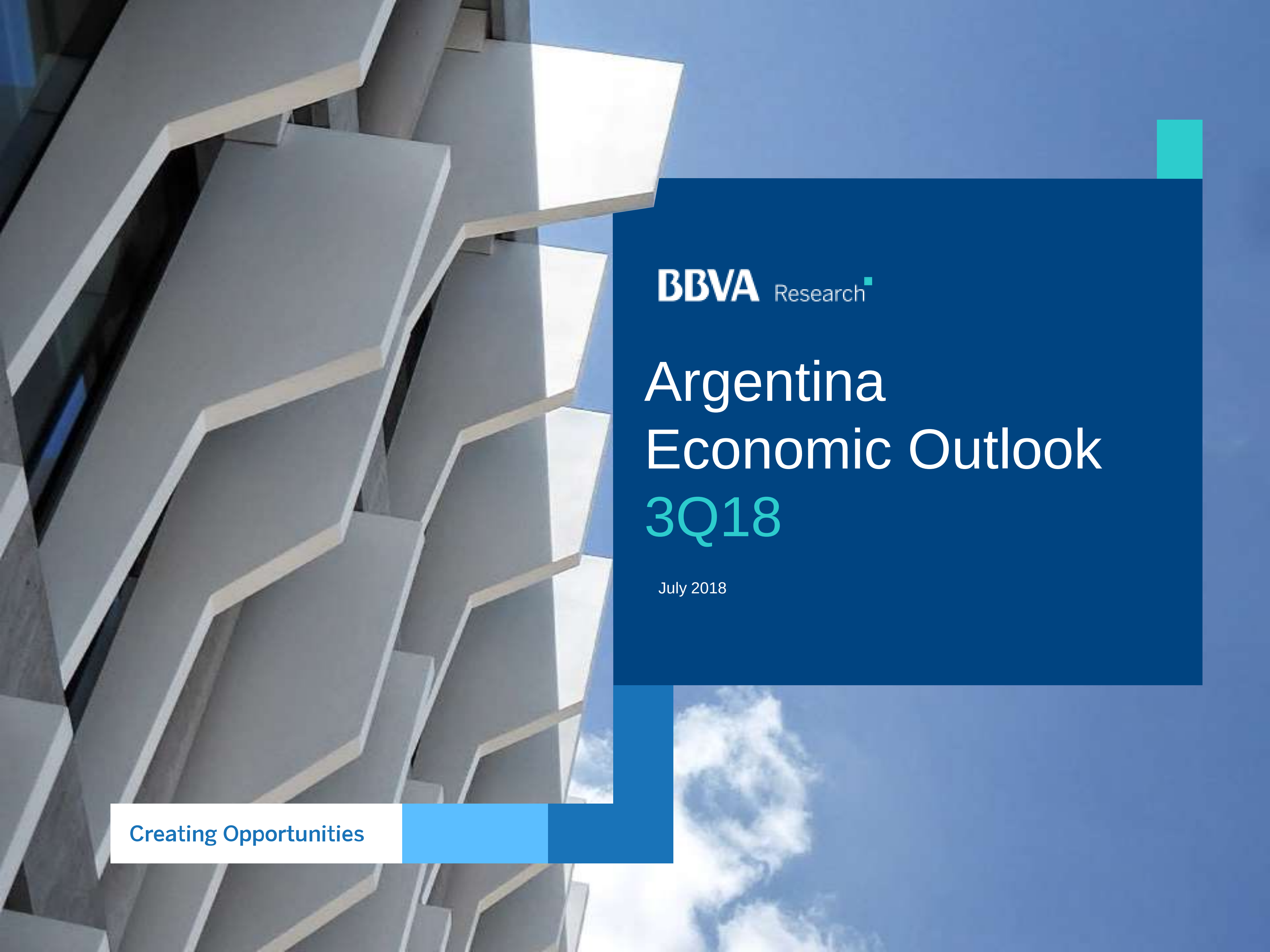

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Argentina Economic Outlook 3Q18

July 2018

Creating Opportunities

Key messages

- Global growth continues, but risks are intensifying.
  due to the possibility of a trade war and the tightening of global financing conditions
- The lack of access to external credit thwarted the gradualist strategy of the Argentinian government and to avoid a disorderly adjustment, a Stand-By agreement was negotiated with the IMF, subject to compliance of stricter fiscal targets and a commitment to reinforce the independence of the Central Bank of Argentina
- The economy will contract in 2Q and 3Q18, due to the impact of the drought and the exchange rate crisis, before beginning to recover in the last quarter. After a very good 1Q, GDP will grow 0.5% in 2018 and 1.5% in 2019.
- Inflation will accelerate in 2018 to 29.6% YoY and 20% in 2019 due to the impact of currency depreciation, the increase in the price of oil and hike in utilities' rates. The new targets agreed with the IMF are more relaxed but could be exceeded if pass-through from the devaluation is not contained
- Monetary policy was tightened substantially to moderate the volatility of the exchange rate and the acceleration of inflation. The drop in rates will be very gradual and more volatile following the decision to complement the monetary policy rate scheme with the monitoring of monetary aggregates.
- The fiscal target commitments made with the IMF for 2018 can be achieved with comfort but in the medium term they involve an adjustment of the accumulated primary expenditure of 3.7 pp of GDP in 3 years and their achievement will require political agreements with the opposition to be reflected in the 2019 Budget
- The adjustment of the external sector deficit will be slow, amounting to 0.8% of GDP between 2017-19, mainly based on the reduction of imports, and particularly of services such as tourism, since increasing the dynamism of exports requires not only a depreciated but also a stable real exchange rate.

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Global environment: global growth is continuing, but risks are intensifying

Global growth continues, but risks are intensifying

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The pace of global expansion is being maintained, but is less synchronised

Growth is robust in the US due to the fiscal stimulus and stable in China, but is declining in Europe

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Increased protectionism

For now, its impact on growth is limited, but it could be greater if the measures under discussion were to be implemented

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Increase in the price of oil

Higher inflation and drag on growth in oil-importing countries

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Different pace of monetary normalisation in Europe and the United States

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More volatility in emerging markets

Increased financial tensions due to increased financing costs and protectionist threats

