

Challenging times

Economics – South America | November 2016

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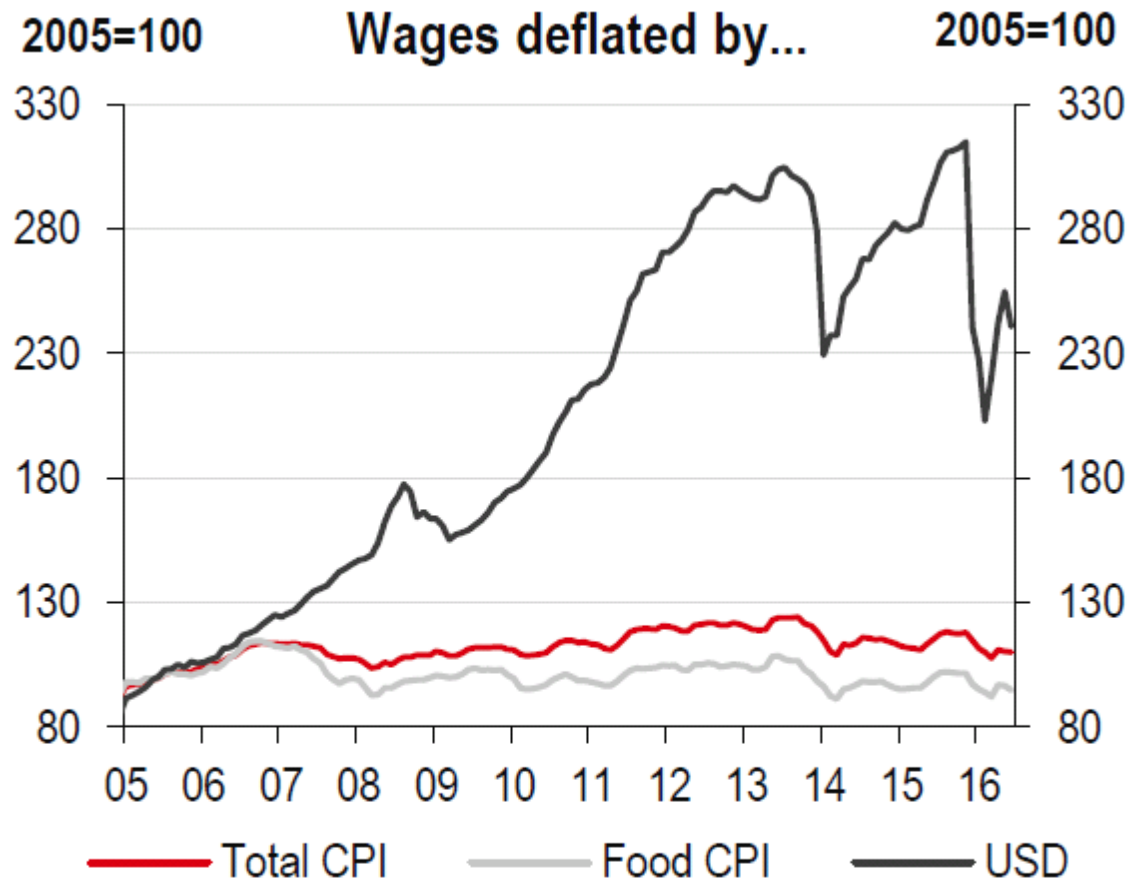
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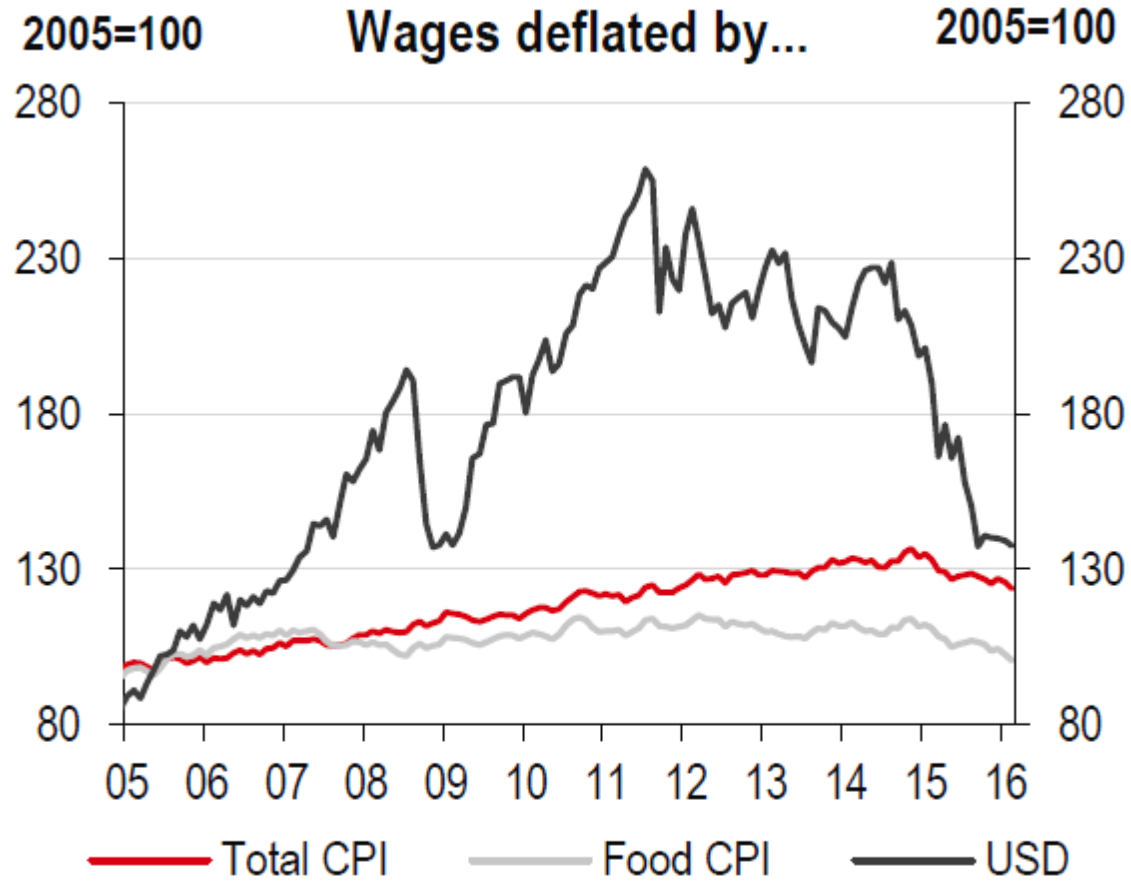


South America

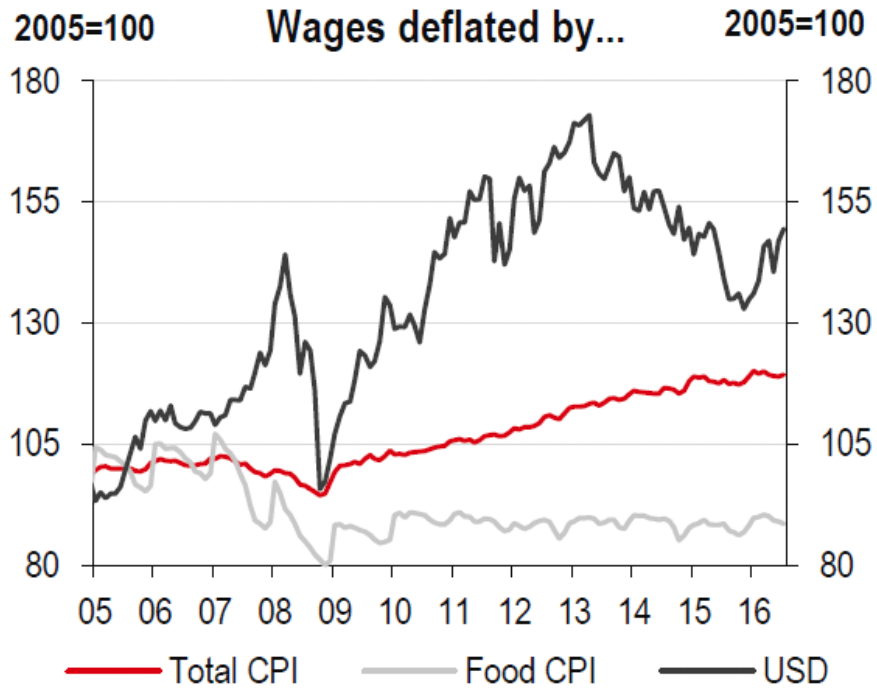
- Stylized facts
 - All of South America has now wages measured in US dollars that are higher than 10 years ago. In some cases, they are more than double, like in Argentina or Uruguay
 - All countries have wages measured in food that are around equal to or lower than 10 years ago – with the exception of Uruguay
- Traps
 - Competitiveness: expensive USD wages suggest that currency adjustment should not be over but FX policy limited by its impact on food prices
 - Fiscal: low food wages render social policies sticky



