Fixed Income & Economics Daily

Monday, September 18, 2017

FX & RATES STRATEGY RESEARCH

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- **COLOMBIA: MPC majority sees rate in neutral territory**

COLOMBIA: Minutes of the August MPC Meeting

- BanRep released the Minutes from their August 31st MPC meeting in which they cut the reference rate by 25bps to 5.25%. The decision was a three-way split with 4 members voting for a 25-bp cut, 2 members voting for a 50-bp reduction and one member voting to keep the rate on hold.

- The members that voted for a 25-bp cut felt that the weak economic activity warranted a reduction in rates. However, this majority group also believed that with the 25-bp cut, the interest rate could be in neutral territory.

- The members in favor of a deeper cut thought that the combination of a large output gap and positive inflation reports provided the space for a stronger stimulus for the economy.

- Finally, the member that voted to keep the rate on hold, emphasized the inflationary risks, although he also expressed concern about the weak activity.

- Given that the majority of members believe that the interest rate could be in neutral territory and given that economic indicators recently surprised to the upside and inflation is in line with BanRep expectations, we expect BanRep to keep the interest rate on hold in the next September meeting and for the rest of the year.

ECONOMICS

Argentina — Macroeconomics

Structural Reforms: A Challenging Task for a Consolidated Government after Mid-Terms

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- **The growth acceleration, together with the recent primaries results, have resulted in a consolidation of the governing coalition, and a subsequent push for a set of high-priority, though challenging, structural reforms aimed at addressing competitiveness issues.**
- **Economic growth has regained strength, mainly due to a strong rebound in construction related to state-led infrastructure works; the construction pick-up together with a surge in capital goods imports are translating into investment expanding more than 10% y/y in 2Q.**
- **As activity gathers pace, jobs are recovering, albeit slowly (0.1% m/m average in 1H17). A labor reform to improve conditions for job creation remains as one of the key challenges for the current government.**
- **The establishment of an inflation-targeting regime has already started to bear fruit, with inflation decreasing to 1.8% m/m, on average, in the six months through August – down from 2.2%, on average, in May-October 2016. Also, expectations are pointing to lower inflation in the next few years, although at a slower pace than the targets set by the Central Bank; therefore, we expect a tighter monetary stance to remain.**
- **Recent exchange rate movements have been highly influenced by political events; we expect subdued peso depreciation in the following months amid strong capital inflows, mostly directed toward public-sector financing.**

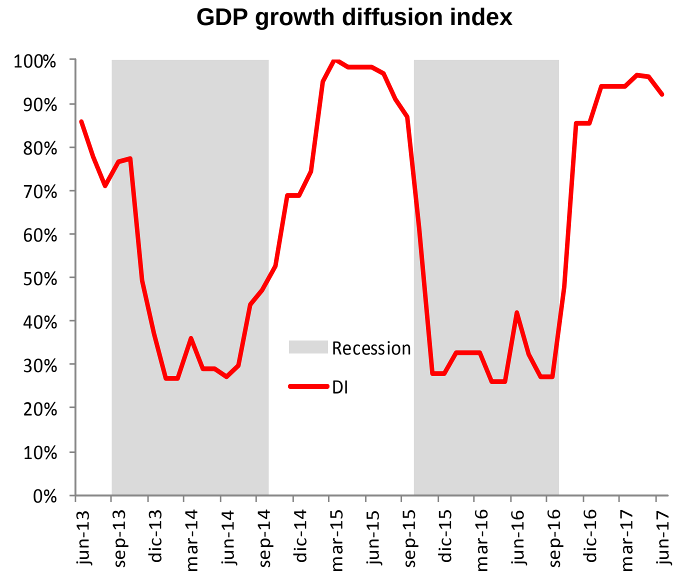
Economic sectors and activity: growth is stepping up

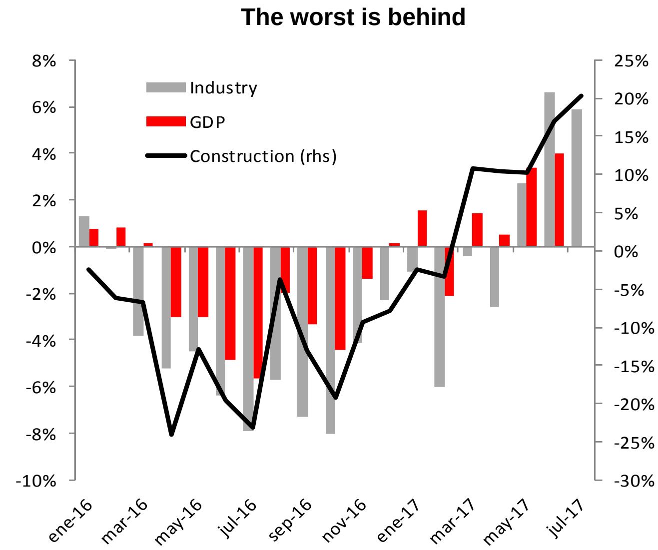
After a 2.2% decline in GDP last year, we currently forecast a 3% expansion throughout 2017. GDP started to expand at the margin during 3Q16, when it edged up 0.1% q/q sa, gaining strength afterwards, to expand 1.1% q/q sa during the first quarter of 2017.

Short-term growth prospects. We estimate that GDP growth will peak in 3Q17 (reaching 5% y/y) and slowly decelerate afterwards, leading to an average 3.5% expansion during 2018. Next year, we expect the expansion of investment expenditures to accelerate to 13% y/y from +7.3% in 2017 and consumption expansion to edge up to 3.2% from the current year's forecasted +2.7%.

Most economic sectors are expanding at the margin. The diffusion index, weighted by the relative importance of each sector in GDP, showed that by the end of 1H17, more than 80% of economic sectors were expanding. In annual terms, all sectors except mining & energy have exhibited positive rates of expansion in June. Agriculture, in particular, has proven to be one of the main contributors to activity expansion. Despite excess humidity conditions across many areas (which are affecting slightly more than 1 million hectares), the current year's harvest is expected to total 122 million tons, a record high (+8.5% compared to 2016's mark).

