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The bank for a changing world

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On 20 June 2018, 18 years after the great financial crisis of 2000-2001, Mauricio Macri's government had to turn to the IMF for assistance again to counter the peso's sharp depreciation in the midst of a mini forex crisis. At a time when investors are more wary of the emerging marketplaces, the peso has lost 40% against the US dollar since the end of April, despite drastic moves by the central bank to raise key policy rates as high as 60%, after quickly ceasing to use foreign reserves to defend the exchange rate.

The standby agreement with the IMF provides a major credit line of USD 50 bn, a little more than 11 times Argentina's country quota. In 2000-2001, the IMF had put about USD 22 bn on the table, 7.5 times the country's quota at the time. The difference in the two sums might give the impression that the current situation is more alarming than in 2000-2001. This is not the case in many ways. The external environment and Argentina's economic trajectory are very different now than in the earlier period.

Before the 2000-2001 crisis, Argentina was mired in recession due to two major external shocks: the Asian and Russian crises of 1998 and the devaluation of the Brazilian real in 1999. The economy was also strapped by the currency board's restrictions, which, given the fixed exchange rate, requires a deflationary adjustment of prices and wages in order to restore the external accounts. To safeguard its credibility, the currency board also requires to maintain the fiscal balance close to the equilibrium.

In 2016-2017, in contrast, Argentina was not hit by any financial shocks comparable to those of 1998-1999. Moreover, despite the emerging countries' higher exposure to portfolio investments, external financing conditions remained very favourable, with abundant liquidity and low risk premiums. Argentina largely benefited from this situation. After taking power in late 2015, Mr. Macri rapidly lifted the capital controls, unified the exchange rates (at the price of devaluing a notoriously overvalued peso), and settled once and for all the arrears on its external debt. Having regained greater flexibility, Argentina's economy swung back into growth.

How did such a simple bout of jitters in the emerging marketplaces end up having such a big impact on the country? Is the economy as fragile as ever? If this is the case, will Argentina be able to withstand the treatment it must undergo in exchange for an IMF bailout, without sinking into a disastrous situation like the one that prevailed in late 2001 (sovereign default, emergence of parallel currencies, and the forced convertibility of bank balance sheets)?

Part one of this article will describe and examine in chronological order the period from Q1 2016 to Q3 2017, which was marked by economic policy changes and the return to growth, and then the six month period prior to the conclusion of the IMF agreement, during which the credibility of monetary policy eroded, the external accounts deteriorated, and inflation surged again. Part two will present the macroeconomic measures and objectives of the IMF plan (coverage of external financing needs, public debt dynamics) and the sources of corporate and banking risks.

Incomplete normalisation process

Off to a good start

When he took power in late 2015, President Macri inherited an economy that had alternated between years of growth and recession since 2012. It was cobbled by several imbalances, including a largely underestimated official inflation rate, swelling fiscal deficits partially financed by central bank transfers, a rapidly deteriorating current account deficit and structural outflows of private capital. Central bank reserves dwindled to a little under USD 25 bn, not far from the alert threshold (3 months of goods and services imports).

A large part of the new government's measures aimed to stabilise external liquidity:

- elimination of forex controls, alignment of the official and parallel exchange rates (at the price of a 25% devaluation) and unification of the two rates, elimination of export taxes, and a narrowing of the scope of application of the import licensing system;

- the payment of arrears on the external public debt under pressure from activist shareholders, fiscal amnesty for undeclared external assets to encourage the repatriation of funds, a new capital markets law to deepen the local financial market and improve corporate governance.

Argentina: growth and household confidence

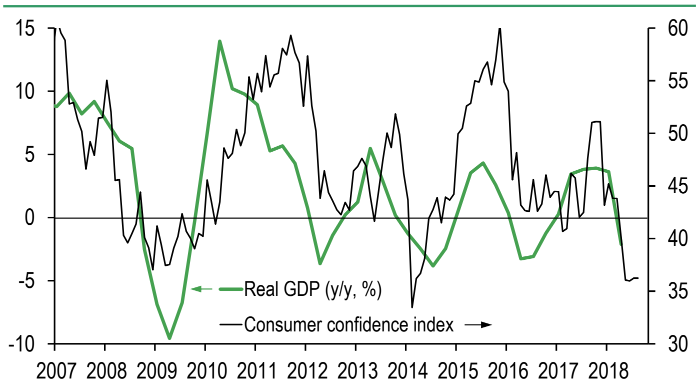

Chart 1 Source: INDEC - Tortuaco di Tella University

Other measures targeted public finances and investment. The government set multi-annual targets to reduce the federal primary deficit and introduced quarterly monitoring in 2017, while trying to limit any recessionary effects.

