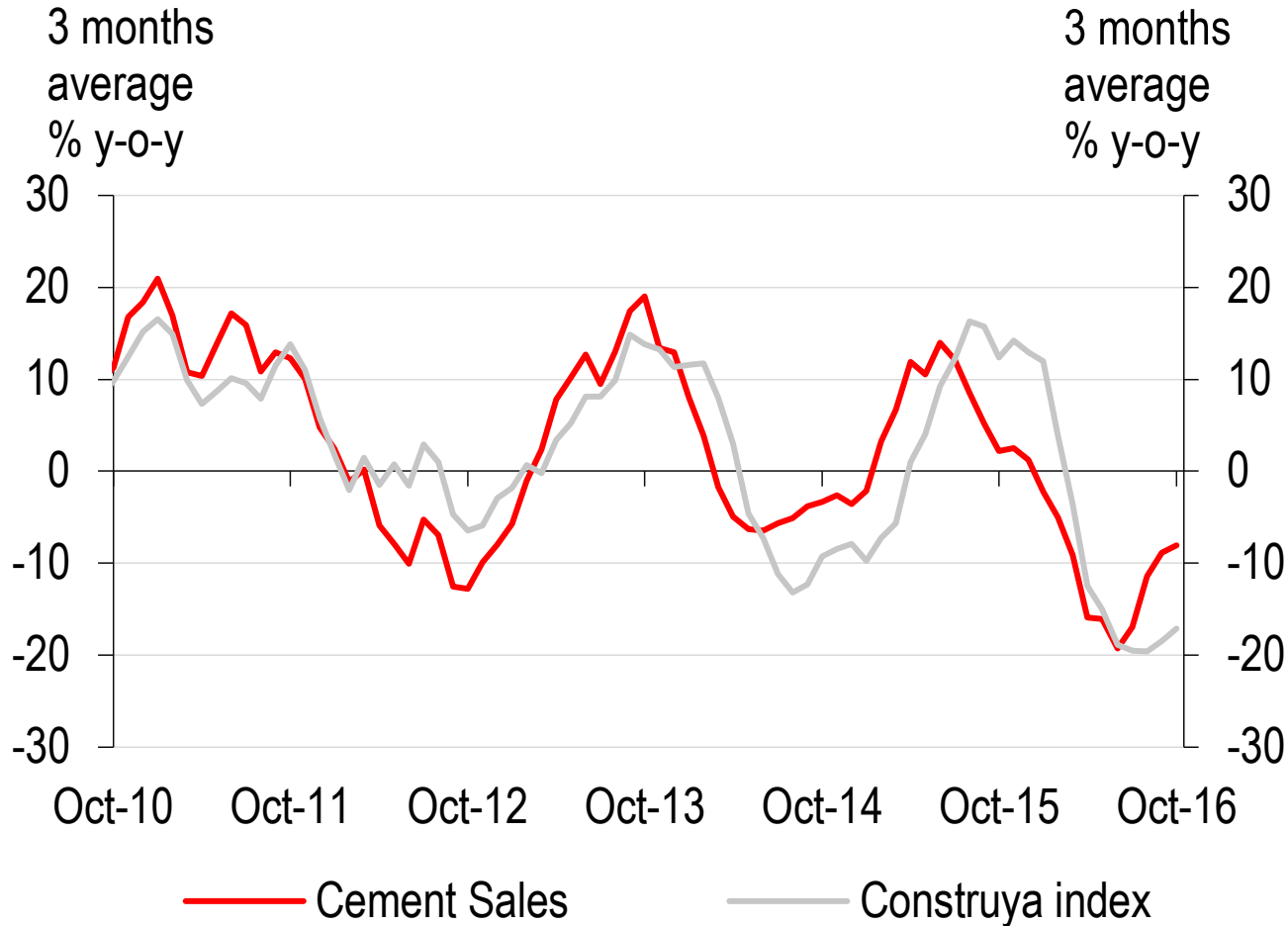


Manufacturing still contracting (3)



No clear signs from construction

Construction activity indicators

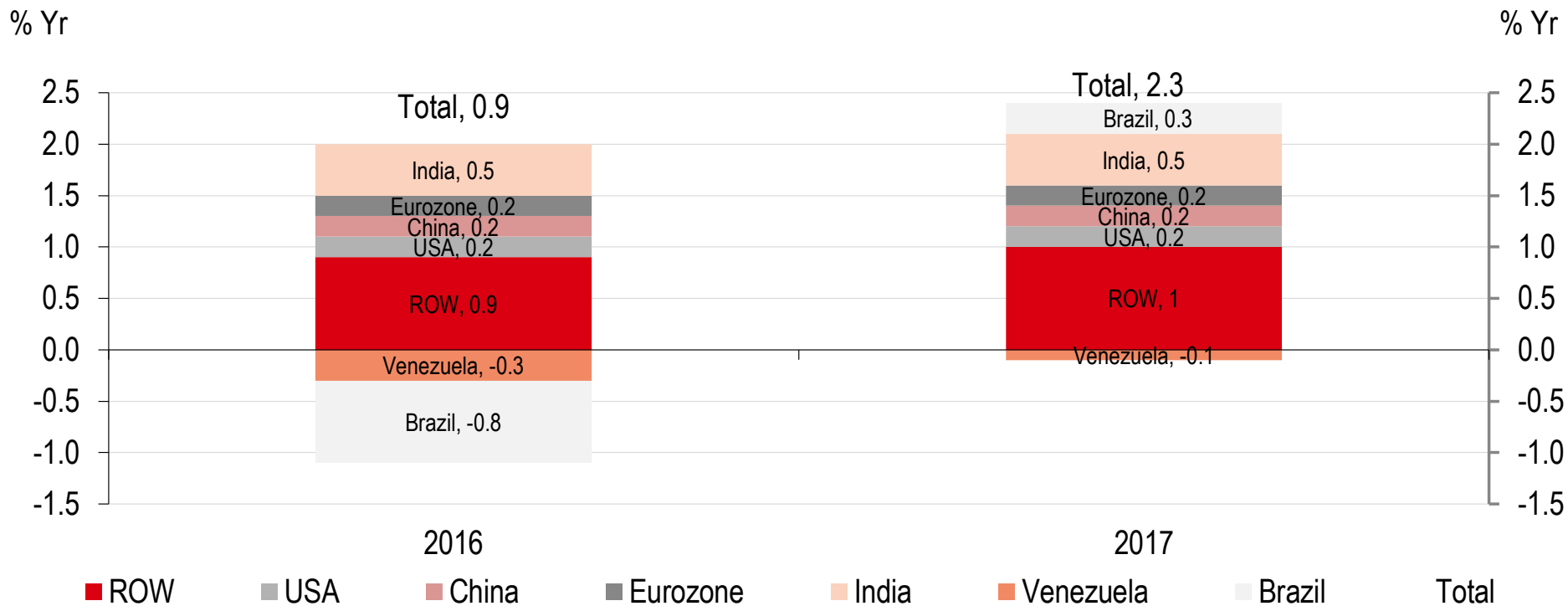


Why is recovery taking so long –and who's to blame?

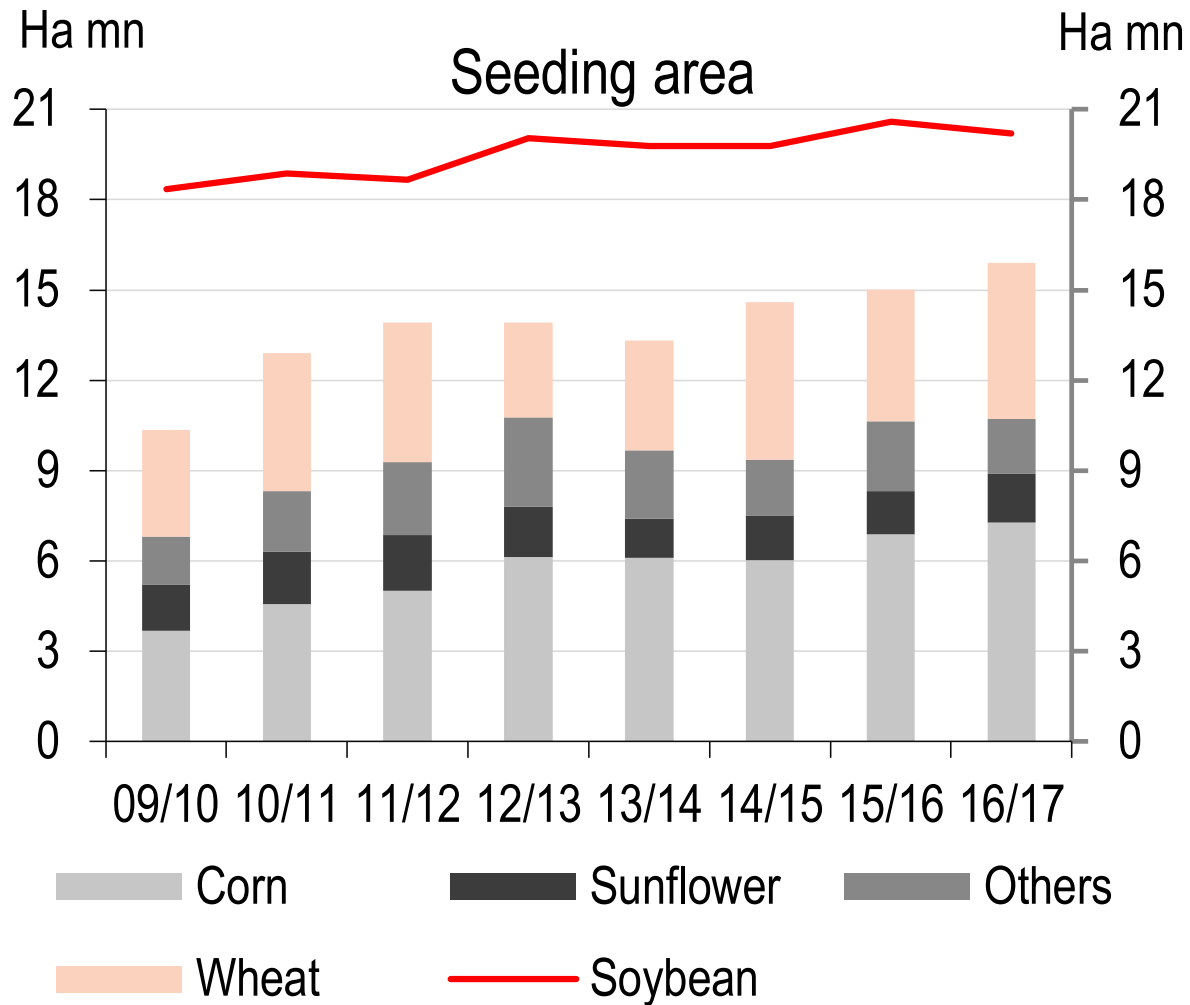
- First round, impacted lower class (due to depreciation); second round impacted middle class (due to tariff hikes)
- Job destruction in construction (public works) and manufacturing (Brazil→cars): 90K Jobs in the formal sector. More in the informal.
- Brazil
- Monetary policy overkill: very high real rates and/or too much absorption
- Uncertainty →savings up
- Normalization yes but structural reforms?

