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Fitch Affirms Argentina's FC IDR at 'RD'; Upgrades LC IDR to 'B'; Outlook Stable

Fitch Ratings-New York-22 March 2016: Fitch Ratings has upgraded Argentina's Long-term local-currency Issuer Default Rating (LT LC IDR) to 'B' from 'CCC', with a Stable Outlook. Fitch has affirmed Argentina's Long-term foreign-currency (FC) IDR at 'RD' and the short-term FC IDR at 'RD'. In addition, we have upgraded the Country Ceiling to 'B' from 'CCC'.

KEY RATING DRIVERS

The LT LC IDR upgrade is driven by the improved consistency and sustainability of Argentina's policy framework, reduced external vulnerability, and the expected easing of fiscal financing constraints. These improvements balance risks related to relatively weak external liquidity, continued macroeconomic underperformance compared with peers, and deterioration of public finances in recent years. Argentina's ratings also balance structural strengths such as GDP per capita and social indicators against a weak debt repayment record.

Since taking power in December 2015, the Mauricio Macri administration removed FX controls introduced in 2011, and increased the flexibility of the Argentine peso, which should contribute towards improving the capacity of the economy to absorb external shocks and relieve pressure on international reserves. Moreover, these policy changes have removed growing exchange rate distortions, evident by a widening spread between the official and parallel exchange rates during 2015.

Monetary policy has been tightened by the new administration and recovered its focus on fighting inflation and reining in the growth of monetary aggregates, which has been fuelled in previous years by monetary financing of the budget deficit. We expect better coordination with fiscal policy and access to fresh sources of financing to allow authorities to phase out central bank financing, a key source of inflationary pressures.

International reserves have strengthened since the end of 2015 to USD29 billion, driven by the liquidation of agricultural export proceeds, reduced pressure to intervene in the FX market and external borrowing by the central bank. Moreover, the immediate liquidity of international reserves has improved through the USD5 billion loan from foreign banks and the monetization of a portion of the swap line with China. Nevertheless, Argentina's external liquidity ratio, estimated by Fitch at 55.7% in 2016, remains low in relation to 'B' rated peers, especially given the country's high commodity dependence and recent episodes of balance of payments pressures.

Inflation has risen above 30% according to private and local government estimates, reflecting the weaker exchange rate and the removal of electricity subsidies. While Fitch expects monetary and fiscal policy objectives to be conducive to disinflation, this process is likely to be gradual and inflation is likely to remain above 'B' rated sovereign levels. After marked underperformance over the last four years, growth could recover through the easing of macroeconomic distortions, reduced government intervention, and greater access to external sources of financing.

Federal fiscal spending growth outpaced revenues, leading to a deficit of 4.1% of GDP in 2015 (6.4% of GDP without taking into account central bank and social security profit transfers). At the general government level, Fitch estimates the deficit widened to 4.7% of GDP, up from 2.5% in 2014 and above the 4.1% 'B' category median. Fitch expects that a gradual fiscal consolidation involving the phasing out of monetary financing by the central bank will reduce the general government deficit to 4.2% of GDP in 2016 and 3.4% in 2019.

Fitch estimates gross government debt rose to 59% of GDP in 2015, from 49% in 2014, and above the 52% 'B' median, driven by the wider fiscal deficit and the depreciation of the Argentine peso. Public sector entities (central bank and ANSES) hold approximately 62% of government's debt stock, thus reducing refinancing risks. Financing needs are likely to remain high in 2016 at 10.2% of

GDP, but intra-public sector debt repayments/roll-overs constitute at least 56% of total debt repayments.

Potential improved access to market financing, a key constraint to Argentina's creditworthiness over the past decade, would reduce pressure on the central bank through the phasing out of both monetary financing and the use of international reserves to meet FC debt repayments. The government has indicated that failure to tap external funding would require a sharper fiscal adjustment.

The affirmation of the LT FC IDR at 'RD' reflects that Argentina has not cured the July 2014 default on external debt. Nevertheless, the government has reached an agreement with the majority of holdout creditors, thus making progress toward removing the injunction that presently constrains Argentina from servicing its restructured debt.

Legislation is currently moving through the Argentine congress to remove the Lock Law and Sovereign Payments Law (two pieces of legislation that prevented authorities from negotiating with holdouts), and to authorize external debt issuance to pay for the settlement, both preconditions to lift the injunction. The government could reportedly issue close to USD15 billion in order to pay holdout creditors and meet 2016 financing needs.

RATING SENSITIVITIES

The main risk factors that, individually or collectively, could trigger a positive rating action for Argentina's LC IDR are:

--Faster-than-anticipated fiscal consolidation and deepening of non-public-sector funding sources;
--Strengthening of external buffers;
--Consolidation of strengthened policy framework leading to improvement in macroeconomic performance in relation to peers.

Conversely, the main factors that could lead to a negative rating action are:

--Re-emergence of financing pressures due to failure to consolidate fiscal accounts or to improve funding sources;
--Erosion of international reserves.

The foreign currency IDR does not have a Rating Outlook.

The resumption of timely debt service on defaulted bonds would lead to the upgrade of the FC IDR. At such time, Fitch will most likely upgrade Argentina's LT FC IDR to the level of the LT LC IDR.

KEY ASSUMPTIONS
--Fitch assumes that the Argentine government will obtain congressional ratification of the agreement with holdout creditors and pay the agreed-upon settlement, which will lead to the lifting of the injunction preventing Argentina from servicing its restructured debt.
--Fitch assumes that Argentina will be able to access external markets to pay the settlement with holdout creditors.
--Fitch assumes that China will avoid a hard landing, growing by 6.2% and 6.0% in 2016 and 2017, respectively. In contrast, Fitch expects Brazil to contract by 3.5% in 2016 and grow by 0.7% in 2017.

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Applicable Criteria
Country Ceilings (pub. 20 Aug 2015)
Sovereign Rating Criteria (pub. 12 Aug 2014)

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