

Fixed Income & Economics Daily

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FX & RATES STRATEGY RESEARCH

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STRATEGY

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ARGENTINA: IMF Comments on the Need to Recalibrate the Policy Mix

- The IMF commented on the need to recalibrate the policy mix, i.e., “a faster reduction in the fiscal deficit, lower taxes and less restrictive monetary policy”. One day after the government announced the controversial change in inflation targets, the IMF released the 2017 Article IV Consultation with Argentina.
- The document that was discussed by the Executive Board on December 18 was kept embargoed until December 29, the day after the government announced the change in inflation targets for 2018 and 2019 from 10 (+/-2)% to 15% and from 5% to 10%, respectively.
- The postponement of the IMF’s release was likely agreed with the government in order to suggest no linkage with the discussions maintained between the IMF Washington-based technocrats and the Argentine authorities in IVQ17.
- The staff report emphasized that despite positive developments toward reducing multiple distortions, tensions have emerged. Specifically, the IMF cited the important side effects derived from the policy mix of large fiscal deficits, the surge in foreign currency borrowing, a growing current account deficit and upward pressure on the real exchange rate.
- Although they welcome the government plan to reduce a 2% of GDP primary deficit in 2018-2019, they considered that a more assertive reduction in the fiscal deficit would ease some of the emerging tensions.
- For that purpose, they recommended the recalibration of the policy mix, a faster reduction in the fiscal front, lower taxes and a less restrictive monetary policy – not “an overall tightening of policies”.
- This would allow for lower interest rates, better-anchored inflation expectations, less upward pressure on the peso, a more sustainable path for the public sector debt and reduced vulnerability to an eventual tightening of external financial conditions.
- Alas, although the government agreed to announce the change in the 2018-2020 inflation targets, aimed at reducing the interest rates and diluting some upward pressure on the real FX quotation, nothing was said on the fiscal front, either to reduce the Central Bank financing to the Treasury or further commitments to deepening the 2% of GDP primary deficit reduction in the 2018-2019 period.
- Moreover, the implications of the change in inflation targets are not straightforward, in our view.
- If inflation expectations do not change significantly and a weaker ARS does not significantly pass through to inflation, lower pressure on the current account deficit would be achieved. Additionally, a weaker real exchange rate and real rates should be supportive for a boost in economic activity.
- On the contrary, if the Central Bank credibility loss is relevant as a result of the change in inflationary targets, the reduced pressure on external accounts and economic activity might be short-lived.
- The nominal appreciation of the peso, which, according to Bloomberg, ended at ARS18.4012/USD on Tuesday or 1.2% below the closing of the last session of 2017, should be viewed as an encouraging welcome from the market to the inflation-targeting changes announced on December 28.

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LATAM ECONOMICS

ARGENTINA

ECONOMICS

We Revise Our CPI Inflation Forecast Upward to 17.5% in 2018

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We revise our CPI inflation forecast upward to 17.5% in 2018. After the changes to the inflation target on December 28 and the interest rate reduction observed in the Lebac secondary market, we revise our inflation forecast upward to 17.5% for this year from our previous 16% estimate, and we maintain an upward revision risk to our forecast. Also, we revise upward our ARS/USD forecast for this year to ARS22/USD from our previous ARS20/USD, given the sudden increase in the exchange rate brought by the unforeseen change in the monetary policy stance (the peso lost 7.6% in the last 30 days to January 2).

The reduction in Lebac secondary market rates led us to think that the BCRA will probably relax monetary policy more rapidly than initially thought (at least in the near term), something that might delay the expected disinflationary process. Bear in mind that the Lebac market yield curve slope turned negative again, while experiencing between a 155-bp and 260-bp reduction depending on the tenor between December 27 and January 2. Yesterday, the CB intervened in short-term operations, while long term Lebacs (where investors would be undoing long-term positions) traded without any Central Bank intervention.

Inflation pressures are expected to increase once again in 1Q18, mainly as a result of the ARS' rapid depreciation, which rose to ARS18.4/USD from ARS17.3/USD (from December 14 to December 29), the second round effects derived from December's utilities' fare hikes and the regulated price increases expected for the first quarter: oil (January), electricity, gas, health services and transport (February to June), and education services (March). In line with the FX impact on prices, we calculate that the pass-through effect in Argentina is 30%.

