ARGENTINA

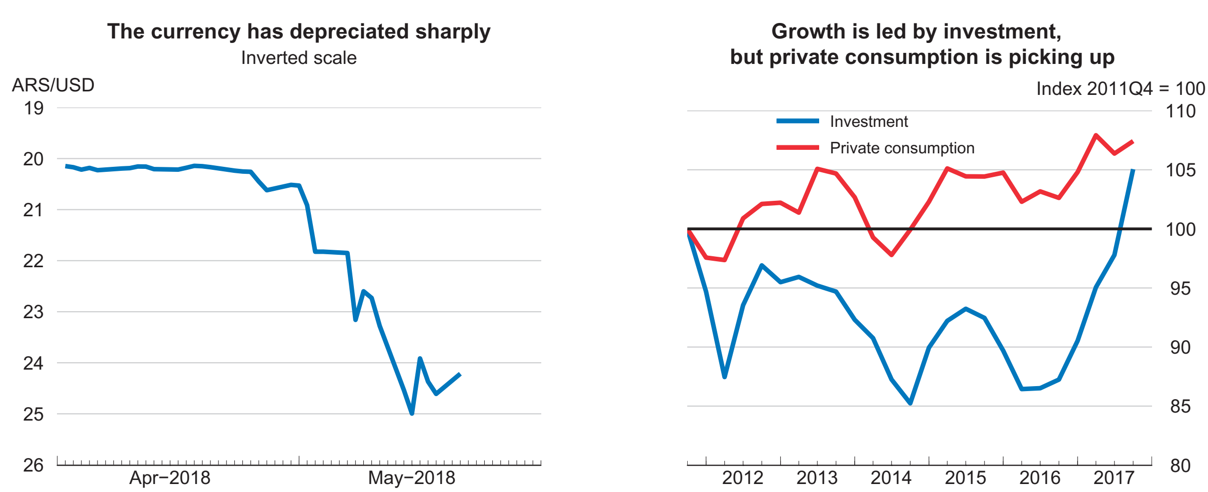
Economic activity is projected to rebound later in the year and growth is projected at 2% in 2018 and 2.6% in 2019, supporting further declines in unemployment. However, recently, the exchange rate has depreciated significantly amidst declining confidence and capital flight. The authorities have reacted with higher interest rates, exchange rate interventions, an accelerated fiscal adjustment and negotiations with multilateral lenders. Inflation has rebounded due to hikes in administered prices, currency depreciation and higher inflation expectations. This limits household real income growth and, together with weather-related declines in agricultural output, will dent growth in 2018.

The gradual reduction of the high fiscal deficit is being accelerated to restore confidence. Recent structural reforms, such as a tax and capital market reforms, a new competition law, improvements in administrative procedures and lower trade barriers in selected sectors are welcome steps to strengthen inclusive growth. Further reforms to foster the integration into the global economy, enhance competition and improve access to quality education could build on this progress.

The currency has depreciated abruptly

Recent developments in international financial markets have brought the vulnerabilities associated with Argentina's gradual fiscal adjustment and the reliance on external debt financing to the fore, although there have been no major changes in economic fundamentals and policies. Investor confidence declined abruptly in early May, setting off a substantial currency depreciation. Possible triggers may have included higher interest rates in the United States, higher inflation expectations following an increase in inflation targets in late 2017, lower dollar inflows due to a bad harvest, and a new tax on non-resident investors. The authorities reacted by raising interest rates, strengthening the commitment to fiscal adjustment, intervening in currency markets and initiating negotiations with multilateral lenders. On the real side, growth has increased and become

Argentina



Source: BCRA; INDEC; CEIC; and Thomson Reuters.