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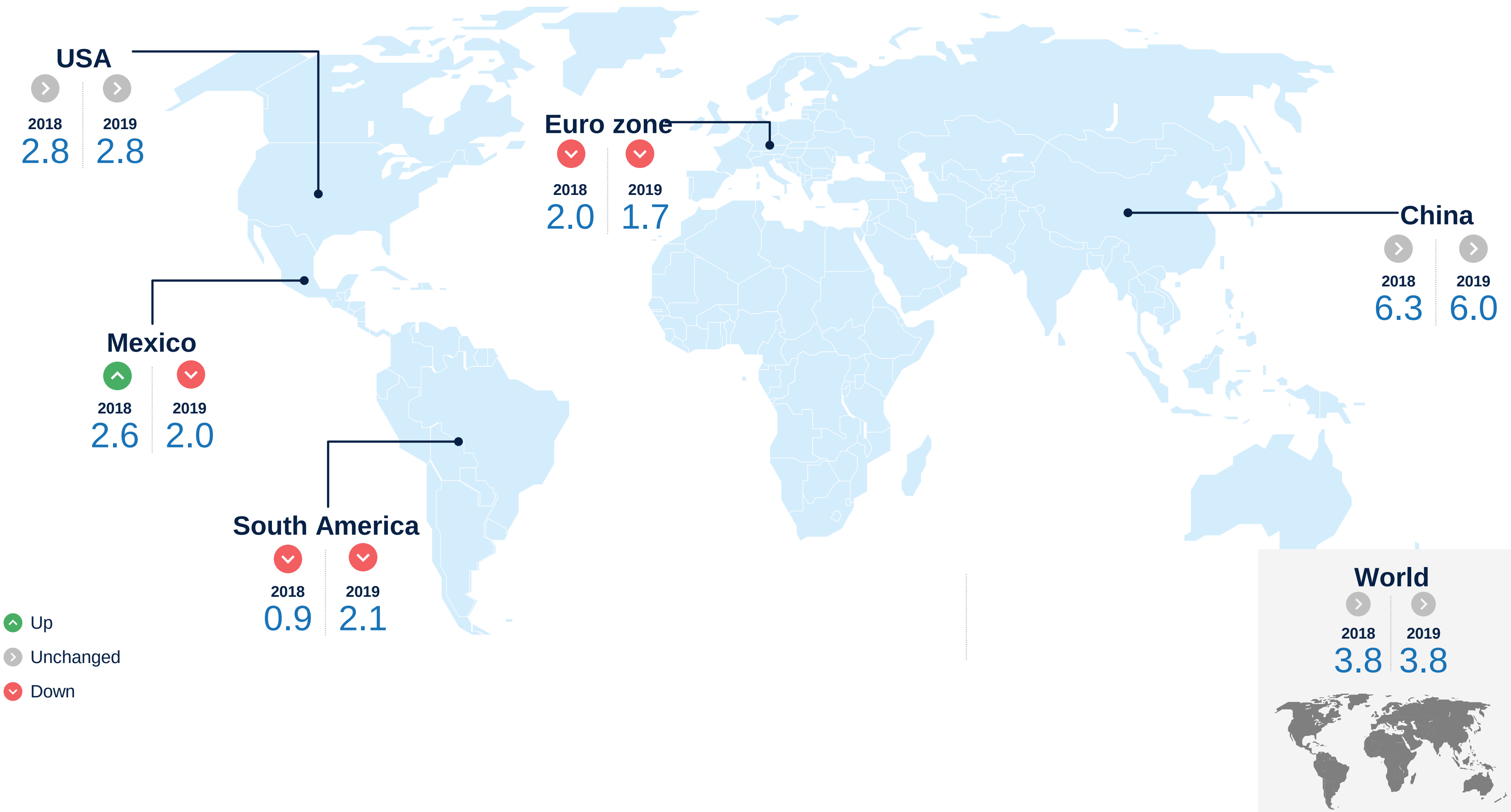
Global risks are intensifying

The possibility of a trade war comes together with greater risks in emerging economies and in Europe

Stable growth in the US, but a slowdown in other areas

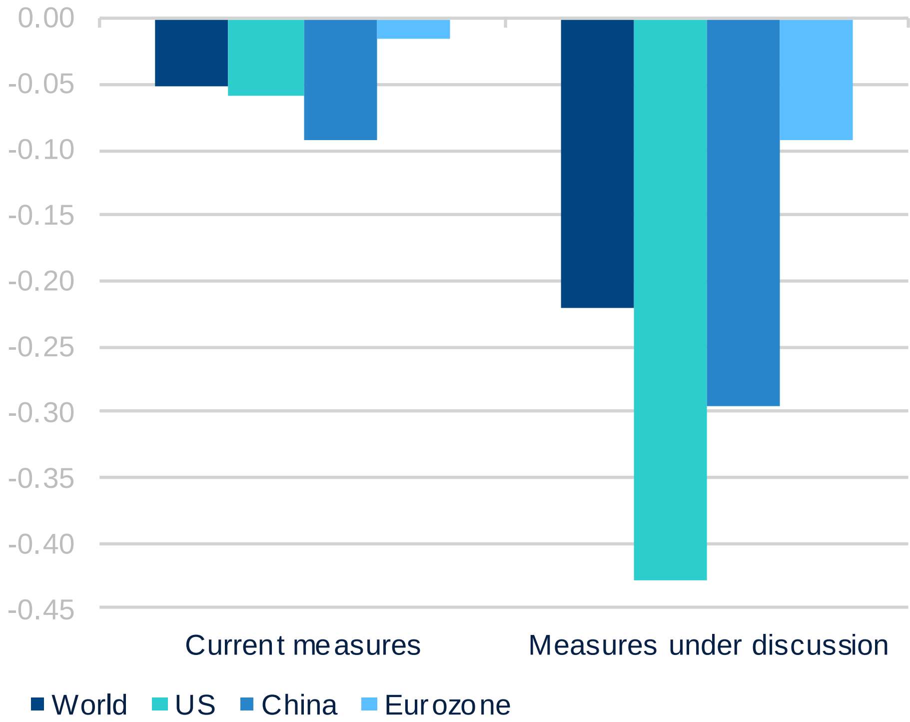


Source: BBVA Research

Limited effect of approved tariff increases, but significant if those being discussed are implemented

Effect on GDP growth of US tariff increases and the response by other countries

(2018-19, pp)



Measures announced: tariff increase to 25% on steel, 10% on aluminium and 25% on Chinese imports for a value of US$50 billion

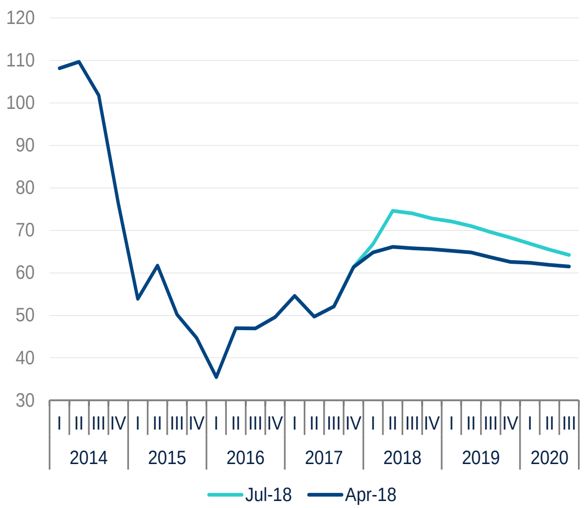
Measures under discussion: tariff increases up to 20% on cars and Chinese imports for a value of US$200 billion