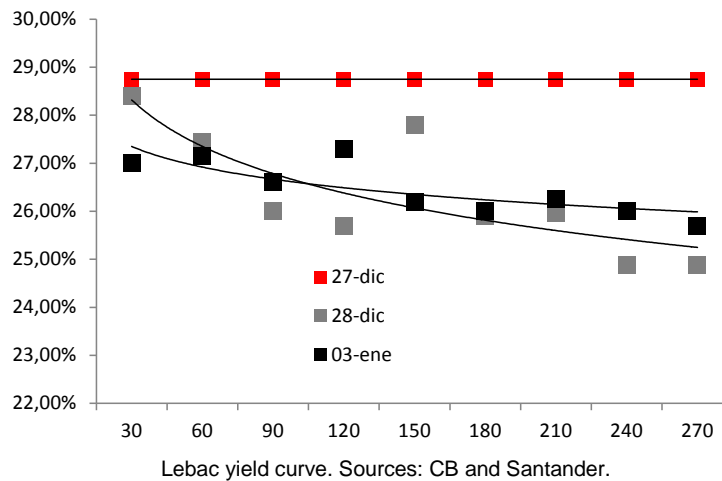
The path of interest rates looks clearer for 1Q18 than for the second half of the year. A question that arises is what will be the response of the Central Bank if CPI inflation continues to misalign from the new target? Will the Central Bank hike again in order to fulfill the Executive power mandate of reaching 15% inflation? It seems too early to give an answer. The next monetary policy meetings and next inflation readings might add new information to address these questions.

The timing of the inflation targets change and the potential faster reduction in interest rates might inhibit anchoring salaries negotiations. Before the changes were announced, labor union leaders were claiming salary adjustments hovering around 17%, while recent demand seems to be climbing up to around 20% for this year. Most salary negotiations are conducted at a sector level between labor unions (typically one union representing the entire workforce in one sector) and business associations, and most of them concentrate on 2Q.

The Treasury published December's tax collection, which reached ARS235.2 bn (-14.6% annually). This annual drop is explained by the high base of comparison, given that in December 2016, additional inflows coming from the tax amnesty of ARS92.2 bn were recorded. The tax collection was driven by the VAT (+30.2% y/y), the tax on financial transactions (+35.6% y/y), and social security revenues (+28.7% annually). In the context of a trade balance deficit, custom duties expanded 6.9% y/y, where import duties expanded 15.8% a/a and export duties declined 4.9% y/y, suggesting that in December a trade balance deficit will be recorded.



A new scenario of interest rates decrease

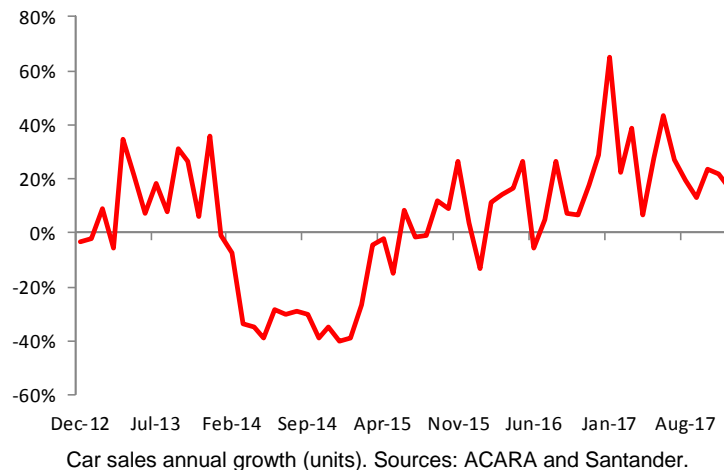


The Central Bank poll of economic forecasters might not represent the current status of inflation expectations. Yesterday, the Central Bank released its latest poll of economic forecasters (REM), which shows inflation expectations at 17.4% for this year. In our view, the number should be looked at very carefully as it comes from a small sample (compared to previous polls) and it only takes into account the forecasts submitted prior to the inflation target changes of December 28. Recall that after the Inflation target change, the Lebac market was pricing a faster reduction in interest rates.

Rising transportation fees since February likely to continue reducing economic subsidies. In order to continue reducing economic subsidies to the private sector and the fiscal deficit, the government announced the calendar for rising public transportation fees in the city of Buenos Aires and Greater Buenos Aires since February. In this context, the Minister of Transport Guillermo Dietrich said that bus fees will increase to ARS8 next month from the current ARS6, to ARS9 in April and ARS10 in June. In addition, subway fees will rise to ARS11 from ARS7.5 and to ARS12.5 in June. Railway transportation fees will also be hiked. According to our estimates, the increase in transport fees will contribute 1.6pp to the annual CPI inflation.

Car sales suggest durable goods demand is still strong. Car sales rose 16.9% y/y in December. According to ACARA (Association of Auto Dealers), vehicle sales rose 16.9% y/y last month, totaling 900,000 car units in the whole year. This was the second best year in sales in recent history (the highest performance was in 2013) and equivalent to annual real growth of 27% y/y.