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Argentina: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices ARS billion	Percentage changes, volume (2004 prices)				
GDP at market prices	4 579.1	2.7	-1.8	2.9	2.0	2.6
Private consumption	2 993.9	3.7	-1.0	3.6	1.6	2.2
Government consumption	776.1	6.9	0.3	2.0	0.0	0.8
Gross fixed capital formation	731.7	3.5	-4.9	11.0	13.7	8.8
Final domestic demand	4 501.8	4.2	-1.4	4.3	3.1	3.0
Stockbuilding[1]	58.7	0.2	0.2	1.7	1.2	0.0
Total domestic demand	4 560.6	4.2	-1.3	6.3	5.1	3.2
Exports of goods and services	659.6	-2.8	5.3	0.4	-0.1	4.9
Imports of goods and services	641.1	4.7	5.7	14.7	12.0	6.2
Net exports[1]	18.5	-1.1	-0.1	-1.9	-1.7	-0.3
Memorandum items						
GDP deflator	_	26.6	40.1	25.3	23.9	15.8
Current account balance (% of GDP)	_	-2.8	-2.7	-4.9	-5.6	-5.5

1. Contributions to changes in real GDP, actual amount in the first column.
Source: OECD Economic Outlook 103 database.

StatLink http://dx.doi.org/10.1787/888933730731

more broad-based. Investment has been outpacing consumption and a rising share of investment is in infrastructure, with likely long-term productivity dividends. Private consumption has been gaining support from expanding credit. Agricultural exports will be significantly affected by a drought in 2018, but external demand, including from Brazil, remains buoyant. Combined with an increase of import demand, lower exports imply a widening current account deficit. Inflation rose to 25% year-on-year in March 2018, well above the year-end inflation target of 15%.

Fiscal adjustment is making progress, but reducing inflation has become more challenging

Fiscal outcomes have shown continuous improvements, including an over-achievement of the 2017 primary deficit target. In light of strong revenue collection and improving control of primary expenditures, meeting the recently tightened primary deficit target for 2018 (2.7% of GDP, from the previous one of 3.2%) appears feasible. The first half of 2018 saw significant progress in reducing regressive subsidies for public utilities. The external financing of the gradual fiscal deficit adjustment reflects shallow domestic financial markets and the relatively lower cost of external funds so far. Such a strategy creates vulnerabilities and entails liquidity risks, but without a major additional depreciation, it does not pose solvency risks. Public debt held outside the public sector is below 30% of GDP.

Bringing down inflation is proving challenging in light of necessary subsidy withdrawals, but core inflation has also risen. Managing inflation expectations has become more complicated since the upward revision of inflation targets for 2018-2020 in December 2017 and the subsequent monetary easing, which cast doubt about the independence of the central bank. More recently, the central bank has reacted with resolve to market pressures and tightened monetary policy by 12.75 percentage points. Maintaining tight monetary policy will remain necessary for some time in light of the currency depreciation, to ensure a continuous decline in inflation and contain volatility in capital markets.

Structural reforms accelerated markedly after the October 2017 elections, but more needs to be done to strengthen productivity and inclusive growth. Competition remains weak in many sectors due to domestic restrictions and high trade barriers. With exports and imports amounting to only 30% of GDP, the economy has ample scope for more integration into the global economy. Further reducing the cost of imported inputs and consumer goods would improve households' purchasing power, create new growth opportunities and allow more people to move into better paying jobs. Improving access to quality education and training would help workers prepare for these new opportunities.

Growth will be lower in 2018 but regain strength in 2019

Growth is projected to slow down during 2018 due to financial market turbulence and the drought. As these effects fade and policy reforms continue to bear fruit, growth will strengthen again during 2019. Disinflation will resume in the second half of 2018 but inflation will remain well above current targets during 2018 and 2019. Private consumption is projected to gradually contribute more to growth as unemployment and inflation recede further. External risks remain substantial in light of the continuous dependence on foreign funding for financing the gradual fiscal adjustment. However, the overwhelming majority of 2018 financing needs is already covered. Further depreciation of the currency or unexpected increases in interest rates in advanced economies would raise the cost of servicing foreign-currency debt. The recent surge in inflation-indexed loans could lead to higher default rates if inflation outpaces wage growth, although household debt levels remain low.