External outlook improvement due to Brazil

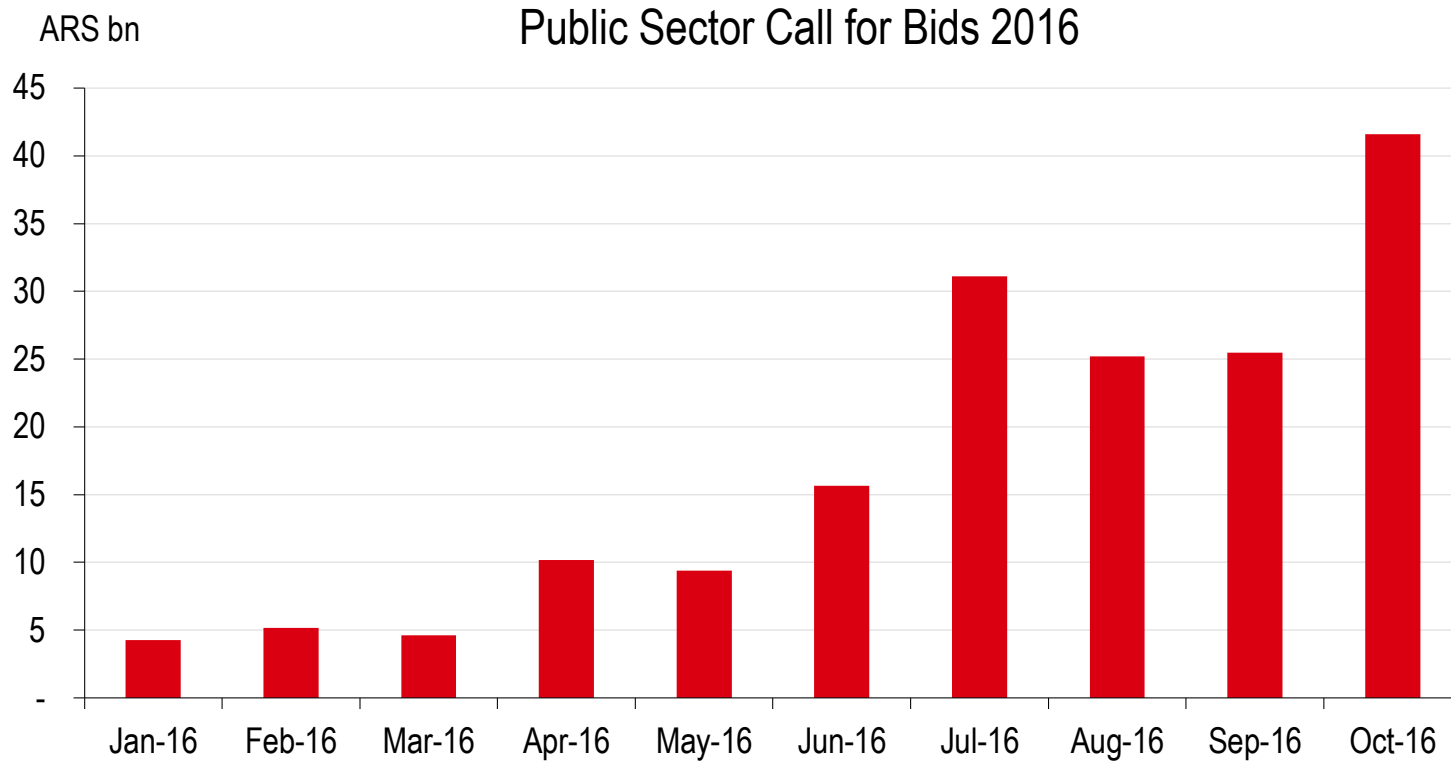
- Growth contribution of Argentina main trading partners