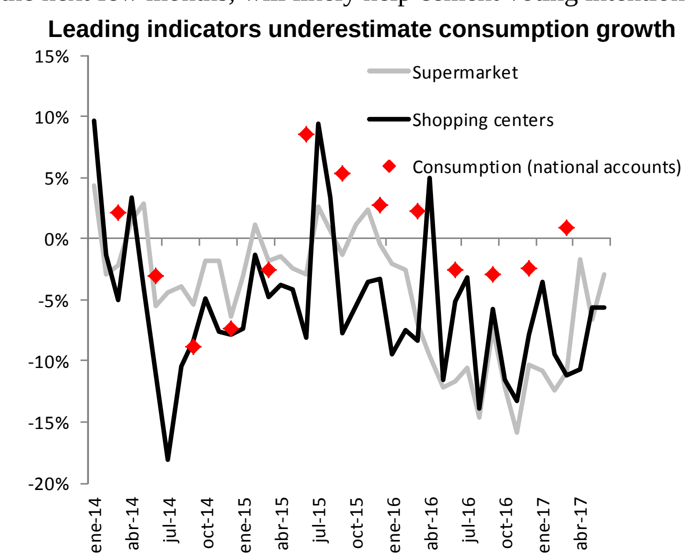
Construction activity, the main growth driver. Construction is experiencing a strong pick-up, mostly driven by public works. The Monthly Construction Indicator has increased almost 14% y/y in the five months through July, after a slump during 2016 (-12.7%). Asphalt sales (+89% in the YTD through June) together with bulk cement consumption (+26% in the YTD through July) reveal the bias towards infrastructure projects (on the other hand, packed cement consumption, related mostly to private works, grew only 2.8% in the first seven months of 2017). Projects are chiefly small-scale and fast-completion works such as sewage, roads, streets and transportation enhancements, which can rapidly benefit the population.

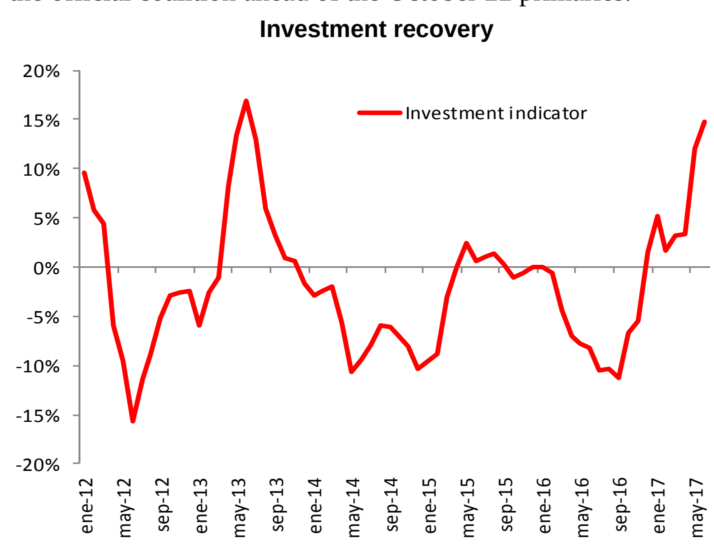




Left: Growth diffusion index (percentage of sectors which are expanding, size-weighted). Right: annual growth in construction activity, industry and economic activity Source: INDEC and Santander.

Most services sectors also in green. The majority of services sectors (which account for 62% of GDP) are also experiencing a rebound. Transportation (9.8% of GDP, closely related to primary activities like agriculture) jumped 3.9% y/y in 1H17; commerce (15.6% of GDP) edged up 0.7% y/y in the same period, although accelerating more recently (+4.3% y/y in May-June). Banking activity is also showing a healthy recovery, expanding 3.1% y/y during 1H17. The low level of credit penetration (13% of GDP) suggests an attractive outlook for financing companies in a scenario in which inflation abates and interest rates are reduced accordingly. Finally, the lagging industrial sector (20% of GDP) has also started to show some signs of life, expanding 4.2% annually in May-June. We believe the pick-up in activity growth, which will continue gathering pace in the next few months, will likely help cement voting intentions for the official coalition ahead of the October 22 primaries.





Left: Inflation-adjusted annual growth in supermarket and shopping center sales, consumption annual growth. Right: Investment expenditures annual expansion. Source: INDEC and Santander.

Consumption slowly rebounding thanks to real wages recovery. Although higher-frequency consumption indicators are still showing a contraction in spending, broader measures suggest that the recovery has already started. Supermarket and shopping mall sales (adjusted by inflation) were still falling in June (-3% y/y and -5.6% y/y, respectively), albeit at a lower rate than during previous months (see chart). However, national accounts data pointed to a 0.9% annual expansion in 1Q17, a rate that has likely accelerated during 2Q and 3Q17. The disparities may be attributed to a likely bias in higher-frequency consumption polls conducted by INDEC, which may not be capturing certain changes in consumption patterns brought about by a recessionary scenario in 2016. Consumers may have started to shift spending from large supermarket chains toward convenience stores, wholesale chains and online platforms (which are not currently a part of the survey). The somewhat slow rebound in consumption is related to the recovery in inflation-adjusted salaries. Wage growth began to surpass inflation in May, after falling 3.5% annually, on average, during 2016. As of July, real salaries were already expanding 4.4% y/y, which is one of the main factors buttressing consumption at the margin.

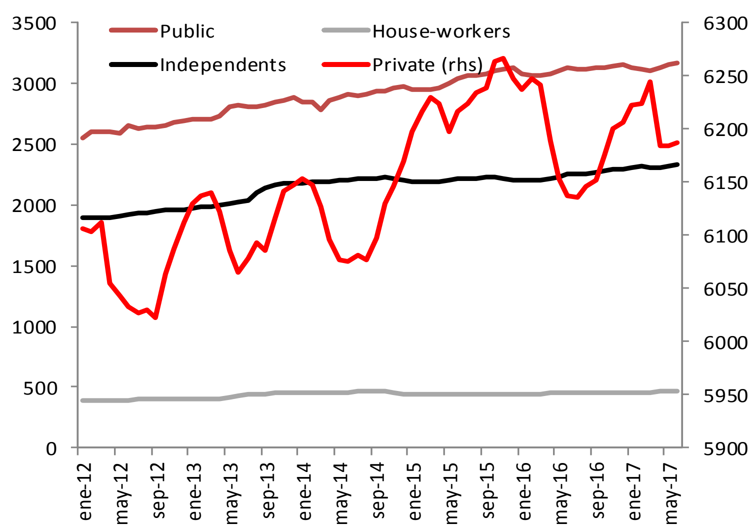
Investment, intended to be the most important GDP growth engine. The strong growth in construction activity (+12.6% y/y in 2Q17) coupled with a ramp-up in capital goods & spare parts imports (+17.5% y/y in 2Q17) are pointing to annual investment growth surpassing the 10% mark in the period, up from +3% y/y in January-March. Stimulating investment expenditures and creating a more favorable environment for investment (which requires sweeping reforms in tax, labor, capital markets and other regulations, see below) is at the top of the government's agenda to ensure a sustainable growth path.

