Monetary Policy Report

October 2018

BANCO CENTRAL
DE LA REPÚBLICA ARGENTINA

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Preface

As established in its Charter, the goal of the Central Bank of Argentina "is to promote monetary and financial stability, employment, and economic development with social equity, to the extent of its powers and within the framework of the policies implemented by the National Government".

Without prejudice to the use of other, more specific instruments for complying with the rest of its mandates —such as financial regulation and oversight, exchange market regulation, and innovation in savings, credit, and means of payment instruments—, the main contribution that the monetary policy may offer to fulfill the monetary authority's mandates is to focus on price stability.

When inflation is low and stable, financial entities are able to better estimate their risks, which ensures higher financial stability. Moreover, higher predictability allows producers and employers to create, endeavor, produce and hire, which fosters investment and employment. Lastly, low income families may preserve the value of their income and savings, which enables economic development with social equity.

The contribution of low and stable inflation to these objectives is never as evident as when it does not exist: the flight from local currency may disrupt the financial system and lead to a crisis, the destruction of the price system hinders productivity and genuine job creation, the inflation tax hits the most vulnerable families and brings about redistribution of wealth that favor the most affluent segments of society. Low and stable inflation, on the other hand, prevents all of these problems.

Therefore, the BCRA makes reducing the rate of inflation its main goal. As a part of this effort, the BCRA publishes its Monetary Policy Report quarterly. The report's main objectives are to communicate to the society the BCRA's perspective of the recent inflationary dynamic and its projection of price evolution, as well as to explain in a transparent manner its monetary policy decisions.

Autonomous City of Buenos Aires, October 22nd, 2018.

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1. Monetary Policy: Assessments and Outlook

Inflation rate accelerated markedly in the third quarter of 2018, reaching a monthly average of 4.5% and a 6.5% reading in September. The increase was mainly related to the depreciation of the Argentine peso starting in April that reached once again a high level by the end of August. The episode of foreign exchange instability during August resulted in more uncertainty and a higher price correction, while posing the risk of disanchoring inflation expectations. According to analysts, inflation expectations for the next 12 months went from 24.1% by the end of July up to 33.4% by the end of August (average estimated by the Market Expectations Survey –REM–).

In order to recover the anchor on expectations and resuming the disinflation path, the Central Bank of Argentina (BCRA) changed its monetary policy scheme by the end of September and left aside the inflation targeting regime effective up to such date, which has failed to achieve the expected results. Nevertheless, inflation targeting regimes are widely used all over the world by both advanced and emerging economies, and have proven to be successful to ensure a context of nominal stability.

The new monetary policy regime effective since October 1 was adopted in order to make a concrete and powerful commitment that may be immediately noticeable and verifiable by the public in general. Thus, the Central Bank commits not to increase the monetary base until June 2019. A zero growth in the monetary base is a challenging commitment considering that this aggregate was growing at a monthly pace higher than 2%. In addition, given the price hikes expected for the following months, the monetary base in real terms will, in fact, decrease with the new scheme. This monetary aggregate was chosen because it is under direct control of the BCRA. The zero nominal monthly growth target of the monetary base will be seasonally adjusted in December and June, when the money demand increases, thus preventing an excessive contractionary bias in the monetary policy.

The monetary base target is accompanied by a definition of foreign exchange intervention and non-intervention zones for the exchange rate until the end of 2018. The non-intervention zone was set on October 1 for an exchange rate of $34 per dollar in the lower bound and $44 in the upper bound. These limits are adjusted daily at a monthly rate of 3%. Beyond the upper bound of the non-intervention zone, the BCRA may sell foreign currency for a daily amount of up to 150 million dollars, thus producing an additional monetary contraction at times when the peso weakens. Conversely, if the peso appreciates and stands below the non-intervention zone, the BCRA may purchase foreign currency. In turn, the BCRA may decide whether to withdraw or not the pesos injected by the purchase of foreign currency within the purchase zone, depending on the pace of inflation and its expectations. Within the non-intervention zone, the exchange rate floats freely. This system adequately combines the benefits of exchange rate flexibility to face real shocks with the possibility of limiting excessive and disruptive fluctuations that may occur in a relatively shallow foreign exchange market.

In addition, the new monetary policy scheme is consistent with the target of a zero primary fiscal balance for 2019 and the 2020surplus target set by the Ministry of Economy. The Central Bank will no longer make transfers to the Treasury. The removal of this source of monetary expansion reinforces the BCRA's commitment to a decreasing inflation over time and puts an end to a growth factor of the Central Bank Bills (LEBACs) in previous years. This factor of monetary expansion will

not be present under the new monetary policy regime, hence will not affect the evolution of the Liquidity Bills (LELIQs).

The zero growth target of the monetary base has been defined in terms of the monthly average of this variable; therefore, a comprehensive assessment of its fulfillment during its first operative month can be made immediately after October. However, to make a preliminary assessment, and taking into account the intra-monthly performance of the variable, we have made a comparison between the average monetary base of the first 21 days of October and its average in the same period of the previous month. This comparison reveals that the monetary base shrank by 24.5 billion pesos. In this period, the reduction required an additional effort since, in the first two weeks of September, the non-remunerated minimum reserve requirement ratio was lower. If the monetary base were adjusted by this factor, October average up to the day 21 of the month would be lower by 60.5 billion pesos than the amount recorded in the same period of September.

Regarding the economic activity, GDP fell by 4% seasonally adjusted in the second quarter of the year against the first quarter. The sharp drop of the agricultural output due to the drought was a determining factor but there was also a 1.1% drop seasonally adjusted of the non-agricultural output as a result of the financial and foreign exchange tensions experienced since April. Both the leading indicators and the analysts' outlook show that the drop of the non-agricultural output would continue in the third quarter, due to a context of more financial uncertainty and inflation acceleration.

The Central Bank of Argentina considers that the monetary plan entailing a zero growth of the monetary base together with the announcement of a zero primary fiscal balance for 2019 made by the Ministry of Economy is the essential tool to start reducing uncertainty and to ease both expectations and inflation rates in the next few months. In addition, the monetary authority considers that it is critical to mitigate this context of uncertainty for the economic activity to start a process of recovery on a sustainable basis.

2. International Context

Emerging economies' conditions of access to international financial markets continued to deteriorate during the third quarter of the year, even though at a slower pace than in the previous quarter. The main factors behind this deterioration include: the rise of the United States' interest rates and the expectation of a lower monetary stimulus by the US Federal Reserve (FED), together with new signs of trade tensions among some of the largest economies. These factors resulted in capital outflows from emerging countries, an increase in the sovereign risk premiums and a depreciation of their currencies. Economies with significant external imbalances and/or high indebtedness levels were especially affected.

Nevertheless, during the third quarter there was a positive performance in the economic activity worldwide, including Argentina's main trading partners. The estimated growth for 2019, *pari passu* with the real exchange rate projected level, would result in a marked improvement of the Argentine external sector performance, with positive impacts on the activity level.

Considering the deterioration of the financial conditions and the activity levels of our trading partners, the international context is signaling a mixed scenario for Argentina. The main risks posed by the international context for our domestic economy continue to be even more contractionary financial conditions, added to a deepening of protectionist measures.

2.1 The activity level of our trading partners will improve in 2019

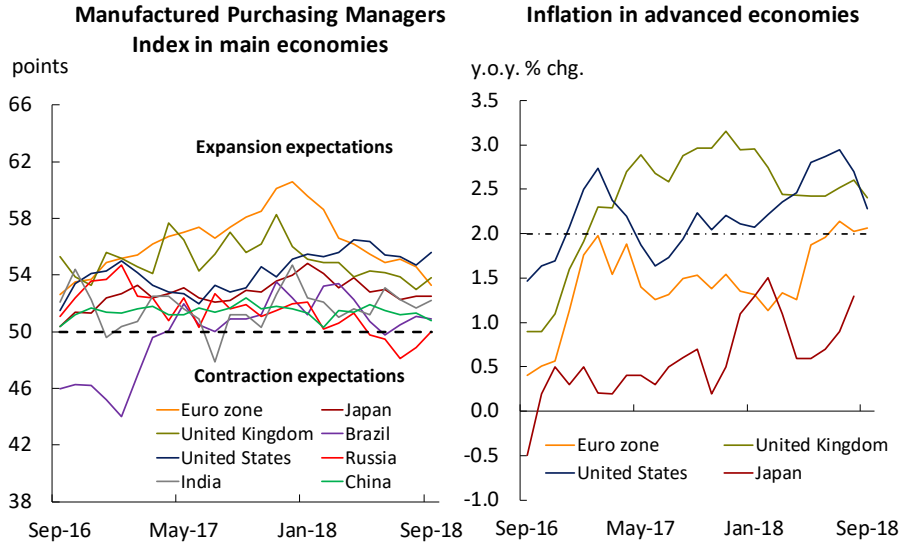
The most recent forecasts indicate that the global economy growth rate would remain unchanged in the rest of 2018, even though growth would be less synchronized than in previous quarters. The IMF estimates that, in 2018, the global GDP will grow 0.2 percentage points (p.p.) less than forecasted in July this year. In the case of Argentina's main trading partners, for the rest of 2018 their growth rates would continue to stand at levels similar to those of the last quarters, and they are expected to reach the maximum value of the last eight years in 2019 (see Figure 2.1).

Figure 2.1 | Principal Argentina's trade partners growth

*Weighted by their participation in the exports of Argentine manufactures.
Source: FocusEconomics, Bloomberg, FRED and ONU Comtrade f:Forecast

The leading activity indicators of the main economies worldwide are still, in all cases, within the expansion zone. This is consistent with the inflation data and would result in a scenario of a more contractionary monetary policy in these economies, especially in the case of the United States (see more details below). Specifically, the US and the UK (United Kingdom) inflation rates are standing 0.3 p.p. and 0.4 p.p. above the target, while in the Euro Zone the inflation rate slightly exceeds the target limit (see Figure 2.2).

