

Economic

Credit Ratings:

Moody's: B3
S&P: B+
Fitch: RD

Nominal GDP (2006):

USD 214.3bn

Population (2006):

39mn

Total Trade / GDP:

36.9%

Currency:

Argentine peso

Exchange regime:

Managed float

Canadian Merchandise Imports (2006):

CAD 166mn

Main sources of Foreign Exchange (excl. FDI):

Processed agricultural products

Largest Merchandise Trading Partner:

Brazil
United States

Main imports:

Intermediate Goods
Capital Goods

Risks to the Outlook:

An upswing in domestic investment

Rising inflation;
Prolonged rise in global risk aversion

November 2007
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Market Spotlight: Argentina is overheating. GDP growth was 8.7% y/y in Q2 and although official inflation fell to 8.6% in August this is likely half of the actual rate. Exports still surging (up 18% y/y in August) but are being outpaced by imports (up 40% y/y in August). ■ Plenty of hard currency reserves provide a decent war chest against global slowdown and modest increase in risk aversion. ■ Bond spreads are down from August peaks and have a long way to go to get back to levels seen in 2004/05, but another bout of global risk aversion could hit sovereign spreads/stock markets hard.

Real Sector: Growth was a robust 8.7% y/y in Q2 with acceleration on a q/q basis. The recovery is relying more on domestic demand, as consumption grew 8.7%, investment was 13.1% while exports decelerated nearly 1p.p. to 8.1%. Consistent with strong consumption and investment, imports growth held strong at 20% y/y. We expect the pattern of increased reliance on domestic growth sources to continue, in particular given the emerging global slowdown, and expansionary fiscal and monetary policies. However, concerns of emerging capacity constraints persist. Beyond 2008, stress points will become more evident with growth scaling back further.

External Sector: Domestic activity is stoking demand for imports pulling down the current account surplus. Net FDI has begun to return, but is still hindered by the government's confrontational approach toward foreign investors. While the private sector can cover its external shortfalls with bond issuances abroad, the government is still restricted in its access to international capital markets. External financing needs are being covered by dollar-denominated domestic issuances. The BCRA's objective of keeping down the peso has led to a significant accumulation of foreign exchange reserves. This would prove a good war chest to stave off potential balance of payments problems that could emerge over the coming two years. But pressures are building which will stress the balance of payments in 3 to 5 years.

Fiscal: Rapid growth and solid demand for Argentine exports are boosting government receipts. Such a strong performance should allow the government to continue its expansionary fiscal policy. The 2007 budget – which uses overly-conservative assumptions for GDP growth, revenue, and expenditures – is targeting a primary surplus worth 3.1% of GDP. We believe that the government will continue to overachieve its fiscal targets, leaving it in a comfortable financing position in 2007. Lending by official creditors should provide additional flexibility. Public debt fell to 64% of GDP at the end of 2006, from 72% a year earlier, bringing debt servicing down to 21.7% of tax revenues.

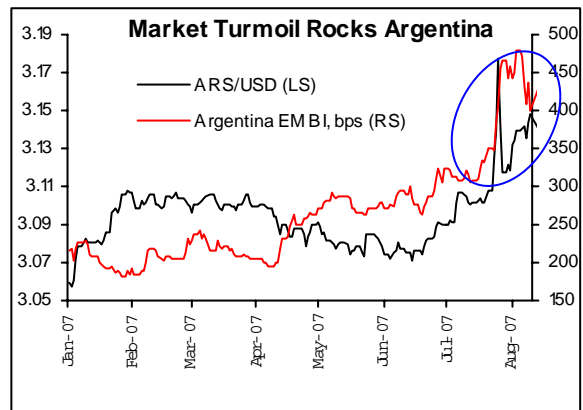
Monetary: Argentina's practice of artificially keeping the peso low has fueled exports and growth pushing up inflation. Although official inflation fell to 8.6% in August, official figures are probably half the actual rate of inflation. The government has implemented price controls, outright rationing in some cases (for consumer food staples) and perhaps worst of all questionable economic accounting to understate official inflation figures. Despite the extension of price 'agreements' and other unorthodox measures through the end of 2007, demand-generated pricing pressures continue to build and the medium-term outlook remains worrisome. Absent and significant change in policy or significant cyclical economic slowdown an acceleration of inflation cannot be ruled out.

Outlook: Short-sighted economic policy means another period of economic turmoil cannot be ruled out. Recent allegations of data manipulation and ongoing reliance on heterodox measures signal underlying macroeconomic imbalances. Going forward, the major risks are the looming energy crisis and unchecked, underreported price growth. With 40% of government debt linked to inflation, the latter constitutes a serious downside risk. Further, as the economy increasingly relies on domestic demand, adverse effects on purchasing power could threaten the sustainability of the recovery. While for the next two years there appears plenty of hard currency reserves and underlying economic strength to manage our forecasted global economic outlook and expected increase in global financial volatility, pressures are building that threaten economic stability 3-5 years out. If a serious and sustained global liquidity crunch emerges Argentina could be hit hard.