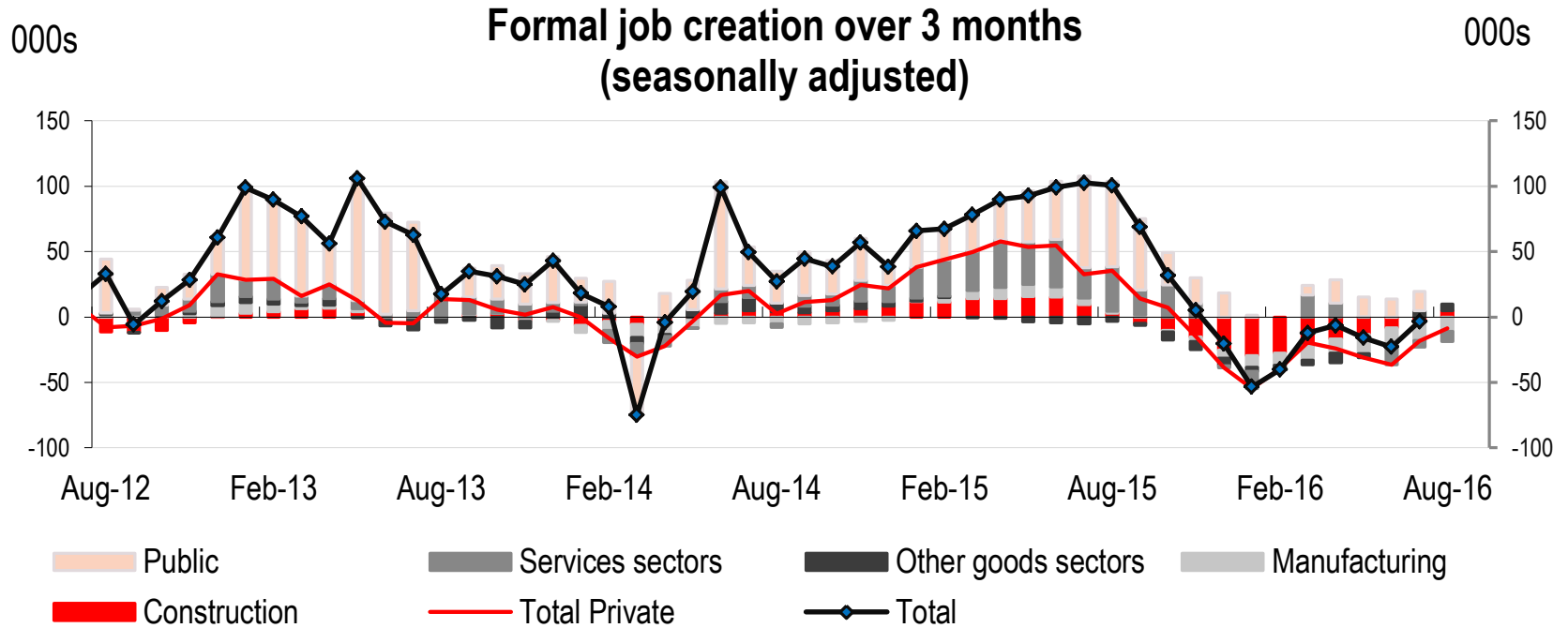
Good harvest prospects



Demand for public works picking up in 3Q16



Labor market also improving



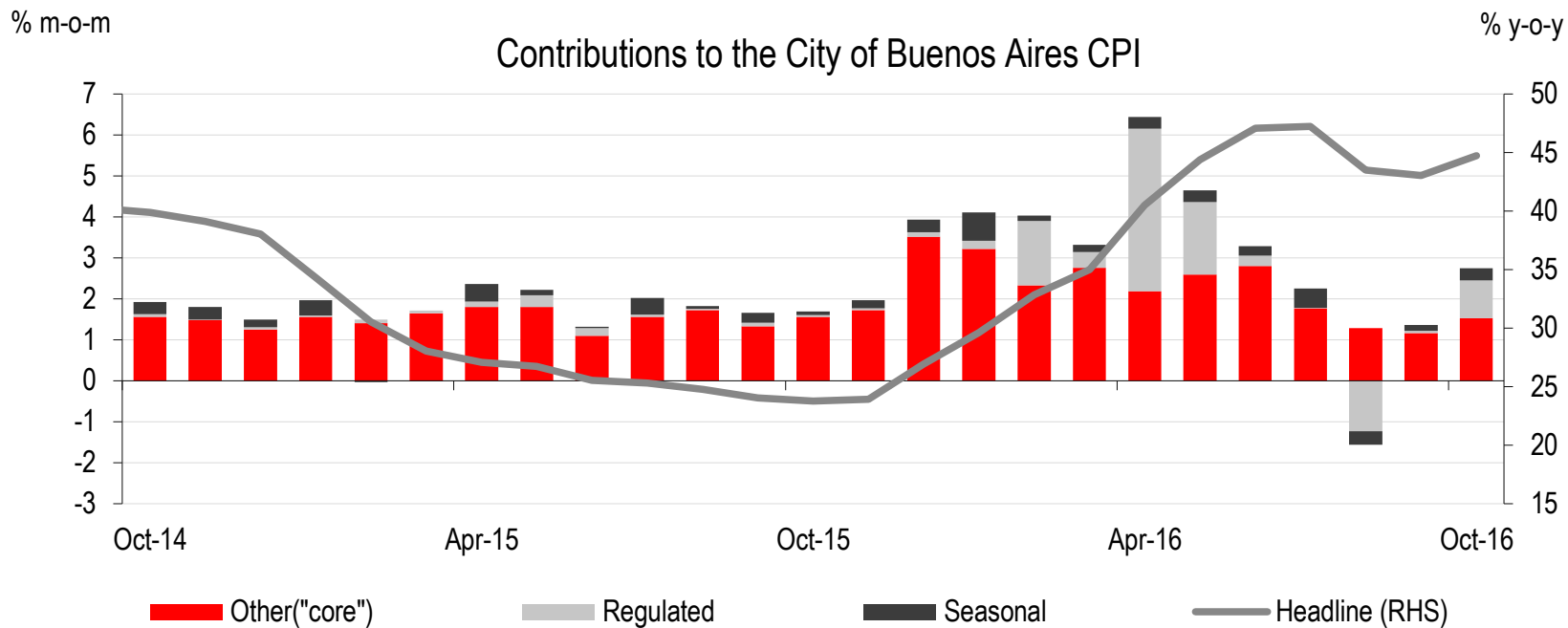
Growth should resume as...

- Brazil stops contracting and emerges from recession
- Public investment picks up
- Pensioners are paid
- Harvest improves
- But...

Why do we expect above target inflation?

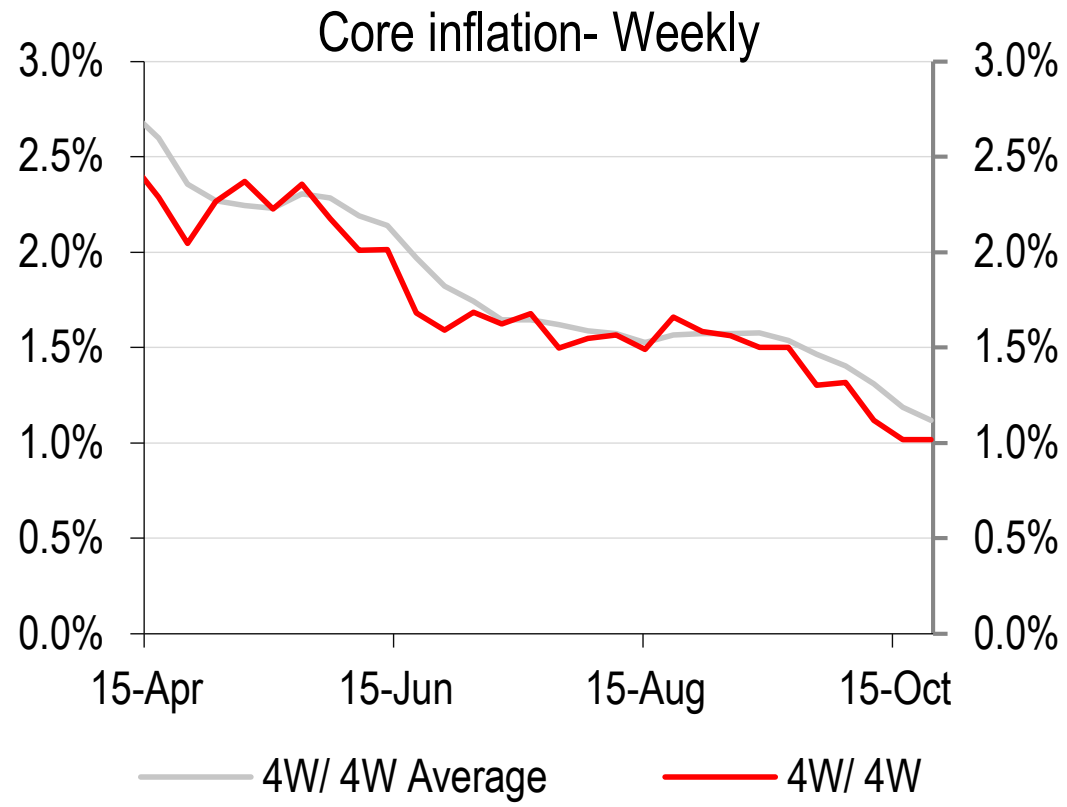
- Inertia: backward-looking wage negotiations. Year-end lump-sum not enough to revert it
- History: big crisis / stabilization plans are how Argentina got to one-digit inflation rates
- GDP growth: 2016 recession was relevant. 2017 recovery should also be
- Pending relative price adjustment without yet on a low inflation regime → pass-through are still high
- Low monetary policy traction
- Election year
- Using FX to anchor inflation

Inflation has come down in recent months...



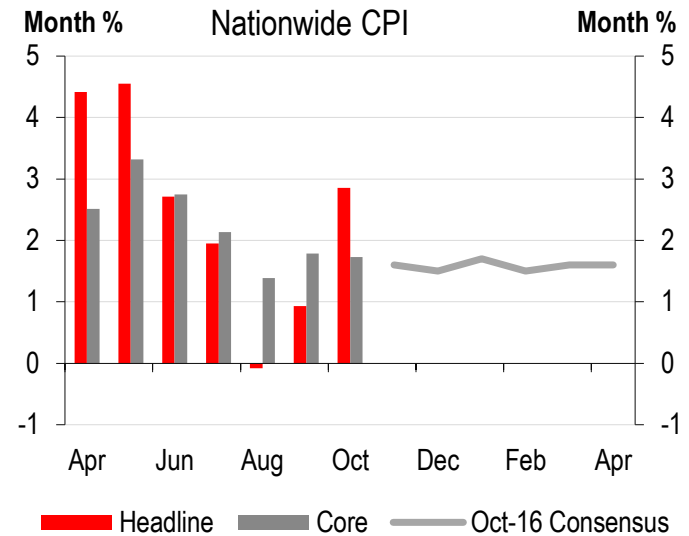
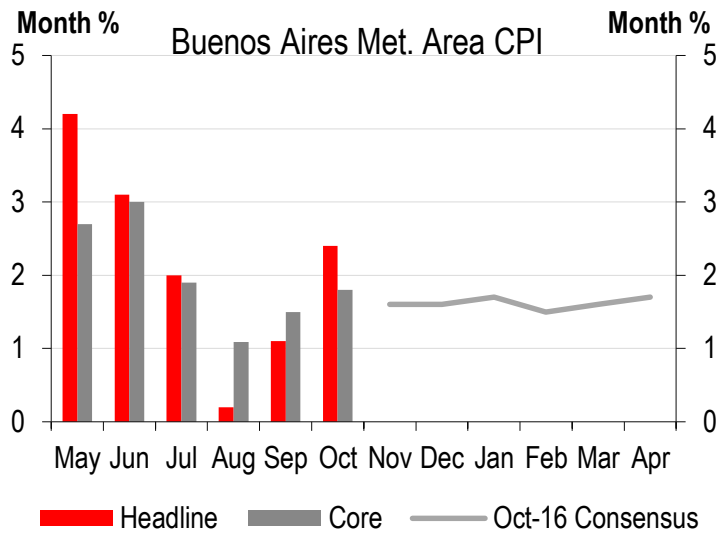
Source: City of Buenos Aires statistics institute

...and core inflation has fallen in recent weeks



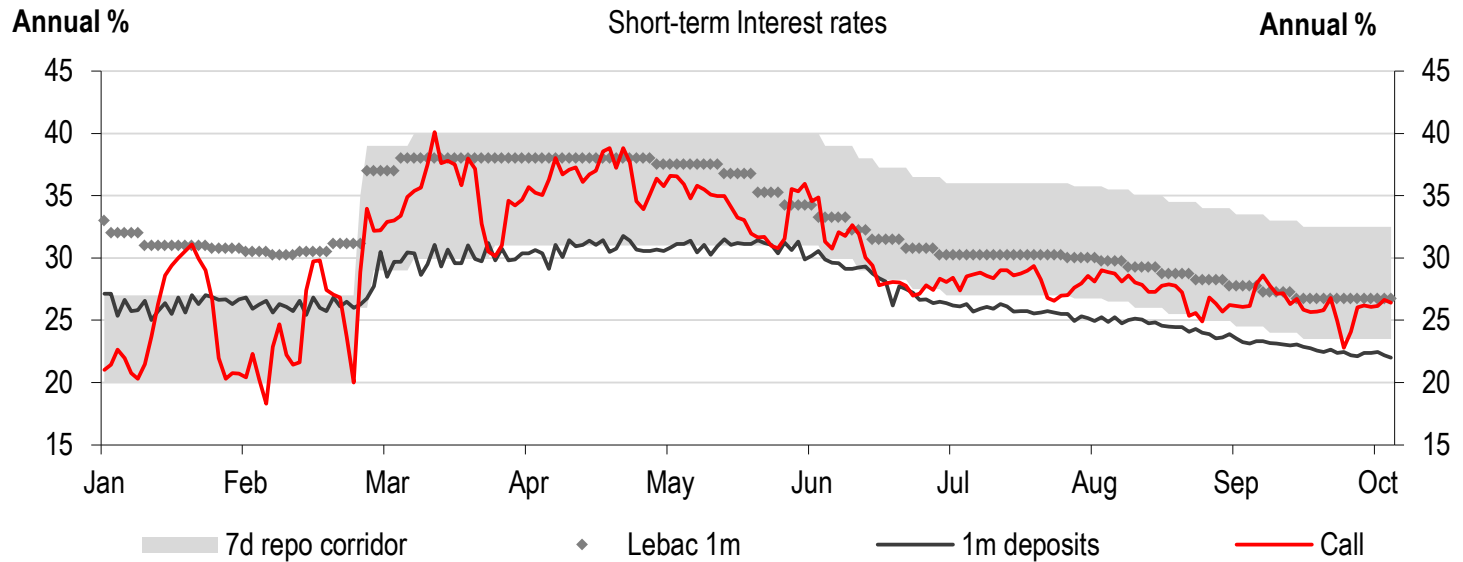
Source: Elypsis

...but hikes to regulated prices imply higher headline readings in the near term



Source: INDEC; BCRA, Provincial Statistics Offices. The nationwide CPI is a weighted average of Buenos Aires Metropolitan Area (44%), Cordoba (34%) & Mendoza (22%). National Core CPI is a weighted average of Buenos Aires Metropolitan Area (44%) & Cordoba (56%)