Source: BBVA Research

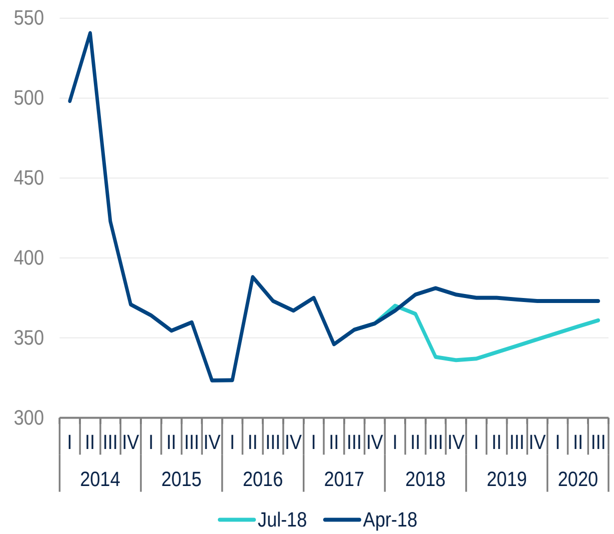
- The tariff increases approved by the US would have a limited direct impact. Indirect effects, via economic confidence and financial channel, could be felt in 2H18
- With a protectionist escalation, the negative effect on growth would also be significant in the US.
- The effect, smaller in Europe, would differ by country and would, above all, affect Germany and the countries in Eastern Europe
- The growth of global GDP could be reduced by around 0.2 pp through the trade channel alone

Deterioration of the terms of trade: rise in oil price due to geopolitical factors and fall in soybean prices due to trade war

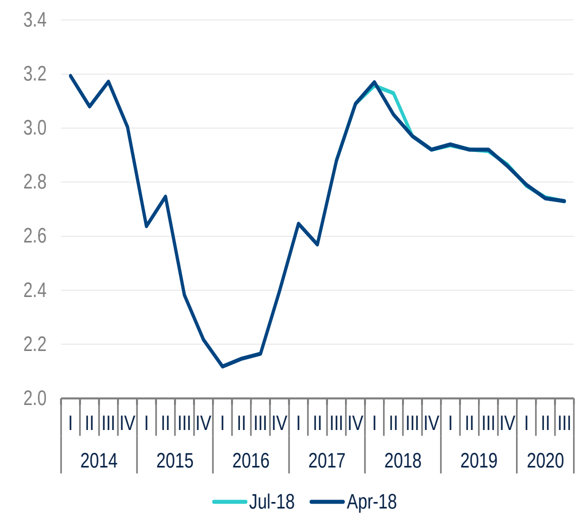
Brent Crude
(US$ per barrel)



Soybeans
(US$ per metric ton)



Copper
(US$ per lb.)



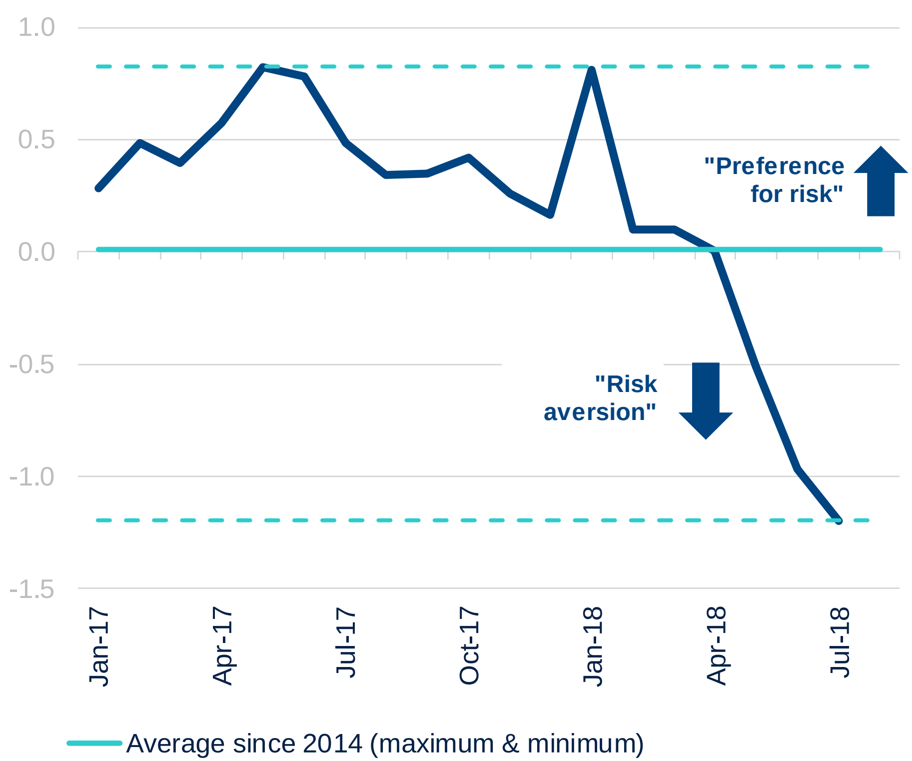
Source: BBVA Research and Bloomberg

The increase in the price of oil stems from a reduction in supply. The price will remain relatively stable in 2018 and 2019. It will begin to flex downwards as export capacity recovers in the US and demand stabilises.

Strong correction of the price of soybeans due to a good harvest in the US and the incipient trade war. China's retaliation with tariffs on US soybeans places downward pressures on the price in CBOT but not on Argentina-Brazil prices. Greater weakening of China's economy would affect global commodity prices

Protectionism and political factors lead to a growing risk aversion

Risk appetite/aversion indicator

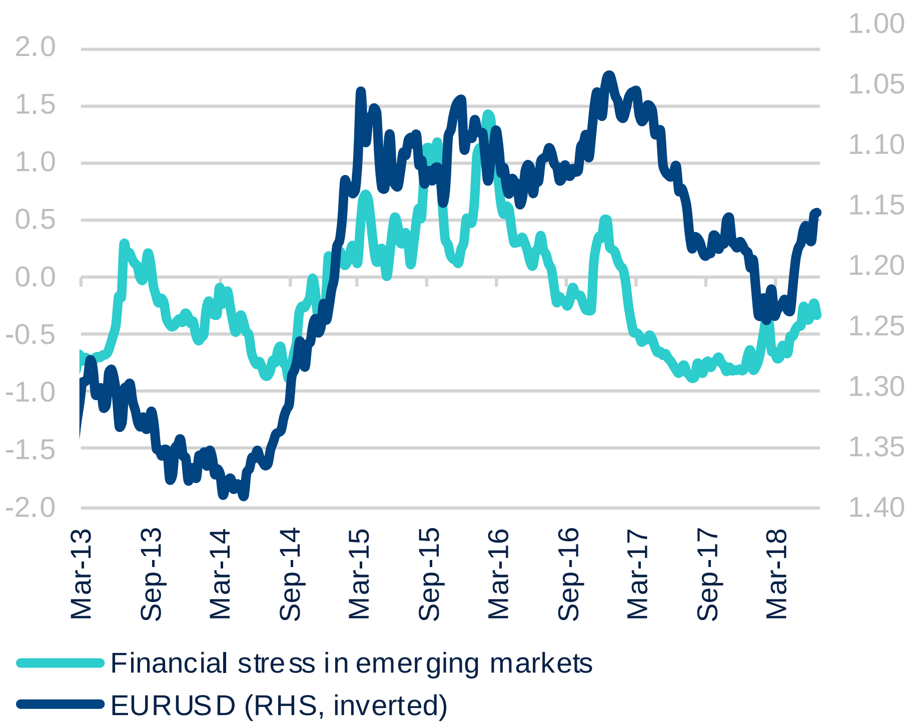


- Investor sentiment has shifted from risk-taking mode (and even a certain complacency) to one of risk aversion
- The change is causing a rotation of flows between assets: from emerging markets to developed ones, and from equities to bonds
- Trade tensions could lead to an environment of flight to quality