Figure 2.2 | Manufactured Purchasing Managers Index in main economies and inflation

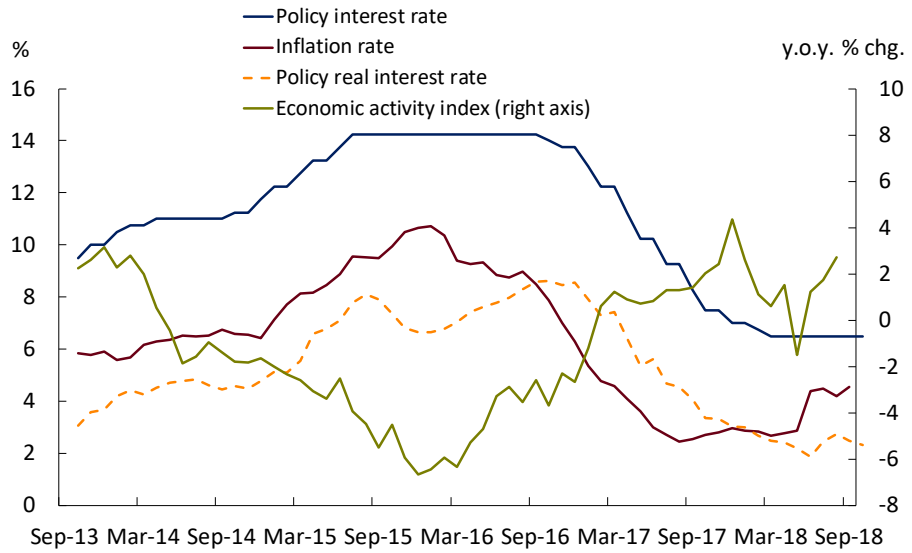


Note: Inflation computed according to the Consumer Price Index.
Source: Bloomberg

The economic activity indicators of Brazil, our main trading partner, show that after falling to a minimum level in May (related in part to trade union strikes), the economic activity would have started to rebound. Even though the forecasts for 2018 (by the Central Bank of Brazil (BCB) and the IMF) continued to be revised downwards, the increase in the activity level of recent months would become evident in 2019, marking a year for which the highest GDP growth rate in the last five years is projected. Specifically, the most recent projections of the Focus Survey —made by the BCB among market analysts— anticipate a 1.3% GDP growth for 2018, standing 0.2 p.p. below the forecast estimated at the time of publication of the previous Monetary Policy Report (IPOM), while the IMF anticipates a 1.4% change (a drop of 0.4 p.p.). In 2019, GDP is expected to increase at a rate of 2.5% according to Focus and 2.4% according to the IMF.

Likewise, within the electoral process of Brazil, there was an increased volatility in the exchange rate. From the beginning of August to mid-September, the Brazilian Real depreciated 13% and then reversed such depreciation. During the quarter, the BCB left the monetary policy interest rate unchanged, at 6.5% (see Figure 2.3). In turn, despite the fact that September inflation rate was the highest since 2017 (4.5% year-on-year (y.o.y.)), it has stood at the center of the target range (4.5% ± 1.5) for the last four months. Until June this year, the year-on-year inflation rate stood below 3% and then increased in June by 1.5 p.p. (again, mainly related to the impact of the trade union strikes). Based on the forecasts of the analysts surveyed by Focus, the inflation rate would finish the year at 4.4%, and would stand at 4.2% in 2019; in turn, the BCB would leave the monetary policy rate unchanged for the rest of 2018 and would raise it to 8% in 2019.

Figure 2.3 | Brazil. Macroeconomic indicators



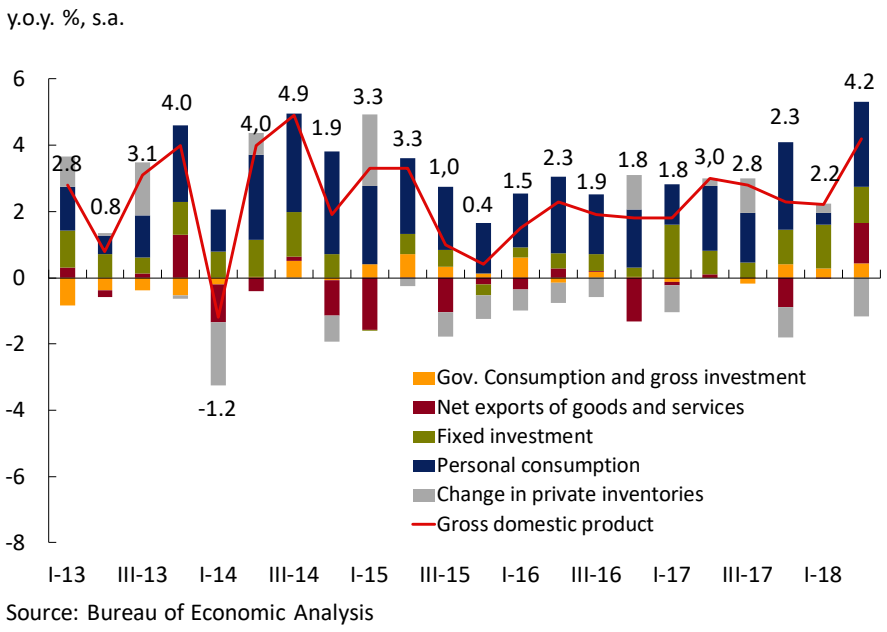
Source: Central Bank of Brazil.

In the euro zone, second destination of Argentine exports, the economic slowdown that started at the beginning of the year continued mainly due, according to the European Central Bank ECB), to a reduced international trade (fewer exports of industrial and capital goods). This was compounded by an appreciation of the Euro at the beginning of 2018. However, according to the latest forecasts, the activity level of the Euro Zone would stabilize at around a quarterly growth rate of 0.4% for the rest of 2018 and at 0.5% in 2019. Lastly, August labor market data show an unemployment rate of 8.1%, the lowest figure since November 2008.

During the quarter, the ECB left its monetary policy interest rate unchanged (applied on its Main Refinancing Operations), which continues to stand at its historical minimum of 0%, and it did not change its rates corridor either. In addition, no changes in the monetary policy interest rate are expected for the rest of 2018 and for most of 2019. Moreover, the ECB has also left unchanged its inflation forecast for 2018 (1.7%) and for 2019 (also 1.7%). Lastly, the ECB has kept its decision to end its quantitative easing program by the end of the year, which has been reduced throughout 2018[1].

[1] In October 2017, the ECB reduced its asset purchase program from €60 billion to €30 billion per month and, as from September 2018 and until the end of the year, the asset purchase pace goes down to €15 billion per month.

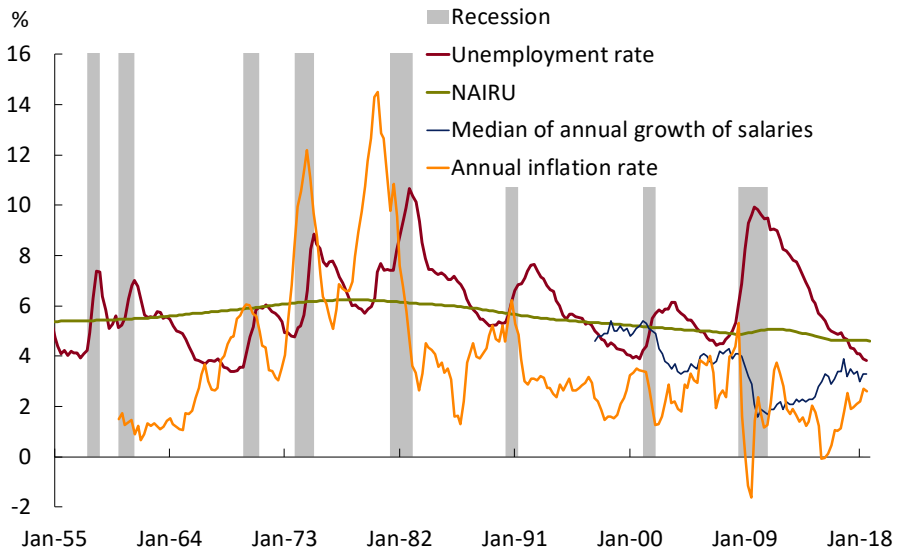
Figure 2.4 | USA. GDP change by components



Source: Bureau of Economic Analysis

In the United States —third destination of Argentine exports— the growth rate of the second quarter stood at 4.2% (seasonally adjusted and annualized), reaching the highest value in the last four years (see Figure 2.4). This was mainly due to the contribution of private consumption to growth —from 0.3% up to 2.6%— and to the contribution of exports (1.2 p.p.). Some leading indicators, such as *GDPNow* of the Federal Reserve Bank of Atlanta, are signaling that the US economic growth rate would also stand at around 4.2% in the third quarter of the year. These rises in the growth rate of the US economy are related to the recent fiscal stimulus measures, which would no longer have an impact on growth in 2020.

Figure 2.5 | USA. Laboral market and inflation indicators.

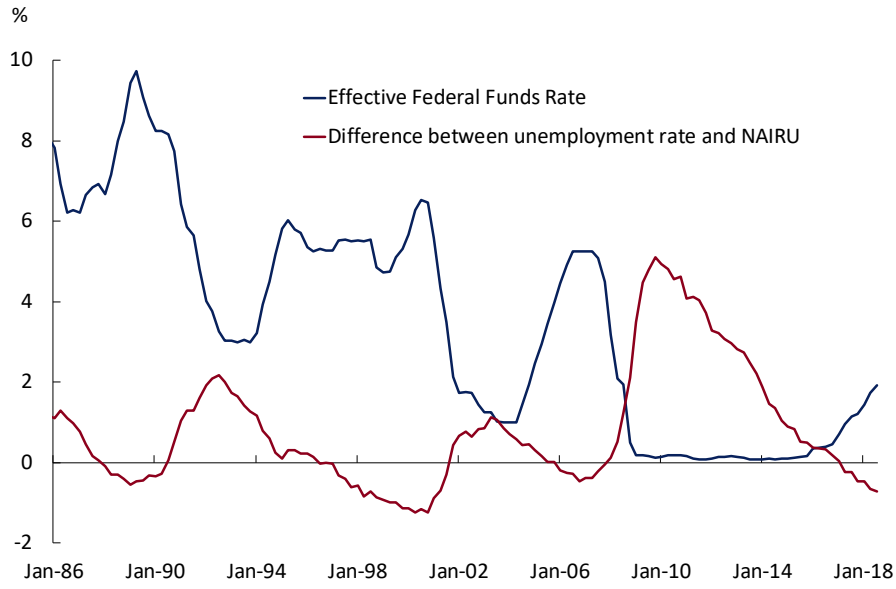


Source: *FRED Economic Data, Federal Reserve Bank of St. Louis*

Regarding the labor market, the increase in wages has accelerated in recent months. In turn, the unemployment rate stood at 3.7% in September (the lowest figure since August 1969, see Figure 2.5) and -0.9 p.p. below the NAIRU[2], something that had not happened since 2001. At that time, the FED benchmark rate was standing at values that more than doubled the current figures, which might be signaling that the FED still has much room to continue raising its monetary policy rate (the message is even more conclusive if we consider the benchmark interest rate in real terms). Anyway, it should also be considered that the FED would have a lesser need to raise the interest rate if structural changes had occurred in such period, and such changes had increased the US potential GDP (something that may be inferred from Figure 2.3 of the Monetary Policy Report of April 2018). In addition, the implicit contractionary bias of the benchmark interest rate may be currently underestimated because it does not take into account the contractionary effect of the end of the unconventional monetary policies (asset purchase program).

