



### Summary

On 23 October 2011, Cristina Fernández de Kirchner won the presidential elections convincingly with 54% of the votes. Her party also regained the majority in congress which it lost in 2009. This will give Fernández a strong position in the coming years. She is likely to proceed with the existing heterodox policy framework. However, she may soon have to make tough decisions, as the extremely expansionary fiscal and monetary policies have resulted in a ballooning subsidies bill and a deteriorating current account balance. The competitiveness of Argentina's industry may come under pressure, as the limited depreciation of the peso fails to offset the high inflation rate. Capital flight has been increasing in recent months. Meanwhile, Argentina is vulnerable to a fall of agricultural commodity prices, and a decline of economic sentiment in Brazil.

### Things to watch:

- Erratic government measures.
- Prices of soy and wheat, and economic sentiment in Brazil.
- High inflation, as the competitiveness of Argentina's industry is deteriorating.

Argentina			
<b>National facts</b>		<b>Social and governance indicators</b>	
Type of government	Republic	Human Development Index (rank)	rank / total 46 / 169
Capital	Buenos Aires	Ease of doing business (rank)	115 / 183
Surface area (thousand sq km)	2,780	Economic freedom index (rank)	138 / 179
Population (millions)	40.1	Corruption perceptions index (rank)	105 / 178
Main languages	Spanish	Press freedom index (rank)	55 / 178
Main religions	Roman Catholic (92%) Protestant (2%) Jewish (2%)	Gini index (income distribution)	48.81
Head of State (president)	Cristina Kirchner	Population below \$1.25 per day (PPP)	3.4%
Head of Government	Cristina Kirchner	<b>Foreign trade</b>	
Monetary unit	Argentina peso (ARS)	2010	
<b>Economy</b>		<b>2010</b>	
<b>Economic size</b>		<b>Main export partners (%)</b>	
	<i>bn USD</i>	<i>% world total</i>	<b>Main import partners (%)</b>
Nominal GDP	370	0.59	Brazil 21
Nominal GDP at PPP	645	0.87	Chile 9
Export value of goods and services	81	0.44	US 17
IMF quotient (in mln SDR)	2117	0.97	China 14
<b>Economic structure</b>		<b>2010</b>	
	<b>2010</b>	<b>5-year av.</b>	<b>Main export products (%)</b>
Real GDP growth (%)	9.2	6.8	Manufactures 35
Agriculture (% of GDP)	10	9	Processed agricultural products 33
Industry (% of GDP)	31	34	Primary 22
Services (% of GDP)	59	57	Fuel and energy 9
<b>Standards of living</b>		<b>Openness of the economy</b>	
	<i>USD</i>	<i>% world av.</i>	
Nominal GDP per head	9138	93	Export value of G&S (% of GDP) 22
Nominal GDP per head at PPP	15918	136	Import value of G&S (% of GDP) 18
Real GDP per head	6261	78	Inward FDI (% of GDP) 1.7

Source: IMF, CIA World Factbook, IHS Global Insight, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

### Economic structure and growth

With a nominal GDP per capita at PPP of USD 15,918, Argentina is the Latin American country with the highest standard of living (although the unreliability of Argentina's statistics argues for interpreting these figures with some caution). Argentina has a very dynamic and advanced agricultural sector, which accounts for 19% of GDP, if one includes industries and services which are directly linked to the sector, 55% of total exports and 14% of fiscal revenue. The sector benefits from the good quality of the Argentine soil, a favorable climate and good access to sea transport. Soybeans and soybean products are the most important agricultural export commodity and account for roughly one-third of Argentina's exports. Other important agricultural products are wheat and beef. Manufacturing is another important pillar of the economy. A large part of Argentina's industry is related to the processing of agricultural products and the country also has a relatively large steel and automobile industry. The most important export market for Argentina's products is Brazil, with Brazil accounting for 41% of all manufacturing exports. The importance of agricultural exports and exports to Brazil mean that commodity prices and economic activity in Brazil are important external factors that determine economic growth in Argentina. With private sector debt accounting for only 14% of GDP in 2010, the financial sector in Argentina is small. This is due to the distrust of banks following the heavy losses during the 2001 default and the negative real interest rates, which encouraged people to save in unconventional ways, such as by buying and storing cars as a preserver of value. The small size of the financial sector makes it difficult for companies to obtain credit, which discourages investment. Nevertheless, companies have been