Source: BBVA Research

The strength of the US dollar and higher interest rates are causing an adjustment in emerging markets

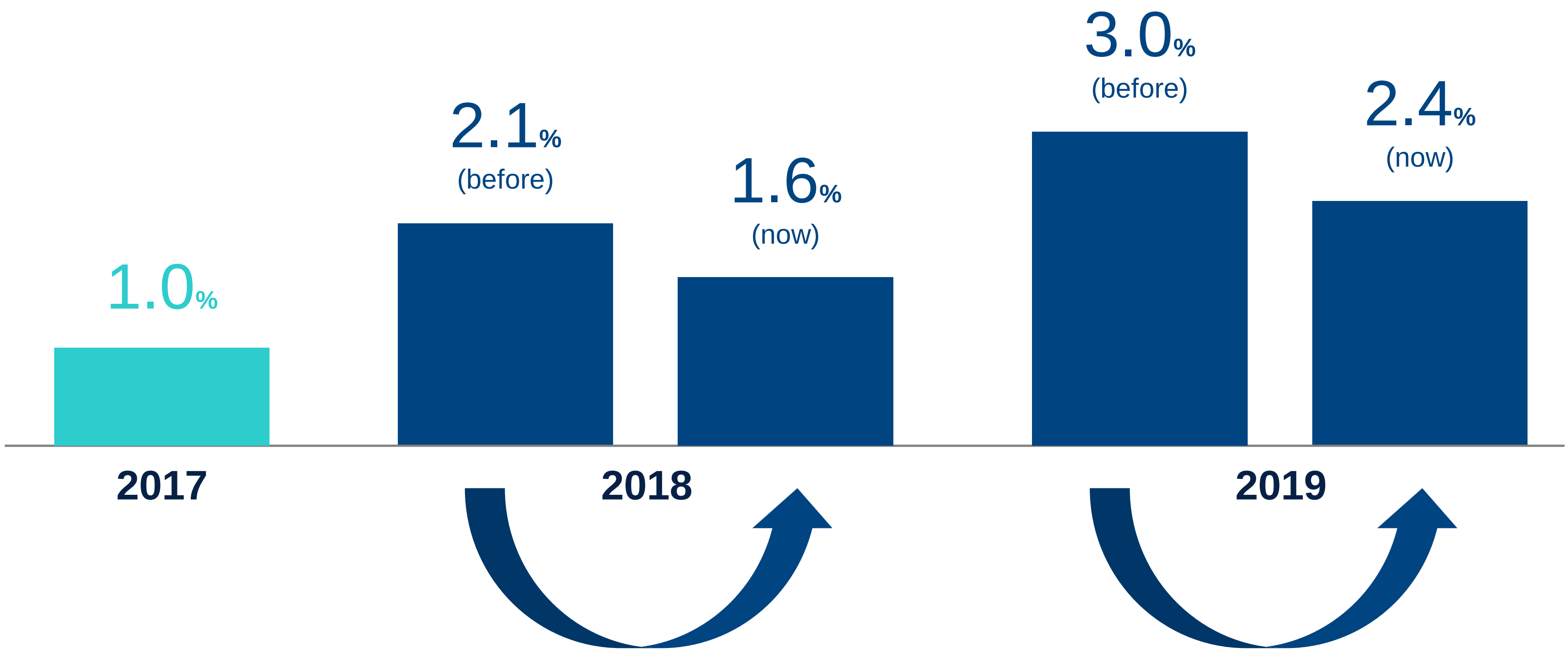
EUR-USD exchange rate and BBVA index of financial tensions in emerging markets



Source: BBVA Research based on Bloomberg

- The most vulnerable countries are those with the greatest trade deficits and the greatest need of external financing
- Shift towards a tightening of monetary policy in emerging countries (except China) to avoid further depreciation of their currencies
- The increase in financial tensions also reflects the intensification of the trade dispute

In Brazil, growth forecasts have been revised downwards, estimating a slower recovery than was expected



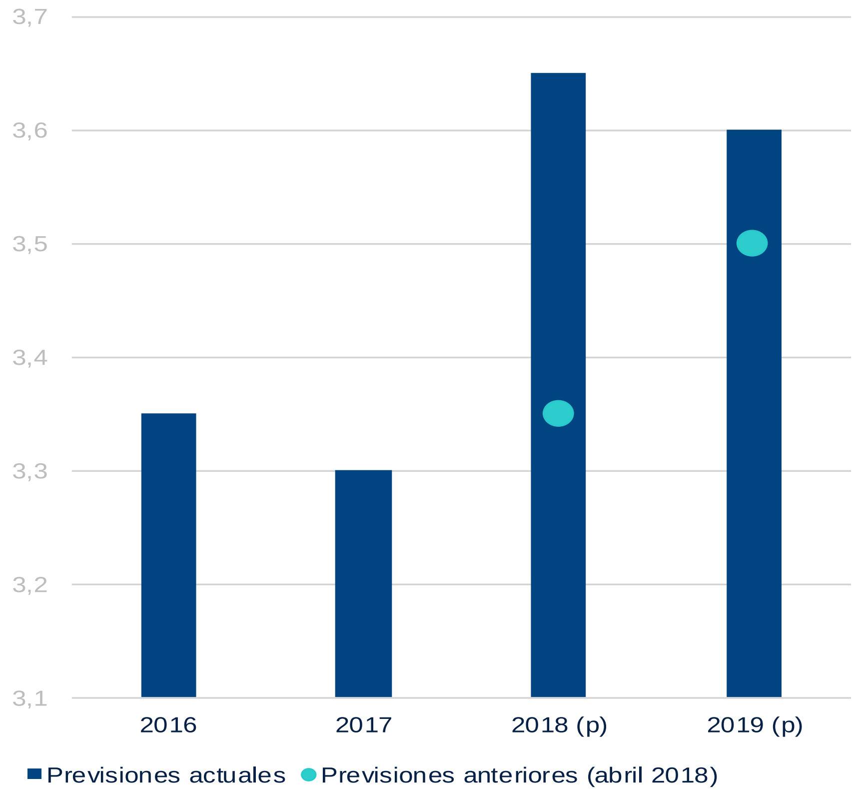
Source: : BBVA Research

Despite the reduced optimism, growth will continue to recover, supported by a relatively solid global demand, the performance of the agricultural sector, the expansive tone of monetary policy and the adjustments made in previous years