Employment: A rigid labor market

A dual labor market. Argentina has a dual labor market, with a formal sector (with approximately 12.1 million jobs nationwide) and a less-productive informal sector (unregistered workers for whom no tax and pension contributions are paid for by employers). The informal sector accounts for approximately one-third of the total workforce, according to INDEC measurements. The share of informal workers has consistently declined to 34.1% in 1Q11 from a peak of 48.9% in 4Q04, in the aftermath of the crisis. However, since 2011 it has remained fairly steady, averaging 33.7% between 1Q11 and 1Q17. Within the formal labor market, the more productive private sector supports roughly 6.2 million jobs, while the public sector accounts for 3.1 million jobs. The formal labor sector also includes 460,000 workers dedicated to housework and 1.9 million independent workers, who perform a wide array of tasks from highly productive well-paid jobs to lower-paid, more sporadic occupations.

Informal labor market

Formal labor market

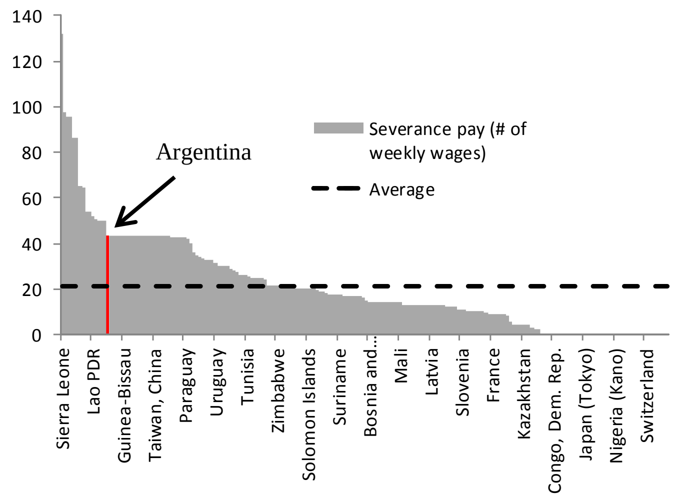


Left: percentage of workforce in the unregistered market. Right: Labor market breakdown. Source: INDEC, Ministry of Labor and Santander.

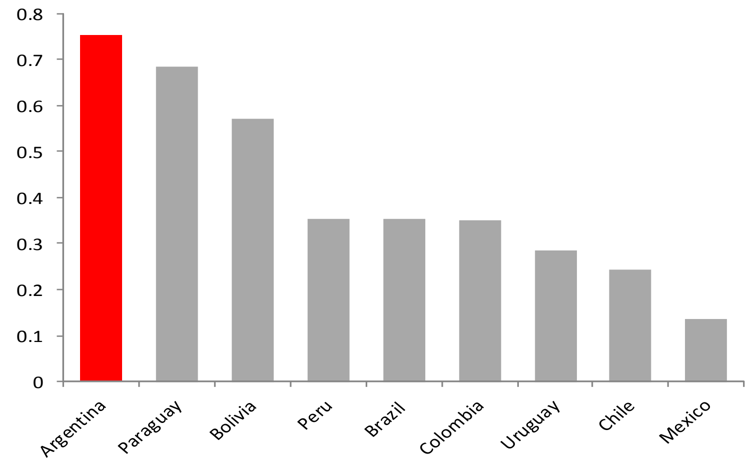
Weak job creation in recent years. Job growth has been very weak in recent years. The formal sector workforce expanded 10.6% in the last five years to June, mainly explained by the public sector (whose workforce rose almost 20% in the period) and independent jobs (+15%). On the other hand, higher-productivity formal private jobs increased only 2.5% in the period, which equates to a paltry 0.5% annualized rate. Since the new administration took office (December 2015), the total formal workforce grew 1.1%, almost totally explained by independent jobs (+5.9%) and the public sector (+5.3%), while the private sector shed 1% in the period. However, having bottomed in July 2016, the number of positions in the private sector is recovering at the margin, driven primarily by growing demand for workers in the construction sector, which is booming thanks to strong public spending in infrastructure. The number of jobs in most services sectors (with the exception of transportation and communications) was, by June, higher than the mark observed in December 2015, taking into account the seasonality typical for some of them. The picture is different in the industrial sector (which is just starting to recover at the margin) and the still weak mining & energy sector, both of which are still shedding jobs. Unemployment reached 9.2% in 1Q17, the quarter in which the joblessness rate peaks due to seasonality patterns; we expect it to decline almost 2 percentage points by year-end.

Highly unionized workforce in the formal sector. In Argentina, the formal labor sector has typically had a highly unionized workforce. Legislation allows only one union to represent workers from a particular economic sector. Their ample representation base gives most labor unions strong bargaining power during the salary negotiation season. Labor unions (many of them closely related to the Peronist party) have a strong presence, wield significant power and are capable of inflicting political and economic costs, particularly in times of economic/social distress. However, this feared capability is starting to wane, as economic activity recovers, inflation moderates and the reasons for mobilizing members and staging demonstrations start to diminish. Moreover, labor unions are highly unpopular among Argentines, according to various pollsters, which will likely put the government in a stronger position to negotiate any forthcoming labor reform.

Disincentive to hire new workers



Minimum wage / value added



Left: severance payment for a 10-year old employee, in number of weekly wages. Right: ratio of minimum wage to value added. Source: International Labor Organization and Santander.