In the meeting held in September, the Federal Open Market Committee (FOMC) of the US FED raised once again the benchmark interest rate[3] to a range of 2-2.25%. In addition, based on the latest forecasts released by the FOMC, the benchmark interest rate is expected to be raised once again in the rest of 2018, to a range of 2.25-2.5%. Consequently, by the end of 2018, the benchmark interest rate in real terms would be positive again for the first time in more than a decade (since September 2008). In this respect, in its press release, the FOMC ceased to describe its monetary policy as expansionary. Likewise, the FMOC forecasts are signaling that there would be three rises of the benchmark interest rate in 2019 (0.25 p.p. on each occasion). In turn, there were no significant changes with respect to economic activity forecasts (growth and unemployment) and to inflation estimates. Therefore, GDP is expected to grow 3.1% and 2.5% in 2018 and 2019, respectively, unemployment is expected to stand at 3.5% (in both years) and inflation is expected to reach 2.1% and 2%, respectively.

Figure 2.6 | US. FED rate and unemployment/NAIRU difference



Source: BCRA based on FRED, Federal Reserve Bank of St. Louis

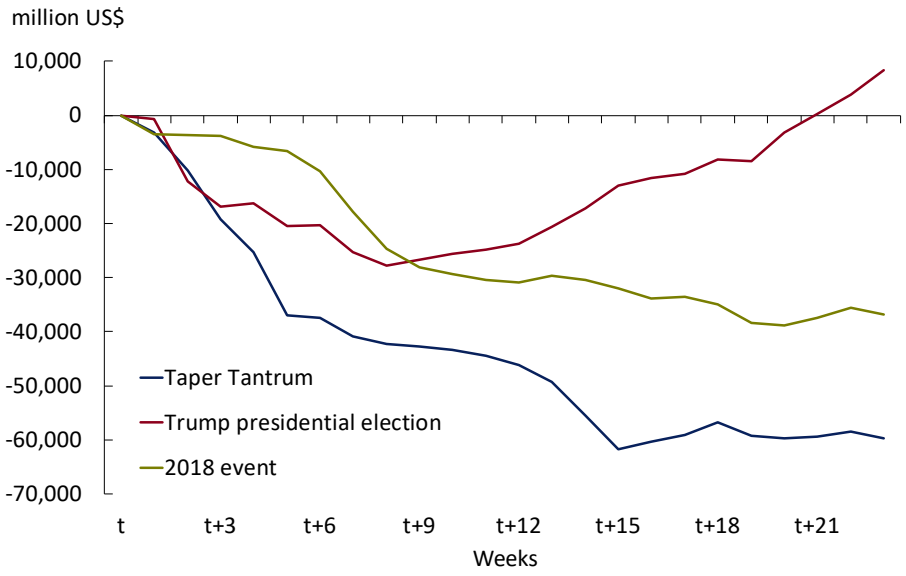
[2] Non-accelerating inflation rate of unemployment (NAIRU).
[3] The target over the Federal Funds Rate.

Lastly, the economic growth pace of China, main destination of Argentine commodity exports, slowed down in the third quarter. This information does not reflect yet the full impact of the duties imposed on China's exports to the United States. Specifically, during the third quarter, its GDP grew 6.5% y.o.y. (down 0.2 p.p. against the value of the second quarter). In this context, some days before, the People's Bank of China had ordered a reduction of the minimum reserve requirements on the financial system. Consequently, China would seek to prioritize growth over its deleveraging policy in place. The most recent forecasts for 2018 show an estimated GDP growth of 6.6% for the current year and of 6.2% for 2019 (the forecasts for 2018 have remained unchanged while the forecasts for 2019 have been revised downward by 0.2 p.p. against previous projections). Finally, the Chinese yuan, which had depreciated markedly against the US dollar since mid-June, was relatively more stable but, nevertheless, it has depreciated against the values in place at the time of publication of the previous IPOM (3.3%).

2.2 The tightening of the external financial context continued, even though at a slower pace than in the previous quarter

The tightening of the external financial context continued in the third quarter of the year, as a result of which the global liquidity conditions worsened for emerging countries in general and for Argentina in particular, even though at a slower pace than in the second quarter. Consequently, emerging markets' currencies continued to depreciate and their sovereign risk premiums went up as a result of the capital outflows from these markets (see Figure 2.7). As pointed out in the previous IPOM, economies with external imbalances and/or high indebtedness levels (see Figure 2.4) were especially affected. Nevertheless, it must be noted that global liquidity conditions, despite the recent deterioration, continue to be supportive in historical terms.

Figure 2.7 | Emergent market. Capital outflows.



Source: JP Morgan, Standard Chartered using information of EPFR

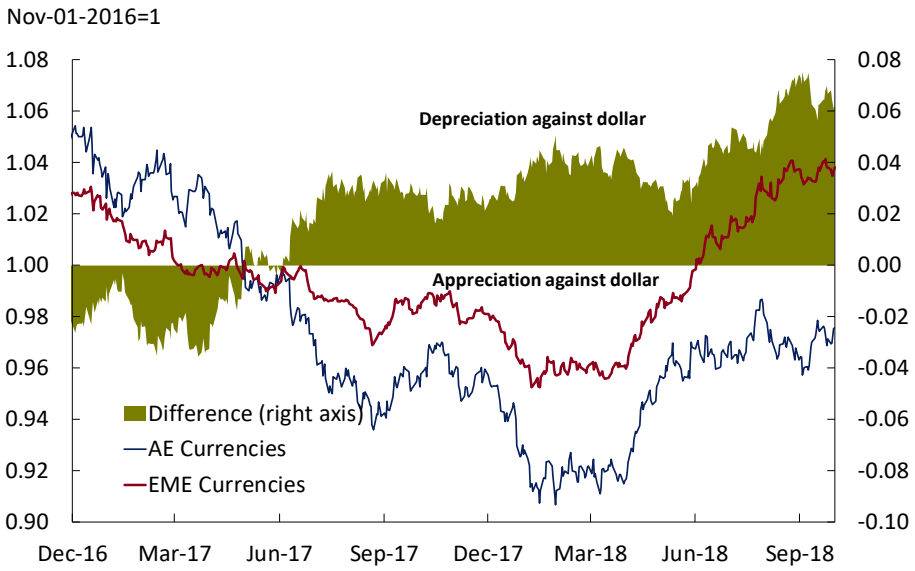
The tightening of monetary conditions in the United States is evident in the interest rate rise of the US 10-year Treasury bond (see Figure 2.8) which started in December 2017. As from April, the increase in the yield of this benchmark started to match an appreciation of the US dollar (see Figure 2.9), impacting more adversely on emerging markets. Then, as from mid-August, the rate of the 10-year bond started to go up. In this context, Argentina and Turkey were the countries with sharper depreciations in their currencies (see Figure 2.10). Other economies were also affected by the international context but due to idiosyncratic factors as well, as is the case of Brazil and South Africa.

Figure 2.8 | USA Treasury bonds and S&P 500 volatility.

Source: Federal Reserve Bank of St. Louis

From January up to August 9, the Turkish lira accumulated a depreciation of 31.6%. On that date, the United States doubled the import duties for steel and aluminum coming from Turkey, on the grounds that it had to protect itself against the use of the exchange rate as competitive tool. As a result, the lira continued to depreciate. With a persistent current account deficit since 2002 (5.4% of the GDP estimated for the current year), Turkey accumulated external indebtedness and depends on new financing to cover the external gap. In order to face this unfavorable external context, Turkey indirectly tightened its monetary conditions and sought for financial aid without resorting to international organizations and got support from Qatar. Later on, in mid-October, the government of Turkey issued debt once again in the international markets.

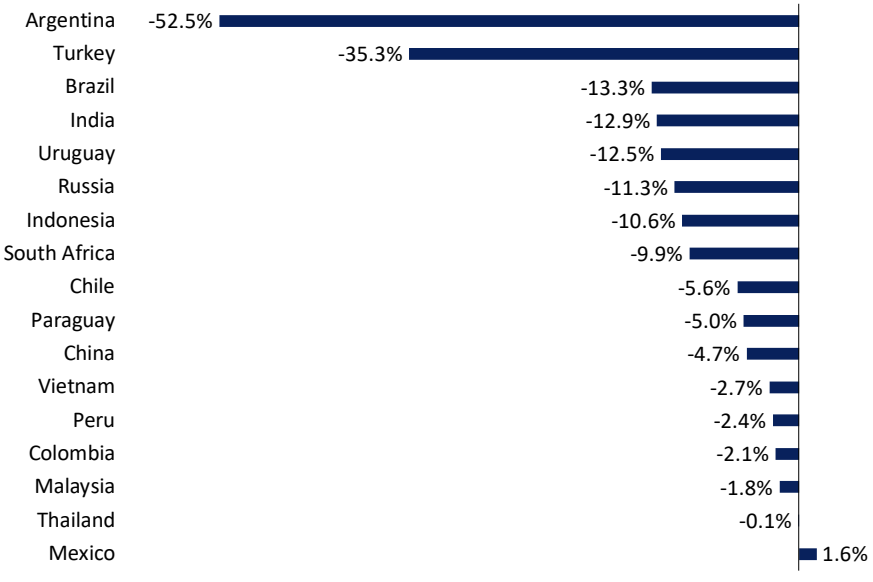
Figure 2.9 | Emergent and Advanced Currencies against US dollar



Source: Bloomberg and World Bank

During the third quarter of 2018, emerging countries faced higher sovereign risk premiums than those of recent years, even though a reduction is observed on the margin. In turn, corporate risk premiums remained relatively stable for emerging markets against the previous quarter and above the levels of 2017 —though still standing at around the minimum values of recent years. In a context where the cost of external financing continued to go up, the amount of gross issues of sovereign and corporate debt by emerging countries went down 42% y.o.y. in the third quarter. The contraction was more marked in sovereign issues, which dropped 77% y.o.y., while corporate issues fell by 31% y.o.y.