Growth could slow if there is no progress in resolving fiscal problems, especially if global risk aversion increases

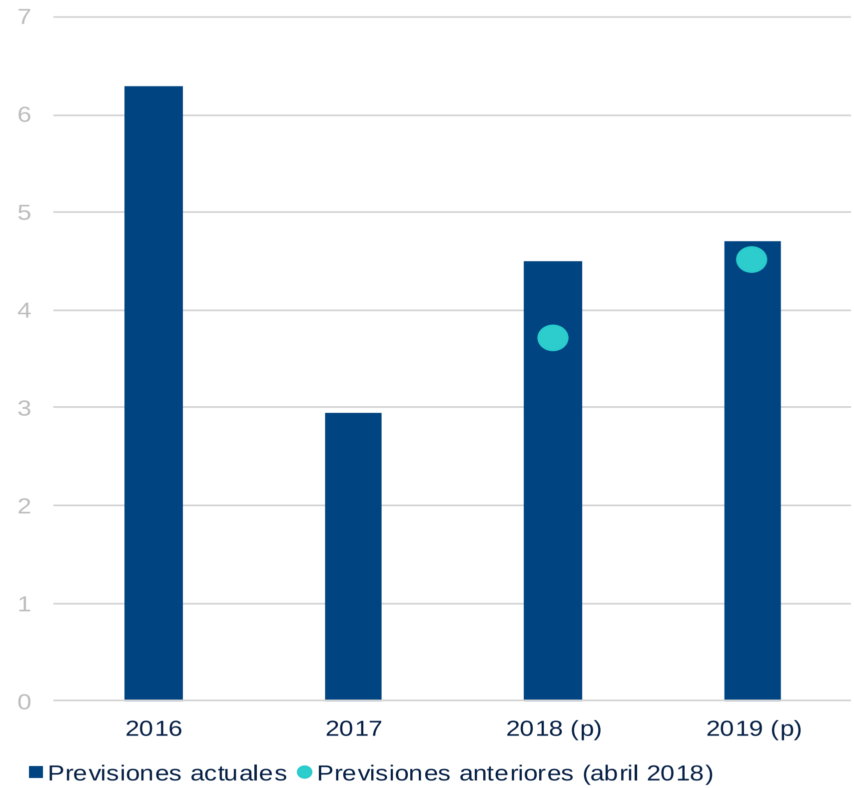
The Brazilian real will remain at more depreciated levels than those observed until a few months ago, generating greater inflationary pressures

Exchange rate
(R$/US$)



Source: : BBVA Research

Inflation: IPCA
(in %, end of period)



Source: BBVA Research

Little margin for the Brazilian real to appreciate in the short term; volatility will remain high at least until the October elections. Less uncertainty after the elections and possible positive signals from the new government on the fiscal issue should allow some appreciation of the Brazilian real towards the end of the year. Inflation on the upside due to the greater depreciation and an increase in the price of oil, in addition to the shortage caused by the truckers' strike. The BCB will maintain the rate at 6.50% until inflationary pressures force it to tighten monetary policy.

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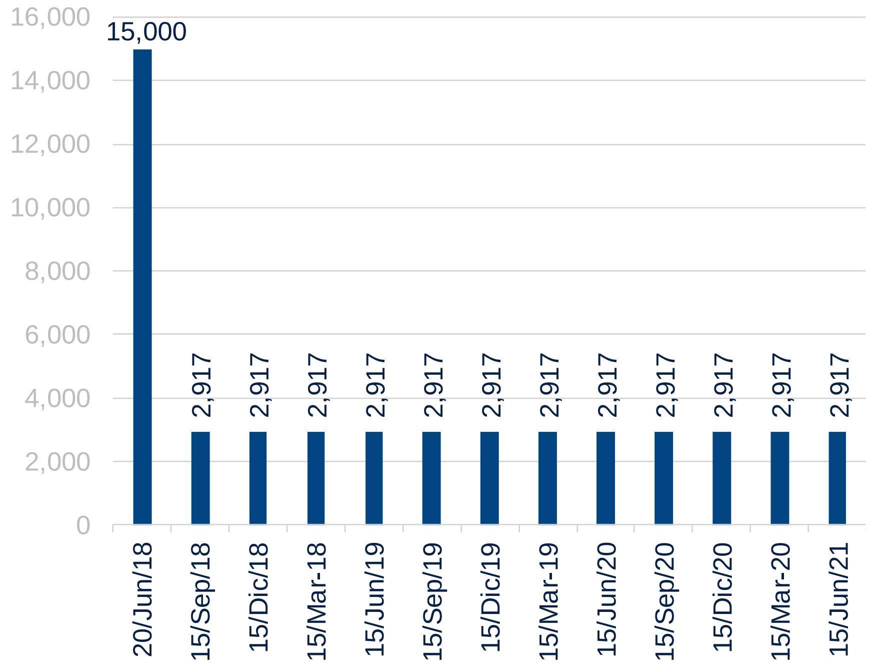
03

Argentina:
The abrupt end of the gradualist dream...

The failure of the gradualist strategy led to the implementation of Plan B

IMF Stand-By Arrangement Disbursement Schedule

(Millions of dollars)



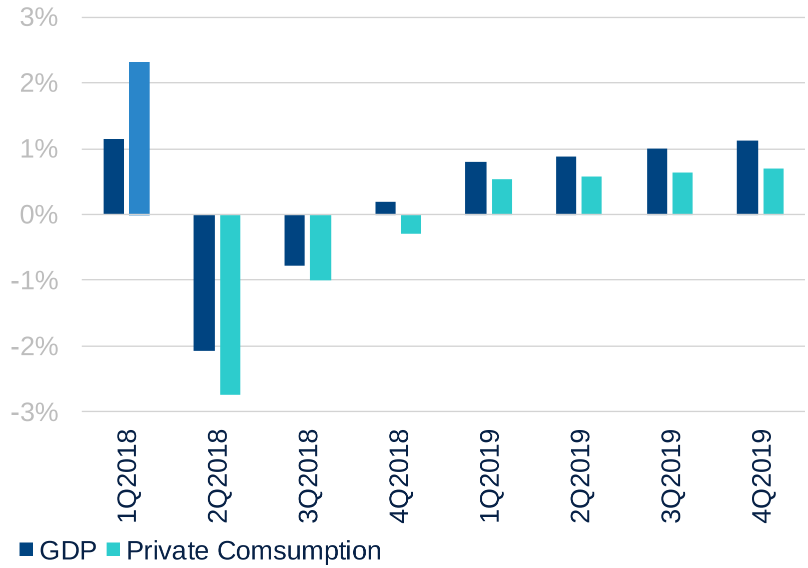
Each disbursement is made after the revision of primary fiscal deficit criteria and monetary targets of the immediately preceding quarter

- The increased cost of international financing led to a devaluation of the peso, which by mid-May had weakened by 32% despite a sharp loss of reserves due to Central Bank intervention
- The lack of credibility of the Central Bank of Argentina to stem the run on the currency and capital flight led to the request for IMF assistance to achieve an orderly adjustment process without crowding out the private sector
- A Stand-By Arrangement of US$50.5 billion over 3 years was signed in mid-June subject to compliance with stricter fiscal targets, international reserve targets and reforms to reinforce the independence of the Central Bank.