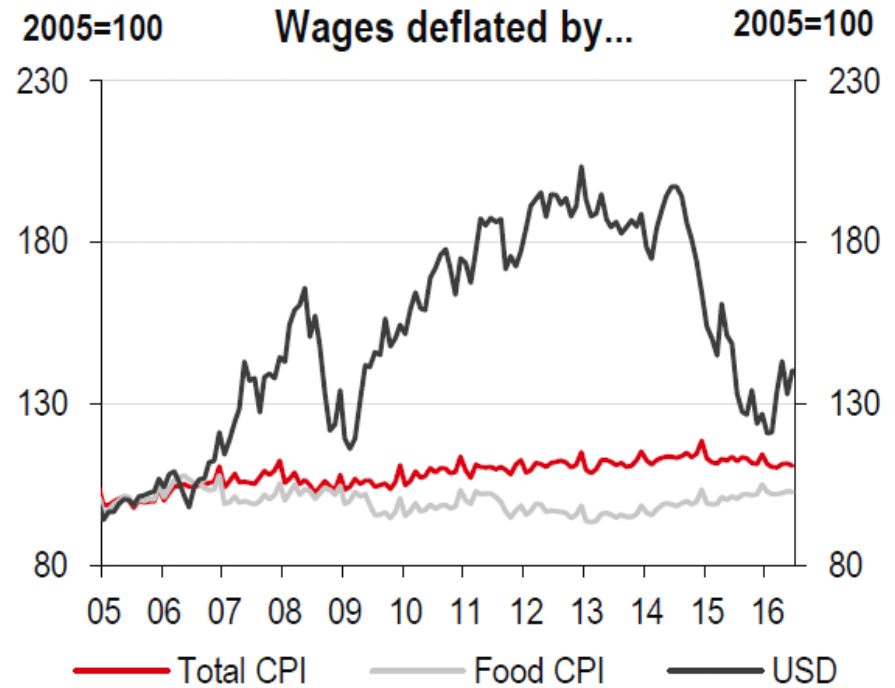
Source: INDEC, BCRA, "Congress CPI" for inflation



Source: IBGE, Reuters Datastream



Source: INE, Central Bank of Chile



Source: DANE, BanRep



Argentina

Impressive pace of reform at the onset

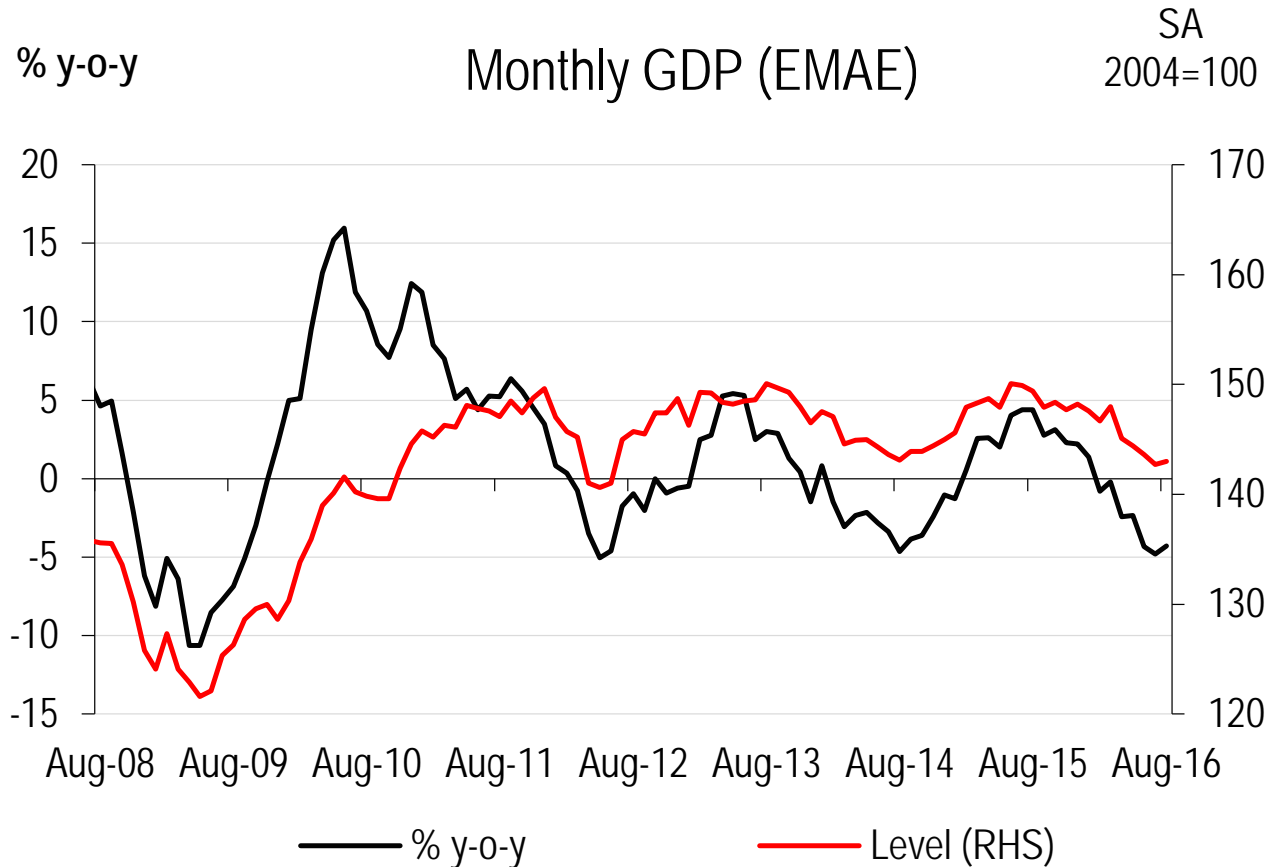
- Sharp currency depreciation
- Liberalization of the capital account
- Reduced tax on exports
- Replenishing liquid central bank reserves
- Significant reduction of the monetary overhang inherited from financial repression
- Steps towards inflation targeting regime
- Settlement and payment to a majority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

But...

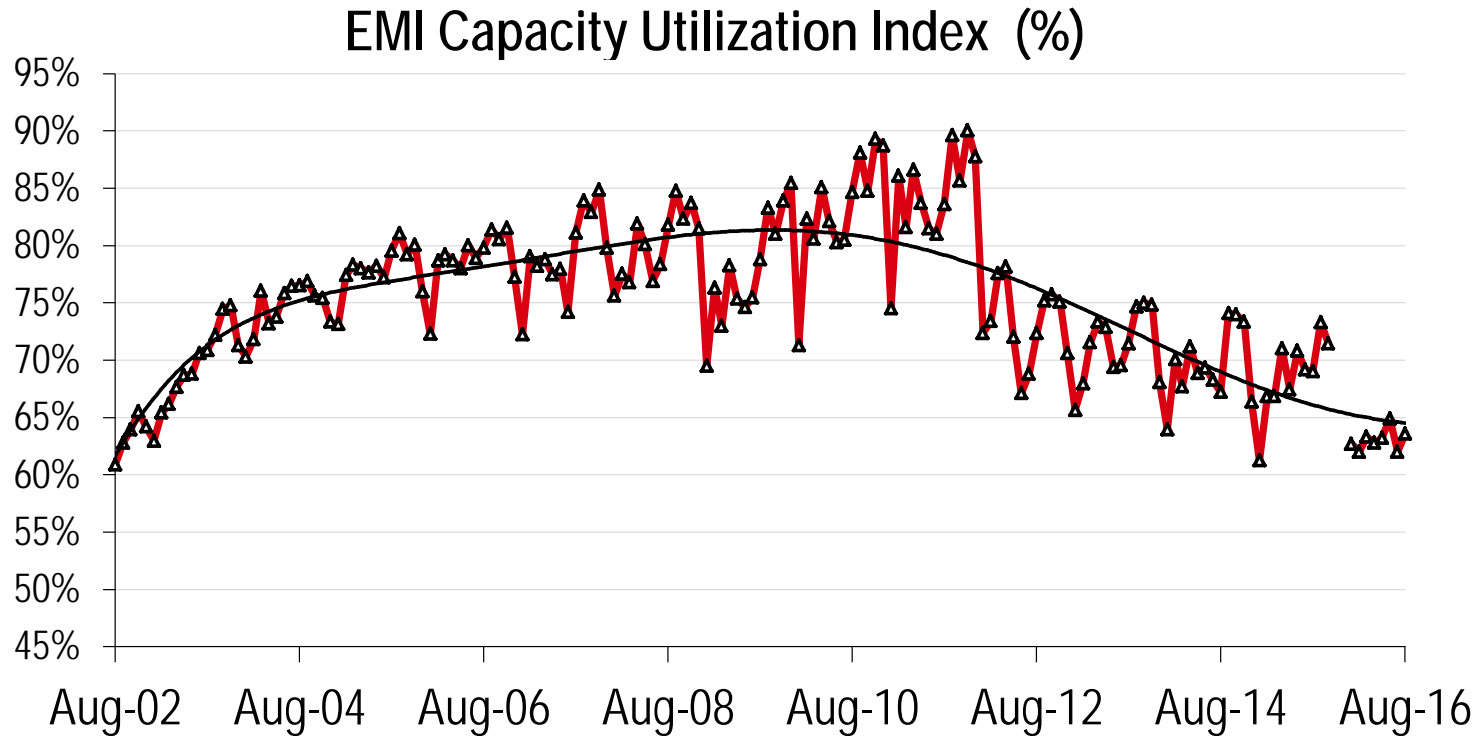
- Initial ARS depreciation partially reverted by inflation
- Import restrictions still in place
- Sterilization is costly
- Renew issuance at a dear cost and in some cases to finance current expenditures
- Fiscal consolidation practically null
- Partial reversal on tariff adjustment
- Recession is deeper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

