FitchRatings

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Fitch Upgrades Argentina's Foreign Currency IDR to 'B'; Outlook Stable

Fitch Ratings-New York-10 May 2016: Fitch Ratings has upgraded Argentina's Long-Term Foreign Currency Issuer Default Rating (LT FC IDR) to 'B'/Stable Outlook from 'RD'. Fitch has also upgraded the Short-Term FC IDR to 'B' from 'RD'. The issue ratings on Argentina's senior unsecured foreign-currency bonds were affirmed at 'B'. Fitch has affirmed Argentina's Long-Term Local-Currency (LC) IDR at 'B'/Stable Outlook and Country Ceiling at 'B'.

KEY RATING DRIVERS

The LT FC IDR upgrade to 'B' is driven by Argentina's resumption of debt payments to restructured bondholders, thus curing the default of July 2014. In addition, Argentina's ratings reflect the improved consistency and sustainability of Argentina's policy framework, reduced external vulnerability, and the easing of external and fiscal financing constraints.

The Stable Outlook balances these improvements against 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.

Argentina has been able to resume service on its restructured bond debt, after meeting the conditions to lift the injunction that blocked payments. The Macri administration obtained congressional approval to remove the Lock Law and Sovereign Payments Law (two pieces of legislation that prevented authorities from negotiating with holdouts) and paid settlement agreements with holdout creditors on April 22nd after raising the necessary funds in external markets.

After an absence of more than a decade and a half, Argentina was able to directly tap international capital markets for a total of USD16.5 billion in order to pay for settlement agreements with holdouts creditors and meet part of its 2016 financing needs, thus increasing the government sources of financing and removing a key constraint to Argentina's creditworthiness over the past decade. Greater availability of market financing 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.

Improved financing sources complement the increased coherence and credibility of Argentina's new policy framework characterized by the removal of FX controls, increased exchange rate flexibility, and revived focus of monetary policy on fighting inflation with the objective of implementing a fully-fledged inflation targeting regime.

Monetary policy has been tightened by the new administration, and decelerated the growth of monetary aggregates, which has been fuelled in previous years by monetary financing of the budget deficit. Fitch expects 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.

After the removal of FX controls in December 2015, the government has 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.

International reserves have increased to USD31.5 billion in early May, driven by the liquidation of agricultural export proceeds, reduced pressure to intervene in the FX market and external borrowing by the central bank, and most recently the external issuance of the sovereign and non-financial sector entities. 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, relatively large fiscal deficits and a slowing economy represent key policy challenges for the Macri administration. Inflation remains high (well above 30% in the first months of the year) according to private and local government estimates. 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.

Short-term growth prospects remain weak, as the economy could contract in 2016 reflecting the impact of higher utility tariffs, weaker exchange rate, and reduced policy stimulus. Growth could recover in 2017 through the easing of macroeconomic distortions, reduced government intervention, and greater access to external sources of financing.

Fitch estimates the general government 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.

In spite of having a minority in congress, President Macri's coalition was able to muster enough political support to approve the necessary legislation to finalize the deal with holdouts creditors. Nevertheless, a slowing economy, rising unemployment and high inflation represent challenges for the government to maintain political support and opposition cooperation to successfully complete the process of rebalancing the Argentine economy and entrench macroeconomic stability.

RATING SENSITIVITIES

The main risk factors that, individually or collectively, could trigger a positive rating action 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 such as maintaining access to capital markets and reducing reliance on intra-public sector financing;
--Erosion of international reserves.

KEY ASSUMPTIONS

--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 3.8% in 2016 and grow by 0.5% in 2017.
--Fitch assumes that remaining legal risks from holdouts creditors will not prevent Argentina from servicing external debt or accessing external capital markets.

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

Additional Disclosures
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