Regulated prices for public services (water, electricity, natural gas and public transport) were also raised sharply to reduce subsidies that were straining the budget. Exemptions were made for low-income families (*tarifa social*), and social welfare benefits were also raised (family allowances, pensions, unemployment benefits). The government also launched an infrastructure investment plan, notably in the northern regions, as well as public-private partnerships in renewable energies. The government has pledged to bring national statistics in line with international standards.

Initially, devaluation and higher public service fees triggered an inflationary shock and recession in the first half of 2016. The monthly inflation rate accelerated to an average of 4.2% between December 2015 and June 2016, from 1.8% between January and November 2015. In response to this inflationary surge, the central bank raised its key rates by 685 basis points to 40% in March 2016, and the economy slid into recession through Q4 2016 (real GDP contracted by a cumulative 3% between Q3 2015 and Q2 2016).

By June 2016, however, the impact of devaluation and regulated price increases had faded out, and core inflation (i.e. excluding seasonal foods and regulated prices) dropped below 2% in July 2016. Between summer 2016 and year-end 2017, headline inflation remained mild despite higher regulated prices thanks to the greater stability of the peso in nominal terms. The central bank was able to loosen its monetary grip, and by year-end 2016, its key policy rate was back to the pre-devaluation rate of 25%. Meanwhile, on the international bond markets, the Argentine government easily managed to raise the funds necessary to pay off its debt arrears.

Argentina's economy truly began to recover as of Q4 2016, with GDP growth accelerating to an annual growth rate of nearly 4% year-on-year in H2 2017 and holding at 3.5% in Q1 2018. Growth was better balanced than during Cristina Kirchner's second mandate. Real GDP relied more heavily on investment and exports[1] rather than on public and private consumption. With the normalisation of interest rates, business picked up strongly in the construction sector in 2017. The lifting of export taxes bolstered grain and oilseed exports, which account for 45% of total exports. Exports of non-agricultural manufacturing goods (30% of total exports) swung back into growth in 2017, for the first time since 2012, thanks to the improved situation in neighbouring Brazil (Mercosur absorbs 20% of Argentina's exports).

First cracks

At the end of 2017, however, the traditional macroeconomic weaknesses reappeared again, undermining the ex-post credibility of monetary policy.

Inflation inertia

In 2017, it was much harder to obtain marginal gains in disinflation than in 2016 (the core inflation rate continued to average 1.6% a month, with a minimum of 1.3%). A priori, there are several possible causes for the downside inertia of inflation: the rigidity of real wages relative to productivity gains, high sensitivity to the exchange rate pass-through, monetary financing of the fiscal deficit, the monopoly power of local producers and/or the low substitution rate of local products and services for imported products.

Real wages began accelerating again in 2017 (+4.5%), at a faster pace than productivity gains, but this is more a reflection of cyclical rather than structural rigidity (between 2012 and 2016, real wages and real GDP both stagnated). Moreover, in 2018, real wages are likely to contract again. Moreover, the inflationary impact of monetary financing disappeared after the central bank stopped transferring profits in December 2016.

Argentina: inflation and the exchange rate

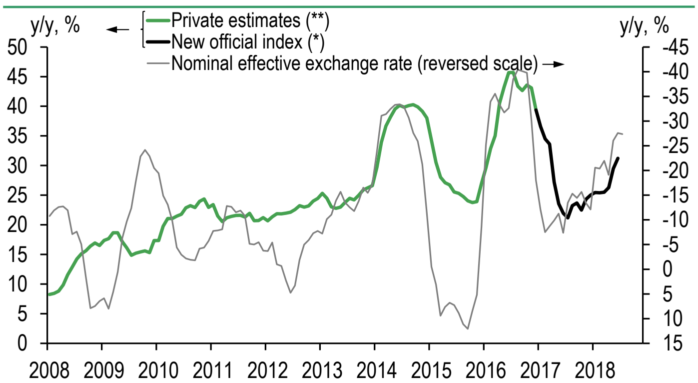

Chart 2 Sources: BIS , INDEC (*), GlobalSource Partners (**)

The main cause of inflation's downside inertia still lies in Argentina's very high sensitivity to the exchange rate pass-through. On, top of that, according to the OECD and the World Bank, the degree of local

[1] Between Q3 2016 and Q1 2018, cumulative investment increased 24% after contracting 2% on average between 2012 and 2015. The investment rate, at more than 22% of GDP, is the highest since 2005.

competition is relatively low compared to other countries, whether advanced and emerging economies.