- Recession
- High Inflation è tight monetary policy to continue
- Backward looking wage negotiations è 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 è macro will be a key factor for elections

Recession lasting through 3Q-2016



Lots of spare capacity to use before investing

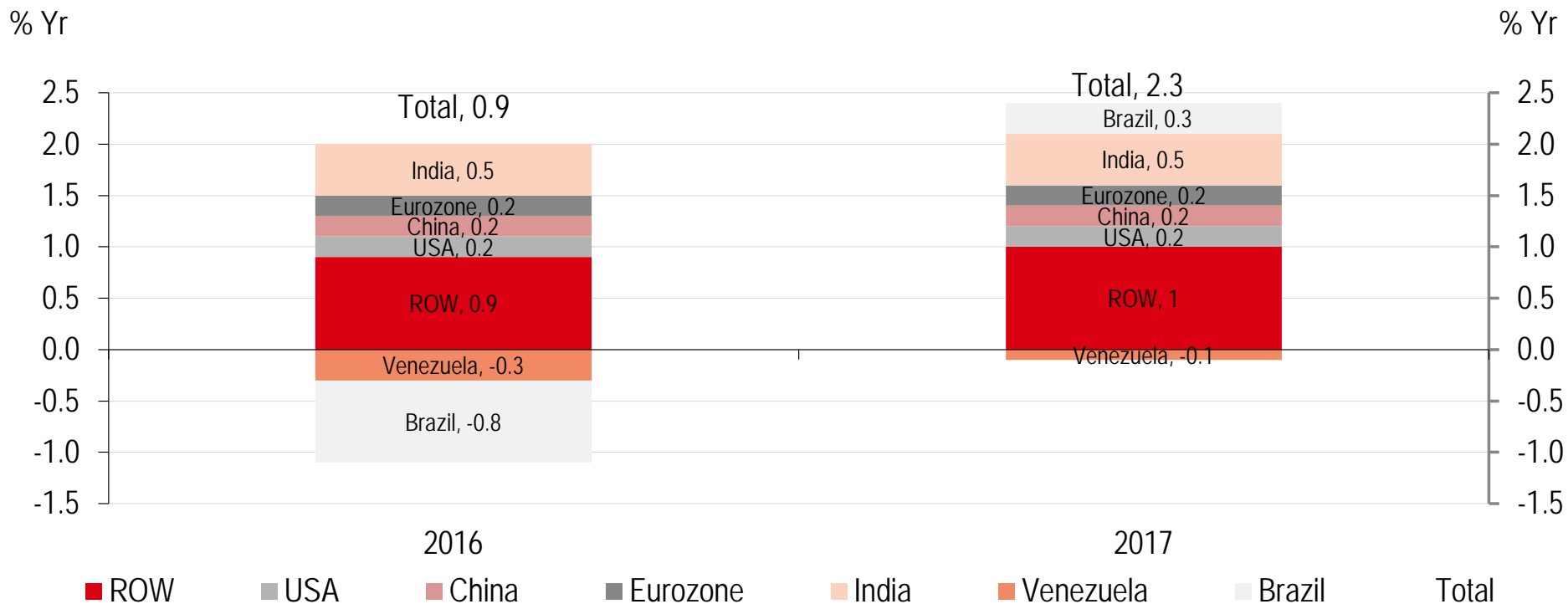


Why is recovery taking so long –and who's to blame?

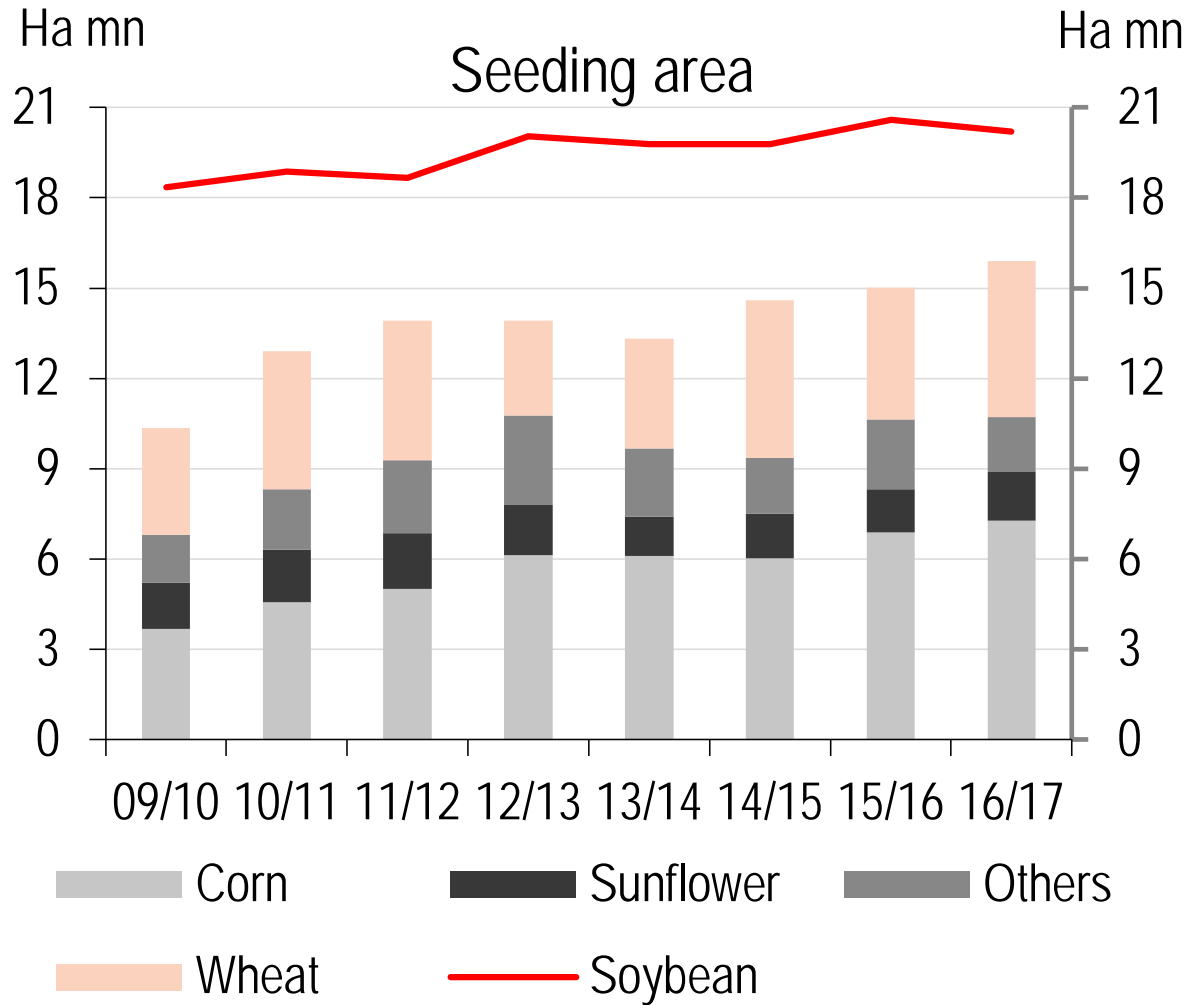
- First round, impacted lower class (due to depreciation); second round impacted middle class (due to tariff hikes)
- Job destruction in construction (public works) and manufacturing (Brazil→cars)
- Brazil
- Monetary policy overkill: very high real rates and/or too much absorption
- Uncertainty →savings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