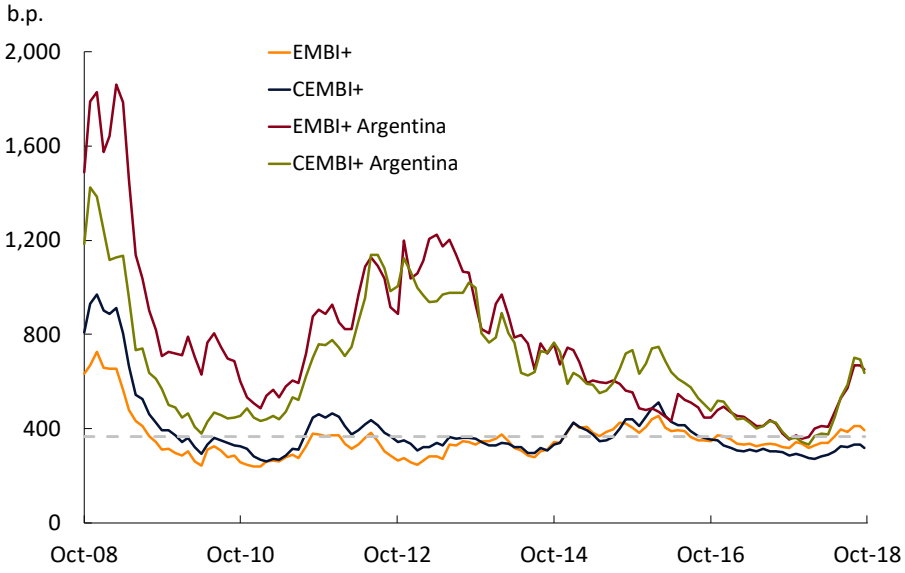
Figure 2.10 | Emergent currencies depreciation against US dollar. October 2018 vs. December 2017



Source: Bloomberg

In the case of Argentina, external lending conditions deteriorated significantly against the second quarter. Argentina's sovereign and corporate risk premiums rose to 2015 levels, with a widening of the spreads relative to other emerging countries, even though there was a slight improvement on the margin (see Figure 2.11). Regarding the Argentine sovereign issues abroad, there were no operations in the third quarter of the year. With the CEMBI+ARG (Argentine Corporate Emerging Markets Bond Index) standing at an average of 670 points, there were no issues in foreign markets by Argentine companies. In fact, the last issue dates back to late April, before the beginning of the financial turbulences.

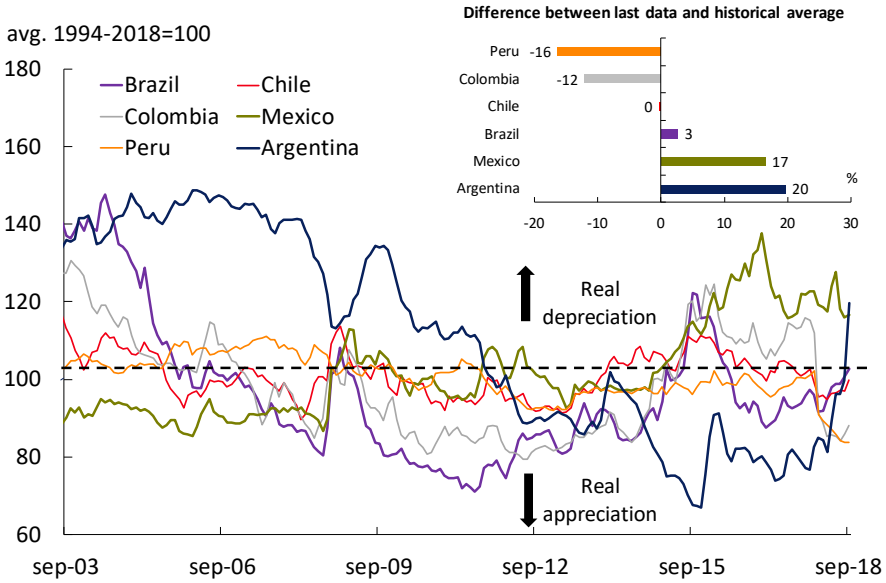
Figure 2.11 | Sovereign and corporate risk indicators



Source: Bloomberg

In the third quarter of the year, the Multilateral Real Exchange Rate (ITCRM) went up 18% on average against the second quarter, mainly due to the nominal depreciation of the Argentine peso against the US dollar. The increase between ends of months was even higher (24%). Thus, the ITCRM stood 21% above the average of the last 24 years in September 2018 (see Figure 2.12). If compared to the currencies of other countries of the region, the Argentine peso has depreciated the most, relative to its historical average, turning domestic goods more competitive in terms of prices. This situation has not happened since early 2012 when Argentina had a goods trade surplus of around 2% of GDP.

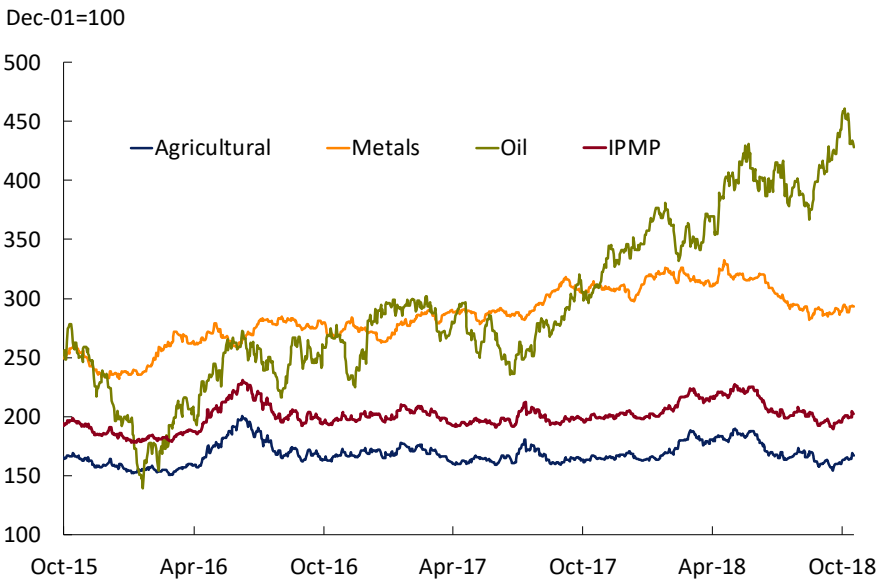
Figure 2.12 | Real effective exchange rate



Source: BIS and BCRA

On the other hand, the international prices of commodities measured in dollars[4] continued to go down in the third quarter, resulting in values that stand around 1% below on the margin than the prices of the same period in 2017. In turn, the prices of agricultural products and metals went up during October, unlike the international price of oil, which decreased slightly even though still standing at around the maximum levels of recent years (see Figure 2.13).

Figure 2.13 | International commodity prices

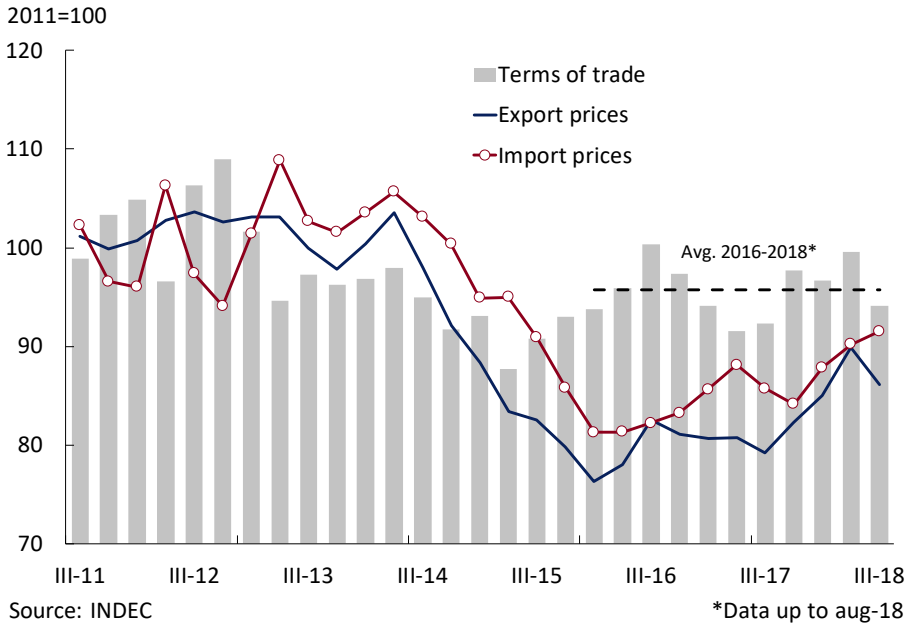


Source: BCRA

[4] According to the Commodity Price Index (IPMP), published daily by the BCRA, which reflects the evolution of the main export commodities of Argentina.

Lastly, as anticipated in the IPOM corresponding to July, the terms of trade (ratio between Argentine export and import prices)[5] dropped 4.1% in July and August, as a result of a decline in the price of exports and an increase in the prices of imports —impacted by the ongoing rise of the international price of crude oil. Both the reduction of soybean price because of the trade disputes between China and the United States and the rise in the oil price impacted on the abovementioned evolution (see Figure 2.14).

Figure 2.14 | Terms of trade



In short, during this quarter the deterioration of the international financial conditions continued to deepen, even though at a slower pace against the second quarter. The good performance (both current and forecasted) of the economic activity level of our main trading partners might offset the adverse financial scenario and give rise to a mixed external context for Argentina. The main risks posed by this scenario are an ongoing tightening of the international financial conditions[6] and a deepening of protectionist measures[7]. Both factors would deteriorate the external situation of emerging countries and would impact on the economic activity level of our trading partners.