Capital inflows offset the deterioration of the current account

The current account deficit swelled to more than USD 30 bn in 2017, a twofold increase compared to 2016, reaching the warning threshold of 5% of GDP. After showing a surplus through 2016, the trade balance swung into a deficit of USD 5.5 bn, the balance of services deficit was nearly USD 10 bn and the deficit on investment income was USD 16 bn (mainly interest charges on the external debt).

Altogether, 70% of the deterioration in the current account deficit can be attributed to the balance of goods and services, and 30% to the balance of investment income. The current account deficit is largely cyclical because the rebound in growth was accompanied by a huge surge in imports of goods and services (+20% in volume) and the exceptionally high elasticity of GDP (more than 4), with is typical during recovery phases. In terms of exports, however, the country was hit by unfavourable exogenous conditions. The drought between November 2017 and March 2018 hurt exports of agricultural products[2], and prices were quasi stagnant for the main agricultural commodity exports (soya, wheat).

Argentina: prices for the main agricultural commodity exports

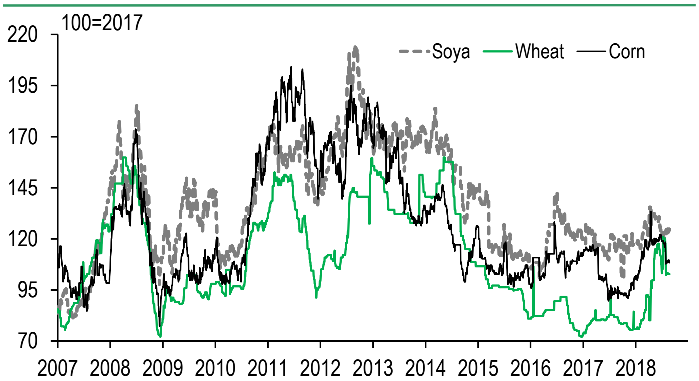

Chart 3 Source: Datastream

For the same reasons, the trade deficit continued to widen in Q1 2018. Yet non-agricultural industrial exports remained dynamic, with volume growth of nearly 10% through early 2018. Actually, Argentina's economy is not very integrated in global value chains (GVC). According to the OECD, the GVC participation rate was only about 40% in 2009, compared to 60% for South Korea, the Czech Republic and Slovakia, for example[3]. Consequently, Argentine exports should not be hit as hard as those of the other emerging countries from the expected structural slowdown in trade linked to global value chains.

Between Q1 2016 and Q1 2018, the deterioration in the current account deficit has had no negative impact on fx reserves. Cumulative figures for the period Q1 2016 through Q1 2018 show that the current account deficit (USD 55 bn) and capital outflows by Argentine residents (USD 35 bn) were largely offset by non-resident capital inflows, namely foreign direct investment (USD 17 bn) and especially portfolio investments (USD 93 bn), since the Argentine government issued a total of USD 56 billion in international bonds.

Argentina: financing of the current account deficit

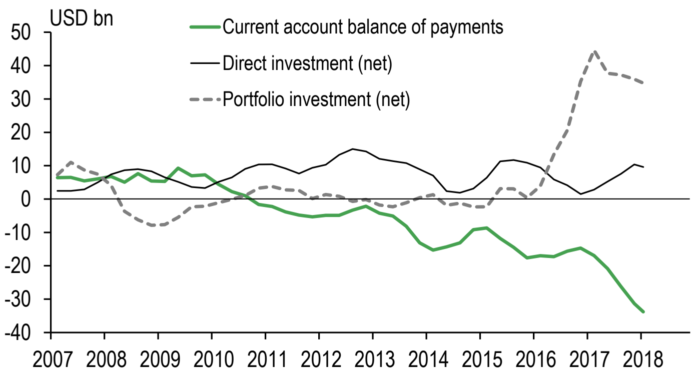

Chart 4 Source: INDEC

Foreign reserves have increased nearly 2.5 fold since the end of 2015, to a high of USD 62 bn at the end of March. Yet external liquidity was rebuilt at the expense of a more fragile financing structure for the balance of payments and a big increase in external debt, since coverage of the current account deficit by foreign direct investments is still insufficient (30%).

Monetary policy constraints

Monetary policy was another source of concern that made investors more wary as of year-end 2017. The monetary policy framework changed radically with the adoption of inflation targeting in September 2016, a real challenge for a highly inflationary economy that for the past two years has benefited from an exceptional inflow of external liquidity requiring sterilisation operations.

The triggering event came when the Central Bank of Argentina (BCRA) revised upwards its inflation forecasts, from an initial range of 8-12% to 15% for year-end 2018, and from 5% to 10% for 2019, and then sharply cut its key rates again, which did not seem to be compatible with macroeconomic dynamics and inflation targeting.