able to invest by using retained profits, which have been high thanks to the booming economy. Argentina's investment rate of 23% of GDP looks good at first sight, especially by low Latin American standards, but includes a lot of expenditure which has more characteristics of consumption rather than investment, such as house building and purchases of cars. According to official statistics, the economy grew with a Chinese-style 9.2% in 2010 and an almost equally impressive 8.3% is expected in 2011. Although official statistics are likely to overstate growth by roughly 2 percentage points, it is clear that the economy has been booming recently. This rapid growth has been driven by a number of factors. Firstly, government policies have contributed starkly, as growth has been fuelled by very expansionary monetary policies and a strong increase of public spending, in particular on salaries and subsidies. Secondly, extremely favorable external conditions, such as record high agricultural prices and strong demand for manufactures from Brazil, have also boosted the Argentine economy. However, economic growth is likely to slow strongly in 2012, due to somewhat lower agricultural prices, lower expected economic growth in Brazil and the deterioration of the competitiveness of Argentina's producers.

### **Political and social situation**

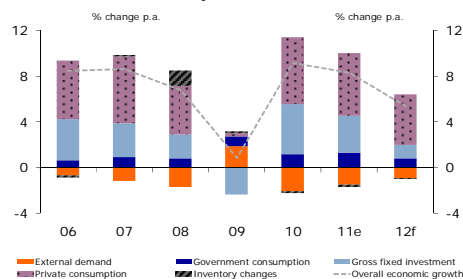
Argentina's politics is centered on persons, with party loyalties and, in particular, ideological leanings playing a much smaller role. The political scene has been dominated by the Kirchners since 2003, when Nestor Kirchner became president. He was succeeded by his wife Cristina Fernández de Kirchner in 2007, although Nestor continued to play an important role in economic policy making until his death in 2010. Both Cristina and Nestor belonged to Argentina's Peronist party, but without leaving this party they developed their own kind of left-wing populism, which is known as Kirchnerism. With its nationalistic discourse, its emphasis on increasing public spending, and its (predominantly rhetorical) antagonism towards the agricultural sector and (foreign) capital, Kirchnerism somewhat resembles the classic Peronism of the late 1940s and early 1950s. Like the classic Peronism, Kirchnerism has been criticized for having authoritarian leanings. For example, the Kirchner government has a difficult relationship with the press and has been accused of applying censorship.

Nevertheless, on 23 October Cristina Fernández de Kirchner convincingly won re-election by gaining 54% of the vote in the first round of the presidential elections. The socialist governor of Santa Fé became second with 17% of the vote, while the candidate of the Radical Party, traditionally Argentina's second most important political party, got a humbling 11% of the vote. It is the largest victory since democracy was restored in the early eighties. Cristina Kirchner thanks her popularity to a number of factors. Firstly, Argentina's economy has grown rapidly, and wages have risen steadily. Secondly, she benefitted from a divided opposition, which did not know how to react to the death of Cristina Kirchner's husband Nestor Kirchner one year ago, as fierce opposition did not seem to work against a mourning president. Thirdly, Cristina Kirchner was able to build a less confrontational image than her deceased husband, whose combative politics had become increasingly unpopular. The Frente para la Victoria, the Kirchnerist faction within the Peronist party, also managed to regain a majority in congress. This means it will be easier for Cristina Kirchner to change laws. Although the Frente failed to obtain the two-thirds majority necessary for changing the constitution, Cristina Kirchner may still try to take away the constitutional ban on a third term presidency, which could allow her to seek reelection in 2015. It is likely to prove difficult for Cristina Kirchner to meet the expectations of the voters though, as the external environment is likely to become less favorable in the coming years, which will bring the internal contradictions of the government's economic policy mix to the fore.

Poverty in Argentina is now much lower than ten years ago. However, like in other areas, the reliability of government statistics is low. Moreover, the number of shantytowns around Buenos

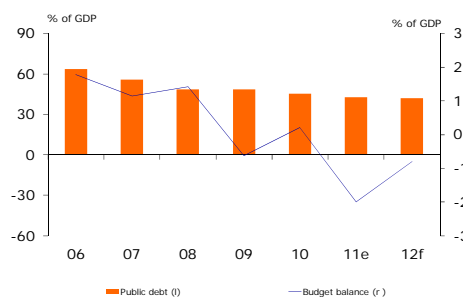
Aires has been growing sharply in the past years. Although this is partially due to the strong pull Buenos Aires has always had on poor migrants from other regions, this suggests that even high growth and high public spending are not enough to eradicate poverty within Argentina. This is partially linked to the fact that public spending has a low level of efficiency and targeting. For example, more than the poorest segment of society it seems that middle class Argentines benefit most from the ultra-low energy tariffs.