Rigid regulations hamper job growth. As an example of the high costs imposed by local regulations, the ratio of minimum wage to value-added in the Argentine job market is the highest among Latin American peers (0.75 vs. the 0.37 average in LatAm); furthermore, the legal number (43) of weekly wages required (as severance) in order to lay off a 10-year worker is more than double the global average (21). Labor taxes are also high. The tax wedge between the labor cost and the net salary received by a worker is 65%, the highest among LatAm peers. Rigid regulation coupled with powerful labor unions result in low incentives for private firms to hire new workers given the high labor costs, lack of flexibility and difficulties in adjusting payroll costs in times of financial distress. In low-productivity, labor-intensive sectors (such as agriculture, construction and retail), those businesses' profitability are not high enough to withstand the costs associated with job creation. Or, alternatively, a lack of supervision by regulators increases incentives for some employers to avoid the mandatory tax and pension contributions. This leads to a relatively low labor participation rate, which stood at 45.5% in 1Q17, according to INDEC (close to the 45.8% average registered since 2003, according to INDEC statistics).

Still high unit labor costs relative to LatAm comparables. High labor-cost-to-productivity ratios act as a powerful deterrent to higher investment in tradables. Unit labor costs for the industrial sector (the only one for which there are data) measured in a basket of currencies (USD, EUR, BRL) relative to Argentine manufacturers' main trading partners stood, by the end of 2016, at approximately the same level observed during 2000-2001, a time when there was a headwind from peso overvaluation affecting local competitiveness.

Need to overhaul regulation. For the current administration, it is all too clear the need to overhaul regulations in the labor market to increase competitiveness and enhance productivity. This represents one of the main challenges going forward. A likely favorable outcome in the forthcoming mid-term elections would result in increased political strength, which would be used to push for new legislation for the labor market. However, we believe this would prove to be a bumpy road and the reform would not be straightforward, as the modifications may start to affect some long-standing and strongly ingrained industries, institutions and ways of doing things. In any case, we believe it will take time to make significant progress on this front, and similar to tax reform, may represent only the first round of many fine-tuning modifications in regulation.

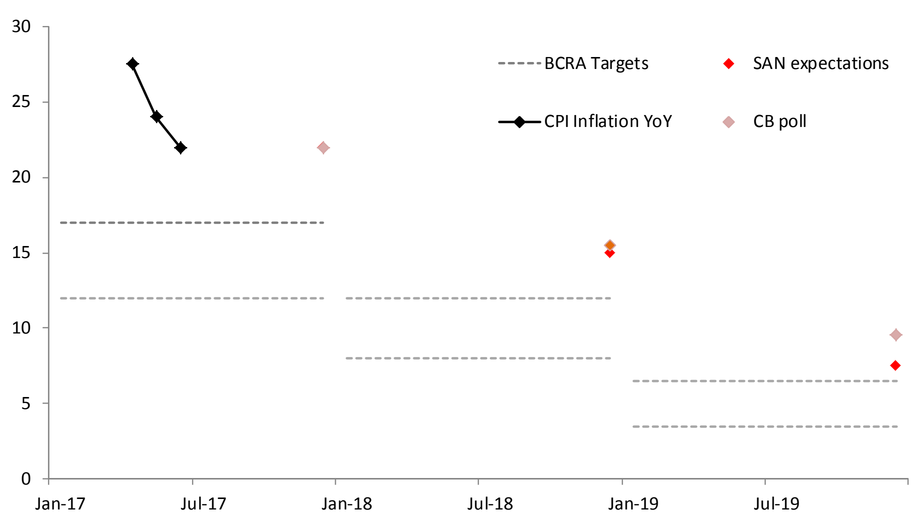
Inflation targeting: Better late than never

Establishing an inflation-targeting regime, finally. The Macri administration implemented big changes in the way the Central Bank (BCRA) conducts monetary policy in Argentina**.** For the first time, the monetary authority is putting its focus on inflation through a strict inflation-targeting (IT) regime. This new strategy for conducting monetary policy has also included a much higher degree of BCRA independence and a significant improvement in the manner in which the CB communicates monetary issues to the public. Macri and the Senate appointed Federico Sturzenegger as the BCRA governor. Sturzenegger is a well-respected economist from MIT, with a vast understanding of monetary policy. His core team also shares such a reputable background.

Monetary policy conducted through 7-day repo rate and Lebacs. The system works in a similar fashion to other inflation-targeting countries that implemented such regimes almost 20 years ago. The BCRA sets a multi-year inflation objective and uses the interest rate (in this case the average repo rate for 7 days) to drive an inflation convergence towards the target. In addition to the repos, it also controls the amount of money in the economy through the issuance of bills up to a one-year tenor (Lebacs). Monetary policy committees (MPC) meet on specific dates set by a calendar published by the monetary authority, while bills auctions occur once a month. The Central Bank governor, three board members and the BCRA Chief Economist compose the MPC. The Argentine inflation-targeting scheme is also set under a managed floating-FX regime (more floating than managed). This last feature is also new for the country. Traditionally, governments have stabilized the economy by anchoring the FX rate, which typically causes rapid disinflation at the expense of a more volatile economic cycle and an increase in balance-of-payment vulnerabilities.

Hawkish monetary policy stance to combat stubborn inflation. Due to the high inflation levels inherited from the previous administration (consistently close to 30% annually), the CB has adopted a hawkish tone pushing real expected interest rates from negative to positive territory and forcing inflation to come down toward the desired level. The current policy rate is 26.25%, higher than the expected inflation level for the upcoming 12 months at 17.2%. The targets for this and next year were set at a range of 12% –17% and 8% –12%, respectively. With inflation currently running in the low twenties, it is highly likely that the BCRA will not meet its objective this year. However, we strongly believe that the disinflationary path will continue in the coming years as economic policy becomes more consistent, especially compared to the previous administration.

No one discusses inflation convergence



Inflation expectations and Central Bank inflation targets. Sources: BCRA, INDEC and Santander Research.

The market expects inflation moderation at a slower pace than Central Bank targets. If BCRA misses this year's (or next year's) target, we would not expect a strong impact on asset prices, as this is currently priced-in by the market. According to the Central Bank poll of economic forecasters (known as REM), inflation will be a few percentage points above the upper inflation target set by the CB (see chart). This gap might be explained by several factors: (a) the rapid growth of the money supply (+27.3% y/y); (b) the small size of Argentina's financial sector, which reduces the effectiveness of monetary policy transmission channels (credit to GDP is 14.5%); (c) expectations for adjustments to utility rates; and (d) a still high fiscal deficit (which is partially financed by the Central Bank; during 2017, the monetary authority is expected to transfer ARS 150 bn to the Treasury, equivalent to 1% of GDP).