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	2.0	8.5	7.5	5.5
Inflation (%chg, pa avg.)	10.1	10.9	9.0	11.0
Fiscal Balance (% of GDP)	0.0	1.8	1.3	1.0
Exports (% comp. annual growth)	8.9	15.0	12.0	8.0
Imports (% comp. annual growth)	2.7	19.4	23.0	13.0
Current Account (% of GDP)	3.7	3.8	2.3	1.6
Reserves (months of curr. debits)	5.5	7.1	8.7	8.5
External Debt (% of GDP)	101.4	51.2	46.0	41.9
Debt Service Ratio (due)	53.1	20.0	20.3	19.1
Exchange Rate (to USD; eoy)	2.6	3.0	3.2	3.3

Source: EIU Database, EDC Economics



Sources: Bloomberg, EDC Economics

General Political Environment:

President Néstor Kirchner was a largely unknown provincial governor before he came to power in 2003 by default after his electoral opponent withdrew. In the 2005 mid-term congressional elections a long-standing rivalry within the Peronist party was exposed as each faction put forward a slate of candidates. Kirchner's camp won a decisive victory and took control of the Senate while falling slightly short of a majority in Congress. The results strengthened Kirchner's mandate and support within his party. Kirchner also has the support of 16 out of 23 Governors, a level which is unlikely to be significantly diluted in the 2007 gubernatorial elections.

Kirchner's popularity ratings, as high as 82% in 2004, have softened and been reported as low as 57% in April 2007. Nevertheless, polling for the October presidential elections indicates that he has no serious challengers. His popularity is built on his unyielding stance against international creditors and foreign-owned utilities combined with Argentina's healthy growth rates in recent years. Speculation abounds that he will endorse the candidacy of his wife, Senator Cristina Fernández for president, but a decision on candidacy is not required for some time and Kirchner is unlikely to show his hand over the next 2-3 months. Inflationary pressures and dissatisfaction with wages could exert downward pressure on the Kirchners' popularity in the meantime.

Kirchner's decision to pre-pay the International Monetary Fund (IMF) in 2006 and placement of loyalists in key economic positions signal his intent to maintain unorthodox policies ahead of the elections, including price controls to address Argentines' fear of high inflation rates.

The Victory Front's minority status in Congress leaves the government dependent on the support of others for policy progress. Legislators from the disaffected Peronist faction as well as center-left parties extend their support on an issue-by-issue basis. The executive has used presidential decrees to govern and the Supreme Court passed two laws granting additional powers, including a lengthy window of time during which a decree can be imposed without legislative approval and greater discretionary powers over the budget approval process. The government has stymied legislation to allow increased access to government information.

Investment Environment:

Currency restrictions imposed during the December 2001 economic crisis have since been relaxed considerably. Businesses are required, however, to advise the Central Bank of intended transfers of hard currency out of the country.

Argentina's foreign investment regime remains one of the most liberal in the world with respect to the procedures for establishing and operating foreign-owned entities. Nonetheless some sectors remain at elevated risk for government intervention. Companies in the utility and energy sectors in particular have serious disputes with the government over Kirchner's decision to freeze tariff rates. The agriculture sector has been unhappy of late with price controls and additional export taxes.

Nearly three dozen cases against the Government of Argentina have been registered at the World Bank's International Center for Settlement of Investment Disputes by investors seeking compensation for losses resulting from Government actions related to the 2001 economic crisis.

As a result of the protracted utility price freeze, there has been a lack of investment in the energy sector causing a serious strain on supply and there is a high risk of shortages in the near term.

The judicial system in Argentina is considered to be open to political influence, and a major corruption scandal that broke in May 2007 has highlighted practices that siphon funds into the hands of government officials.

Political Violence:

Widespread poverty and unemployment caused by the 2001 crisis led to the emergence of radical groups called *Piqueteros*, that stage large protest marches and demonstrations to pressure for jobs and benefits. The actions of these groups have caused business disturbances. Protests are likely to mount as the elections approach, and the government will have to avoid repressive actions or risk a significant loss of popular support.

Political

Political Structure

Federal Republic

President
Néstor Kirchner

Cabinet Chief (Jefe del Gabinete de Ministros)
Alberto Fernández

Legislative Bodies

- National:
Chamber of Deputies (257 seats); Senate (72 seats)
- Regional: 23 states and one autonomous federal district – each has its own governor and legislature

Major Parties

- Victory Front (Kirchner)
- Partido Justicialista (Peronist)
- Unión Cívica Radical (UCR)
- Propuesta Republicana (PRO)
- Afirmación para una Republica Igualitaria (ARI)
- Right of center parties

Last Elections

- Presidential - April 2003
- Congressional (½ Chamber of Deputies and 1/3 of Senate) - October 2005

Next Elections

- Presidential - October 28 2007
- Congressional (½ Chamber of Deputies and 1/3 of Senate) - October 28 2007
- Gubernatorial – 2007 all 24 State governors

Press Freedom Survey:

- 2006 Score: 45 Partly Free (0: Free; 100: Not Free)
- freedomhouse.org

Control of Corruption Index:

- 2005 Score: -0.44 (-2.5: Worst; +2.5: Best)
- worldbank.org

June 2007

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Political Outlook

Kirchner's continued popularity bodes well for the President's elections strategy and it is unlikely that he will change his populist attitude towards foreign investors and creditors in the near term. The issue then is how Kirchner (or Fernández) would manage growing cracks arising from mismanagement of the economy in Kirchner's first term. Recent labour unrest points to a mounting impact of this mismanagement on workers and consumers. Argentina's strong growth rates over the past few years are expected to moderate over the foreseeable future and without a coherent plan to shield the general public from the fall-out, political instability could return to Argentina over the medium-term.