External outlook improvement due to Brazil

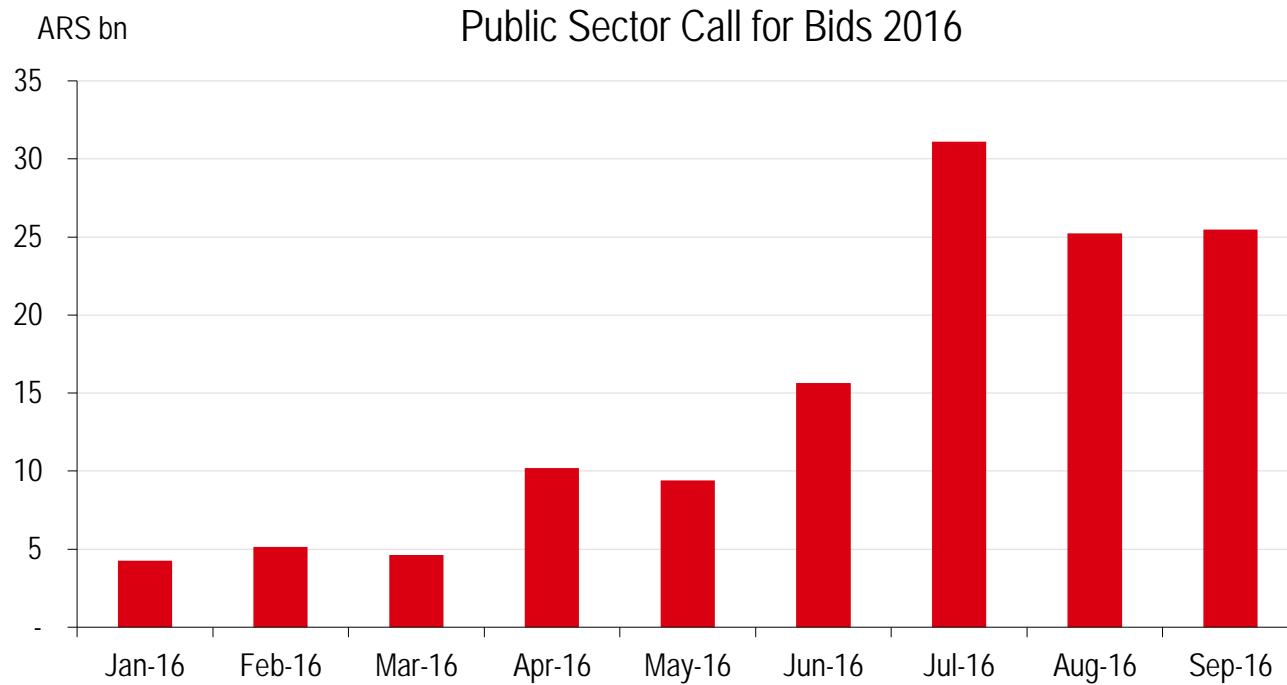
- Growth contribution of Argentina main trading partners



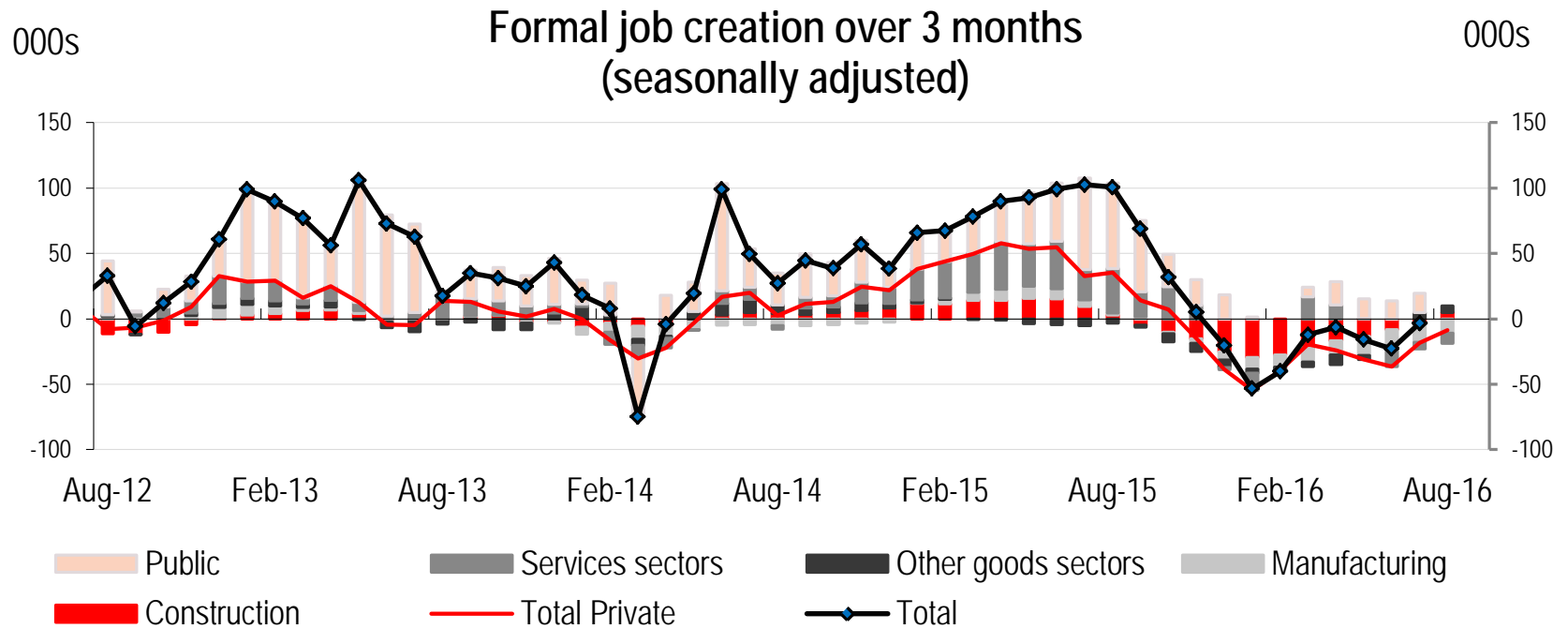
Good harvest prospects



Demand for public works picking up in 3Q16



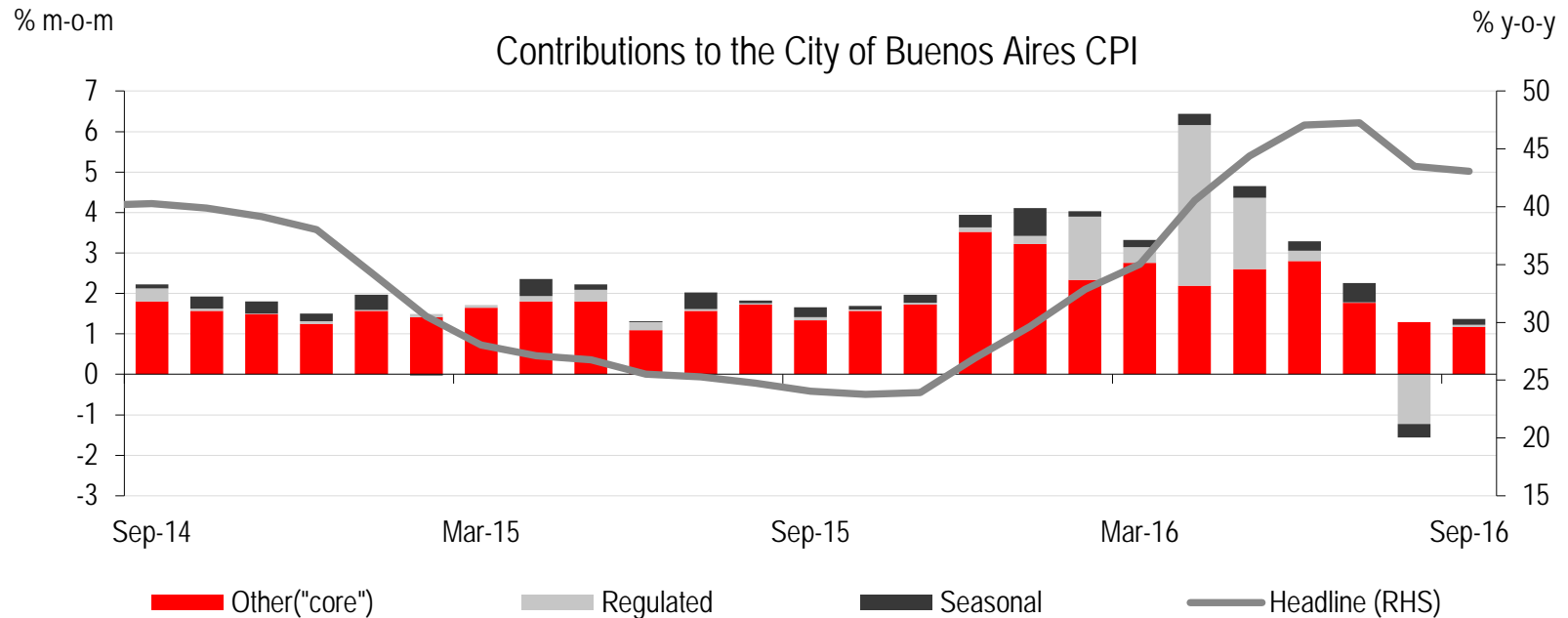
Labor market also improving



Why do we expect above target inflation?