BCRA timing for cutting surprised



Source: BCRA

Can monetary policy decouple from politics?

- **Red alerts**
 - **Break nominal commitments (2016: ARS160bn and 2017: ARS150bn)**
 - **Wage negotiations**



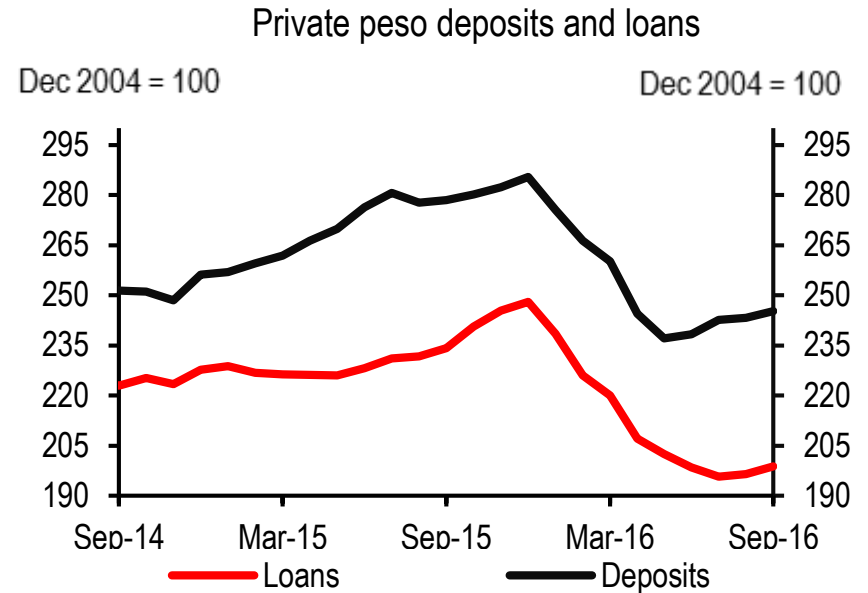
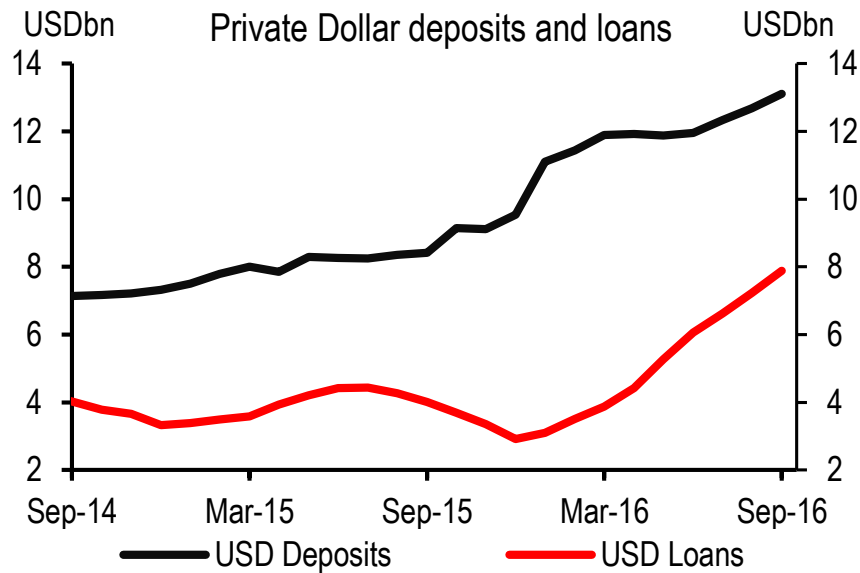
Maxi Montenegro
@maximmontenegro



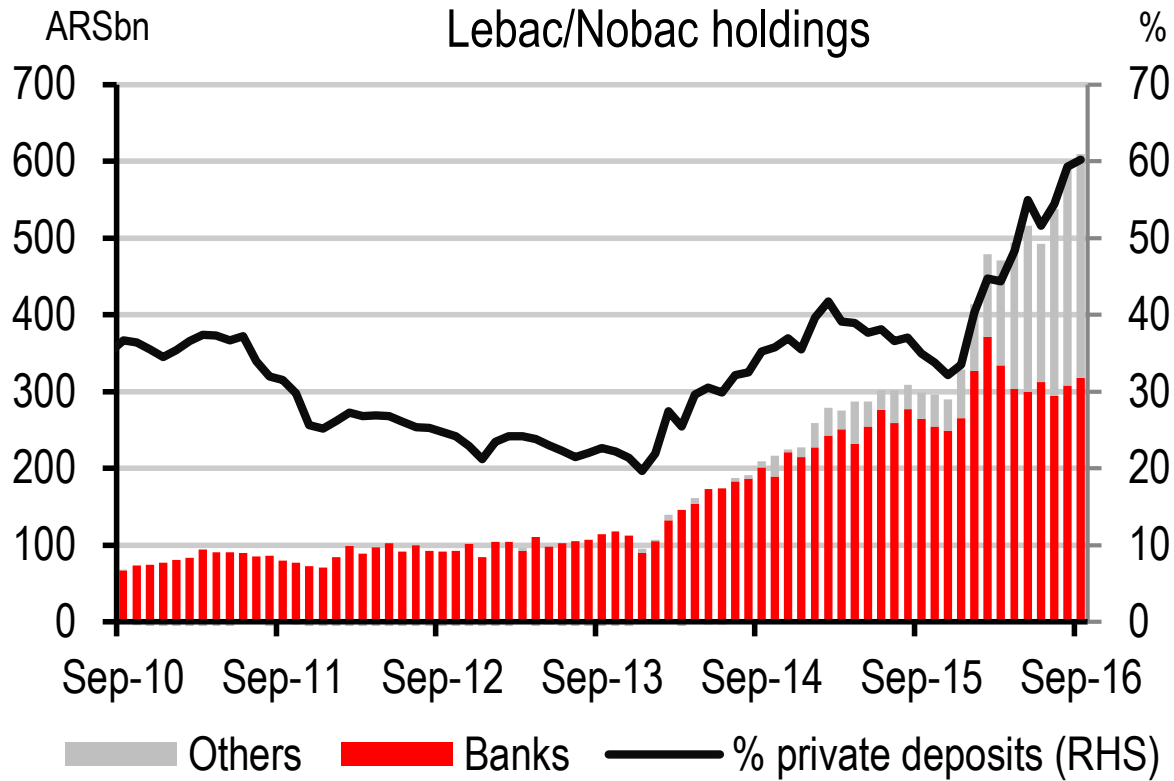
Following

Baradel: "Para 2017 estimamos una inflación entre 25 y 30% Queremos 10 puntos más, perdidos este año"

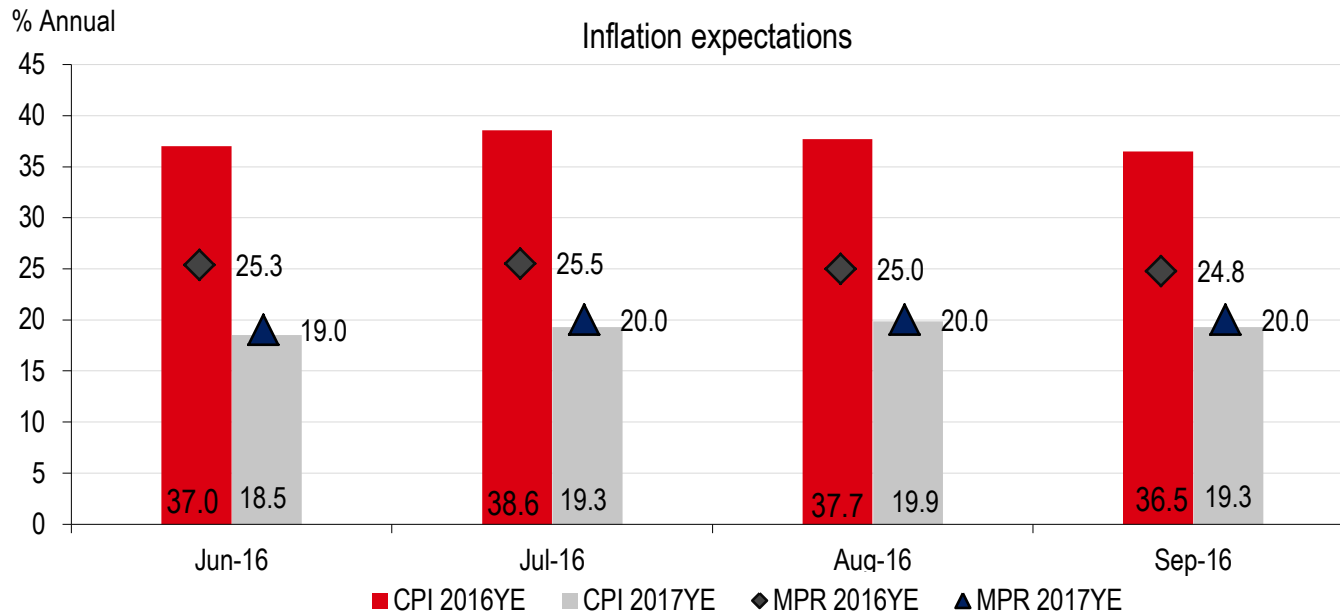
Lending in local currency remains sluggish