Federico Sturzenegger, the central bank's governor at the time, was confronted with a classic dilemma: to anchor the credibility of inflation targets, he needed to maintain key rates at very high levels, but he also needed to discourage capital inflows, or take measures to sterilise them, in order to contain money supply growth, a major source of inflation for

[2] For the grain harvest, output forecasts called for a decline of between 20% and 30%.

[3] A country's Global Value Chain (GVC) ratio is calculated by the sum of 1/ value added generated by trading partners contained in the country's exports (upstream links) and 2/ the country's value added used as inputs in the exports of trading partners (downstream links), as a share of the country's total exports. For commodity exporting countries, this ratio is very low by nature since the above mentioned exports have a direct end use. In Argentina's case, however, even its industrial products have a low GVC ratio, except in the "transport and equipment" sector. A priori there is no reason why the GVC ratio should have increased since 2009, and it is even more likely to have declined.

Argentina. In other words, using interest rate tools would either counter its inflation target or at least hamper its realisation.

In Argentina's case, the impossibility of meeting two objectives with a single instrument was compounded by a specific problem, "fiscal dominance", another major constraint for monetary policy. Fiscal dominance occurs when monetary policy is either dictated by or sharply constrained by fiscal targets, either through the interest rate channel, which affects the interest charge on public debt, or directly via transfers and advances to the Treasury[4].

In Argentina's case, interest on government debt is not a very big source of fiscal dominance. Over the period 2011-2017, the interest charge averaged only 2% of GDP despite a significant increase in public debt, which rose from 38.9% of GDP at end 2011 to 57.1% at end 2017. Two factors explain the relative inertia of interest charges to the increase in debt:

- Nearly half of the debt (49%) is held by public entities, notably the social security administration (ANSES) and BCRA, in the form of non-marketable securities. According to the IMF, BCRA holds the equivalent of 18% of GDP in non-interest-bearing debt.
- Looking beyond its very high volatility, the real exchange rate appreciated slightly over the period, which reduced by as much the real cost of the debt denominated in or indexed to hard currencies (mainly the dollar), which accounts for 70% of total debt. As a result, the apparent interest rate (interest paid/total debt) was only 6.2% between 2011 and 2015 for an annual nominal GDP growth rate of more than 25% (a highly negative snowball effect).

Central bank financing, in contrast, provided a major source of coverage of financing needs: BCRA profits transferred to the Treasury accounted for as much as 1.7% of GDP in 2014 and 0.7% of GDP in 2017, while BCRA commitments to the government rose from less than 10% of GDP in 2011 to 20% at year-end 2015. Moreover, this is solely an internal source of monetary inflation. We must also add an external source, i.e. the central bank's conversion of USD-denominated bonds issued by the government into the local currency[5]. All in all, monetary inflation has been and remains closely linked to changes in the fiscal deficit, at least via its financing.

In addition to these two constraints, one general and the other specific, the central bank also faces an operational constraint. The BCRA's main monetary policy instrument is tied to the issue of LEBAC and LELIC sterilisation bonds, because Treasury repurchase agreements would not suffice to cover its sterilisation needs. The LEBAC stock accounts for a little more than 10% of GDP and 130% of money supply (vs 7% and 60%, respectively in early 2016). According to GlobalSource calculations, the apparent cost of its LEBAC stock, calculated as interest over money supply, was 36% at year-end 2017, compared to 17.5% in early 2016. By comparison, interest received on forex reserves is a far cry from offsetting interest paid on LEBACs and LELICs. In other words, the need to sterilise hard currency government bond issues (and other capital inflows) to contain monetary inflation implies an increasingly high fiscal cost.

IMF rescue plan: restore confidence

The IMF stand-by agreement signed in June calls for a USD 50 bn credit line. The first USD 15 bn tranche was paid out just after the programme was validated, with half going to the Treasury to ease government financing needs, and the other half to the BCRA to consolidate its foreign reserves. The remaining USD 35 bn is intended to serve as a precautionary credit line.

At this stage, the IMF plan is not a bailout plan (for banks and/or corporates recapitalisation needs); it is aimed at restoring confidence and ease pressure on the balance of payments. The plan is built around three classic pillars: 1) bolstering external liquidity and reducing external vulnerability, 2) strengthening fiscal discipline to ensure debt sustainability, and 3) shoring up the credibility of inflation targeting. The plan also has a fourth pillar: it stipulates that protection must be provided for the most vulnerable populations.

