

Argentina: Current Economic Conditions and the Effects of Macri's Policies

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Overview

Argentina grew 0.3% YoY in Q1 2017, the first positive figure after three consecutive quarters of GDP contraction last year.

Over the last decade, the primary fiscal deficit and the current account deficit increased and inflation was consistently high. These problems are among the most important that were choking the economy. At the end of 2015, Macri was elected president. In order to address these economic problems, his government began implementing a series of policies.

Recent signs indicate that Macri's policies may be beginning to have a modest, positive impact on the Argentinean economy. Argentina is expected to record positive economic growth in 2017 and 2018. Business friendly policies, such as the removal of export taxes and import restrictions, are expected to increase private investment. The stabilization of inflation is another key factor that will help the economy. Although Argentina's year-end inflation rate is expected to be above the upper range established by the Central Bank, inflation will be considerably lower than in 2016.

Congressional elections will take place in October 2017 and this is a process that requires follow up due to its potential impact on policy implementation.

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1. Argentina's Current Economic Conditions

GDP

Argentina passed through several cycles of economic growth followed by a contraction over the past 10 years. In Q1 2017, Argentina grew 0.3% (Figure 1), the first positive figure after three consecutive quarters of GDP contraction last year.

Consumption

Household consumption is still on weak footing, although in Q1 2017 it registered its first positive figure (0.9% YoY) since Q1 2016 (Figure 2). The persistently high inflation, although lower than in the previous year, continues to be a drag on household consumption.

Investment, Exports and Imports

Investment is slowly recovering and in Q1 2017 registered an increase of 3.0% YoY (Figure 3), the first positive figure since Q4 2015. This was mainly driven by an increase in construction (2.0% YoY) and transportation equipment (21.0% YoY). Exports registered a drop of 1.8% YoY that is mainly explained by a fall in exports of soybeans products. Imports, on the other hand, grew 4.3% YoY due mainly to an increase in automobiles and fuels and lubricants.

Figure 1: GDP

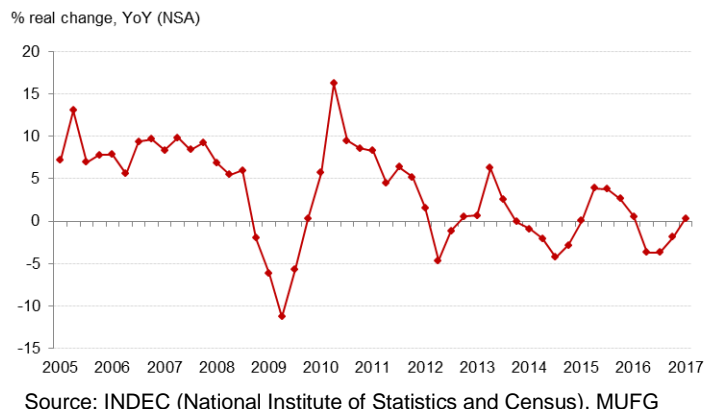


Figure 2: Consumption

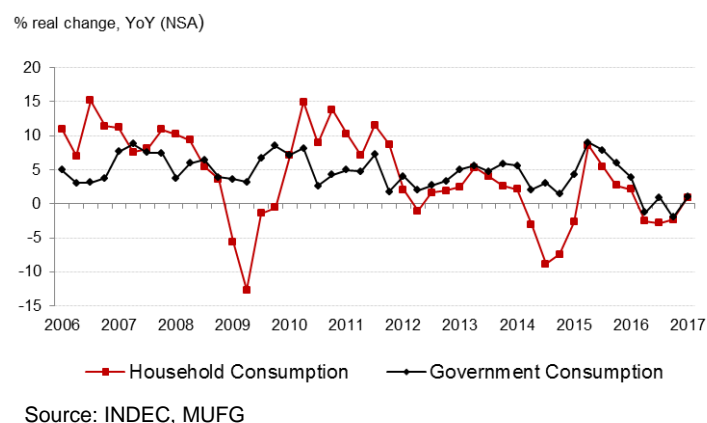
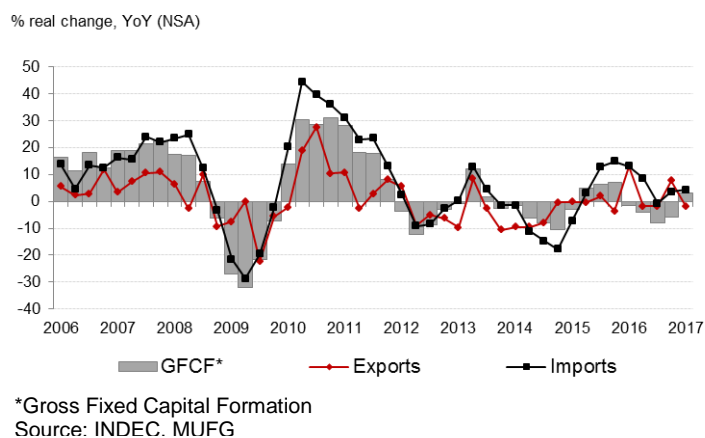