But keeping a tight monetary policy is costly



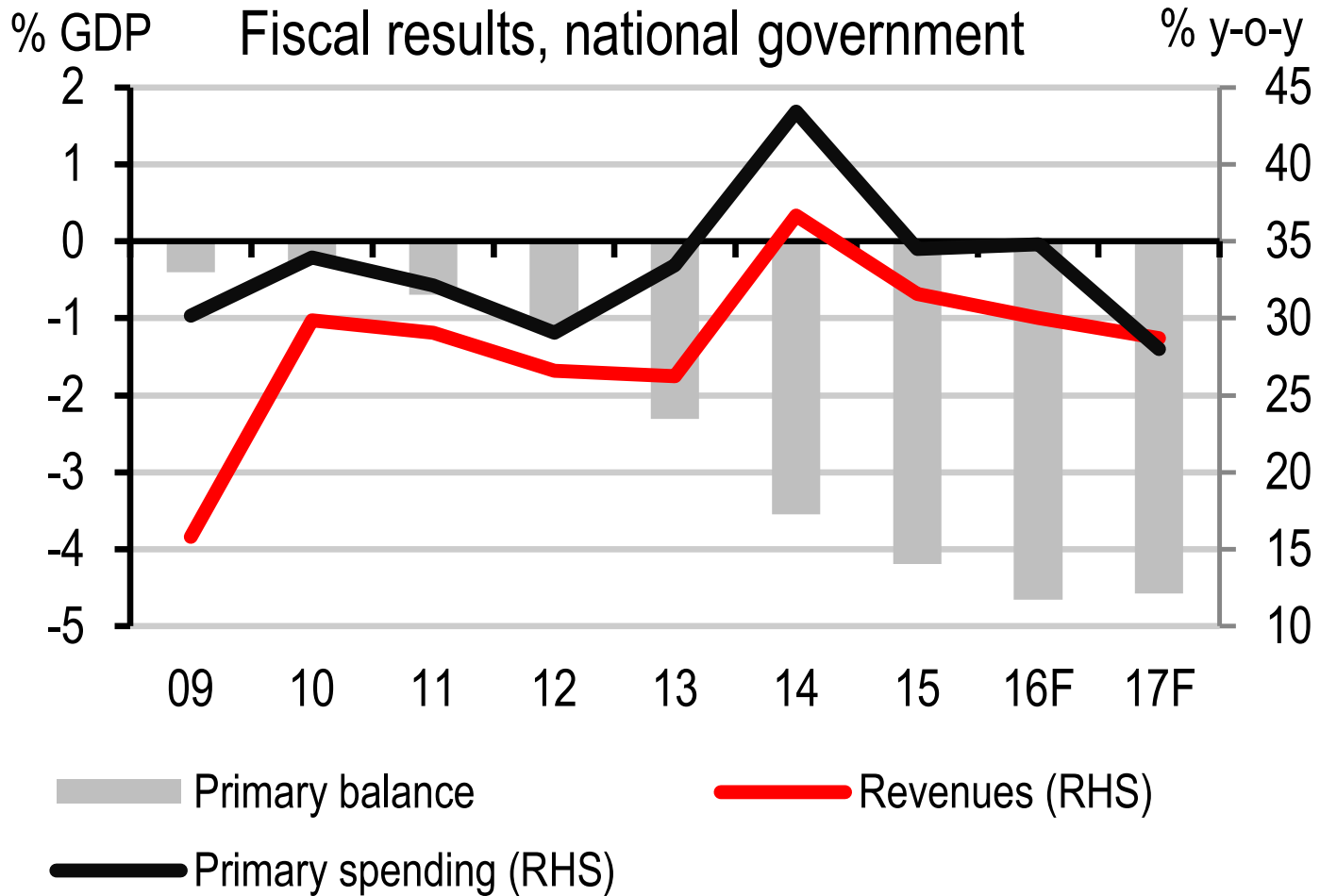
The consensus sees a tight monetary policy ahead



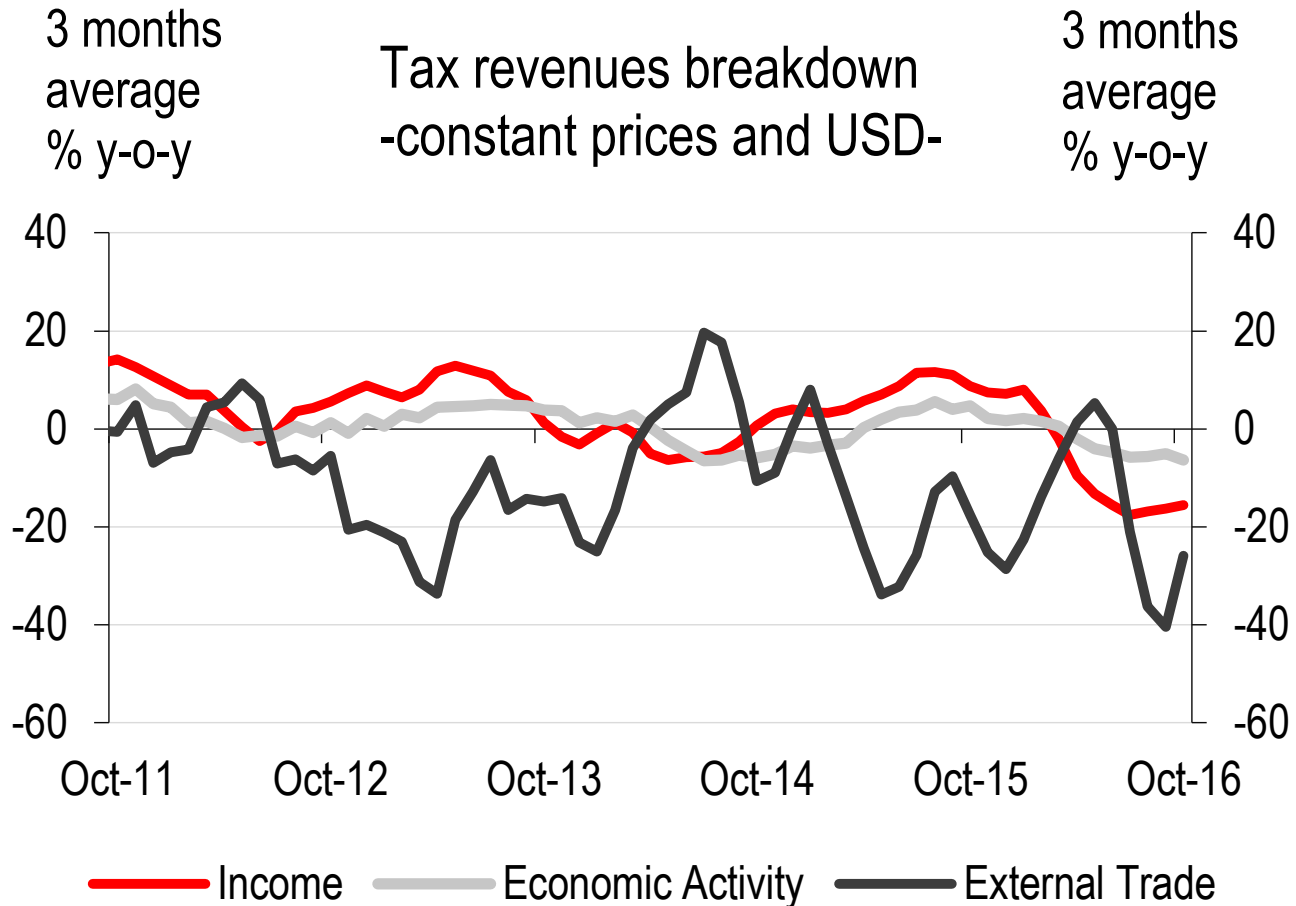
Fiscal policy

- Slow consolidation, high funding needs
- External context relevant for cost of funding
- Is external funding a problem for tight monetary policy?