Liquidity is ensured in the short term, but there is a massive need for USD refinancing

The pay out of the first tranche has already helped rebuild the foreign reserves that were used by the BCRA. The foreign reserve now exceeds USD 60 bn. The IMF plan calls for the targeting of net foreign reserves, so that by the end of the programme, Argentina meets IMF standards for the adequacy of foreign reserves. In the short term, the expected slowdown in growth (the IMF revised downwards its growth estimates to 0.4%, from 2.5% at year-end 2017) and the real depreciation of the exchange rate (the IMF forecasts that the effective exchange rate will decline 18% at year-end 2018) should make it possible to reduce the current account deficit by a little more than 1 point of GDP this year. The deficit should fall back below 3% in 2020, despite higher oil prices and thus a wider oil deficit. The decline in the current account deficit will help offset the decrease in inflows of foreign direct investment and portfolio investment.

The IMF credit line and Argentina's foreign reserves cover nearly two and a half years of the country's external financing needs (current account deficit plus medium and long-term debt amortisation). At year-end 2017, INDEC estimated the amortisation of Argentina's external debt at USD 14 bn in 2018 and USD 10 bn in 2019 (amortisation of the first IMF tranche will not begin until 2021, and that of debt restructured in 2005 and 2010 not until 2024). Repayment of interest and principal on international bonds will amount to only about USD 2 bn in H2 2018, USD 8.5 bn in 2019 and USD 6 bn in 2020. Consequently, unless there is a massive outflow of resident capital, Argentina's ability to repay its external debt is not endangered in the short term. The unused credit line

[4] I.e. seigniorage revenue in the narrow sense of the term. Using a broader definition, seigniorage revenue includes state gains from high inflation when fiscal spending is partially indexed to resources.

[5] In general, the central bank must convert non-resident portfolio investment inflows into the local currency bond and equity markets into the local currency, which contributes to the increase in internal liquidity.

was calibrated to cover the country's external financing needs in an adverse scenario.

Even so, Argentina's USD-denominated financing needs are huge. The repayment of interest and principal on the central government's USD currency debt (external and domestic) will amount to USD 34 bn in 2018 and USD 22 bn in 2019. Faced with such a big need for USD liquidity, it is crucial to bolster foreign reserves and the stability of the exchange rate. External solvency has also deteriorated sharply. The external debt as a percentage of goods and services exports has practically doubled since 2011, to more than 320% at year-end 2017. This is one of the highest ratios among the emerging countries. What is even more alarming is that the IMF does not expect this ratio to decline by the year 2023.

Fiscal discipline and the credibility of monetary policy: a classic but necessary combination

The GDP growth assumptions published by the IMF (cumulative figure for the period 2018-2020) indicate that real GDP will be 4% lower than its December 2017 forecast. Unsurprisingly, it revised downwards its 2018-2019 growth forecast due to the forex shock and tightening of monetary and fiscal policies. Even so, the economy is expected to avoid recession, which seems like a very optimistic assumption.

Argentina: twin debts

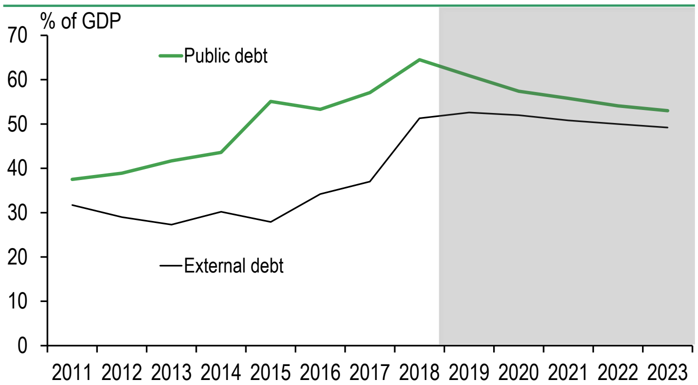

Chart 5 Source: IMF

The authorities and the IMF are hoping to reverse the public debt ratio. The government will have to reduce the federal primary deficit (excluding BCRA transfers) at a faster pace than initially intended if it is to reach an equilibrium by 2020. The primary deficit has increased constantly since the beginning of the decade, to 4.2% of GDP in 2016.

In 2017, the primary deficit narrowed slightly to 3.8%, thanks to the reduction in energy and transport subsidies, which were partially offset by higher spending on pensions.

