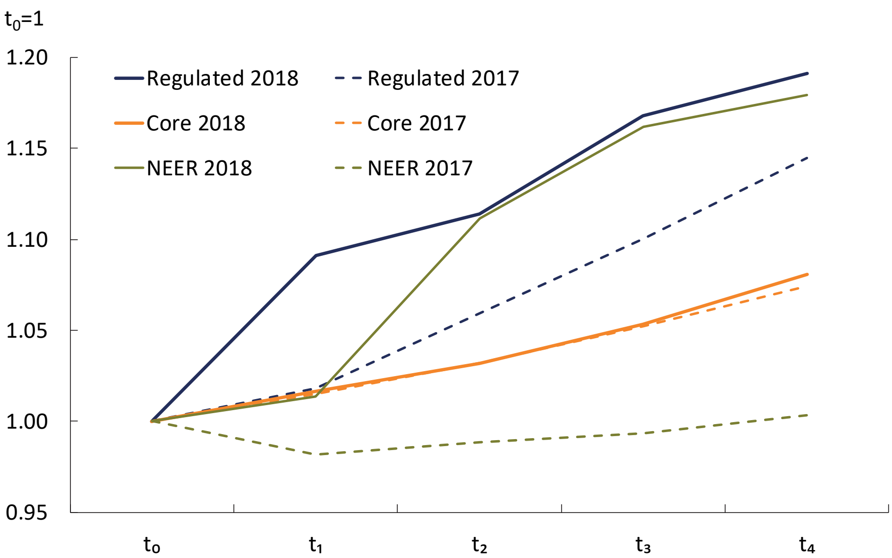
Monetary Policy: Assessment and Outlook

Inflation accelerated in the first quarter of 2018 compared to the last quarter of 2017, reaching a monthly average of 2.2%. The rise in inflation was due to the impact of higher public utility prices and, to a lesser extent, to the depreciation of the peso observed between December 2017 and February 2018. Core inflation showed similar trajectories in the summers of 2017 and 2018, even though this year there were significantly higher increases in regulated prices and exchange rate (see Figure 1.1).

The Central Bank of Argentina (BCRA) considers that higher inflation is transitory and that, once the above mentioned factors are overcome, it will resume its downward trend and monthly inflation will be at levels that the Argentine economy has not registered since the global financial crisis. This favorable outlook is based on the fact that: a) monetary policy shows a tighter bias than in the first half of last year; b) the adjustment of regulated prices is smaller than in 2017 and, by concentrating on the first quarter, will slow down sharply after April; c) no future significant peso depreciation is expected due to macroeconomic fundamentals and the Central Bank's own action; and d) public and private sector wage negotiations are being agreed around the 15% target.

Figure 1.1 | Comparative inflation trends in early 2017 and early 2018

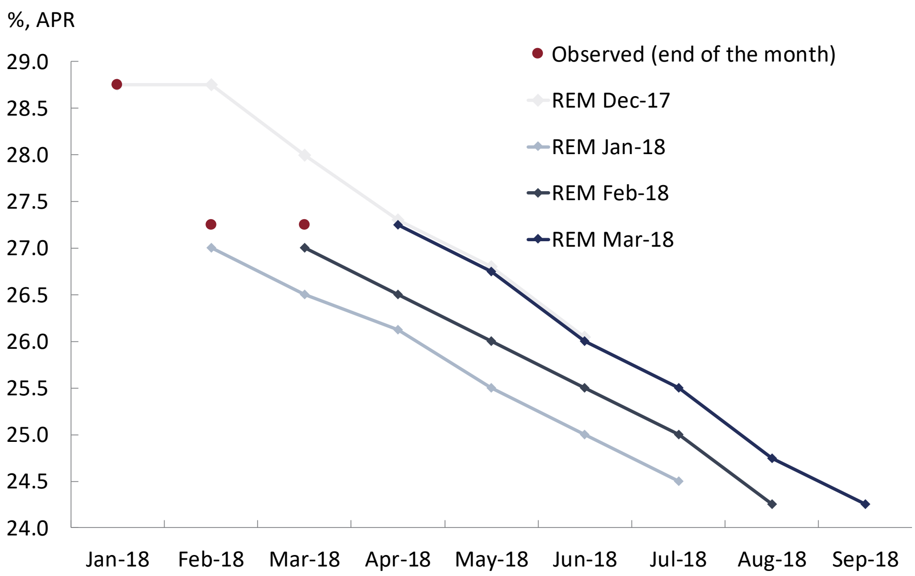
(monthly data)



Note: For 2018 t_0 is Nov-17 and for 2017 is Dec-16
Source: INDEC and BCRA

Considering that price pressures were due to temporary factors, the Central Bank kept the policy interest rate unchanged, following the reduction decided in January to make it compatible with the lower disinflation required by the new intermediate target. However, the one year deferral of the 5% inflation target, the adjustment of the intermediate targets for 2018 and 2019 and the decrease in the policy interest rate at the beginning of the year were interpreted by the market as the prelude to an excessive easing of monetary policy (see Figure 1.2). This led to a depreciation of the peso, reflecting a market view of future monetary policy that was not consistent with the Central Bank's view. In that context, and in a complementary manner to interest rate setting, the Central Bank intervened in the exchange market as of the beginning of March. A higher depreciation of the peso than that recorded so far was not justified by real economic factors or by the expected course of its monetary policy and, if not avoided, could affect the disinflation process. Analysts have begun to incorporate a more contractionary behavior of the Central Bank than the one they foresaw at the end of January; and monetary policy rate expectations are already at the level expected in December 2017 (see Figure 1.2).

Figure 1.2 | Expected path of the monetary policy interest rate



Source: REM - BCRA

The economy continues to grow at a sustained pace and with low volatility. In line with what was anticipated in the January Monetary Policy Report, gross domestic product (GDP) grew 4% year-on-year seasonally adjusted in the fourth quarter of 2017, maintaining a similar pace to the rest of the year. During the first quarter of 2018, the economy continued to expand, completing seven quarters of uninterrupted growth for the first time since 2011. The latest GDP nowcast of the BCRA (PCP-BCRA) shows a quarterly increase of 0.73% seasonally adjusted for the first quarter of 2018. Investment grew strongly in 2017, with spending on durable production equipment reaching an all time record; and it is expected to continue to lead the expansion of aggregate spending in 2018.

The view of the BCRA is that the rate of inflation will fall once the above-mentioned transitory factors are behind us. In order to consolidate this scenario, the monetary authority will be extremely cautious with the pace at which the monetary policy rate accompanies the fall in inflation; it will remain vigilant in the foreign exchange market to avoid any movements that are inconsistent with its vision of monetary policy and its commitment to disinflation; and it will be ready to act by adjusting its monetary policy rate upwards if the disinflation process does not follow the expected path. The tightening bias of monetary policy will thus be used to reach the intermediate inflation targets of 15% in 2018, 10% in 2019 and a target of 5% in 2020. In this way, it will continue to promote monetary stability, financial stability, employment, and economic development with social equity.