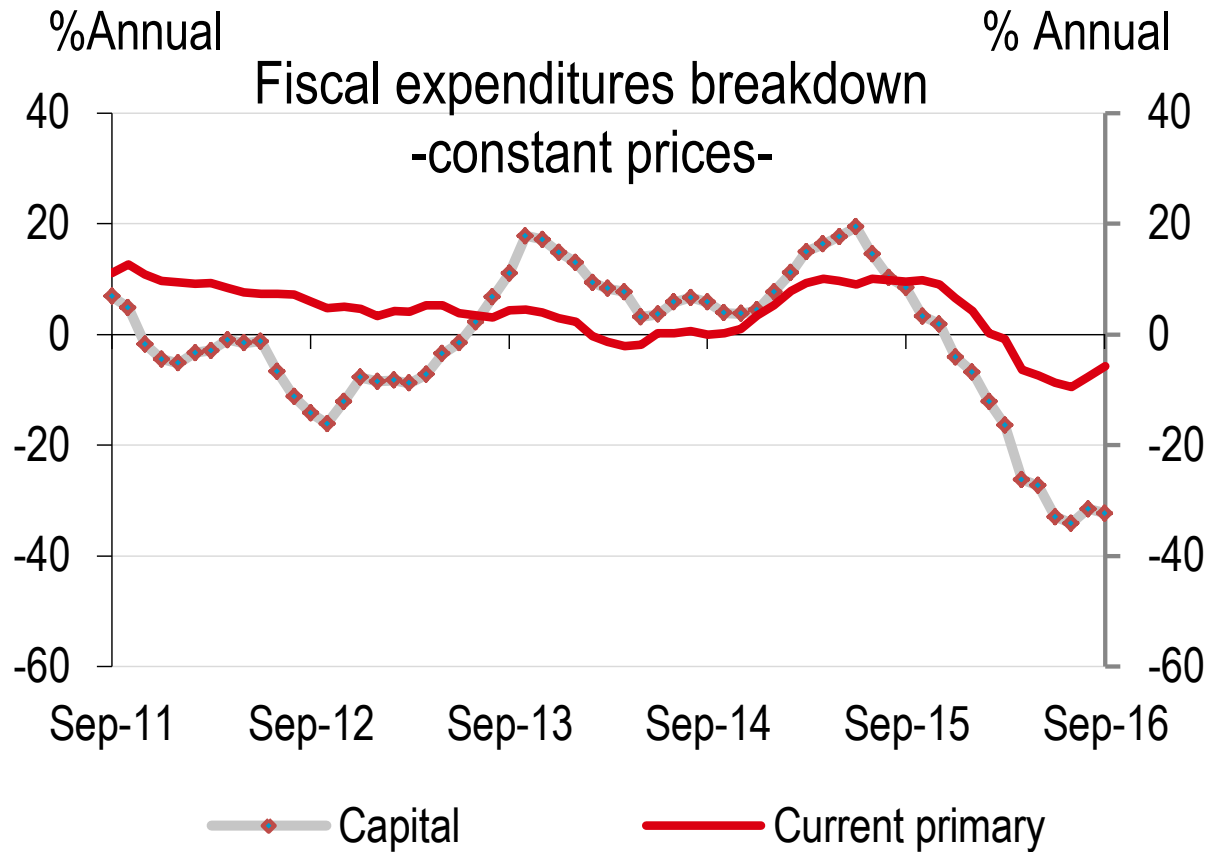
Easy fiscal policy



Revenues down on tax cuts, recession



Spending likely to accelerate



We expect a higher fiscal deficit than the budget does

2017 budget and HSBC forecasts

	% GDP					% y-o-y			
	2015	2016		2017		2016		2017	
		Budget	HSBC	Budget	HSBC	Budget	HSBC	Budget	HSBC
Primary revenues	20.4	19.3	19.2	19.4	19.4	27.4	30.0	24.5	28.7
Primary expenditures	24.4	24.0	23.9	23.5	24.0	32.5	34.8	21.3	28.0
Primary balance	-4.0	-4.7	-4.7	-4.2	-4.6	57.9	59.0	8.5	25.0
Interest Payments	2.1	2.4	2.4	2.6	2.5	261.9	264.9	32.4	33.5
BCRA, FGS	2.2	2.1	2.1	1.8	1.8	-174.8	-175.2	5.8	7.3
Fiscal Balance	-3.9	-5.0	-5.0	-4.9	-5.3	-22.9	-22.3	21.3	36.7

Significant debt issuance after holdouts deal

Debt issuance by Argentina's entities in 2016

Type of bond	USDbn
Foreign Law (US)	
USD bonds	6.0
EUR bonds	2.8
Holdouts	10.5
GDP Warrants swap	2.8
Subtotal	22.1
Local Law (USD)	
ICSID rulings	0.4
Nat Gas Suppliers	1.1
T- bills (outstanding)	5.8
Subtotal	7.3
Subtotal Foreign currency	29.4
Local Law (ARS)	
Inflation linkers	1.8
variable rate bonds	2.8
fixed rate bonds	11.1
Subtotal local currency	15.7
Total	45.1

Source:Ministry of Finance

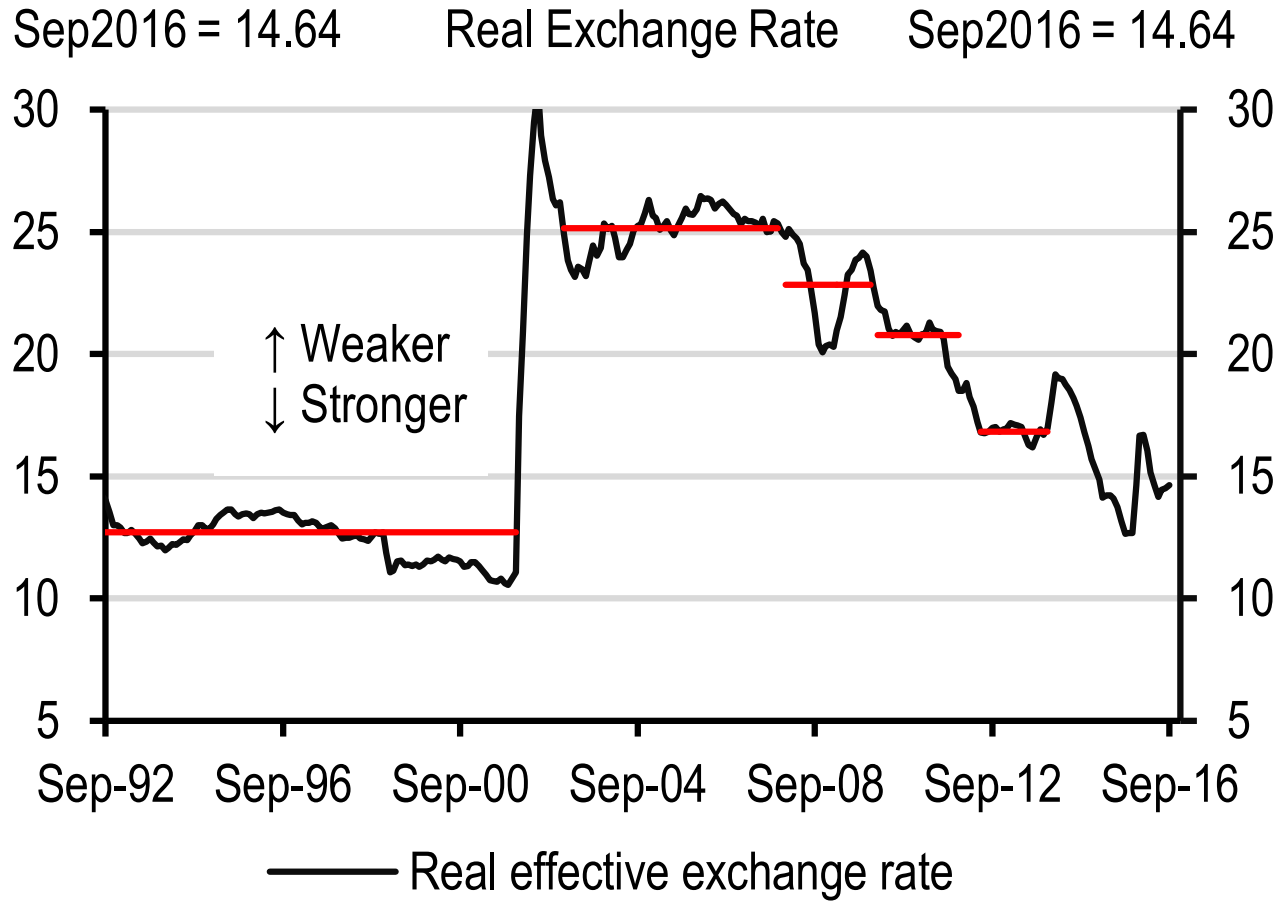
Financial needs for 2017 are larger than this year's needs

Argentina's financing program (USDbn)