Figure 3: Investment, Exports and Imports



2. Argentina's Structural Problems and Macri's Economic Policies

Over the last decade, the primary fiscal deficit and the current account deficit increased and inflation was consistently high. These problems are among the most important that were choking the economy. At the end of 2015, Macri was elected president. In order to address these economic problems, his government began implementing a series of policies.

2.1 Fiscal Deficit

a) The Deterioration of the Fiscal Balance

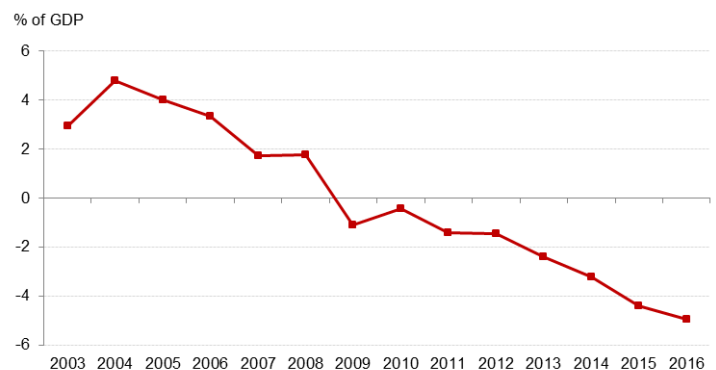
Starting in 2008, the primary fiscal surplus Argentina enjoyed began to erode and the fiscal balance shifted from a primary surplus of almost 2.0% of GDP in 2007 to a deficit of 4.4% of GDP in 2015 (Figure 4).

The principal factor that led to a deterioration of the primary fiscal balance was continuous rapid growth in expenditures caused by an increase in social spending, rather than a fall in revenues. The fiscal balance was further exacerbated by low commodity prices and the global financial crisis.

Public social expenditures comprise the largest share of expenditure, and by 2015, they represented around 30% of GDP (Figure 5)¹. Social security expenditures comprise the largest share of public social expenditures.

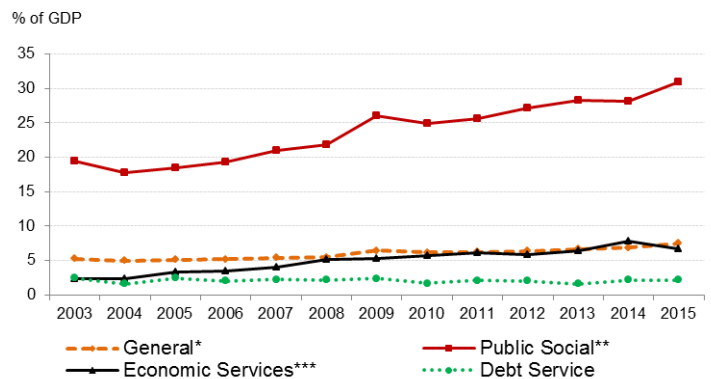
Subsidies to energy expenses were another reason for the rapid increase in expenditures.

Figure 4: Argentina's Primary Balance



Source: IMF, MUFG

Figure 5: Expenditures by purpose



* Includes expenditures on justice, defense and general administration.

** Includes social security, subsidies and programs in education, health, and other social sectors.

*** Includes energy and transportation subsidies, expenses on communication, industry and others.

Source: Treasury Ministry, MUFG

¹ The government changed methodology in 2016; historical data with this new methodology is not available. Figure 5 is based on the previous methodology.

b) Macri's Policy to Improve the Fiscal Balance

In January 2016, in order to improve the deteriorated fiscal balance, the government eliminated energy subsidies². Nevertheless, the fiscal deficit increased to 4.9% of GDP in 2016 from 4.4% of GDP in 2015³. The bulk of government expenditures continued to be social security expenditures, and as there was no policy change regarding these payments, they grew by more than the savings from the elimination of the energy subsidies.

The attempt to reign in the fiscal deficit appears to have been short lived, and in June 2017, the government modified their 2017 budget, increasing expenditures. This change will likely increase the fiscal deficit, which is currently expected to be 4.2%⁴ of GDP. This measure may be due to the upcoming congressional elections in October⁵, with the government attempting to spur economic growth and ensure that social security payments continue without any changes.