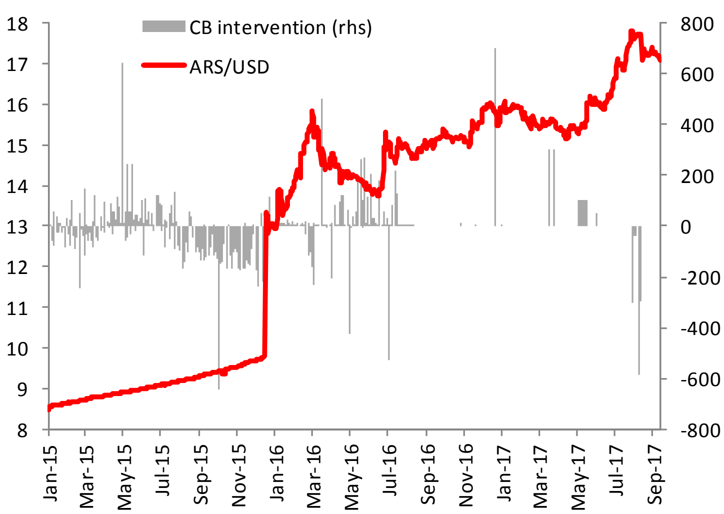
Our inflation forecasts. With the implementation of this new regime, we expect inflation to continue coming down in the coming years, as the gradual fiscal consolidation should bring more consistency to economic policy. We expect CPI inflation to remain at 22% this year and approach 15% next year.

External sector & FX

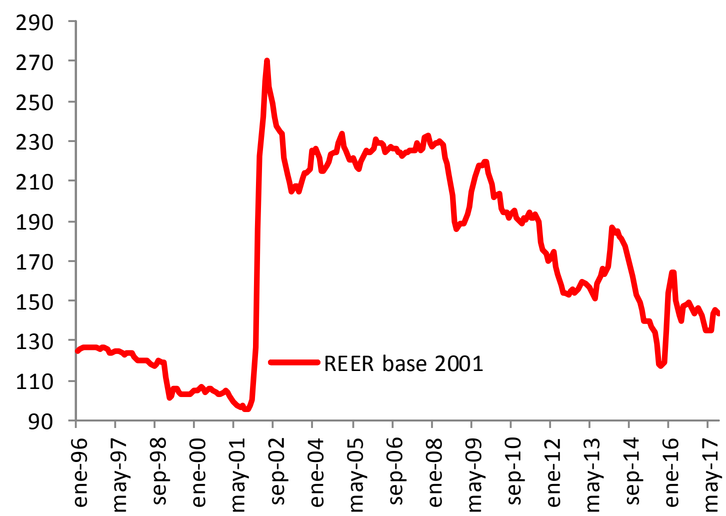
Current account deficit to widen amid growing capital inflows. Unlike what we saw in recent years, the external balance has started to be characterized by a deepening current account deficit financed with a positive capital account, thanks to the re-connection to international capital markets after the hold-out issue ended. We estimate that this year the current account will reach a deficit equivalent to 3.8% of GDP (USD 24 bn), higher than the 2.7% of GDP recorded last year. While export growth has proved weak in the year through July (+1.4% y/y) due to falling volumes in key primary products and agricultural product sales (and despite a 3.5% annual price increase in the period), imports have grown strongly (+15.4% in the YTD through July) mostly due to a 22% annual increase in capital goods purchases (related to recovering investment). As a result, the trade balance has turned to a USD 3.4 bn deficit in the first seven months of 2017, the largest on record in such period. Also, both the services account and interest & dividend payments will see record deficits during 2017, reaching USD 9.8 bn and USD 13 bn, respectively, according to our estimates. For 2018, we expect the trade deficit to widen to USD 4.5 bn due to imports growing more strongly than exports.

Higher FX volatility and sensitivity to external shocks. In this context, the FX market displays higher volatility and greater sensitivity to external shocks given that the Central Bank conducts only scant intervention in times of heightened uncertainty (see chart). For example, in the run-up to the primaries, between July 28 and August 11, the Central Bank sold USD 1.8 bn to reduce the volatility associated with the uncertainty regarding election results. As the official coalition's performance turned out to be better than expected, the FX appreciated and volatility abated. Also, as exporters are now allowed to sell their proceeds in the FX market up to 10 years from the export date, the typical seasonality observed in some export sales is starting to attenuate. During April-May (the harvest season) agricultural exports (totaling USD 4.4 bn in the period) were the lowest on record since 2003.

A more volatile peso



REER, base Dec 2001 = 100



Left: ARS/USD exchange rate and Central Bank intervention in FX market. Right: Real effective exchange rate, base Dec 2001 = 100. Sources: Bloomberg, Central Bank, INDEC and Santander.

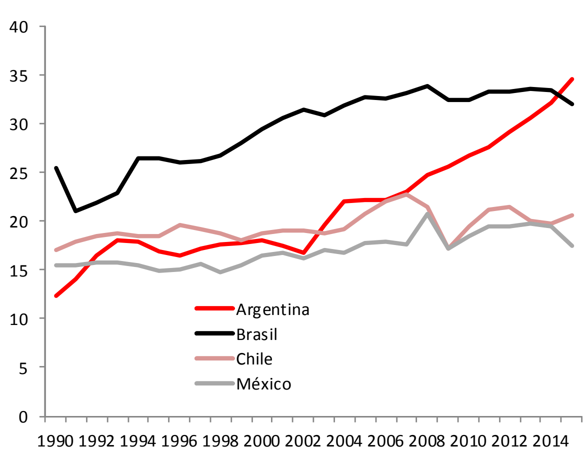
The real exchange rate is overvalued, but not as much as in other misalignment periods. The relationship between exchange rate depreciation and inflation constitutes a never-ending concern among local producers, mostly in the industrial sector and in some primary production sectors. While year to date through August prices rose 24.2%, the ARS/USD increased only 14.4%, resulting in a 5% strengthening against the U.S. dollar. However, the appreciation of other currencies compared to the USD (notably the BRL and the EUR), helped sustain competitiveness in local currency. Our measure of the REER strengthened only 2% annually in August. As the Central Bank often remarks, a free-floating FX regime (something totally new for the country) helps to avoid longer periods of strong currency misalignment, allowing the exchange rate to depreciate during negative shock events, and cushioning the impact on the economic cycle. However, we estimate that the current REER measure is approximately 15% stronger than the equilibrium level (during convertibility, in the 1990's, the overvaluation averaged more than 35%). Unlike many other experiences in the past, this government intends to regain competitiveness through a set of structural reforms and infrastructure investment in order to reduce the costs of doing business.