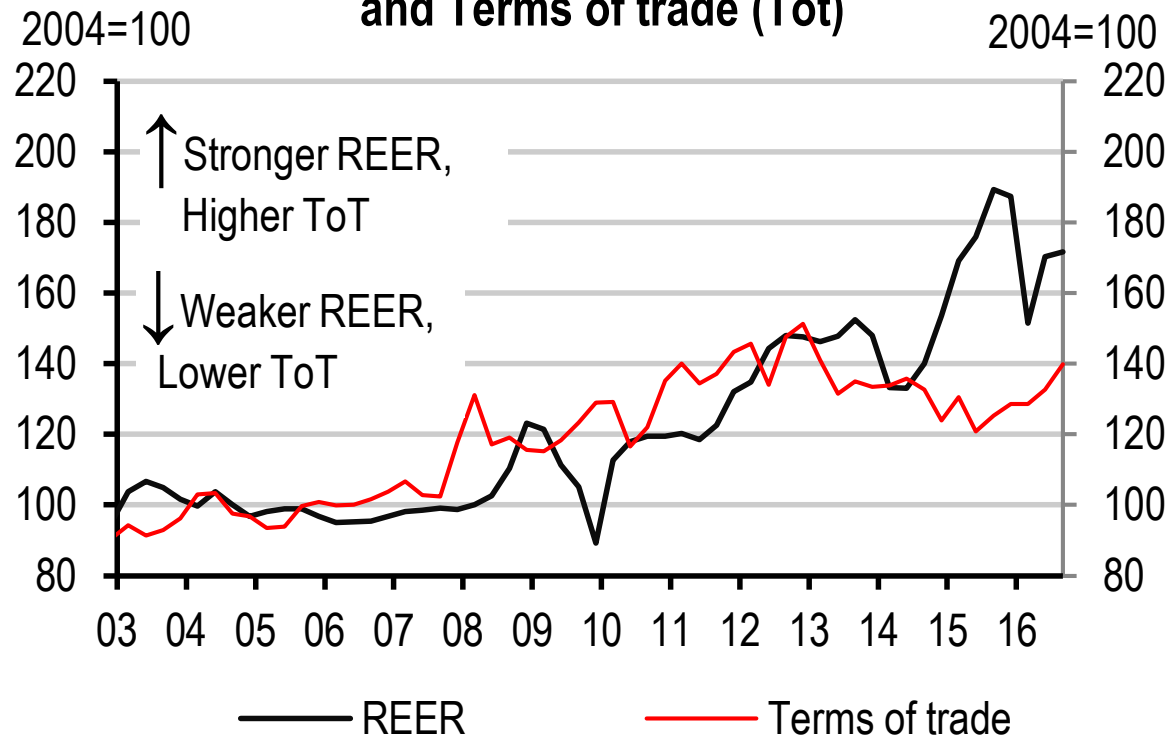
	2016			2017		
	ARS	FX	Total	ARS	FX	Total
Uses	35.2	9.8	45.0	39.8	22.2	61.9
National primary deficit	25.5		25.5	27.7		27.7
Debt Service	9.7	9.8	19.5	12.0	22.2	34.2
Multilateral and official		4.9	4.9		4.6	4.6
Interest		0.9	0.9		0.8	0.8
Amortizations		3.9	3.9		3.8	3.8
Private creditors	9.7	4.9	14.7	12.0	17.5	29.6
Interest	3.3	3.5	6.8	4.7	4.2	9.0
Amortizations	6.4	1.4	7.9	7.3	13.3	20.6
Sources	26.1	23.1	49.2	8.5	6.6	15.1
Public Sector	11.6		11.6	8.5		8.5
BCRA	10.7		10.7	7.7		7.7
Others (Banco Nacion, ANSES)	0.9		0.9	0.8		0.8
Multilaterals		6.9	6.9		6.6	6.6
Markets (issued YTD)	14.5	16.2	30.8			
Placed locally	14.5	7.4	22.0			
ARS	13.5		13.5			
Inflation linkers	1.0		1.0			
USD		7.4	7.4			
Placed under US-Law		8.8	8.8			
USD		6.0	6.0			
EUR		2.8	2.8			
Gap	9.1	-13.3	-4.2	31.2	15.5	46.8

Source: Ministry of Finance, HSBC. Does not include issuance to pay for overdue obligations: holdouts (USD10.5bn), GDP warrants swap (2.8bn), ICSID rulings (USD430mn).

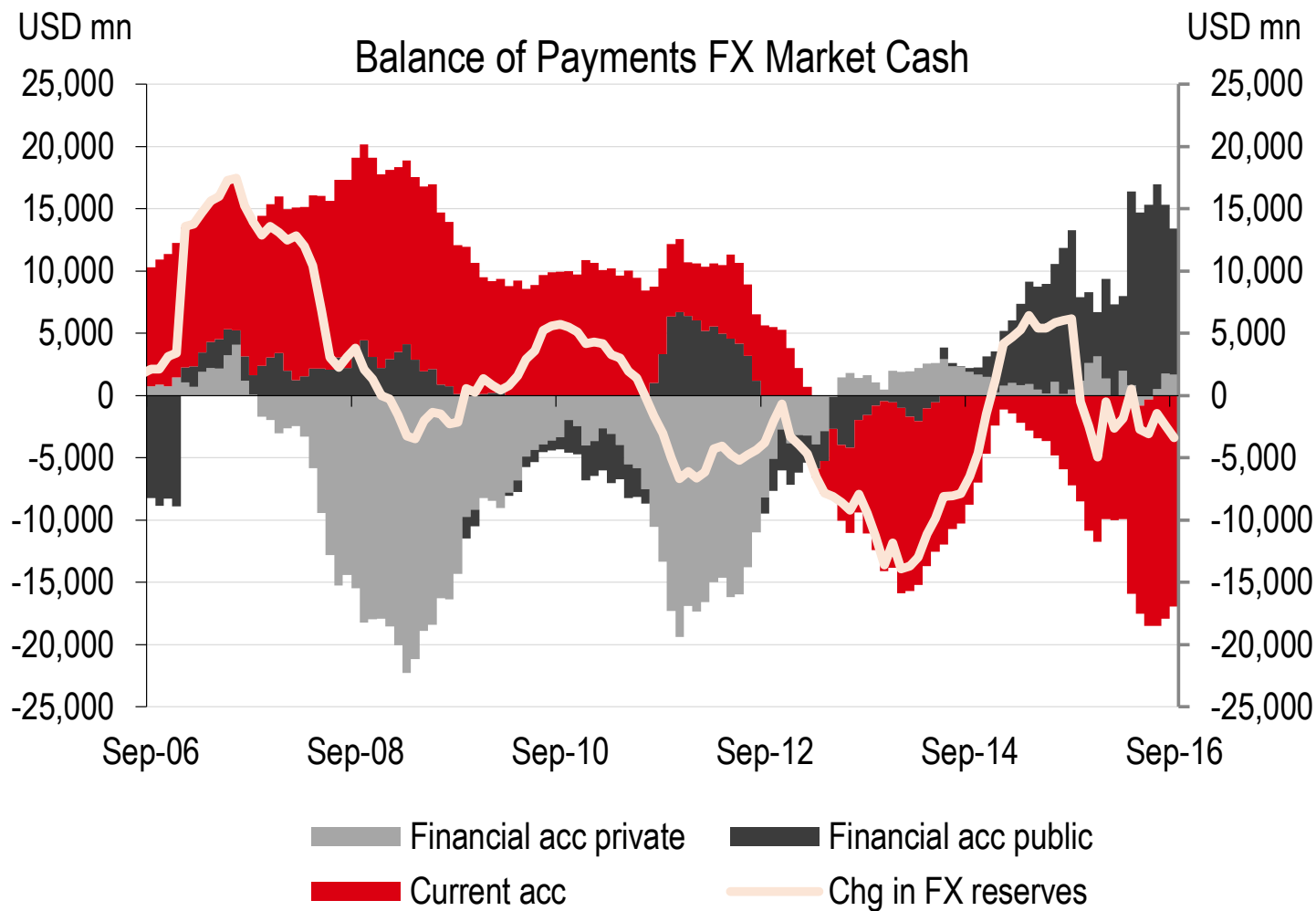
The peso remains quite strong



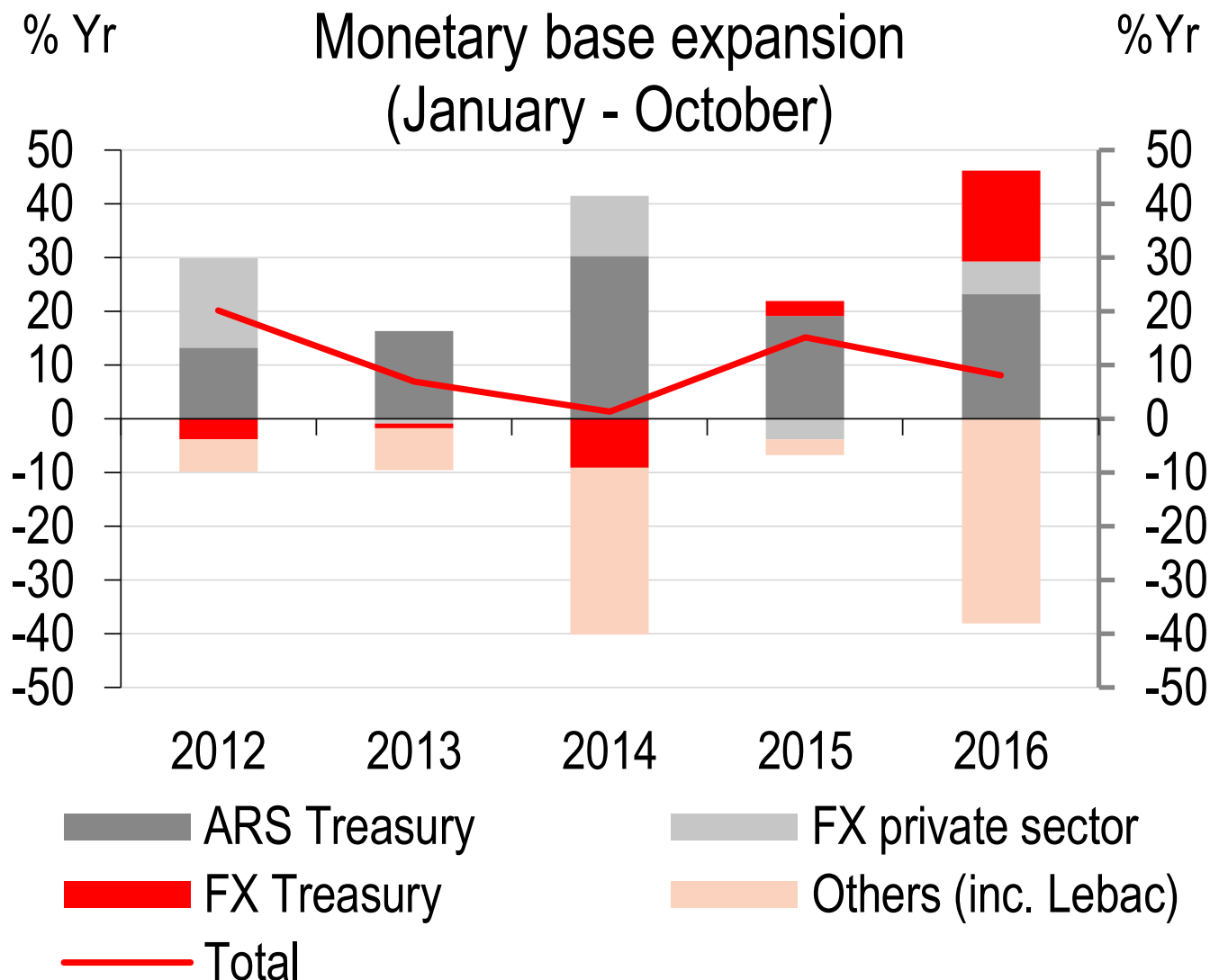
Real exchange rate (REER) and Terms of trade (Tot)