Strong car sales growth





CEE ECONOMICS

POLAND

ECONOMICS

Base Effect Pushed Inflation Down to 2%

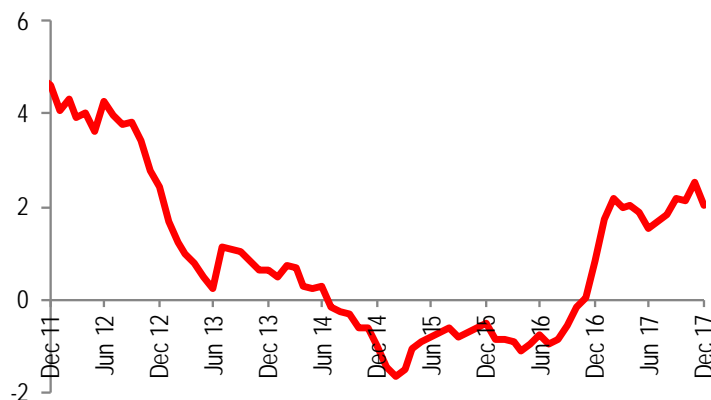
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Polish CPI inflation fell in December to 2.0% y/y from 2.5% in November, in line with our forecast. The main reason behind the decrease was a high base effect in fuel prices, which rose sharply in December 2016 and fell in December 2017. Also, growth in food prices has weakened slightly, according to our estimate. We think that the core CPI (excluding food and energy) dropped slightly to 0.8% y/y. The full release is scheduled for January 15. According to our forecast, CPI is likely to remain near 2% y/y until February 2018, after which it should climb above 2.5% in mid-year, and drop again toward 2.0% by December. Meanwhile, core inflation should be climbing gradually throughout the year, toward 2% y/y.

CPI inflation, % y/y



Source: GUS.

POLAND

ECONOMICS

Floating-Coupon Bonds Garner More Interest

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We believe that in Thursday's auction, the Ministry of Finance (MoF) will sell the higher range from the planned supply (c.PLN5bn from scheduled PLN3-5bn). The MoF will offer floating-coupon bonds WZ1122 and WZ0528, zero-coupon bonds OK0720 and fixed-coupon bonds PS0123 and WS0428. **The relatively low supply in the auction is a result of high budget liquidity.** The MoF announced that, at the turn of the year, the Ministry account was above PLN20bn, while at the end of the year, the budget borrowing needs for 2018 were financed at the level slightly above 25%. For comparison, the supply planned for the first auction this year is PLN1bn less than it was a year ago, while, in 4Q17, the planned supply was on average 4-8 billion PLN per auction.

This time, we expect greater interest in the (floating-coupon bonds) WZ-series. **We expected major demand for the floating-coupon bonds from domestic investors and the lack of motivation to extend the maturity by the MoF will help to increase the share of floating-coupon bonds in the auction (c50% sell) and 2Y OK0720 zero-coupon bonds (up to 20% sell).**



POLAND

ECONOMICS

Manufacturing PMI at 34-Month High

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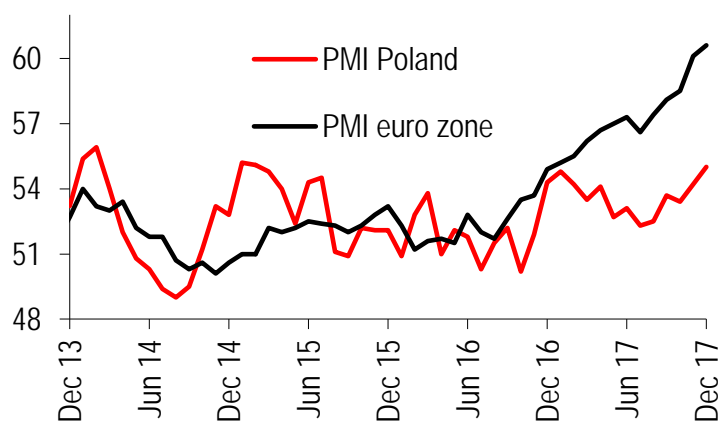
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Polish manufacturing PMI rose in December to 55.0, its highest level since February 2015. Companies reported a solid rise in output and in new orders (with domestic orders outpacing external ones), as well as an acceleration in employment growth. The survey suggests that Polish industry remains in very good shape, benefiting from economic revival in the euro zone and a strong local consumer market.

We think that December's industrial production growth will slow down considerably compared to previous months due to the calendar effect (two working days less than in December 2016), however surprisingly high PMI implies an upward risk to our forecast at 2.2% y/y (market consensus 3.1% y/y).

Manufacturing PMIs



Source: HIS Markit, BZ WBK.



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