**Chart 1: Growth performance**



Source: EIU (official statistics, which are likely to overstate growth)

**Chart 2: Public finances**



Source: EIU

**Economic policy**

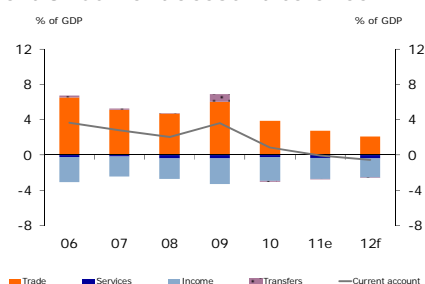
During her re-election campaign, Cristina Kirchner did not present detailed economic plans, but after her election victory she said that she intends to continue with the existing policy mix. This should be a cause for concern, as Argentina’s government lacks a clear and coherent set of economic policies. Instead, it has so far tried to boost short-term growth and employment as much as possible by applying expansionary fiscal and monetary policies and has frequently resorted to ad hoc interventions, which has resulted in a difficult business environment and macroeconomic policy stances which are unsustainable in the longer run.

For example, faced with a deterioration of the trade surplus (see also the next chapter), the government decided to implement several new trade restrictions, which have helped to make Argentina one of the most protectionist countries in the world. The government now requires companies to match their import dollar-for-dollar with exports. Another example is the inflation policy of the government. Thanks to very expansionary fiscal and monetary policies, Argentina suffers from high inflation. This is even visible in the official inflation statistics, which have been grossly underreporting inflation since 2007. According to these figures, inflation is now above 10% and thus quite high. However, independent consultants estimate that inflation is much higher and put it in the 20-30% range. The government seems disenchanted with these figures and has stated that it has fined the consultants as it accuses them “criminally publishing false numbers to generate unfair profits for their clients, to the detriment of consumers and the Argentine state”. However, it should be noted that the government greatly benefits from underreporting the official inflation rate, as most of its debt is inflation indexed. At the same time, the government has more or less acknowledged (and contributed to) high inflation by granting nominal public sector wage rises of more than 20%. A judge has recently subpoenaed the users of the independent inflation estimates, such as journalists, the IMF office in Argentina, the tax ministry, the central bank and the stock market. In response, the Miami based Inter American Press Association has condemned the judicial order as unusual and improper.

Although Argentina has had high inflation for quite some years, the government has so far managed to avoid a spiraling out of control of inflation. It has used the exchange rate and low energy tariffs to suppress inflation. However, it cannot keep on following this road. Firstly,

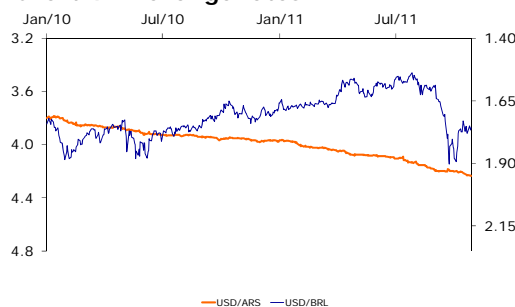
Argentina’s monetary and exchange rate policies are incompatible in the medium term. To compensate for the high inflation rate, a depreciation of the peso is necessary to keep Argentina’s industry competitive. However, as already mentioned, the government limits the fall of the peso to keep inflation in check. Thus, while prices are expected to increase by 50% between late 2009 and late 2011, the peso is expected to fall only 13% over the same period. Until recently, the resulting real appreciation was not so much of a problem thanks to the economic growth in Brazil, the rapid appreciation of the Brazilian real and the increase of soy prices. However, in the past months, the real has fallen sharply against the USD (see chart 4), and soy prices have also gone down. A more rapid depreciation now seems unavoidable, but this will boost inflation. Secondly, thanks to the government policy of keeping energy prices ultra-low, the costs of energy subsidies has grown rapidly to USD 4.6bn in the first half of 2011, which implies a growth by 76% year-on-year. Other types of subsidies have increased rapidly as well. As a result, the nominal growth rate of subsidies has been roughly 40%. Total public spending in nominal terms has been growing with 32% per year in the last four years. As a result, public spending has grown to unprecedented levels. It is expected to equal 27% of GDP this year, against only 19% of GDP in 2007. Meanwhile, Argentina is likely to have a fiscal deficit of roughly 2% of GDP, the biggest deficit since the 2001 default, even as the economy is now booming. This makes the fiscal position vulnerable to a decline in economic sentiment and a deterioration of the external environment. The government has presented a 2012 budget bill, which proposes a much lower rate of spending growth. However, in particular the expenditure assumptions of the bill seem unrealistic. It remains to be seen whether the government dares to control spending, as this will hit its popularity. Net public debt has been falling in Argentina from 75% of GDP in 2005 to 38% of GDP in 2011. This fall has been achieved by high government income, low deficits, high economic growth, the official underreporting of inflation, which lowers the interest burden on inflation-indexed bonds, and the fact that public institutions, such as state banks and public pension funds, have bought large amounts of public debt. The percentage of government debt owned by public institutions may now be as large as 50% of the total government debt. This is a necessity. Although Argentina has restructured most of the sovereign debt it defaulted upon in 2001, it is still in conflict with some creditor hold-outs. The government claims that it is able to tap financial markets, but there is a risk that the proceeds from new bond sales will be claimed by courts. Moreover, the country still has to settle its USD 9bn with Paris Club official creditors.