External debt funding the current account deficit



Fiscal deficit, hard currency issuance have monetary impact; makes tight monetary policy more expensive

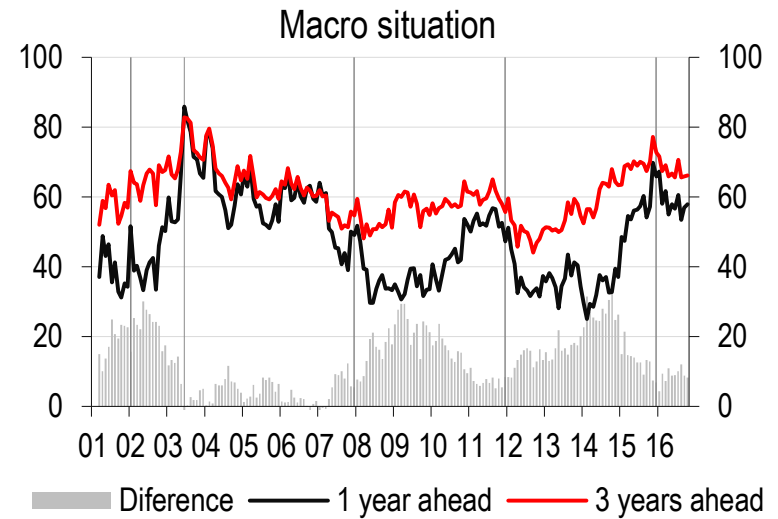
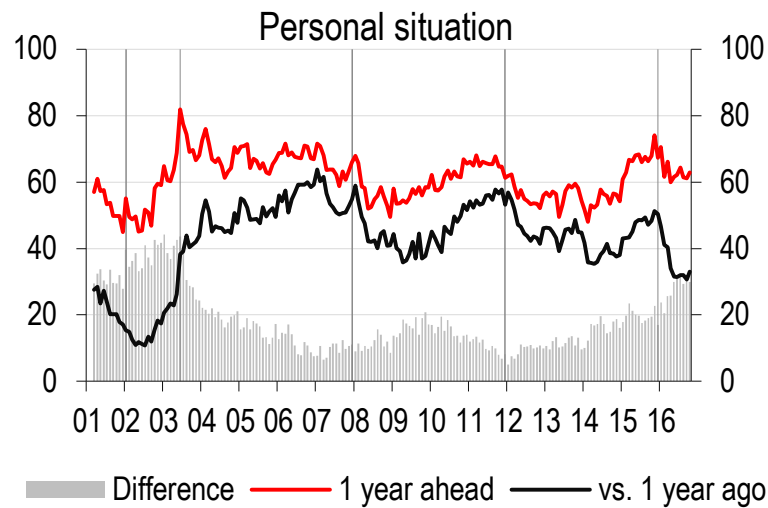


Public approval relevant for reform agenda

- The public remains optimistic, so far
- 2017 mid-term elections matter
- Ongoing bargaining (ie, with unions, governors, Congress) also relevant

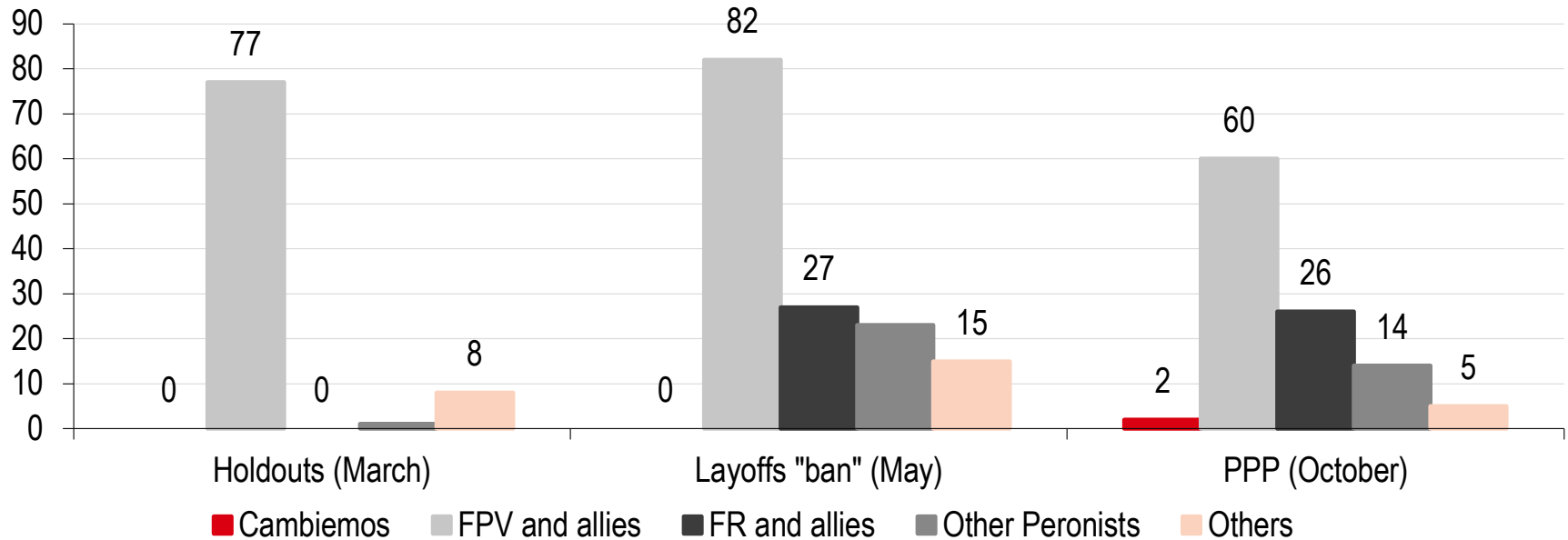
The public remains optimistic about the future

Consumer expectations survey



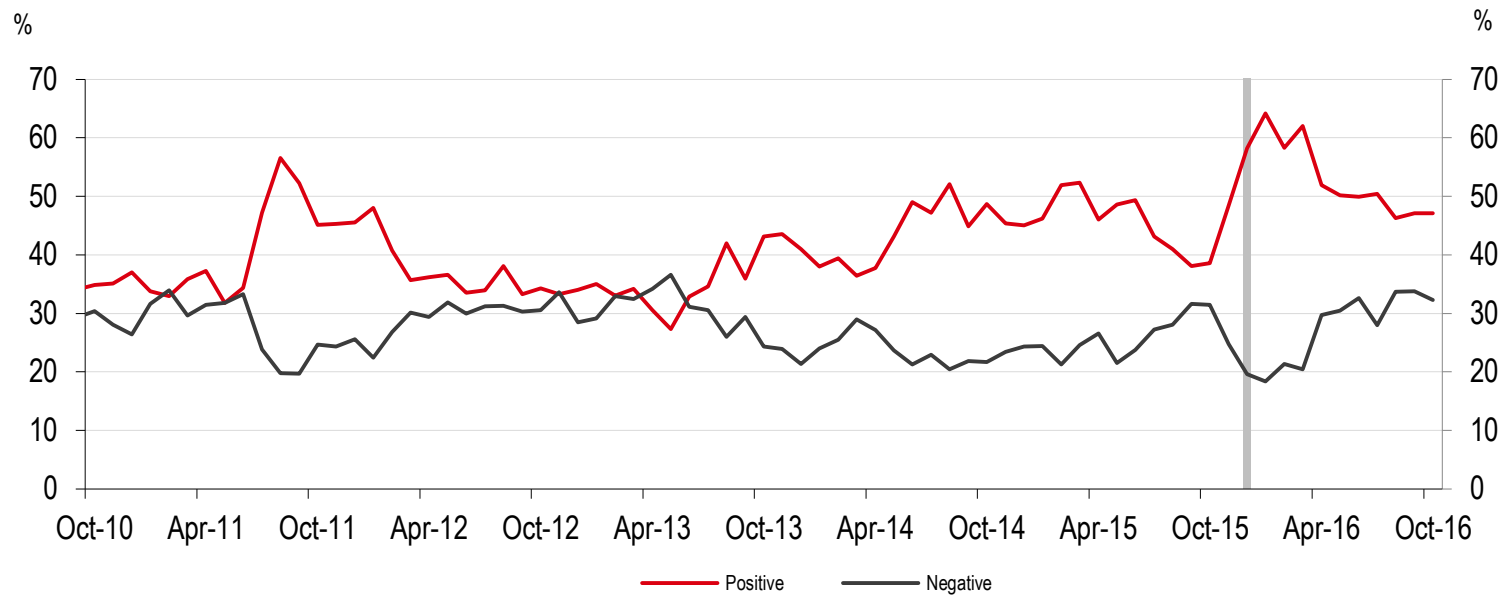
...to support political bargaining

Lower Chamber members voting against government initiatives



President Macri needs approval rating to remain high...

Macri's popularity according to polls



Conclusions

- Direction of change is positive
- Speed of change is conditioned by legacy → gradualism
- Gradualism requires financing
- Need to consolidate ruling coalition