Source: : BBVA Research, IMF

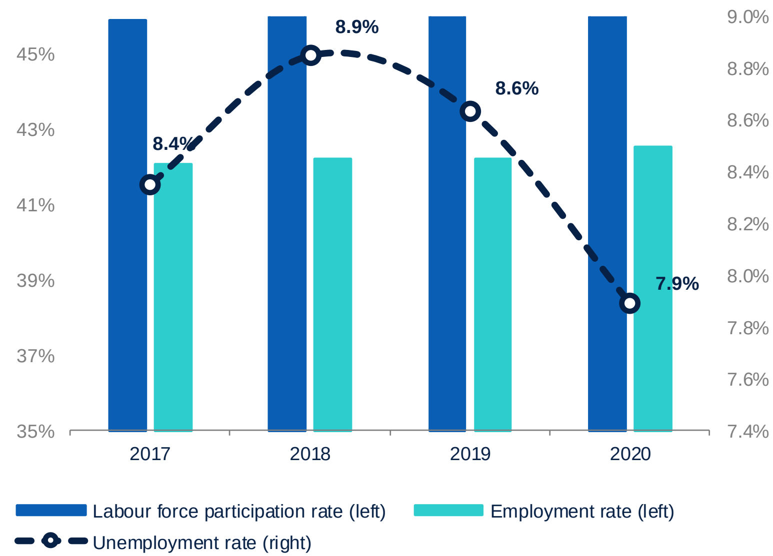
The economy will grow by only 0.5% in 2018 due to the impact of the drought and the currency crisis, but growth will recover to 1.5% in 2019

GDP and private consumption
(% change QoQ, seasonally adjusted)



Source: BBVA Research, INDEC

Labour force, employment and unemployment rates
(% of urban population and % of working population)



Source: BBVA Research, INDEC

Activity will begin to recover in 4Q18 thanks to good prospects for agriculture, after contracting in 2Q and 3Q.

In 2019 the economy will maintain an expansion rate of around 0.8% QoQ, but due to the negative drag of 2018 it will grow by only1.5% on average

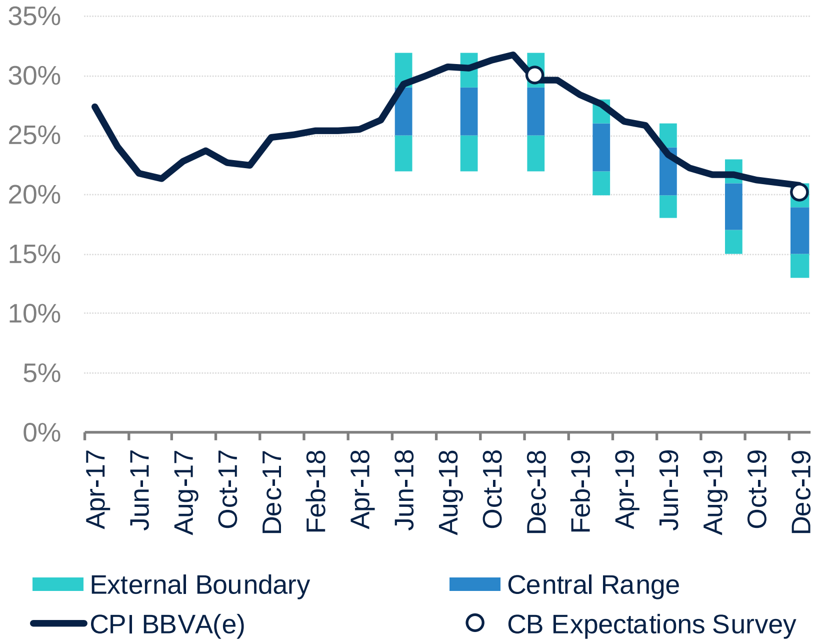
The impact of the Fx crisis will be reflected in private consumption due to a fall in real income and public consumption due to fiscal adjustment.

Unemployment, after falling back in 2017, is likely to increase as a result of lower economic activity if the labour force participation rate does not fall significantly

The impact of the devaluation is accounted for in looser inflation targets but they could be overshot again...

IMF targets and inflation estimates

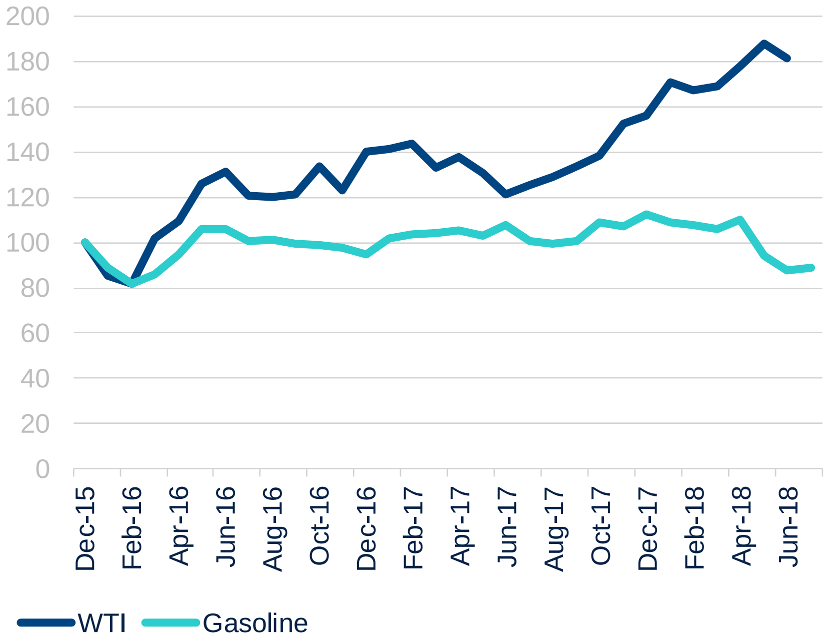
(% YoY)



Source: BBVA Research and Central Bank of Argentina

International price of oil and local price of petrol (gasoline) in dollars

(US$)