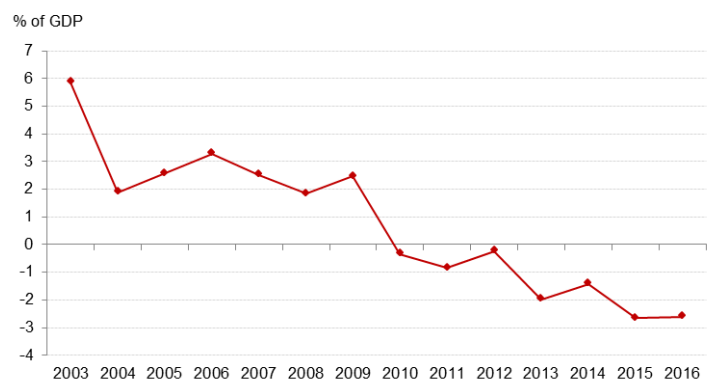
2.2 Current Account Deficit

a) The Deterioration of the Current Account

In 2010, Argentina moved from a current account surplus to a deficit, a deficit that continued in subsequent years (Figure 6).

There are several factors that affected the current account balance in Argentina. Some of the possible factors that led to a deterioration of the current account balance are the increase in capital outflows, the imposition of a series of export taxes and import licenses. Exacerbating the factors mentioned above, the end of the commodity price boom, the global slowdown in economic growth, and especially the lackluster economic performance in Brazil strained Argentina's current account balance even further.

Figure 6: Current Account Balance



Source: IMF, MUFG

² Electricity tariffs in Argentina were frozen since 2003. Subsidies benefit mostly the province of Buenos Aires. Electricity and gas prices are still regulated by the government and a social tariff to protect the most vulnerable is still in place. In 2016, the cost of natural gas was increased around 220%. In 2017, the government announced an increase in gas prices of about 25% and in January 2017, announced an increase in electricity tariffs of around 30%. The price increases will likely affect inflation in 2017. Government expenditures on the energy subsidy grew 1,400% in the last 9 years in nominal terms.

³ This figure is based on IMF data. The Government reported that the primary balance in 2016 was -4.6% of GDP.

⁴ Fiscal target set by the government.

⁵ Argentina will hold congressional elections in October 2017, where one third of the upper house and half of the lower house are up for election. Macri's party currently does not hold a majority in either house of Congress, and the congressional elections are likely to be a referendum on Macri's policies and could foreshadow the presidential election in 2019.

b) Macri's Policies to Improve the Current Account Balance

In December 2015, in order to improve the current account balance, Macri's administration eliminated export taxes on products such as wheat, corn and beef⁶ and reduced the tax on soybean exports from 35% to 30%. His administration also lifted the import restrictions that were previously in place. The current account deficit reduced slightly in 2016 compared to 2015 (-2.6 % of GDP from to -2.7% of GDP). The fact that Brazil was in recession during 2016 reduced the impact of these policies.

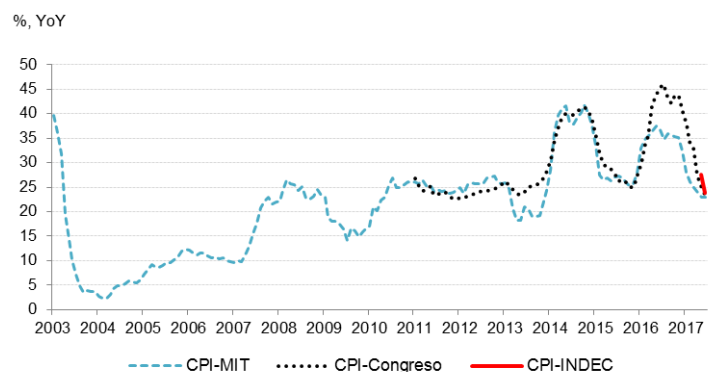
2.3 High Inflation

a) The Increase in Inflation in Argentina During the Last Ten Years

Argentina has a history of having high inflation and this situation worsened considerably since the global financial crisis. The inflation rate released by the government hid the real magnitude of the inflation increases in Argentina from 2011 to 2015 because the National Institute of Statistics became politicized and lost credibility. As a result, several private organizations calculated a more realistic inflation rate for Argentina (Figure 7)⁷.

While constant increases in food prices due to trade restrictions contributed to the high inflation, the depreciation of the currency⁸ and the increase in money supply⁹ are other factors that may have led inflation to rise even further.