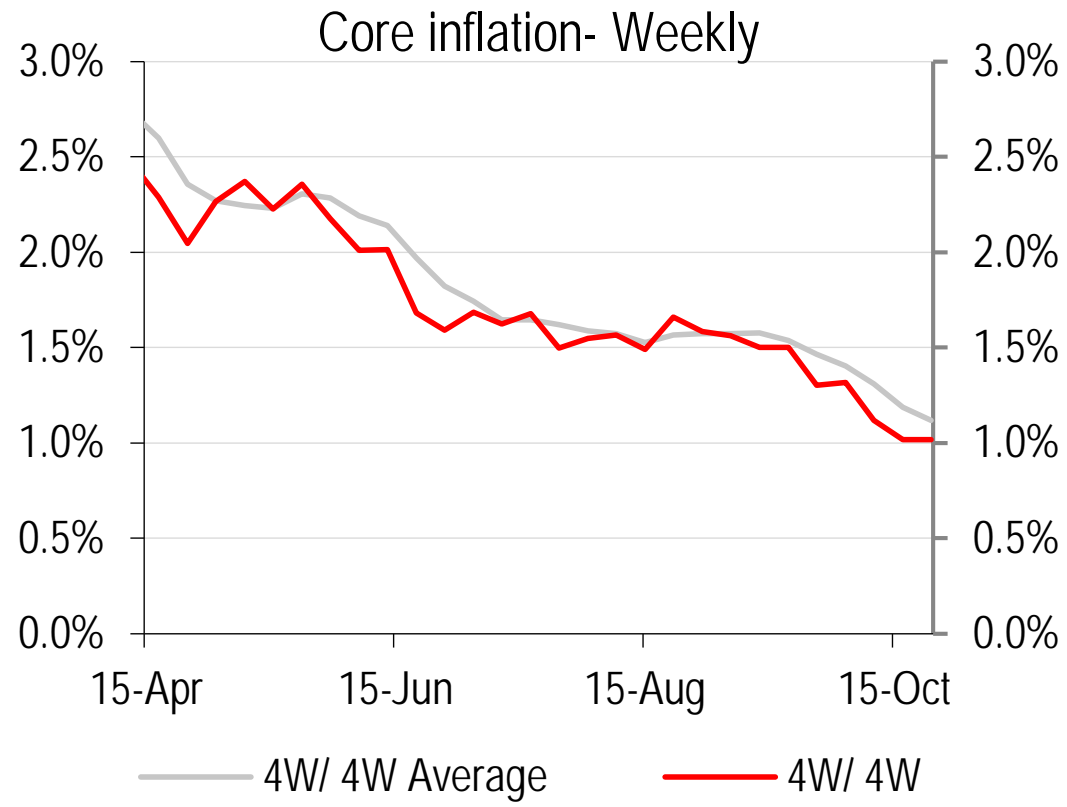
- Inertia: backward-looking wage negotiations. Year-end lump-sum not enough to revert it
- History: big crisis / stabilization plans are how Argentina got to one-digit inflation rates
- GDP growth: 2016 recession was relevant. 2017 recovery should also be
- Pending relative price adjustment without yet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

Inflation has come down in recent months...



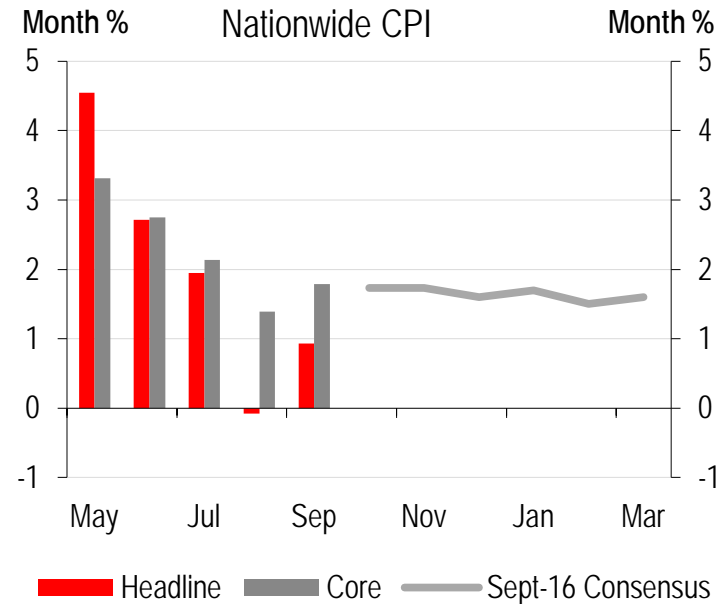
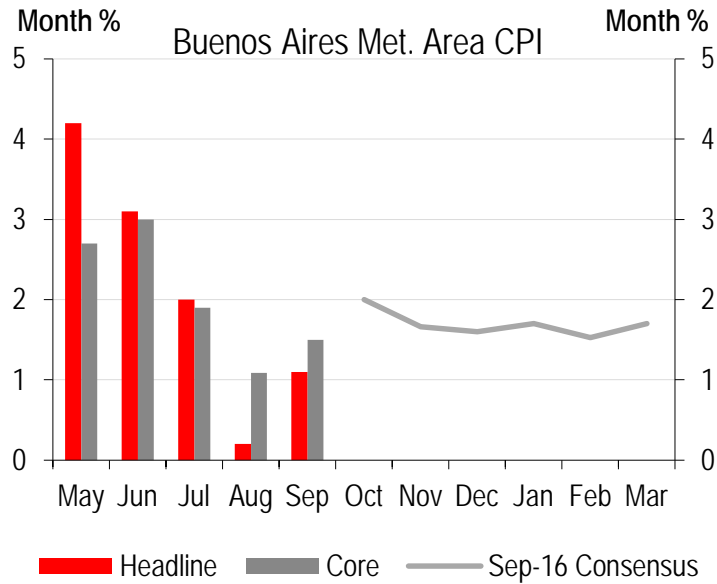
Source: City of Buenos Aires statistics institute