Our FX forecasts. We expect that ARS/USD will reach 17.70 by year-end (increasing 11.5% y/y), well below the expected inflation level (22%) and we estimate it will rise to ARS/USD 20 in December 2018 (+13%).

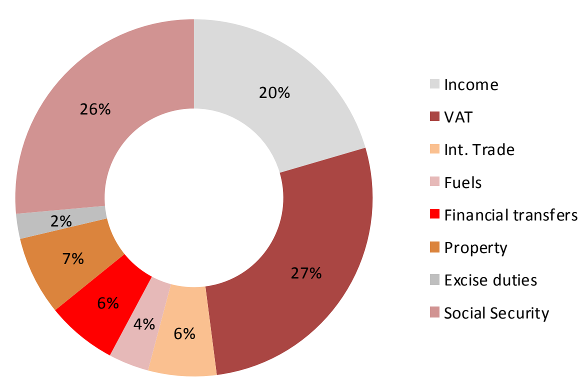
The tax system: in need of reform

Peaking fiscal pressure. Argentina's tax system is characterized by high fiscal pressure to finance the public sector's expenditure growth. Total tax collections represent 34.5% of GDP (considering national, provincial and municipal taxes), a regional record compared to the rest of Latin American. From a historical perspective, current fiscal pressures are at their highest ever, and 18 percentage points above the average level observed in the 1990s. The fiscal pressure growth in recent years was explained chiefly by the incorporation of new taxes in the duty structure, such as taxes on exports (which were eliminated and/or lowered last year), the financial transactions tax, the tax rate hikes in municipalities and provinces (e.g. the highly distortive provincial gross sales taxes), and tax adjustments above the inflation rate (as tax brackets and limits are explicitly set in nominal terms, in an inflationary scenario such as that seen in recent years, the actual pressure increases only as an effect of rising prices/incomes).

Increasing tax take



Tax revenues breakdown



Left: total tax take as a percentage of GDP. Right: tax revenues breakdown, as a percentage of the total. Sources: Ministry of Economy, OECD and Santander.

Tax revenues have increased in recent years. Last year, the VAT represented 27% of total tax revenues and was the most important in the national structure. In 1990, the VAT rate was 13% and in 1995 it reached 21% – the rate still currently effective. The second-most-important source of federal taxes comes from Social Security resources (from both personal and employer contributions), representing 26% of total tax collections in 2016. The fiscal pressure on social security taxes is one of the highest seen in recent years, reaching 7% of GDP compared to the 3.6% observed in 2006. In 2008, in the midst of the international financial crisis, Congress nationalized the privately-managed capitalization pension system, in effect transferring all assets under management to the publicly-managed pay-as-you-go system and hiking social security taxes. In turn, these funds were then used as a financing source for a wide variety of public spending initiatives different from the original purpose, actually acting as a counter-cyclical buffer.

High labor levies and distortive taxes. The high level of labor taxes is one of the most significant weaknesses in terms of competitiveness: according to Price Waterhouse Coopers (a consultant), labor contributions reached 35.3% of the average wage, the highest in Latin America, compared to Brazil at 30.5%, Chile at 30.2%, and Mexico at 19.2%. Another characteristic of the Argentine tax system is the existence of several highly distortive taxes, such as the financial transactions tax and the gross sales tax (in this case, collected by provinces and representing the 75% of their own tax resources, on average). The credit and debit banking tax represented the 6% of the total national collection and is today one of the most important income sources, affecting the financial system by taxing all transfers between banking accounts with a 1.2% duty.

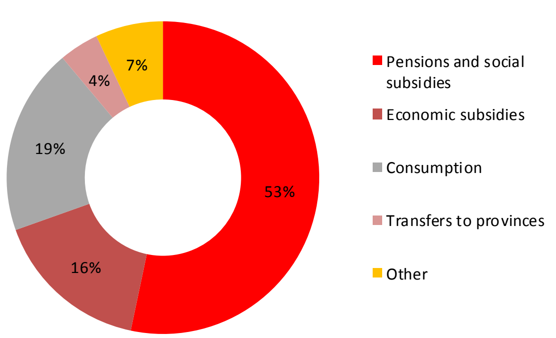
Elimination/lowering of taxes on exports. International trade taxes (coming from exports and imports) represented 6% of tax revenues in 2016 and were another key driver in the national tax structure. Is important to highlight that the new administration (which took office in December 2015), eliminated almost all withholding taxes on exports, including those from agricultural, energy, mining and industrial sales in order to reinvigorate production and external sales. Due to its importance, the withholding tax on soybeans and derivatives (meal and oil) was only lowered 5 pp (to 30% in the case of soybeans) and the government plans to reduce them 0.5 pp per month starting in January 2018.

Tax-sharing scheme between the federal and provincial governments: a tilted playing field. The tax revenue distribution between the national government and the provinces is conducted according to the co-sharing law approved in 1988. The eligible funds coming from national tax revenues to be shared are determined by a set of fixed weights, depending on the tax (for example 89% in the case of VAT and 64% for income taxes). Then, 40% of the total eligible funds are transferred to the Federal Government; the remainder 60% is distributed among the provinces according to a set of predetermined weights. This distribution system results in two significant impacts: (a) the concentration of the Federal Government resources, which receives approximately 70% of total national tax revenues, and (b) an increasing disparity between the relative economic importance of a province and the share of revenues received, which disproportionately affects larger provinces. This is the case for example, for the Buenos Aires Province (the country's largest, which accounts for approximately 40% of national GDP), which receives 20% of the eligible funds distributed among the 24 provincial districts.