Figure 7: Inflation Rate



Note: For further information please see footnote 7.
Source: MIT, Argentina Congress, INDEC, MUFG

⁶ 20% tax on corn exports, 23% tax on wheat and 15% tax on beef exports.

⁷ **CPI-MIT** corresponds to a private calculation of the CPI of Argentina. Cavallo, Alberto, professor at MIT.

CPI-Congreso is the average of 9 consulting firms plus the official inflation of San Luis and the city of Buenos Aires. This inflation rate was widely used by analysts in order to report Argentina's inflation during 2011-2015, and it is still in used to monitor INDEC figures.

CPI-INDEC corresponds to new official figures. INDEC underwent many changes after the election of Macri and started publishing more reliable information about consumer prices beginning in April 2016. Historical data is not available.

⁸ As a result of restrictions on the foreign currency market an un-official (black) market develop where people could buy and sell foreign currency. The price of foreign currency in this market was much higher than the official exchange rate.

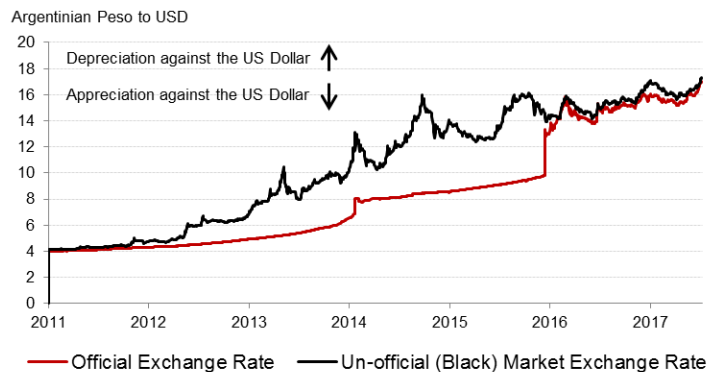
⁹ During the previous administration, changes were implemented at the Central Bank in order to finance the fiscal deficit. Some of the changes that took place between 2010 and 2015 were: a) In 2010, the previous president dismissed by decree the governor of the Central Bank because he refused to fund government expenditures with foreign reserves; b) In 2012, the Central Bank charter was modified, increasing the amount of resources the government could obtain from the Central Bank.

b) Macri's Policies that Affected Inflation

Some policies that Macri has implemented so far have had mixed effects on the inflation rate. For instance, Macri lifted currency controls, which caused the peso to depreciate and led to an increase in the inflation rate in 2016 (Figure 8).

On the other hand, the Central Bank recovered its independence, allowing it to focus¹⁰ on inflation. The Central Bank has explicitly stated that its main objective will be to control inflation. The YoY inflation target established by the Central Bank is between 12% and 17% for 2017. In 2017, the Central Bank increased the interest rate once by 1.5%, from 24.75% to 26.25%, due to the persistently high inflation, and at its meeting in July, the Central Bank decided to keep the rate unchanged.

Figure 8: Foreign Exchange Rate



Source: Bloomberg, DataStream, MUFG

3. Economic Outlook

Recent signs indicate that Macri's policies may be beginning to have a modest, positive impact on the Argentinean economy. Argentina is expected to record positive economic growth in 2017 and 2018. Business friendly policies, such as the removal of export taxes and import restrictions, are expected to increase private investment. The stabilization of inflation is another key factor that will help the economy. Although Argentina's year-end inflation rate is expected to be above the upper range established by the Central Bank, inflation will be considerably lower than in 2016.

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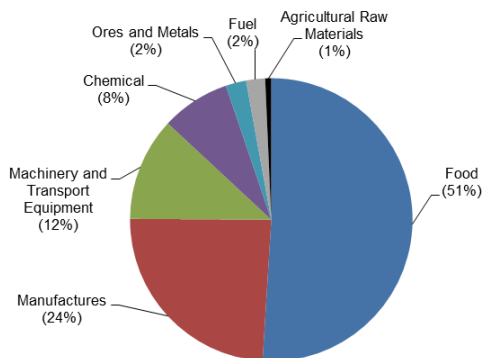
¹⁰ In 2016, Argentina's Congress approved the payment of the remainder of its outstanding unpaid debt of 4.6 billion dollars. This enabled Argentina to borrow from international creditors and finance their activities through sovereign bonds once again, instead of via the Central Bank.

Box 1: Exports Profile

Argentina is the main exporter of soybean and its sub-products in the world¹¹. As a result, Argentina's economy remains heavily dependent on commodities. In 2015, food exports (soybean meal (17.0%) and soybeans (7.4%)) were among the most important exported products and accounted for over 50% of total exports (Figure 9).