As part of the IMF rescue plan, the government has pledged to make a cumulative fiscal effort of 4.2 points of GDP in 2018-2019. This effort will consist mainly of spending cuts, since the government won parliament's approval to carry out a 5-year fiscal reform, presented in November 2017, to reduce the fiscal pressure on companies[6]. Under the IMF plan, the application of some of the fiscal reform measures would be postponed and the 25% tax on soya exports would be maintained (for a total of 0.4 points of GDP). The plan thus concentrates on reducing primary spending, especially current spending and transfers, for 3.1 points of GDP[7]. Social welfare benefits, in contrast, will be preserved and are expected to increase by 0.6 points of GDP by 2020, to 10.3% of GDP. The Argentine government also ring-fenced social welfare benefits for low income households by placing a floor on these expenses, with extra manoeuvring room of 0.2 points of GDP should the economic situation require a bigger than expected increase. The apparent fiscal multiplier is less than 1 (4-point downward revision of GDP growth for a fiscal effort of 4.2 points of GDP), which is a rather optimistic assumption.

Bolstering the credibility of monetary policy depends more than ever on inflation targeting, but no inflation target was set for year-end 2018 to avoid disappointing the markets again (the target is 17% for year-end 2019). Alongside the fiscal effort, the greater credibility of monetary policy should enable real interest rates on peso-denominated debt to return to the late 2017 level as of year-end 2019. This is the justification behind the assumption that the economy will simply slow down, rather than relapsing into recession.

Argentina: twin deficits

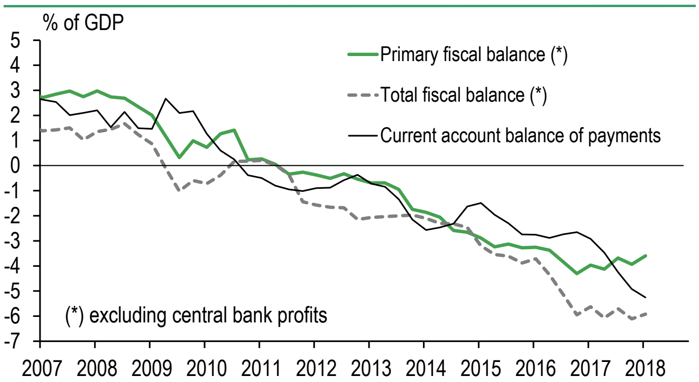

Chart 6 Sources: INDEC, Ministry of Finance, GlobalSource Partners

To achieve this, the government has agreed to halt the transfer of central bank profits as of this year, which should reduce the stock of LEBAC to 3.4% of GDP by year-end 2019[8], from 9.7% currently, and its loans to the government to 12%, from 17.6%.

[6] The reform calls notably for a reduction in the sales tax rate applied by the provinces, a reduction in the corporate tax rate (to 25% from 35%) on reinvested earnings, the deductibility of the financial transaction tax, and a reduced rate for employer contributions on low income workers, in order to reduce the fiscal wedge to 19% from an average of 27%. The IMF estimates the gross cost of the reform at 3.75% over 5 years, including 1.5% for the reduction in the sales tax and 2.25% for the other measures.
[7] Including 1.3 points for the reduction of transfers to the provinces and state-owned companies, 0.7 points for additional streamlining of energy and transport subsidies, 0.5 points for the reduction of current spending, and 0.6 points for cutbacks in central government investment.
[8] To do so, the central bank will use the Treasury's repayment of the equivalent of USD 25 bn in non-marketable securities (Adelinos transitorios equivalent to

Sustainability of public debt requires the stabilisation of the real exchange rate

In 2018, the depreciation of the real exchange rate will necessarily raise the debt/GDP ratio, due to the weight of USD-denominated debt. In our central scenario, this ratio will begin to narrow as of 2019, and will fall back to the year-end 2017 level by 2021. Government financing needs will be trimmed to less than 10% through 2021, compared to 13% in 2017.

Yet despite disinflation, the IMF does not foresee a reduction in the effective interest rate on public debt by 2023, and the real interest rate could even become positive again as of 2021. In 2017, the effective interest rate on non-indexed peso-denominated market securities hit 22%, and the real interest rate was still negative. For the moment, the non-indexed peso-denominated debt market accounts for only 23% of total debt, which limits the impact on the effective interest rate of the debt. But the substitution of Treasury bonds for *Adelantos transitorios* will automatically drive up the average interest rate on the debt for the Treasury[9].

Our central scenario, in contrast, calls for the peso to appreciate again in real terms, a necessary assumption for the stabilisation of the debt ratio. This is a big assumption, even though it is in keeping with a reduction in the current account deficit. Unlike the primary deficit, the debt ratio and financing needs are not performance criteria. Even so, the IMF will monitor them to make sure they do not exceed the alert thresholds of 70% and 15%, respectively.