**Chart 3: Current account balance**



Source: EIU

**Chart 4: Exchange rates**



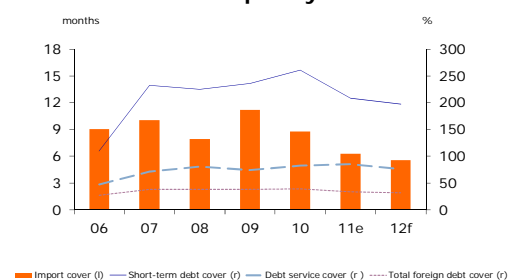
Source: Ecwin

**Balance of Payments**

Due to Argentina’s bad access to financial markets, maintaining a current account surplus has been a cornerstone of Argentina’s post default balance of payment policy. This policy has been facilitated by the rapid rise of commodity prices, which has resulted in a pronounced growth of export income in the past ten years. However, as already mentioned, the very expansionary fiscal and monetary

policies of the last years have led to a strong growth of imports. In the first months of 2011, import growth surpassed export growth, which resulted in the cumulative 12-month trade surplus falling to USD 9.9bn in July 2011, the lowest level since 2001. The government reacted with trade protectionism in early 2011, which has brought the country into conflict with important trade partners such as Brazil and China. Nonetheless, the effectiveness of these measures seems to have been limited, as exports fell in volume terms by 0.6% year-on-year in the second quarter of 2011, while import volume growth surged ahead by 28%. Meanwhile, thanks to the ultra-low energy prices, which stimulate demand, but depress investment in supply, Argentina is on its way to become a net energy importer, despite having sizeable reserves of oil and gas. In the first seven months of 2011, the country posted an energy trade deficit of USD 2.1bn, while it had posted energy trade surpluses of USD 1.8bn in 2010 and USD 6bn in 2006. Overall, the trends discussed above imply a deterioration of the current account balance. Thus, for the first time since 2002, the country may thus post a current account deficit in 2011. At the same time, with FDI inflows equal to 1.7% of GDP, Argentina attracts low levels of FDI. Meanwhile, the country has been facing capital flight recently. In the first half of 2011, almost USD 10bn has left the country, while the country had already experienced USD 11.4bn capital flight in 2010. Capital flight seems to have intensified in the last months, as local sources report that it has grown to USD 2.3bn in July and USD 2.5-2.7bn in August. One of the driving forces behind the outflow of capital is the expectation that the government will allow the peso to depreciate more quickly after the elections in order to restore competitiveness for Argentina's industry and to counter the deterioration of the current account balance. Besides, the negative real interest rates are also likely to contribute. Due to the capital flight, Argentina's reserves have fallen from USD 51.7bn in end-June to USD 48.3bn in early-September. Right after the 23 October elections, the government reacted to the capital flight, as it sent tax officials to exchange houses asking the visitors to fill in currency exchange forms and provide identification and source of income. The government says it wants to crack down on investors who use other people to buy dollars. However, the move may induce even more capital flight.

**Chart 5: External liquidity**



Sources: EIU, Rabobank estimates

### External position

Nonetheless, Argentina still has a sizeable foreign reserves buffer, with reserves almost accounting for 9 months of imports in 2010. Moreover, foreign debt has fallen as a percentage of GDP and the country has a positive net international investment position. However, as mentioned before, reserves have fallen recently due to capital flight. The government has so far used foreign reserves to repay its external debt, but the amount of reserves to be freely used has thus been reduced sharply recently. This, together with the vulnerability to lower commodity prices, less economic growth in Brazil and the bad access to international financial markets makes that Argentina's external position is less good than it may look at first sight.