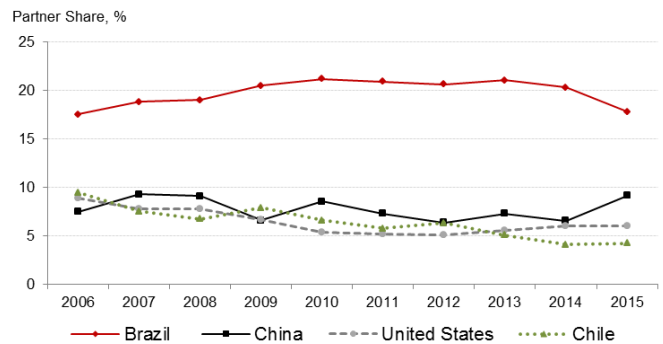
Brazil is Argentina's largest export market, and 17.8% of total Argentinean exports went to Brazil in 2015 (Figure 10). Reduced demand from Brazil has exacerbated the weakening of export sectors in Argentina.

Figure 9: Exports by Products (2015)



Source: World Bank, MUFG

Figure 10: Top 4 Export Partners*



*Based on 2015 data
Source: World Bank, MUFG

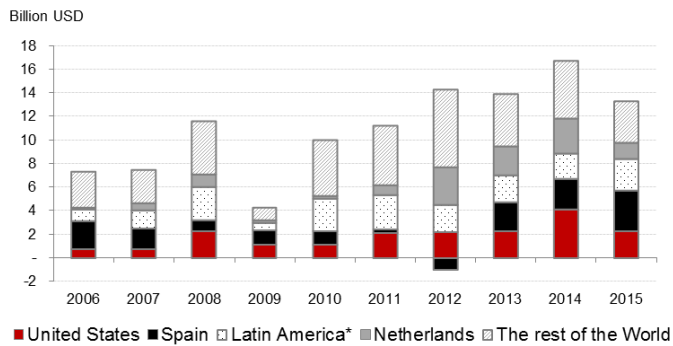
¹¹ Argentina accounts for 36% of total world exports (MIT, media atlas).

Box 2: FDI Profile

The three main investors in Argentina are Spain, US and Netherlands (Figure 11), and the principal sectors where this investment was directed in 2015 were the chemical, rubber and plastic industry (26%), financial services (14%) and the food industry (10%) (Figure 12).

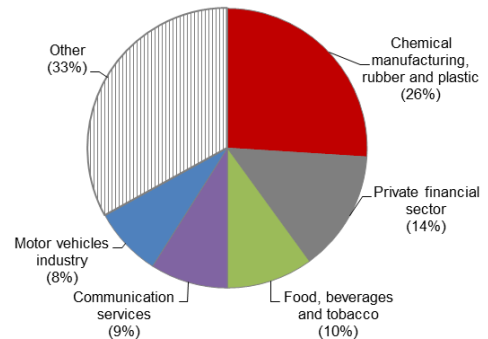
Protectionist policies implemented by the previous administration, such as the nationalization of the energy sector (that affected the Spanish oil company Repsol) and tax increases on the agricultural sector, are likely to have discouraged some investors in the past.

Figure 11: Argentina's FDI Inflow by Country



*Chile, Uruguay and Brazil
Source: Central Bank of Argentina, MUFG

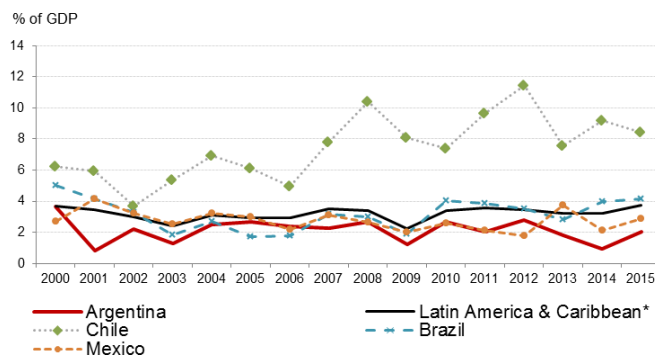
Figure 12: Argentina's FDI Inflow by Sector (2015)



Source: Central Bank of Argentina, MUFG

Throughout Latin America, FDI accounts for just around 4.0% of GDP, while FDI in Argentina accounted for only 2.0% of GDP in 2015 (Figure 13).

Figure 13: Latin American's FDI Inflow



*Based on the World Bank classification, 28 countries are taken into account
Source: World Bank, MUFG

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