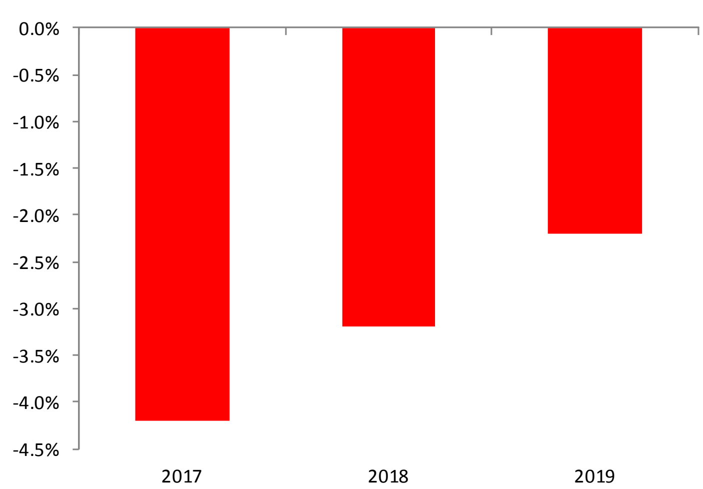
Public expenditures: slowly rolling back

An overwhelming public sector advance. During the last three presidential terms, the size of the public sector increased significantly, in a part as a political interpretation of the social demands emerging after the 2001-2002 crisis. According to the IMF, total governmental expenditures (federal government, provinces and municipalities) represented 39% of GDP in 2016, well above the 25% reached ten years earlier. National government primary expenditures reached 24.7% of GDP in 2016, 10.7 percentage points above the mark observed in 2006. Approximately 80% of this public expenditures growth in the period was explained by the social security system and economic subsidies outlays.

Public expenditures breakdown



Projected primary deficit



Left: national government expenditures breakdown, as a percentage of the total. Right: primary result official targets, as a percentage of GDP. Sources: Ministry of Economy and Santander.

An overreaching social safety net. In the case of social security, the strong increase was due to the incorporation of approximately 1.2 million new pensioners, which previously were not entitled to receiving transfers, given that they had not made or completed contributions during their active life. In addition, a pension-payment-adjustment law enacted in 2008, which links pension increases to increases in the salaries index and the growth of total tax revenues, is another reason for the rapid growth of social transfers outlays. Other factors are: the creation of new social transfers (a universal allowance for deprived sectors of population) and (during the current administration) the program to cancel long-dated pension liabilities (since the 1990s many pensioners sued the national government for inaccurate disbursements, usually well below the legally determined payment).

Public outlays breakdown. In 2016, pensions and social services represented more than a half of total public expenditures (53%), followed by public consumption (20%) and economic subsidies (16%). Total subsidies (including both economic and social) represented 6% of GDP in 2016, 3.5 percentage points above 2006's figures and is comprised of transfers to the private sector in the energy and transportation sectors.

Gradually bringing down the subsidies account. The transfers grew significantly as a way to maintain output as local energy prices were frozen well below the cost of generation/extraction. In 2016, the new government began to lift utility rates in order to gradually converge local prices with international prices, increase market transparency and reduce expenditures. The current administration inherited a high fiscal deficit, which reached 5.2% of GDP in 2015. Their main objective on the fiscal front is to gradually reduce the primary deficit to 2.2% of GDP in 2019 through a combination of higher revenues (derived from a recovery in GDP growth and the fight against tax evasion), coupled with increased efficiency in the government's expenditures and savings coming from a lower level of economic subsidies.

Recent fiscal performance. In the first seven months of 2017, fiscal revenues expanded 31.4% y/y and expenditures grew 30% y/y. We expect an improvement in the revenues related to the GDP recovery: VAT and income tax collection expanded 10.5% y/y and 9.8% y/y respectively in July, in real terms. On the other hand, remember that the tax amnesty revenues added ARS 46.6 bn to fiscal revenues in 1T17, equivalent to 0.5% of GDP. On the expenditures side, the social security system showed an expansion of 40% annually, well above the inflation rate mostly due to the growth of pension outlays. Subsidies expenditures (primarily for energy and transportation) declined 10.6% annually between January-July, generating a public fiscal savings of 1.2% of GDP this year. We expect that the federal government will reach the primary fiscal target of 4.2% of GDP this year.

Conclusion

Summing it all up, our outlook for Argentina remains optimistic, provided that the government's victory in recent primaries is confirmed in the forthcoming mid-term elections, which would put the official coalition in a stronger position to negotiate a set of structural reforms encompassing labor, tax and pension regulation. However, we believe that the changes in regulation will not be far-reaching in a first stage, and anticipate resistance from various sectors (such as labor unions or the more ideological fringes of the Peronist party). Therefore, we expect that the structural reforms will be completed in different stages, assuming that the governing coalition continues to consolidate power in the future.

We believe that this scenario would be favorable for GDP expansion to reach 3% in 2017 and 3.5% in 2018, in a context of slowly declining inflation (22% this year, 15% in 2018). Finally, the fiscal consolidation (i.e., decrease in the primary and fiscal deficits) is expected to remain only very gradual (we expect a 6.6% fiscal deficit for 2017, declining to 5.4% next year).