Looking beyond these assumptions on growth and respecting the primary deficit target, the risk of an upturn in the debt ratio lies in its sensitivity to real interest rates and above all the real exchange rate. In the IMF's adverse scenario, the economy would be hit by a short-term recessionary shock (the assumptions for the variables differ from the central scenario mainly in the first two years). In particular, the hypotheses for changes in the real exchange rate differ little from the central scenario as of 2019. Consequently, the adverse scenario does not show any explosive dynamics, because the debt ratio would be just 4 points of GDP higher than its trajectory in the central scenario, and would still be in decline.

The IMF concludes that the public debt should remain "sustainable, but not with a high probability". First, the fiscal consolidation effort is ambitious. According to the IIF, the median effort of IMF programmes (measured as the variation in the primary balance after two years) is 1 pp of GDP, compared to 3.8 pp for Argentina, which would place it in the bottom decile in the distribution of countries by degree of realisation, according to the IMF. Second, the different scenarios do not take into account specific financing needs, such as the debt of local administrations (which account for only 6% of GDP because most regions have balanced budgets) and contingent liabilities (recapitalisation of the central bank, the financing needs of state-owned companies and pension funds). Third, in a combined shocks scenario, the financing need would rapidly exceed 15% and would continue to rise even if the debt ratio levels off.

Looking beyond these simulations, the interest rate and exchange rate dynamics are central variables that will depend in the end on the plan's success. Yet this can generate conflicting objectives. Disinflation requires high real interest rates, at least initially, and an appreciation of the real exchange rate over the long term. Public debt reduction clearly imposes an appreciation of the real exchange rate, but lower real interest rates than when the plan was implemented, not only to reduce the debt burden, but above all to offset the recessionary effects of fiscal policy. Lastly, reducing external vulnerability depends, a priori, on a depreciation in the real exchange rate, which contradicts the inflation and debt stability targets.

In Argentina's case, the current account's sensitivity to the real exchange rate is low (-0.06 according to the IMF[10]), which is not surprising given the structure of foreign trade, and notably the small share of non-farm manufacturing exports. A priori, this specificity gives the appreciation of the real exchange rate an advantage in restoring the main macroeconomic equilibriums. All other factors being the same, a reduction in the current account deficit of only 2 points of GDP would require a depreciation of the real exchange rate by about 30. Based on the IMF's simulation, this would have an automatic impact on the debt ratio of about 15 points of GDP.

Non systemic vulnerabilities of corporates and banks

Despite the deterioration in financing conditions (depreciation of the real exchange rate, increase in real interest rates), the probability of a systemic crisis is a priori limited, even though credit risk will necessarily rise.

The call for IMF assistance did not trigger a run on deposits. The rotation of peso deposits into dollars was relatively mild with respect to the currency's depreciation. Even so, the dollarization of deposits has increased 3 fold since year-end 2015 (from 10% to 33% at the end of June), although this only very partially reflects the flight to USD (in 2016, fiscal amnesty triggered the repatriation of USD deposits).

Argentina's banking system does not show any major weaknesses. The banking system's overall liquidity is satisfactory, with a ratio of total loans to total deposits of only 71%. According to Moody's, market financing accounted for less than 6% of bank resources in mid-2017. The private sector has a low credit penetration rate (15% of GDP) because high inflation rules out long-term financing, since loan indexation is prohibited (except very recently, for mortgage loans).

Consequently, the non-performing loan ratio is low and has held steady at 2% in recent years. Moreover, it is largely covered by provisions. For

3.9% of GDP). The central bank's LEBAC stock should shrink from 10% currently, to 3.5% by May 2017. The Treasury will finance this move by issuing Treasury notes.

[9] Using the 2017 structure of debt and interest rates, the average rate would rise from 6.5% to 8%.

[10] A 10% appreciation of the real exchange rate would only reduce the deficit by 0.6 points of GDP.

the banking sector as a whole, there are no balance sheet imbalances: in June 2018, the external position as a share of GDP was only very slightly negative (-0.5%) and the foreign exchange position accounted for only 7% of capital requirements. Banks are not authorised to grant USD loans to companies that do not have corresponding revenues, and foreign currency loans to households are forbidden.

As of 2017, lending growth, in real terms, was nonetheless very strong, at 25% for the year, for both household and corporate lending. Future corporate bankruptcies and layoffs will necessarily mean more non-performing loans for the banks, but this trend will continue to be capped by the shallow loan base, especially for households (only 7% of GDP). Moreover, corporate data collected by the BCRA shows that Argentina's debt/ EBITDA ratio is much lower than for the other countries in the region, and has declined between 2012 and 2016, the last year for which statistics are available[11].