[5] A decline of the terms of trade has an unfavorable impact on the Argentine balance of trade, while an increase has a favorable impact.
[6] In the Global Financial Stability Report, dated October 2018, the IMF analyzes the potential impacts of this tightening and concludes that emerging economies are still vulnerable if this scenario finally holds true.
[7] In the World Economic Outlook, dated October 2018, the IMF makes an analysis of the potential impact of these measures worldwide in Scenario Box 1. Global Trade Tensions (page 33). In this Box, the IMF comes to the conclusion that if the most adverse scenario finally held true, then the global GDP would fall 0.4% over the long term.

3. Economic Activity

During the second quarter, the economic activity contracted in line with the adverse scenario anticipated in the previous Monetary Policy Report (IPOM). In turn, during the third quarter, the drop of the non-agricultural output deepened due to a higher-than-expected deterioration of domestic financial conditions.

Both public and private consumption and investment fell once again while net exports contributed positively to the output's quarterly change. At a sectoral level, the decline was widespread and it was partially offset by the regularization of the agricultural activity and the upward trend of some activities such as livestock, oil and gas.

The decision of the Executive Branch to accelerate the convergence towards a zero primary fiscal balance and the earlier disbursements resulting from the agreement with the IMF allow for clearing up the doubts of financial markets about the financing needs of the government. After the initial contractionary impact of the peso depreciation, a higher real exchange rate is expected to start boosting the tradable goods sector during 2019 and to contribute to the reversal of the current account imbalance.

Even though the economic outlook deteriorated against the previous IPOM, the Central Bank of Argentina (BCRA) still considers that the correction of the external and fiscal deficits will allow the economic activity to start a process of recovery during 2019 on a more sustainable basis.

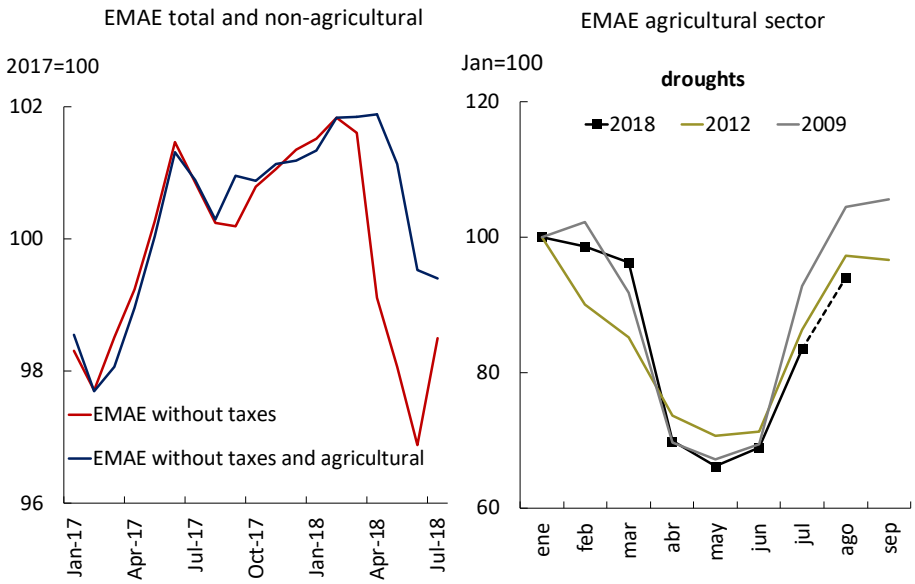
3.1 The economic activity will shrink in 2018

During the second quarter of 2018, GDP went down 4% seasonally-adjusted and 4.2% year-on-year (y.o.y.) in line with the adverse scenario anticipated in the previous IPOM. The drop of the "non-agricultural" GDP (-1.1% quarter-on-quarter seasonally-adjusted) was due to the contraction of the domestic demand caused by the financial tensions resulting in the significant jump of the exchange rate which, in turn, led to a rise of inflation, a drop of the real wage and an increasing uncertainty. Transport and trade were also indirectly impacted by the drought that affected the agricultural output.

During August, the dollar appreciated at global level and the financial assets prices of emerging economies deteriorated. The domestic currency of Brazil –our main trading partner– depreciated as a result of the new international shock, and the forecast of its growth rate for 2019 was revised downward. There was an increased perception of risk over the Argentine economy's vulnerabilities, giving rise to an additional portfolio rebalancing and a new depreciation of the peso, which had not been foreseen in the macroeconomic assumptions of the previous IPOM's baseline. The increase of inflation during August and September resulted in a deterioration of the real wages, and this explains why the drop of the domestic demand deepened during the third quarter. Within this context, the BCRA adopted a new monetary policy regime to limit the foreign exchange instability and to curb price rises (see the Chapter on Monetary Policy).

In a more adverse-than-expected context, the non-agricultural output went down in the third quarter, while the regularization of the agricultural activity contributed around 2 percentage points (p.p.) to the quarterly change of GDP, partially offsetting the contraction of the remaining sectors. The information available is in line with such forecast. The Monthly Economic Activity Indicator (EMAE), prepared by the National Institute of Statistics and Census (INDEC), went up 1.4% seasonally-adjusted in July mainly due to a 26% seasonally-adjusted recovery of the agricultural sector against June (see Figure 3.1). The General Activity Index (IGA), prepared by O.J. Ferreres, also went up in July due to the farming sector effect (4.5% seasonally-adjusted) and remained stable in August. The latest BCRA's GDP Contemporaneous Forecasting (PCP-BCRA) corresponding to the third quarter signals a 0.5% drop quarter-on-quarter seasonally-adjusted.

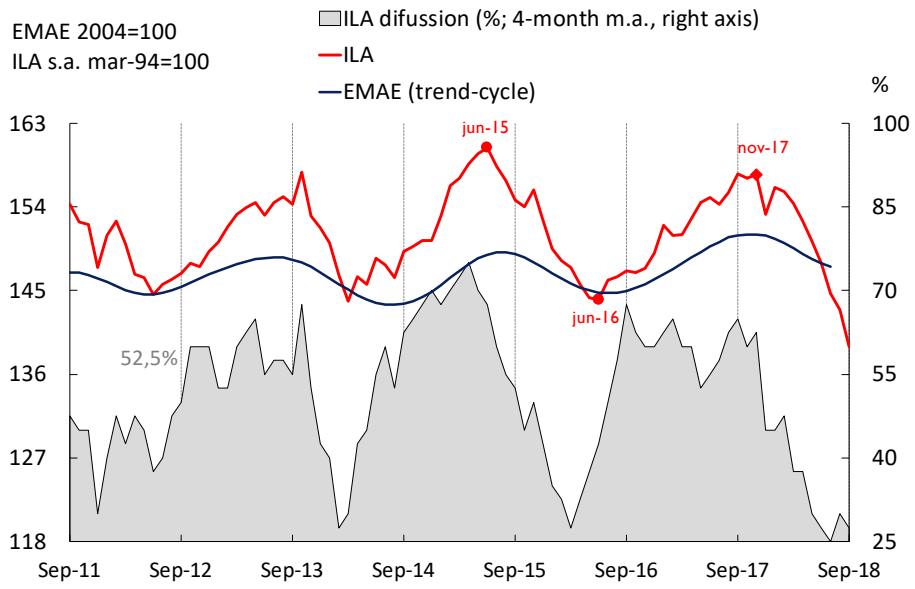
Figure 3.1 | Monthly evolution of economic activity



Source: BCRA with data from INDEC

For the rest of 2018, the Leading Indicator of Economic Activity (ILA - BCRA) is not signaling a change in the recessive phase that started in the second quarter of 2018. In September, ILA recorded the seventh consecutive monthly drop, while growth diffusion stood at 27.5%, close to the minimum historical values[8] (see Figure 3.2).

Figure 3.2 | Leading indicator of economic activity (ILA)



Source: INDEC, AFIP, Sectorial chambers, Bloomberg and UTDT

[8] The purpose of this indicator is to give an alert about a turning point in the activity from an expansionary phase to a recessive phase or vice-versa. In this case, ILA exhibited a turning point alert in November 2017 and the maximum value in the "non-agricultural" EMAE was recorded some months later, in April 2018. For more details, see Exhibit 3 / BCRA Leading Activity Index, Monetary Policy Report (IPOM) - January 2017.

The BCRA's new monetary policy regime aims at moderating foreign exchange volatility and gradually reducing inflation. In turn, the Executive Branch decided to accelerate the fiscal consolidation process, a pre-condition to lower financing costs and ease the financial and exchange rate instability. Towards the end of September, a new agreement was reached with the IMF staff in order to clear up any doubts over the 2019 financial program. In the next few months, the external and financial deficits of the economy will be corrected so as to start a process of recovery in 2019 on a more sustainable basis.

3.1.1. As from the second half of 2018, domestic demand mirrored the deterioration of financial conditions, which added to the fall of agricultural exports

In the second quarter of 2018, the sharp drop of domestic demand (-2.1% seasonally-adjusted) added to the reduction of exports resulting from the drought that affected the production of soybean and corn[9]. The lower inflow of foreign currencies due to the supply shock of the agricultural sector, together with the deterioration of the financial conditions and the sharp rise of the exchange rate, impacted adversely on real wages and led to the contraction of private consumption (-1.1% seasonally-adjusted) and investment (-6.9% seasonally-adjusted). Leading indicators anticipate that the contraction of domestic demand continued in the third quarter.

Table 3.1 | GDP quarterly change and contributions by components

	III-17	IV-17	I-18	II-18	III-17	IV-17	I-18	II-18
	Qtly. % chg., s.a.				contributions to qtly. % chg. s.a. of GDP in p.p.*			
GDP constant prices	**0.5**	**0.8**	**0.7**	**-4.0**	**0.5**	**0.8**	**0.7**	**-4.0**
Demand	-0.5	1.5	1.4	*-2.1*	*-0.5*	*1.6*	*1.5*	*-2.3*
Private consumption	-1.6	1.2	1.9	*-1.1*	*-1.2*	*0.9*	*1.4*	*-0.8*
Public consumption	-0.5	-1.2	-0.3	*0.0*	*-0.1*	*-0.2*	*-0.0*	*0.0*
Gross fixed investment	3.8	4.3	0.9	*-6.9*	*0.8*	*0.9*	*0.2*	*-1.5*
Net Exports					*-1.0*	*-1.6*	*1.8*	*-1.3*
Exports	1.2	0.5	6.9	*-14.2*	*0.2*	*0.1*	*1.3*	*-2.9*
Imports	4.2	5.8	-1.3	*-5.4*	*-1.2*	*-1.7*	*0.4*	*1.7*
Chg. Of stocks and statistical discrepancy					*2.0*	*0.8*	*-2.5*	*-0.4*

*Component contribution to annual change of GDP. Calculated as the product of the % change of the component and its share on previous period GDP.