...and core inflation has fallen in recent weeks



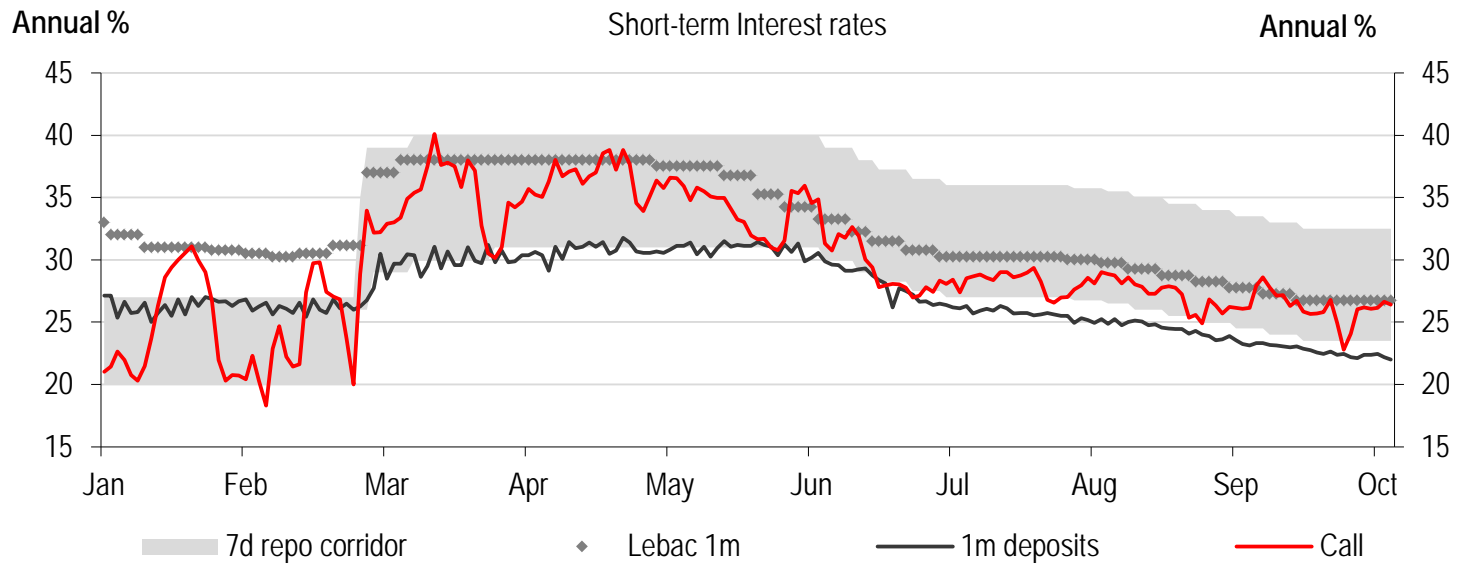
Source: Elypsis

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



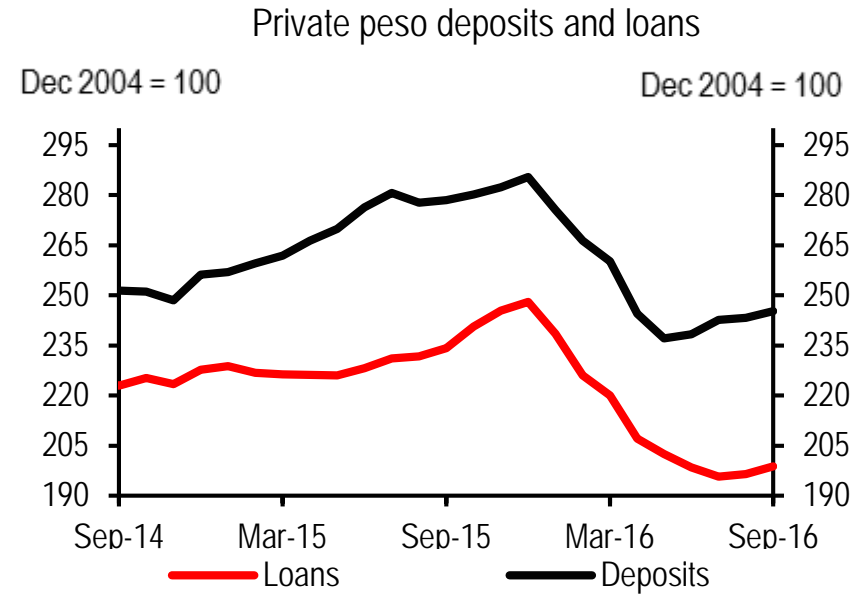
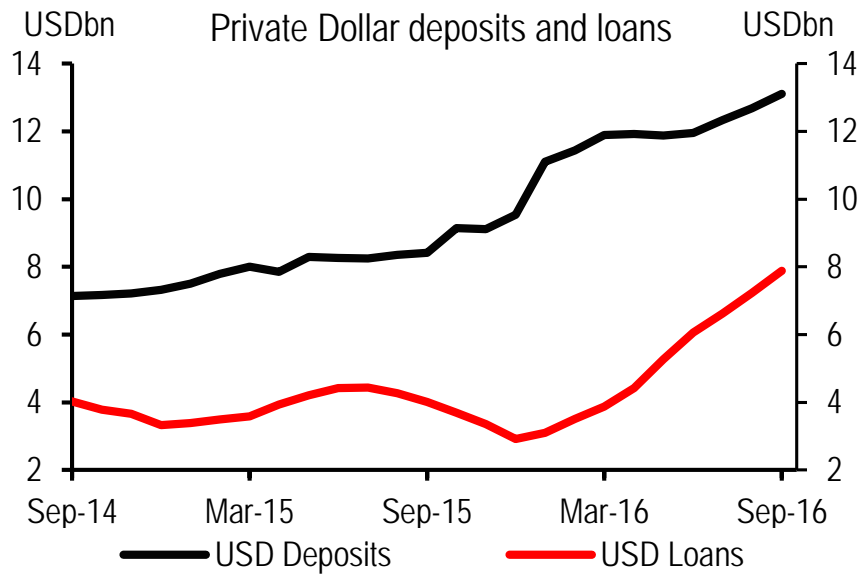
Source: INDEC; BCRA, Provincial Statistics Offices. The nationwide CPI is a weighted average of Buenos Aires Metropolitan Area (44%), Cordoba (34%) & Mendoza (22%). National Core CPI is a weighted average of Buenos Aires Metropolitan Area (44%) & Cordoba (56%)