Argentina: financial conditions deteriorate

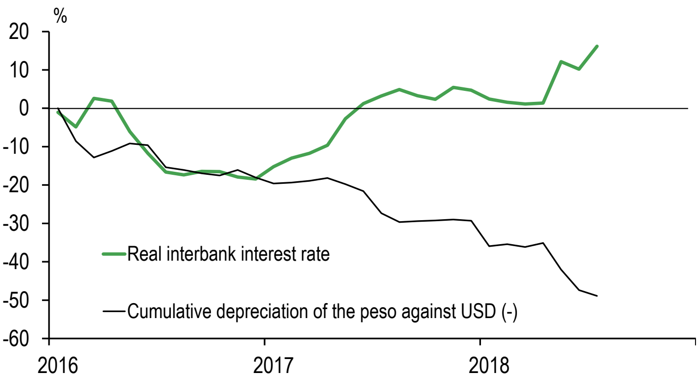

Chart 7 Sources: Datastream, INDEC

Two sources of risk must be pointed out. First, home loans and construction sector retail loans have experienced the fastest growth since 2017, notably after new loans for individuals were introduced in 2016 that are expressed in cost of construction units (UVI) and indexed to the CER[12]. The aim is to facilitate home ownership by applying the real interest rate to the loan, which considerably reduces monthly payments at first. Yet since the loans are indexed to inflation, households could see their monthly payments rise if wages do not keep pace with inflation, which is likely to be the case since real wages are highly cyclical.

Second, banking lending in dollars has increased 5.5 fold since year-end 2015, to USD 16.1 bn at the end of June 2018. In general, the foreign currency debt of non-financial companies has increased strongly, regardless of which measure is used. According to BIS statistics, USD-denominated debt of the non-banking sector, after deducting international sovereign bonds, amounted to USD 47 bn at end 2017, up from USD 21 bn at end 2015. This is a low estimate. A high estimate would consist of adding the banking sector's foreign currency loans and all of the external debt of non-financial companies (including intra-group loans), which would bring debt to USD 78 bn at end 2017 compared to USD 63.5 bn at end 2015. At the same time, the country's USD revenues remain virtually flat, at USD 74 bn over the past three years. At the macroeconomic level, the foreign currency debt ratio has increased sharply for companies. Granted, the external position of the non-banking private sector is still largely positive (USD 167 bn, excluding the balance of direct investment stocks), reflecting the cumulative outflow of resident capital in recent years. Corporate debt is thus covered by a buffer of USD assets. Evaluating the foreign exchange position remains a very approximate exercise, however, if for no other reason than the external position includes both households and companies. The corporate data collected by the BCRA confirms that companies have a rather high exposure to currency risk. In 2016, USD-denominated debt as a share of all corporate liabilities was about 40% in industry, 35% in the primary sector and 30% in services.

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Mauricio Macri's government managed to pull the Argentine economy out of isolation, after the country was stigmatised by the 2001 default, debt arrears and its rupture with the IMF. The new government achieved this by lifting forex controls, devaluing the currency, paying off its external debt arrears and adopting a policy of inflation targeting. Thanks to this normalisation policy, the economy swung back into growth in 2017 and the central bank consolidated its foreign reserves thanks to portfolio investment inflows. The negative counterpart was a wider current account deficit, an increase in the government's USD-denominated debt and indirect inflationary pressures and higher costs for the sterilisation of capital inflows for the central bank, which undermined the credibility of its new monetary policy. As a result, Argentina's economy was still fragile at a time when investors began pulling out of the emerging marketplaces. The Argentine government promptly called on the IMF to stabilise its currency before exhausting its foreign reserves. Given the state's heavy foreign currency debt, the government is faced with a classic dilemma: it needs to stabilise both the public debt and the external debt, which a priori requires opposing movements in the real exchange rate. In the very short term, disinflation, monetary policy easing and the state's solvency argue for the stabilisation of the real exchange rate. The same can be said for companies, whose external debt has increased sharply in recent years. Nonetheless, despite higher real interest rates and currency depreciation, there is little risk of a systemic credit crisis given the low level of domestic debt for both companies and households, and the absence of bank balance sheet disequilibrium. In contrast, the stabilisation policy will have an economic cost for the people of Argentina due to a very restrictive monetary policy and greater fiscal consolidation efforts than the government originally envisioned at year-end 2017. The government is also likely to have to pay a political price when general elections are held in 2019.

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[11] BCRA H2 2017 Report on Financial Stability
[12] *Coeficiente de Estabilización de Referencia* (CER) is the index used for inflation-indexed mortgage loans.

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