Argentina							
Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
<i>Key country risk indicators</i>							
GDP (% real change pa)*	8.5	8.6	6.8	0.8	9.2	8.3	5.4
Consumer prices (average % change pa)*	10.9	8.8	8.6	6.3	10.5	9.8	9.5
Current account balance (% of GDP)	3.6	2.8	2.1	3.6	0.8	-0.1	-0.5
Total foreign exchange reserves (mln USD)	30904	44682	44855	46093	49734	45500	44000
<i>Economic growth</i>							
GDP (% real change pa)*	8.5	8.6	6.8	0.8	9.2	8.3	5.4
Gross fixed investment (% real change pa)*	18.2	13.6	9.1	-10.2	21.2	14.2	4.9
Private consumption (real % change pa)*	7.8	9.0	6.5	0.5	9.0	8.5	6.7
Government consumption (% real change pa)*	5.2	7.6	6.9	7.2	9.4	10.5	6.5
Exports of G&S (% real change pa)*	7.3	9.1	1.2	-6.4	14.6	7.5	6.6
Imports of G&S (% real change pa)*	15.4	20.5	14.1	-19.0	34.0	18.0	11.8
<i>Economic policy</i>							
Budget balance (% of GDP)*	1.8	1.1	1.4	-0.6	0.2	-2.0	-0.8
Public debt (% of GDP)	64	56	49	49	45	43	42
Money market interest rate (%)	7.2	8.7	10.1	10.2	9.1	10.1	11.5
M2 growth (% change pa)	20	24	8	17	33	35	29
Consumer prices (average % change pa)*	10.9	8.8	8.6	6.3	10.5	9.8	9.5
Consumer prices (average % change pa) (unofficial)	12.3	9.8	21.1	14.6	26.8	23.5	20.0
Exchange rate LCU to USD (average)	3.1	3.1	3.1	3.7	3.9	4.1	4.3
Recorded unemployment (%)	10.2	8.5	7.9	8.7	7.8	7.2	6.8
<i>Balance of payments (mln USD)</i>							
Current account balance	7768	7355	6754	11061	3081	-260	-2630
Trade balance	13957	13457	15423	18525	14266	11980	10270
Export value of goods	46545	55982	70019	55672	68134	83710	89280
Import value of goods	32588	42525	54596	37147	53868	71730	79010
Services balance	-502	-512	-1283	-1157	-852	-1440	-1870
Income balance	-6150	-5942	-7553	-9011	-9973	-10470	-10750
Transfer balance	459	354	170	2704	-360	-340	-280
Net direct investment flows	3098	4970	8334	3307	5247	5900	6700
Net portfolio investment flows	4274	2752	-7088	-2029	8557	-480	360
Net debt flows	-4425	-5121	3119	-1688	1761	5320	6030
Other capital flows (negative is flight)	-6775	4134	-10866	-8995	-14440	-15000	-12000
Change in international reserves	3940	14089	253	1656	4206	-4520	-1540
<i>External position (mln USD)</i>							
Total foreign debt	115863	117317	118901	120183	127957	135980	140900
Short-term debt	28299	19260	19977	19537	19043	21860	22300
Total debt service due, incl. short-term debt	65592	62853	55454	62479	60228	53160	57790
Total foreign exchange reserves	30904	44682	44855	46093	49734	45500	44000
International investment position	21890	34444	57816	54919	n.a.	n.a.	n.a.
Total assets	177994	206097	210703	223735	n.a.	n.a.	n.a.
Total liabilities	156104	171653	152887	168816	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	6.5	5.1	4.7	6.0	3.9	2.7	2.1
Current account balance (% of GDP)	3.6	2.8	2.1	3.6	0.8	-0.1	-0.5
Inward FDI (% of GDP)	2.6	2.5	3.0	1.3	1.7	1.6	1.6
Foreign debt (% of GDP)	54	45	36	39	35	31	29
Foreign debt (% of XGSIT)	188	157	133	167	149	133	129
International investment position (% of GDP)	10.2	13.1	17.6	17.8	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	106	84	62	87	70	52	53
Interest service ratio incl. arrears (% of XGSIT)	19	18	15	20	17	9	9
FX-reserves import cover (months)	9.0	10.0	7.9	11.2	8.8	6.3	5.5
FX-reserves debt service cover (%)	47	71	81	74	83	97	97
Liquidity ratio	92	111	118	120	116	114	108

Source: EIU, M&amp;S consultores, Rabobank estimates

\*Official data, unofficial estimates may deviate.

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