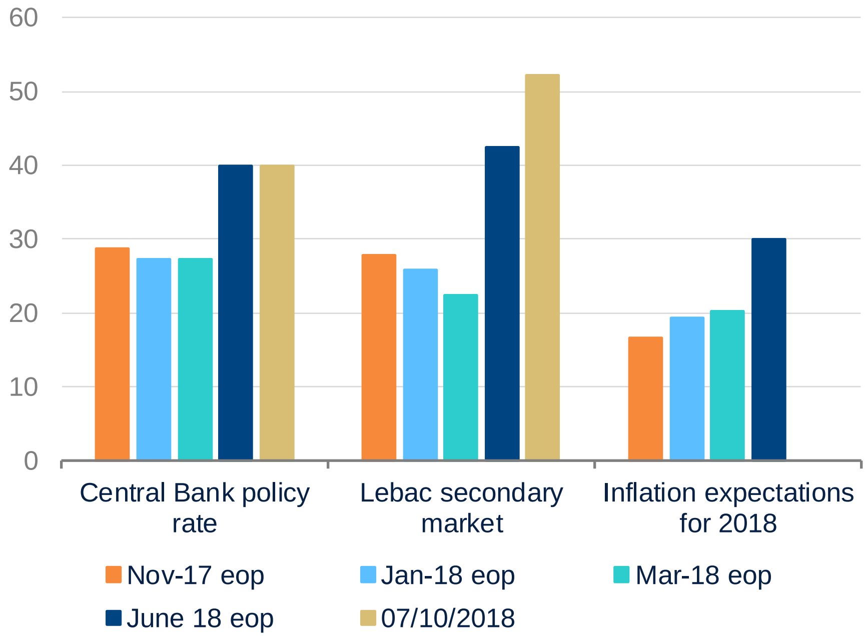
Source: BBVA Research, Haver and Confederation of Hydrocarbon and Related Trade Entities of the Argentine Republic

The inflation targets were reduced to 27% y/y (2018) and 17% (2019) but it will be necessary to consult the IMF board if inflation exceeds 32% and 21% respectively. The stabilisation of the exchange rate and a relatively contained pass-through are key for inflation to fall to 29.6% YoY at eop 2018 and 20.8% YoY in 2019

Additional inflationary pressures could come from the increase in energy prices given the strong depreciation of the peso and the increase in the international price of oil and potential renegotiation of wage agreements

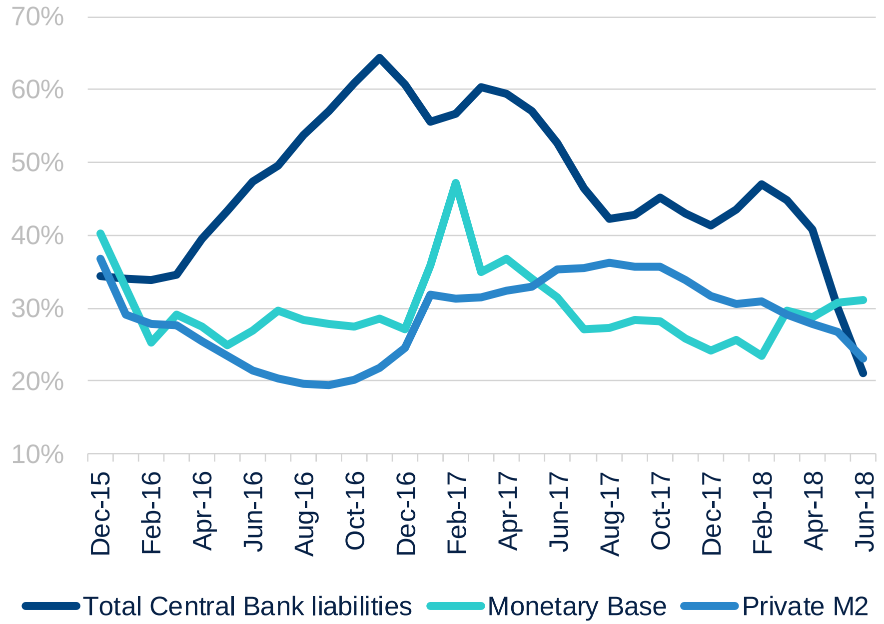
The strong tightening of monetary policy to combat exchange rate volatility will continue in the short term

Monetary Policy Rate, Lebac secondary market and expected inflation
(%)



Source: BBVA Research and Central Bank of Argentina

Monetary Base, Central bank liabilities and M2
(Change % YoY)



Source: BBVA Research and Central Bank of Argentina

The Central Bank set the MPR at 40% at the beginning of the crisis and we expect a slow decline in 4Q18 as inflation converges to lower levels.

The Lebac rate is higher than the MPR and shows more volatility due to the commitment with the IMF to reduce the stock of CB bills while restricting liquidity in order to avoid impact on the exchange rate

The Central Bank of Argentina announced that it would complement the interest rate based inflation targeting scheme with a stronger focus on following monetary aggregates.

The trajectory of M2 and the wider liabilities of the CB already reflect the increased monetary tightening

Fiscal adjustment at a faster pace will require political agreements to reach the targets agreed with the IMF in 2019

IMF agreement, income and primary expenditure variation targets
(% of GDP)

	2018	2019	2020	Acum.
Total income	**-0,4**	**0,4**	**0,1**	**0,1**
Primary expenditures	**-1,5**	**-1,1**	**-1,1**	**-3,7**
Pensions & Social benefits	0,1	0,5	-0,2	0,4
Energy & transport subsidies	-0,3	-0,4	-0,4	-1,1
Salaries, goods and services	-0,4	-0,2	-0,1	-0,7
Transfers to provinces	-0,2	-0,3	-0,1	-0,6
Other expenditures	0,0	-0,1	0	-0,1
Capital expenditures	-0,7	-0,6	-0,3	-1,6

- The revised target of 2.7% of GDP for 2018 can possibly be overachieved since in the 1st half of 2018, the primary deficit fell to 0.8% of GDP
- Our forecast of total deficit after interest remains at 5.3% of GDP due to the fact that the improvement of the primary deficit will be neutralised by higher interest charges on dollarized debt.
- The reduction of the primary deficit by 1.3% of GDP committed to for 2019 will require continued adjustments in primary spending since no increases in tax pressure are contemplated
- Pensions and social benefits will continue to increase slightly, but a reduction of energy and transport subsidies is expected. Additional cuts in capital spending, in the public sector wage bill and transfers to provinces that will require negotiations with the opposition

Source: BBVA Research and Treasury

Argentina will avoid accessing international markets in the remainder of 2018 and 2019

Official Financial Programme

(USD billions)

	Jul-Dec 2018	2019
Financial needs	**19,6**	**32,3**
Primary deficit	8,4	7,4
Interest payments (private sector)	6,0	14,0
Principal payments (private sector)	5,2	10,9
International bonds	0,3	2,8
Repo	3,9	3,2
Domestic bonds	1,0	5,0
Sources of financing	**19,6**	**32,3**
International markets (gross)	0,0	3,0
Repo	0,0	4,0
IFIs	16,4	13,0
IMF	13,4	11,7
Other	3,0	1,3
Domestic markets (gross)	3,2	12,3
Intra public sector	0,0	0,0
Net financing from markets		8,0
GDP (%)	0,4	1,4
Exchange rate (28/Jun/18)	27,81	27,81