Source: INDEC

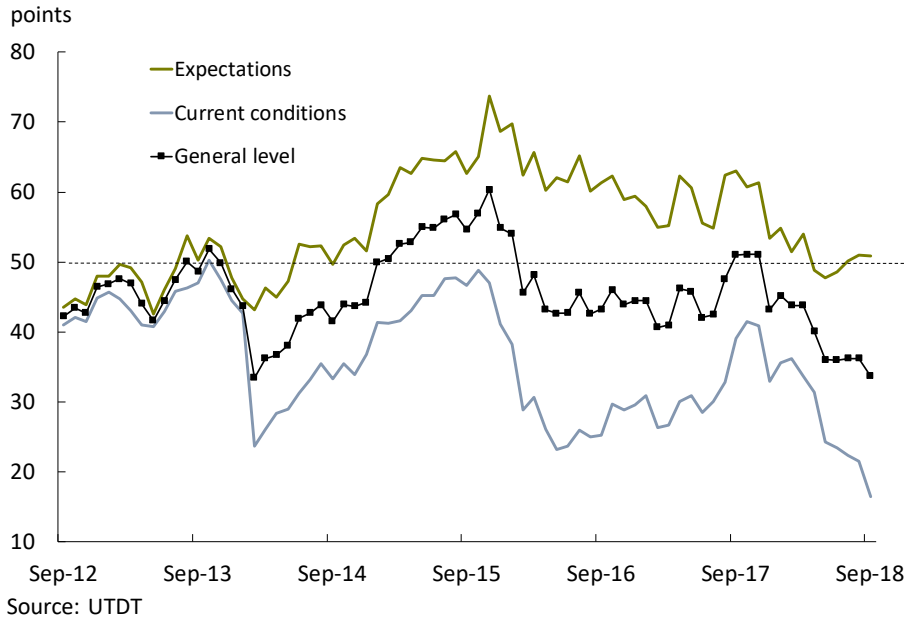
Private consumption was affected by households' lower real disposable income within a context of more restrictive lending conditions and deterioration of consumers' expectations. The real wage of registered workers decreased 1.7% on average during the second quarter. Between April and June, spending of the national public sector on social protection (retirements, pensions, family allowances and other social

9 According to information from the Secretariat of Agribusiness, in the 2017/2018 cycle, the production of soybean and corn fell by 31.3% y.o.y and 12.5% y.o.y., respectively.

programs) increased 28.1% y.o.y. in nominal terms. However, in order to protect the most vulnerable sectors, the Government has decided to raise the Universal Child Allowance for Social Protection (AUH) through two non-recurring payments to the beneficiaries (4 million people). Thus, this spending component would exhibit an increase above 10% in real terms during 2018.

In the third quarter, the expectations of consumers deteriorated markedly, anticipating a negative performance in terms of consumption. According to the Consumer Confidence Index (ICC) prepared by Universidad Torcuato Di Tella, confidence stood in September at the lowest level since February 2014, recording a 34% drop in year-on-year terms (see Figure 3.3). A breakdown of ICC components shows that willingness to purchase durable goods and properties (home appliances, houses and vehicles) was the component that evidenced the sharpest decrease, and the decline was even more marked in the provinces.

Figure 3.3 | Consumer confidence

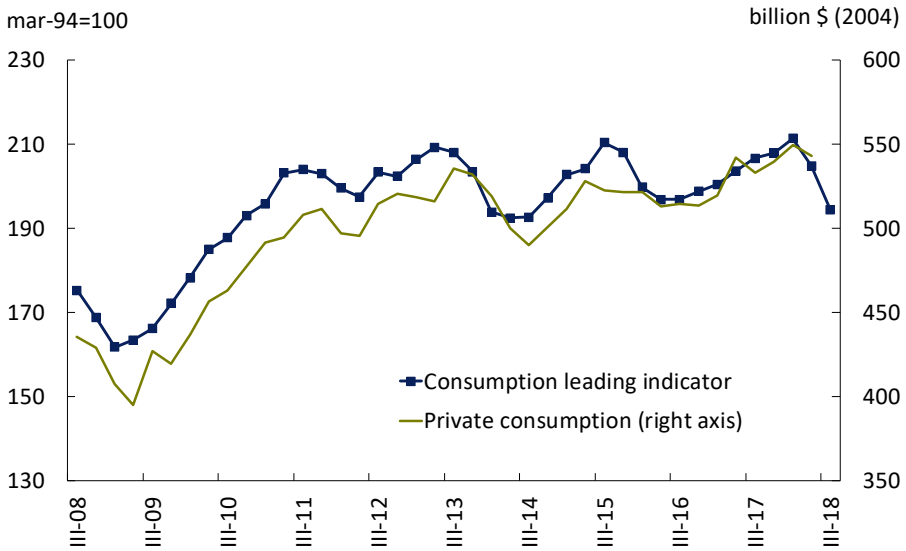


Source: UTDT

The Contemporary Private Consumption Index prepared by the Under-Secretariat of Macroeconomic Planning went down 1.7% seasonally-adjusted in the third quarter, while the BCRA's Leading Indicator of Private Consumption[10] also suggests that the contraction of consumption was sharper between July and August (see Figure 3.4).

[10] Monthly Frequency Index that includes traditional and non-traditional indicators of goods and services consumption. For further details, see Exhibit 1 / Private consumption, a difficult variable to monitor in real time, Monetary Policy Report (IPOM) - July 2017.

Figure 3.4 | Private consumption



Source: INDEC

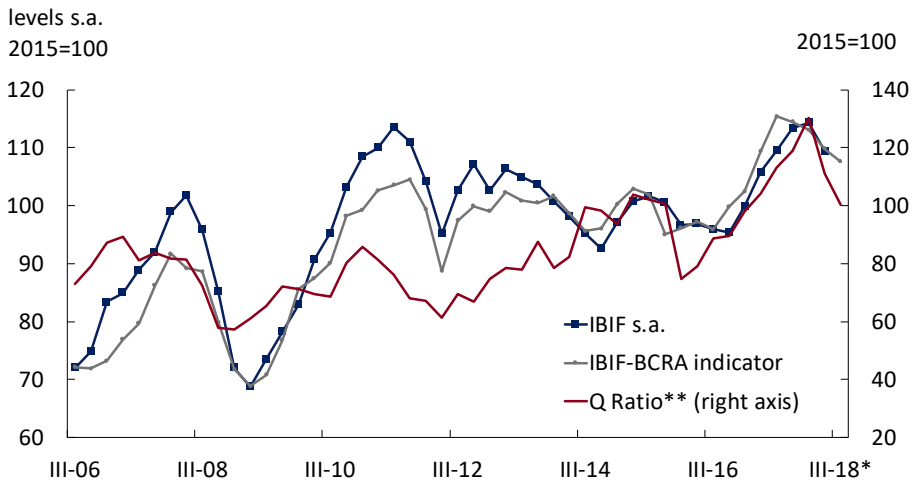
Within a scenario of more uncertainty, private consumption is expected to find its floor during the first quarter of 2019, in line with the reopening of bargaining agreements that will allow for an improvement of real wages against the minimum values projected for the fourth quarter of 2018.

As regards investment decisions, they were impacted, as from the second quarter, by the increase in the relative prices of capital goods, the deterioration of domestic financial conditions and the unfavorable perspectives for domestic demand. The contraction of the domestic gross investment in the second quarter (-6.9% seasonally-adjusted) was the factor that contributed the most to GDP quarterly decline. Among its components, especially remarkable was the reduction observed in durable equipment (-5.7% seasonally-adjusted), which mainly resulted from lower imports of imported transport materials (-16.3% seasonally-adjusted).

Partial indicators show that investment continued to decline in the third quarter. The BCRA Gross Domestic Fixed Investment Indicator (IBIF-BCRA)[11] fell 2.3% seasonally-adjusted against the previous quarter while the Contemporary Investment Index, prepared by the Under-Secretariat of Macroeconomic Planning under the Ministry of Economy, exhibited a 5% drop seasonally-adjusted. This evolution can be anticipated through the Q Ratio, which relates the market value of assets to their replacement cost, and kept going down up to August (see Figure 3.5).

[11] Quarter-on-quarter changes of the IBIF-BCRA Indicator are a weighted average of quarter-on-quarter changes seasonally- adjusted of the Summarized Construction Activity Indicator (ISAC) (INDEC), of capital goods imports (INDEC) and of the national production of capital goods (FIEL). The weighting factors correspond to the incidence of construction and investment in durable production equipment (EDP), both imported and national, in the IBIF of the previous quarter. Between July and August, ISAC fell 2.3% seasonally-adjusted against the second quarter of 2018, imports of capital goods fell 4.4% seasonally-adjusted, while national production of capital goods went up 2.7% seasonally-adjusted.