The central bank has been on hold recently



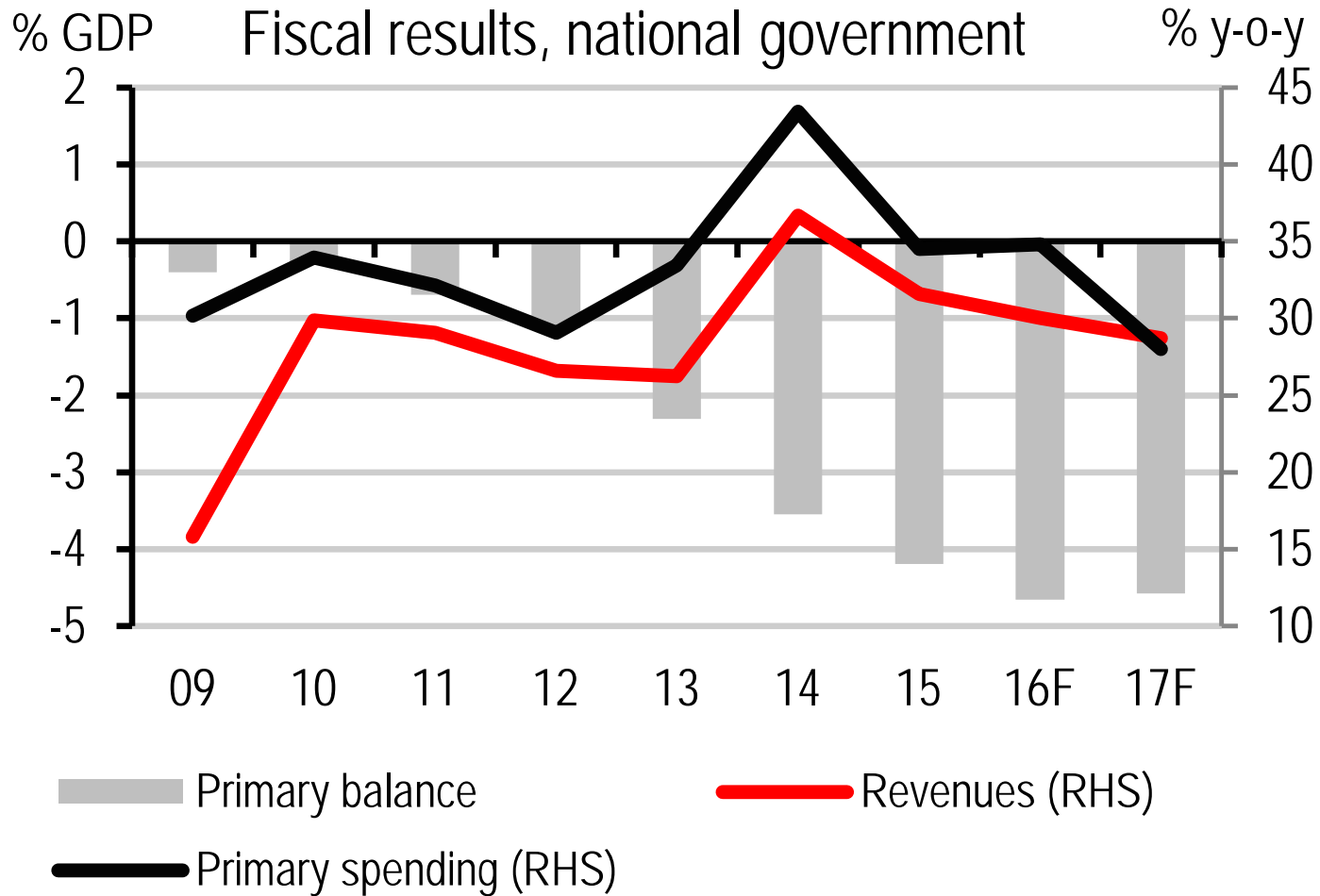
Source: BCRA

Lending in local currency remains sluggish

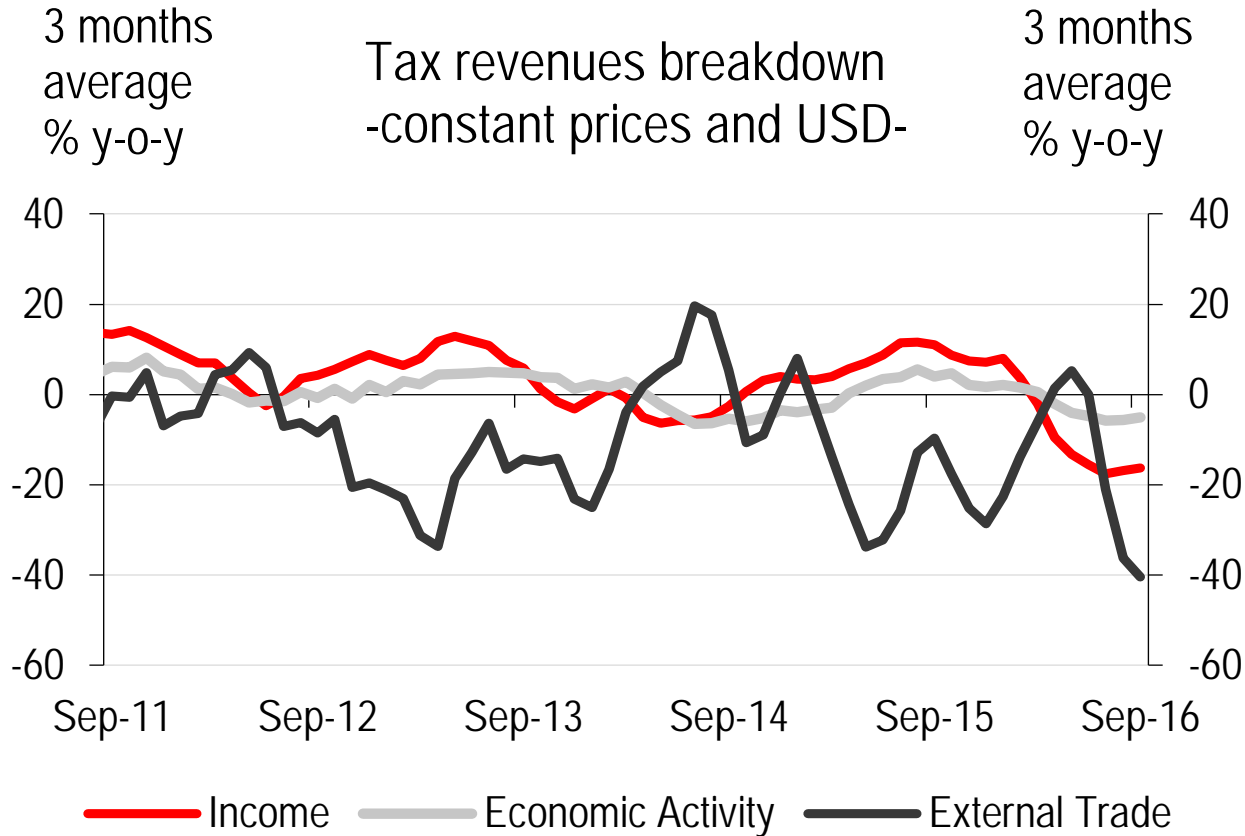


- Slow consolidation, high funding needs
- External context relevant for cost of funding
- Is external funding a problem for tight monetary policy?

Easy fiscal policy



Revenues down on tax cuts, recession



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

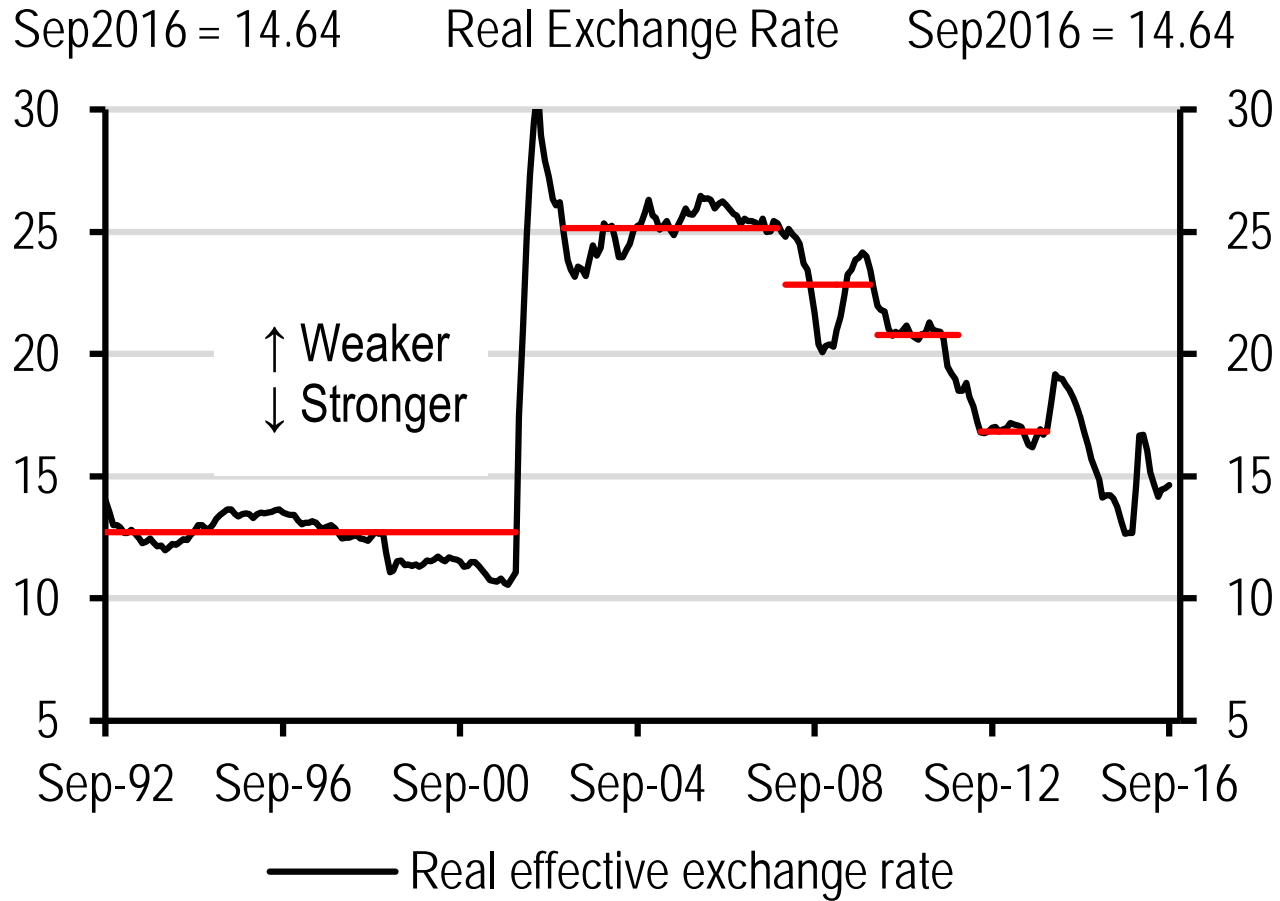
Financial needs for 2017 are larger than this year's needs

Argentina's financing program (USDbn)

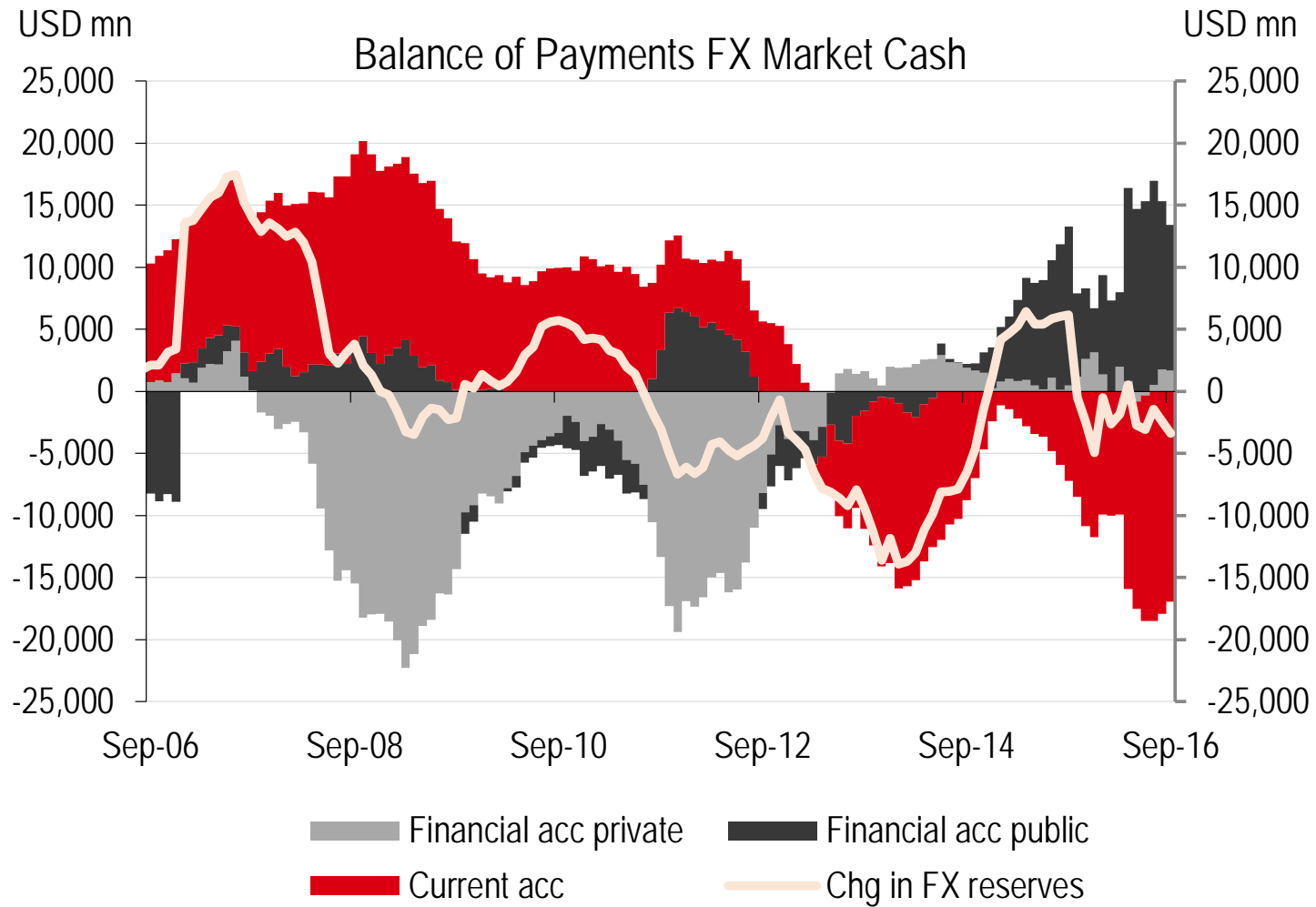
	2016			2017		
	ARS	FX	Total	ARS	FX	Total
Uses	35.2	9.8	45.0	39.8	22.2	61.9
National primary deficit	25.5		25.5	27.7		27.7
Debt Service	9.7	9.8	19.5	12.0	22.2	34.2
Multilateral and official		4.9	4.9		4.6	4.6
Interest		0.9	0.9		0.8	0.8
Amortizations		3.9	3.9		3.8	3.8
Private creditors	9.7	4.9	14.7	12.0	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