ARGENTINA – MAIN VARIABLES FORECASTS

	2013	2014	2015	2016	2017F	2018F
National Accounts & Activity Indicators						
Real GDP (Δ% y/y)	2.3	-2.56	2.6	-2.3	3	3.5
Private Consumption (Δ% y/y)	`	-5.19	3.5	-1.4	2.2	3.2
Public Consumption (Δ% y/y)	5.32	2.95	6.8	0.3	2.7	1
Investment (Δ% y/y)	3.91	-7.6	3.8	-5.5	7.7	13
Exports (Δ% y/y Local Currency)	-3.52	-6.98	-0.6	3.7	6.5	9
Imports (Δ% y/y Local Currency)	3.88	-11.48	5.7	5.4	9.2	12.2
GDP (US$ bn)	614.2	567.5	631.89	545.1	616.8	630
Monetary and Exchange Rate Indicators						
CPI Inflation (Dec Cumulative)	10.5	24.9	26.9	37.7	22	15
CPI core Inflation (Dec Cumulative)	10	24.1	25.7	32.1	20	13.9
US$ Exchange Rate (Average)	5.5	8.1	9.26	14.78	16.63	18.92
Central Bank Reference Rate (eop)	21.6	20.4	33	24.75	23	14.25
Private sector credit (% of GDP)	12.7	12.5	13.8	13.2	13.4	15.2
Fiscal Policy Indicators						
**Fiscal Balance, % of GDP	-2.9	-4.3	-4.6	-5.9	-6.5	-5.4
**Primary Balance, % of GDP	-1.7	-2.7	-4.9	-4.3	-4.4	-3.5
Balance of Payments						
Trade Balance, % of GDP	0.2	0.5	-0.5	0.4	-0.6	-0.7
Current Account, % of GDP	-0.9	-1.4	-2.7	-2.7	-3.8	-3.6
Debt Profile						
Central Bank International Reserves (US$ bn)	30.1	31.4	25.6	38.8	49	52
Total Public Debt (net of public sector holdings, % of GDP)	18.1%	17.6%	16.0%	25.0%	27.0%	29.3%
Of which: Foreign-currency denominated (% of GDP)	18.3	13	13.6	20.3%	22.0%	24.0%
Labor Markets						
Unemployment Rate (% eop)	6.4	6.9	5.9	7.6	7.2	6.8

**Excluding CB transfers.
Sources: Economy Ministry, Central Bank, and Santander estimates.

Brazil Macro Compass

More on the Surprisingly Low Inflation

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Upcoming Releases

Inflation data dominate the schedule of domestic indicators. On Thursday, IBGE releases the September IPCA-15. We expect monthly inflation at 0.17%, bringing 12-month inflation to 2.62%. Foodstuff prices should continue to fall – we expect -1.8% MoM, whereas rising fuel taxes and higher airline ticket prices should prevent a decline in the headline index.

On the same day, the Central Bank releases its Quarterly Inflation Report (QIR), which should not bring anything new (compared to what was published in the latest monetary policy minutes, see below) for the CB's short-term forecasts and monetary policy signaling. For the first time, the CB is expected to present the results of its models for 2019 and 2020 inflation, and we expect to gain a better understanding of why it raised forecasts for regulated prices this year (from 6.6% in the July minutes to 7.5% more recently), despite reducing headline projections (from 3.6% to 3.3%). This divergence may be explained by the shock in foodstuff prices, but it will also be important to see how the CB views services inflation, given that this component is more sensitive to monetary policy and the economic cycle.

What's Going on?

The minutes of the latest Copom meeting did not add much to what was issued in its statement. The committee disclosed that, according to its models and assuming the main variables (Selic and exchange rates) at market consensus, 2018 CPI inflation should be 4.4%, quite close to the midpoint of the inflation target range (4.5%) and suggesting that the terminal level for the policy rate should be close to what the market is currently pricing in (7.0%). The statement also reaffirmed that monetary policy is already expansionary, which implies, in our view, that either the terminal rate will be raised when the output gap narrows significantly (by the end of 2018, according to our estimates – see our report *Monetary Policy and the Last Crusade*, from August 30) or that, by the end of 2018, the structural (neutral) rate should have already declined, potentially in response to reforms and fiscal consolidation. We maintain our view that Selic will reach 7.5% by year-end and remain at this level throughout 2018, admitting that, given Copom's speech of a "moderate reduction of the pace of easing" and the rate already at 8.25%, our estimates are skewed to the upside of the range of possibilities.

On the economic activity front, data released last week were mixed: July IBC-Br, the Central Bank's monthly GDP proxy, surprised to the upside (0.4% MoM vs. 0.1% according to market consensus) and confirmed our view that the recession is over and that 2017 GDP growth will be 0.5% or higher. However, IBGE's estimates for the volume of services ticked down in July (-0.8% MoM) after three consecutive months of growth. On a year-over-year basis, the index is still falling (-2.8%), discarding, in our view, a more robust economic recovery this year (the share of services in Brazil's GDP was around 73% in 2016). Core retail sales were flat in July (compared to June), but 3.1% higher than in the same period of 2016. The broad index (including vehicles and building materials) has been performing significantly better (+0.2% MoM, +5.7% YoY), influenced by the base effect and the substantial improvement in credit conditions.

Political Agenda

Electoral reform discussions in Congress seem likely to be extended until the deadline (September 30) for them to be applied to the 2018 general elections. Last week once again a set of new rules was discussed, but no consensus emerged. Most changes to election laws require constitutional amendments, which need to be approved by a 3/5 majority in both houses.

The electoral reform should continue to impose a deadlock on the reform agenda – the government has been saying that the discussions around the pension reform will be resumed by October. **Moreover, the lower house will likely prioritize voting on whether the new criminal charges against the President should be adjudicated by the Supreme Court**. The charges were presented by the chief prosecutor last Thursday, but will only be sent to Congress after a Supreme Court decision (which is expected next week) regarding whether some of the evidence presented can still be used. Once the Supreme Court makes its decision, the process should move quickly in Congress – the charges presented on June 26 were voted (and filed) on August 2, and we expect the same promptness in this matter.

In-Depth Research: Social Security Reform Beyond the Fiscal Impact

We tried to look to the ongoing discussion about social security reform through the lens of its potential effects on Brazil's severe income inequality. Currently, more than 80% of those who benefit from early retirement (women younger than 54, men younger than 59) belong to the top-half of the income distribution. The introduction of a minimum retirement age would mitigate this distortion and also contribute to extending Brazil's so-called demographic bonus in the decades ahead.

Another feature of the proposed reform that may have important distributive effects is applying the ceiling for benefits received through the social security system to public sector workers (currently it applies only to private sector workers). The ceiling is currently around BRL 5.5k/month, whereas the average monthly benefit paid to retired public sector workers is over BRL 8k/month.

Visit our website for the full report (*Social Security Reform: Well Beyond the (Necessary) Fiscal Impact*, September 13).

Recent Publications

- *Social Security Reform: Well Beyond the (Necessary) Fiscal Impact* (September 13, 2017)
- *Monetary Policy and the Last Crusade* (August 30, 2017)
- *Unusually Low Risk Aversion Triggers a More Bullish Scenario in the Short Term* (August 17, 2017)
- *Fiscal Policy: 2017-2020 Long Range Fiscal Targets* (August 16, 2017)

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