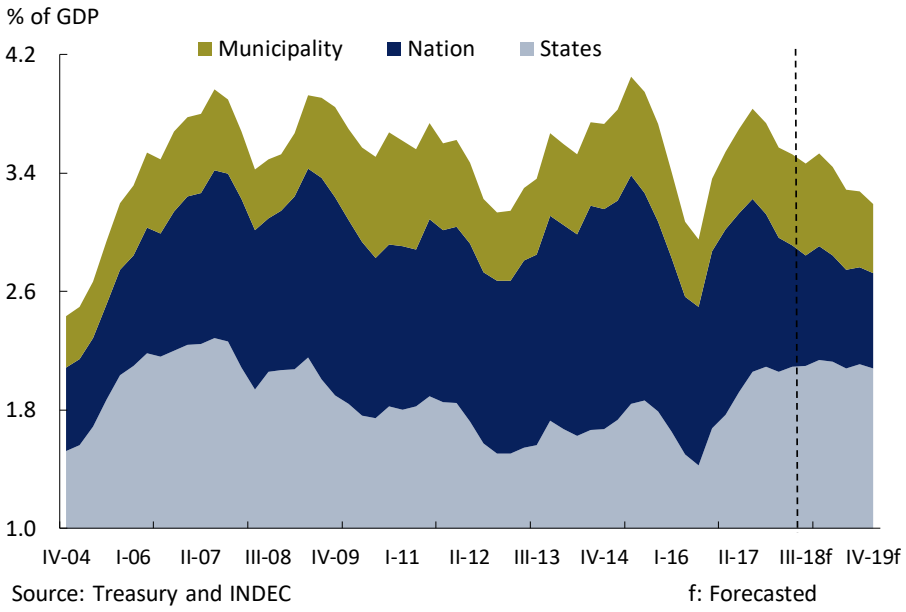
Figure 3.5 | Evolution of investment



**Q Ratio: asset's price vs. replacement cost. The prices of the apartments for rent in CABA are taken into account as representative of the market value of the properties, and the Merval index of the rest of the assets. As replacemente cost, construction and durable production equipment deflactors taken from national accounts are used, respectively.
Source: INDEC, UADE, Statistical Office of City Buenos Aires, Merval and FIEL. *Data up to august.

The negative trend of private investment is expected to continue but its evolution will reverse as soon as the financial uncertainty comes to an end and the outlook of domestic demand starts to improve. In turn, the contribution of public investment will be lower than in 2017 in line with the fiscal accounts consolidation policy implemented by the Executive Branch. The capital spending of the consolidated public sector is expected to be lower in the second half of the year if compared to the first half, and this trend would continue in 2019 (see Figure 3.6).

Figure 3.6 | Public capital expenditure



Source: Treasury and INDEC
f: Forecasted

The energy sector, especially the exploitation of wells for the extraction of oil and gas in Vaca Muerta, is one of the main exceptions to the abovementioned unfavorable evolution of investment. The projects of this sector have not been affected by the recent turbulences in the foreign exchange and financial markets, and propects are encouraging for the coming years.

The BCRA considers that, as soon as financial conditions stabilize, private investment will start to recover, led by the tradable sectors that are in a position to take advantage of a more competitive real exchange rate.

3.1.2. Net exports would contribute positively to aggregate demand with the regularization of the agricultural activity, thus buffering the fall of the third quarter

As anticipated in the previous IPOM, there was a sharp drop in the exported volumes of goods and services in the second quarter (-14.2% quarter-on quarter seasonally-adjusted), mainly due to a more limited availability of grains after the drought (soybean and corn sector). During the third quarter, the recovery of agricultural exports added to the positive trend being experienced by the remaining exports since late 2015. Goods and services imports went down 5.4% quarter-on-quarter seasonally-adjusted in the second quarter due to the impact of recession and the rise of the exchange rate. It is worth mentioning that this drop was more marked from July to September.

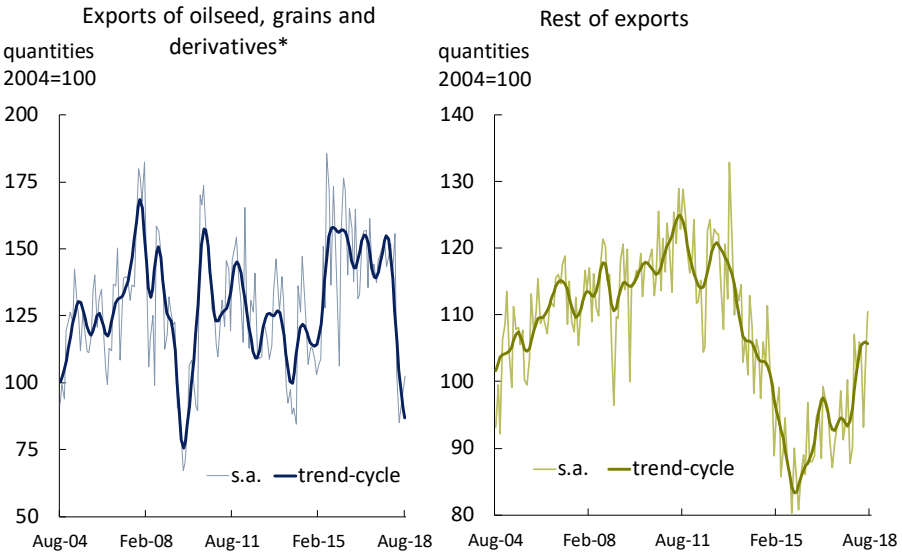
The export volumes of grains, oilseeds and their by-products plummeted from April to June 2018 (-37.7% seasonally-adjusted)[12], evidencing a higher contraction than that of the second quarter of 2009 (-28.5% seasonally-adjusted). In turn, during the third quarter, volumes went up 6.4% seasonally-adjusted against the second quarter and they are expected to increase even more during the last quarter of the year, thus recovering their previous levels on a gradual basis.

In the third quarter, the remaining exports (excluding the grains and oilseeds sector) kept their positive trend starting in December 2015, after a slight drop in the second quarter (-4.6% seasonally-adjusted). Data about July and August show that the volumes sold of these goods altogether went up 6.9% seasonally-adjusted against the second quarter, standing 12.6% above the values of the same month of 2017 (see Figure 3.7). This year-on-year evolution mainly resulted from the external sales of land transport materials (7.6 p.p.), especially to Brazil, and from the shipments of crude oil (1.3 p.p.) and meat (2.6 p.p.). The recovery process of foreign markets for the meat industry is in progress: from January to August, beef exports reached the highest level since 2009[13].

[12] Based on the monthly indexes of volumes (2004=100) prepared by INDEC.

[13] According to the Argentine Chamber of Industry and Commerce of Meat and By-Products (CICCRA), beef exports in tons of beef on bones increased 72.6% y.o.y. in the first nine months of 2018..

Figure 3.7 | Exports of goods

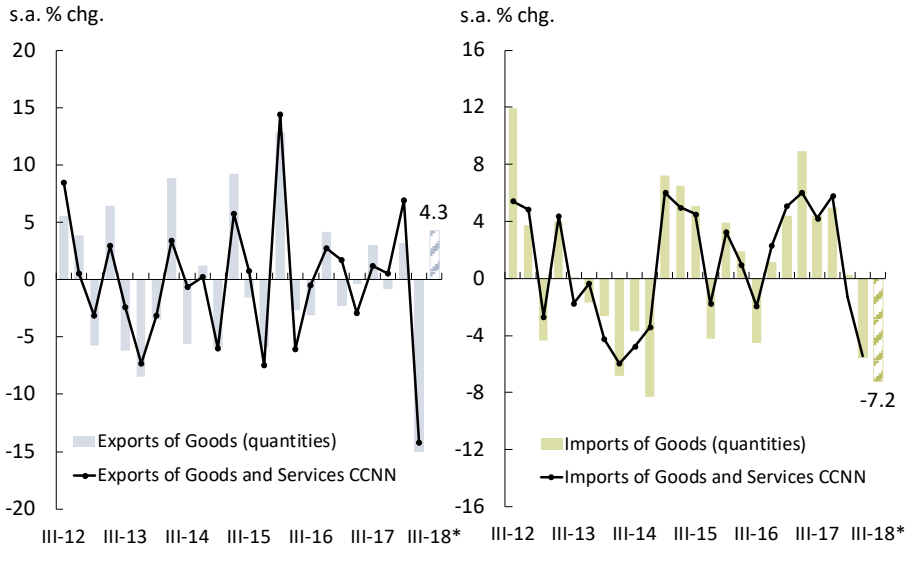


*Includes cereals, oilseeds, fats, oils and food industry wastes.
Source: INDEC

As a result, the data available for the July-August period confirmed the expected trends: export volumes of goods went up 4.3% seasonally-adjusted against the previous quarter, and import volumes went down 7.2% seasonally-adjusted with drops in all uses. In this sense, the contraction of purchases related to investment stood out. On the services front, a similar evolution is expected with a recovery of inbound tourism and a marked drop of outbound tourism. Particularly in August, the number of foreign tourists who entered the country by plane went up 7.4% y.o.y. while the number of Argentine tourists who left the country by plane contracted 11.9% y.o.y.

For the third quarter, the BCRA anticipates that total exports and imports of goods will keep a trend similar to that observed until August (See Figure 3.8). As a result, net exports will contribute positively to the quarterly growth of GDP in the third quarter (around 3 p.p.).

Figure 3.8 | Exports and imports of goods and services



Source: INDEC

*Data up to august

Box. The current account deficit is expected to decrease

In the previous four quarters up to the second quarter of 2018, Argentina accumulated a current account deficit equivalent to 5.6% of GDP. As mentioned in the IPOM of April 2018, this deficit mainly resulted from the negative gap between saving and investment of the public sector. Due to the lack of a deep domestic capital market, the strategy adopted by the National Government for the gradual reduction of the fiscal deficit implied high foreign financing needs. Consequently, the dependence on saving from the rest of the world was one of the main vulnerabilities of the economy.

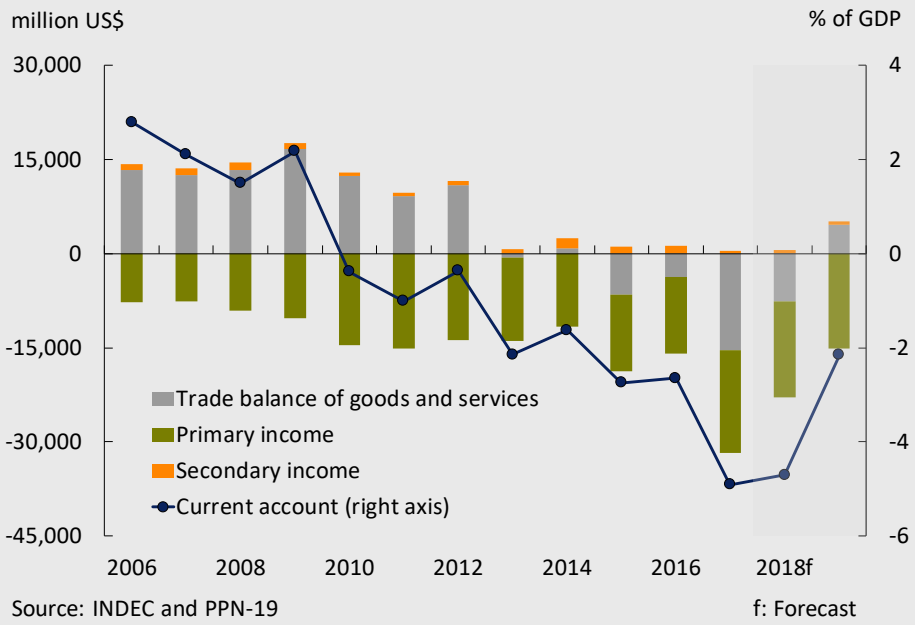
The risk of lack of liquidity associated with this strategy held true after a series of external and domestic shocks affecting the domestic economy and leading to a change in the market sentiment that translated into a sharp depreciation of the Argentine peso and a reduction of domestic assets demand (by both residents and nonresidents). Consequently, the multilateral real exchange rate went up 38% so far this year, standing at levels similar to those of the second half of 2010. The economic activity was impacted by the abrupt change in relative prices and entered into a recessive phase as from the second quarter of 2018.