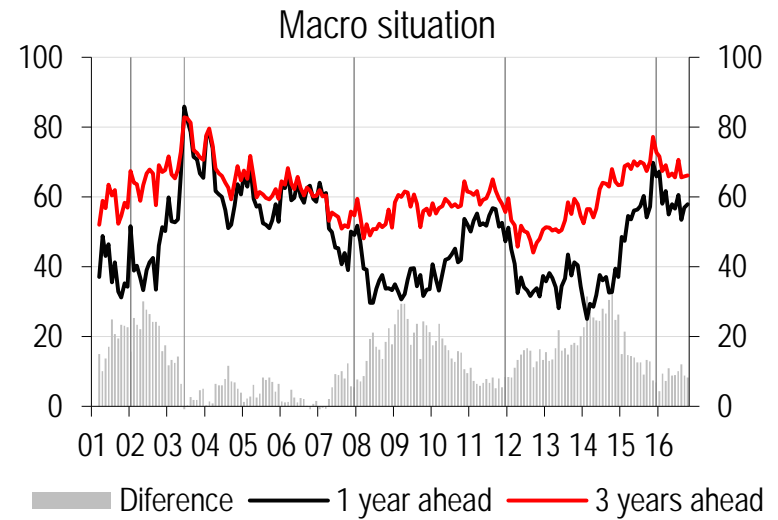
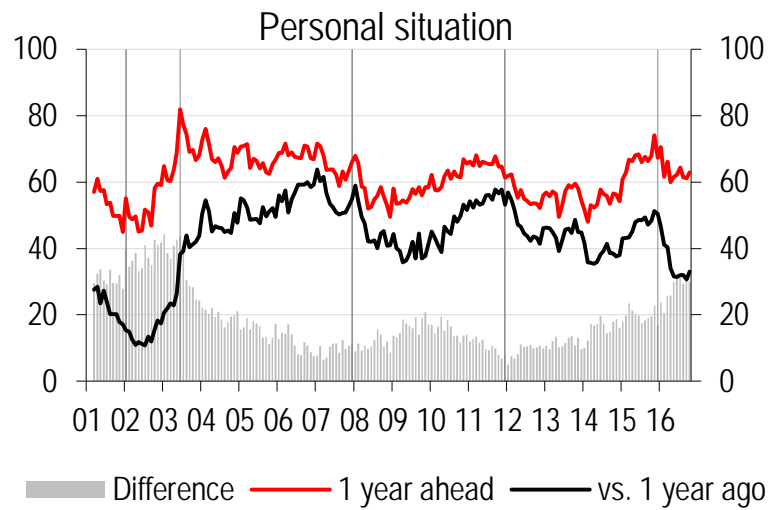
External debt funding the current account deficit



Public approval relevant for reform agenda

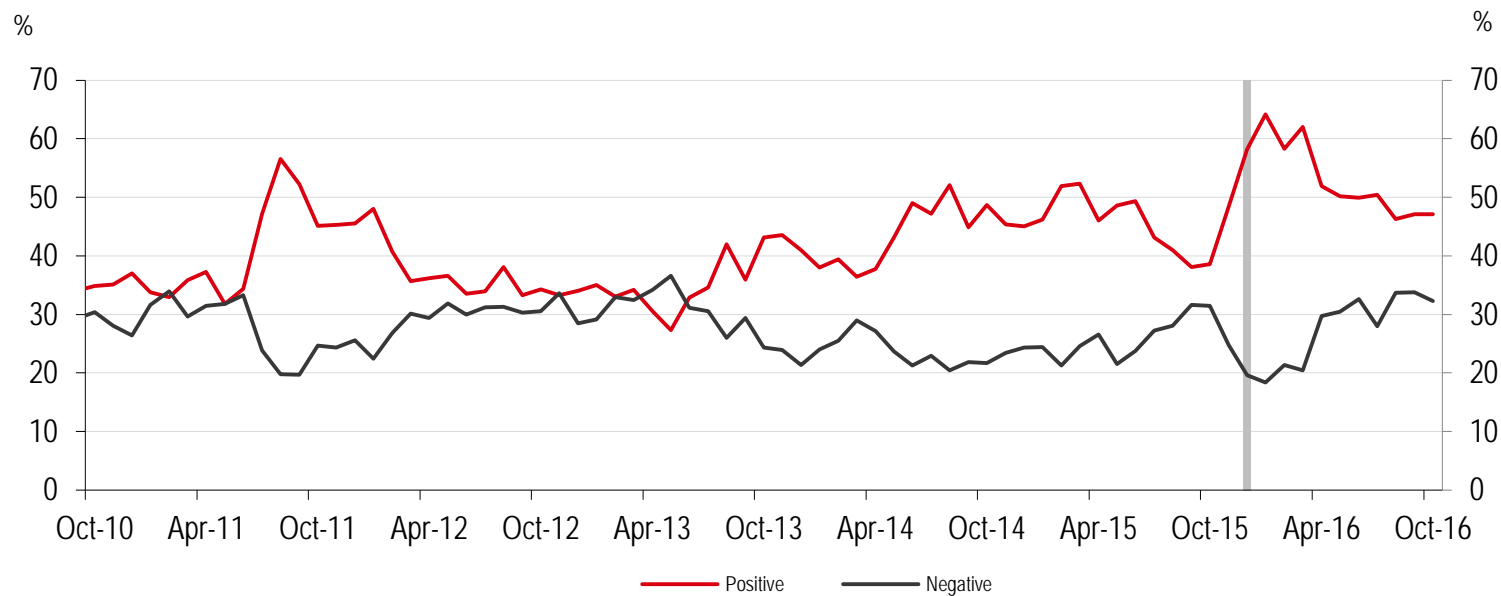
- The public remains optimistic, so far
- 2017 mid-term elections matter
- Ongoing bargaining (ie, with unions, governors, Congress) also relevant

Consumer expectations survey



President Macri needs approval rating to remain high...

Macri's popularity according to polls



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

Argentina HSBC forecasts

	2014	2015	2016F	2017F	2018F
GDP growth (y-o-y %)	-2.6	2.4	-1.5	2.5	2.8
GDP (USDbn, current prices)	505.9	575.9	479.0	560.8	665.1
CPI (AMBA, December % y-o-y)	38.5	27.7	41.0	24.0	16.0
CPI (AMBA, average % y-o-y)	38.6	28.1	41.1	27.8	19.9
Wages (December, y-o-y %)	30.3	36.4	33.2	26.1	21.8
Wages (Average, y-o-y %)	38.5	27.7	41.0	24.0	16.0
Primary balance (% GDP)	-3.4	-4.0	-4.7	-4.6	-2.7
Fiscal balance (% GDP)	-2.4	-3.6	-5.0	-5.3	-4.8
Trade balance (USDbn)	6.0	-0.4	-1.4	-6.9	-10.2
Current account (% GDP)	-1.6	-2.8	-3.0	-3.0	-2.7
Central Bank Reference rate (% year-end)	20.4	33.0	25.8	20.8	17.1
BCRA FX reserves (year-end)	31.4	25.6	34.7	37.8	42.8
USD-ARS (year-end)	8.46	12.94	15.75	18.00	20.00

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