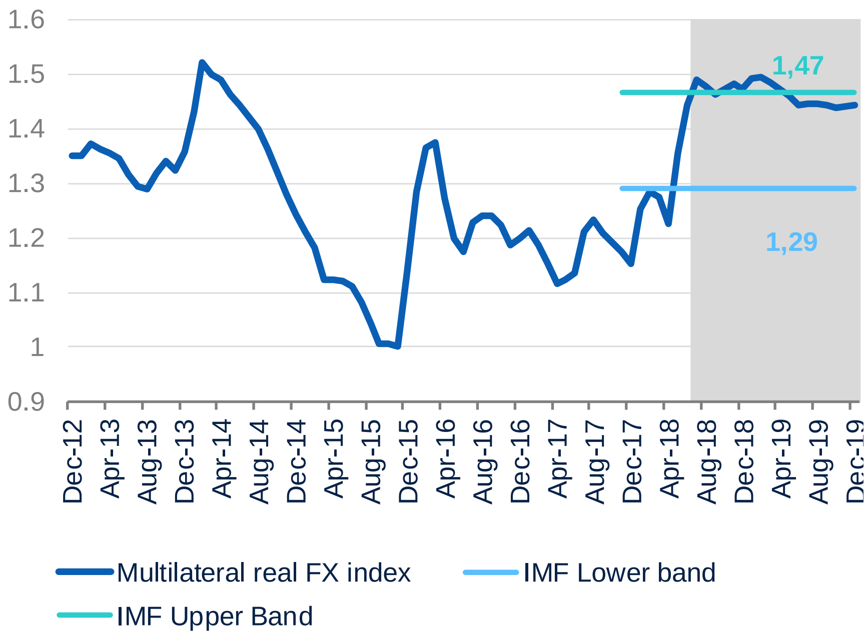
Assumptions: Excludes Letes and assumes full renewal of maturities in 2018 and 2019. Gross financial needs of 2019 will be financed in the domestic market.

Source: BBVA Research and Treasury

- The official financial programme for 2019 envisages the issuance of US$8 billion in net terms, to be placed in the domestic market.
- Most of the deficit will be covered by the disbursements from the IMF and the Multilateral Credit Agency.
- The programme assumes the renewal of the maturing debt including Letes in dollars (about USD 18 billion in 2018).
- The gradual replacement of Lebac by Treasury debt agreed on with the IMF, in addition to the objective of replacing Letes with longer-term bonds could add some volatility to the markets during the year.

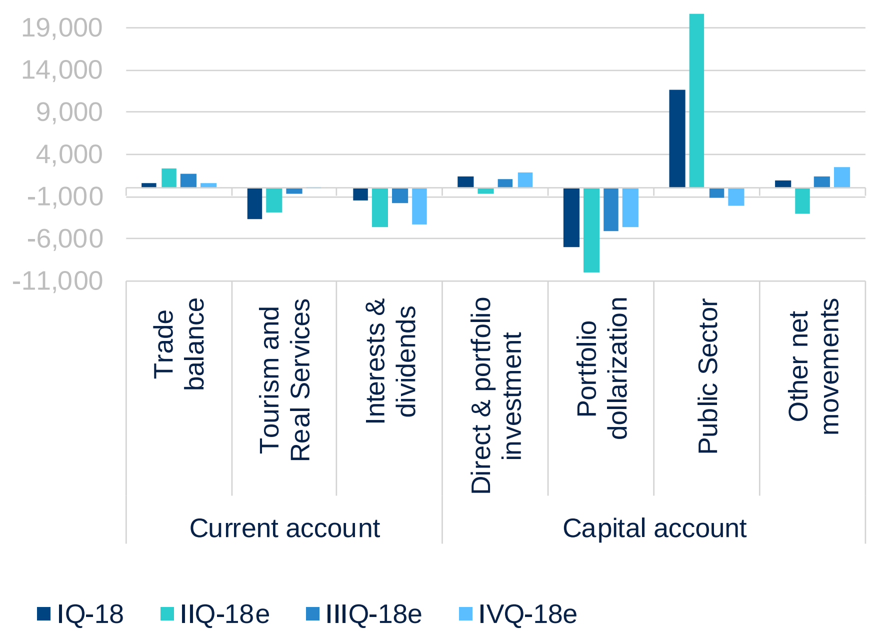
The adjustment of the external sector requires a depreciated and stable real exchange rate

Multilateral Real Exchange Rate and IMF bands
(Index Base 2015:11=1)



Source: BBVA Research and Central Bank of Argentina

Exchange market Balance 2018: main items
(Millions of dollars)



Source: BBVA Research and Central Bank of Argentina

The adjustment in the current account will be slow: 0.2 pp in 2018 and 0.6 pp in 2019 due to the drought. The real depreciation of the peso of 25% in 2018, if pass-through remains contained, will reduce the imports of goods but above all of services, with a strong adjustment in tourism

Reduced portfolio dollarization, together with the reduction of the current account deficit, will allow the level of net reserves to recover by around US$5.5 million in 2H18, as agreed with the IMF.

Argentina could reduce its external vulnerability with more FDI but this requires avoiding frequent changes in the ground rules

Comparative ranking: receipt of FDI, attractive potential and extended potential appeal (2010-2017)

Total countries: 189

Country	Actual FDI received	Potential for FDI attraction	Potential FDI attraction including Institutional Variable
Brazil	19	46	58
Colombia	25	77	57
China	27	5	39
Spain	37	27	30
Mexico	41	23	28
Czech Republic	46	12	11
Uruguay	52	71	52
India	61	21	47
Turkey	79	2	5
Argentina	**86**	**33**	**60**
Egypt	89	43	61

Source: BBVA Research, World Bank, IMF, Heritage Foundation

The potential of Argentina as an FDI destination not only depends on its endowment of natural resources and the size of its market, but legal and institutional stability is also a key variable when determining the attractiveness of an economy for long-term investors.

Focus on day to day emergencies, along with the political cost of rebalancing the economy towards greater savings could generate setbacks in the progress of structural reforms and the improvement of institutional quality

Annual macroeconomic forecasts

	2016	2017	2018 (f)	2019 (f)
GDP, INDEC base 2004 (% y/y)	-1,8	2,9	**0,5**	**1,5**
Inflation, National CPI (% y/y, eop)	39,4	24,8	**29,6**	**20,8**
Exchange rate (vs. USD, eop)	15,8	17,7	**28,9**	**32,9**
Policy rate (%, eop)	24,8	28,8	**32,0**	**21,0**
Private consumption (% y/y)	-1,0	3,5	**0,5**	**0,1**
Government consumption (% y/y)	0,3	2,2	**-1,1**	**-0,1**
Invertment (% a/a)	-4,9	11,0	**6,4**	**0,3**
Fiscal balance (% GDP)	-5,8	-6,0	**-5,3**	**-4,0**
Current account (% GDP)	-2,7	-4,9	**-4,7**	**-4,1**

(f) Forecast.
Source: BBVA Research