The real depreciation of the Argentine peso and the lower domestic absorption are expected to contribute to a significant adjustment of the external imbalance as from the third quarter of 2018. Imports are expected to be impacted by the negative "income effect" related to the lower economic activity level. Empirical evidence signals that a significant change in relative prices causes a "substitution effect" on spending patterns in favor of domestic goods[14] and limits the purchase of foreign goods. The outlook on the way the present current account deficit will reduce still exhibits the features of the typical adjustments that the Argentine economy has historically experienced: a preponderance of the "income effect" over the "substitution effect". In the future and as the floating exchange rate regime consolidates, external adjustments are expected to be smoother (see Exhibit 1 /Floating Exchange Rate and Current Account Volatility – IPOM – October 2017).

In fact, the first signals that the economy is on track towards a reduction of its current account deficit are already evident. In June, both the imported volumes of goods and the travels abroad by plane of resident tourists fell 11% y.o.y. and 3% y.o.y., respectively, thus putting an end to a 15-month period of uninterrupted growth. In the third quarter, both variables dropped once again. The extended stress in financial markets and the deterioration of the economic growth outlook will result in an acceleration of the external adjustment relative to the pace anticipated in the previous IPOM (see Figure 3.9).

[14] See Gervais, O. et al. (2016): "Current account dynamics, real exchange rate adjustment, and the exchange rate regime in emerging-market economies"

Figure 3.9 | Current account



Source: INDEC and PPN-19 f: Forecast

In turn, as mentioned in the previous IPOM, the harvest for the next cycle is expected to be among the highest on record, which would result in a marked increase of agricultural exports in 2019 (in particular from the soybean sector) against the low comparison basis of 2018. Likewise, the new fiscal consolidation path, more stringent than the previous one, will contribute to a faster closing of the saving-investment gap of the public sector which–as previously mentioned– is one of the main determining factors of the current account deficit (See Exhibit 2 /Fiscal Consolidation and Current Account Result. IPOM July 2018).

The combination of the "substitution effect" (foreign goods are replaced with domestic goods) and the "income effect" (caused by recession in the short-term), added to higher agricultural exportable stocks, would allow for a reversal of the balance of trade for goods (from a deficit in 2018 to a projected surplus in 2019) and for a significant reduction of the services deficit. All of the above would allow Argentina to moderate considerably its current account deficit in 2019 and to reduce one of its main vulnerabilities.

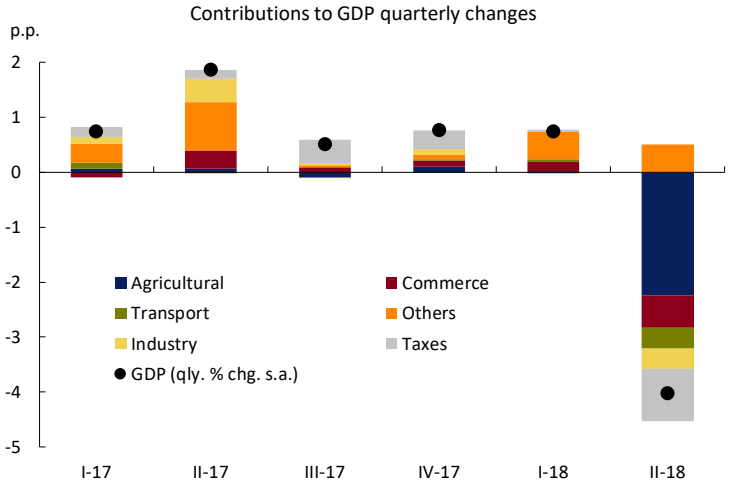
3.1.3. There was an across-the-board decline of the economic activity at sector level

During the second quarter, the abovementioned drop of domestic demand and the negative impact of the drought were the main reasons behind the sharp contraction of GDP across-the-board: in 14 out of the 20 sectors, activity fell against the first quarter. The contraction of total GDP[15] resulted from the combination of the agricultural sector performance in the adverse scenario described in the previous IPOM and a contraction of the remaining sectors in line with the estimated baseline scenario (-3.7% seasonally-adjusted vs. -3.5% in the scenario; see Table 3.1, IPOM–July 2018). The GDP measured at market prices recorded a quarterly decline of 4%. This difference mainly results from a remarkable drop in tax collection (-5.7% seasonally-adjusted), which is generally more volatile than GDP at basic prices and, therefore, tends to deepen the changes observed in the measurement at market prices.

[15] Measured at basic prices.

Figure 3.10 | Growth by sector

	II-18	
	q.o.q. % chg. s.a.	contribution to GDP q.o.q %chg. (p.p.)
GDP at market prices	-4.0	-4.0
Taxes	-5.7	-1.0
GDP at basic prices	-3.7	-3.1
Agricultural sector	-31.8	-2.2
Transport	-4.7	-0.4
Commerce	-4.5	-0.5
Industry	-2.2	-0.4
Construction	-1.2	0.0
Rest	1.5	0.5



Source: INDEC

The Gross Value Added (GVA) of goods-producing sectors –excluding the farming sector– evidenced a 1.7% drop seasonally-adjusted, essentially due to the contraction of the industry. In turn, services lost ground in a similar percentage (-1.8%) as a result of the strong deterioration of transport and trade, which were affected not only by the drop of domestic demand but also by the reduction of the agricultural activity. The remaining services, which are less linked to the business cycle, continued to go up even though at a slower pace if compared to that of the first quarter.

During the second quarter, the fall of the agricultural output was consistent with the adverse scenario anticipated in the previous IPOM (-31.8% quarter-on-quarter seasonally-adjusted vs. -30% in the scenario) and impacted directly on the change of total GDP (-2.2 p.p.) (see Figure 3.10).

In the third quarter, different indicators signaled a deepening in the contraction of the non-agricultural sectors. The direct and indirect impact of the agricultural output recovery would partially offset the contraction of the remaining sectors.

A sharper fall of domestic demand during the third quarter had a widespread effect on the different sectors of GDP. With data as of August, the Monthly Industrial Indicator (EMI) prepared by INDEC contracted 1.6% seasonally-adjusted against the previous quarter, the Industrial Production Index (IPI), prepared by O.J. Ferreres, went down 1% seasonally-adjusted, while the FIEL index dropped 3% seasonally-adjusted. On the other hand, the construction sector was impacted by the deterioration of financial conditions and the deceleration of public works; consequently, its contraction deepened from a -1.2% seasonally-adjusted fall in the second quarter to -2.3% seasonally-adjusted in the third quarter[16]. In turn, the services linked to the business cycle, such as transport and trade, fell at a pace slower than that of the non-agricultural output from July to September. The effect of the basis for comparison with the second quarter (negatively affected by the drought) partially offset the decline recorded in these services.

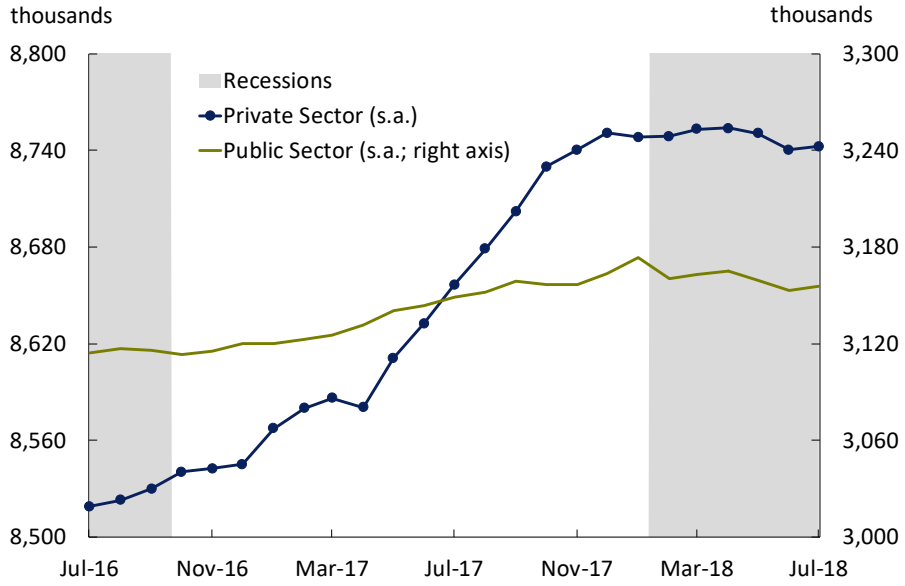
Once the short-term contractionary effects of the domestic currency depreciation are left behind, a higher real exchange rate is expected to boost the activity of tradable sectors (export sectors and import substitution sectors) due to the improvement in their relative prices.

[16] July-August seasonally-adjusted change against the second quarter of the Summarized Construction Activity Indicator (ISAC) prepared by INDEC. The Construya Index contracted 5.6% seasonally-adjusted in the third quarter.

3.1.4. Labor market conditions mirrored the first impacts of the contractionary phase of the activity

In the second quarter of 2018, GDP drop resulted in a moderate contraction of formal employment, which interrupted the expansion cycle starting in 2016 (see Figure 3.11). Registered wage-earning jobs stagnated between December and March and then showed a slight contractionary trend.

Figure 3.11 | Formal employment



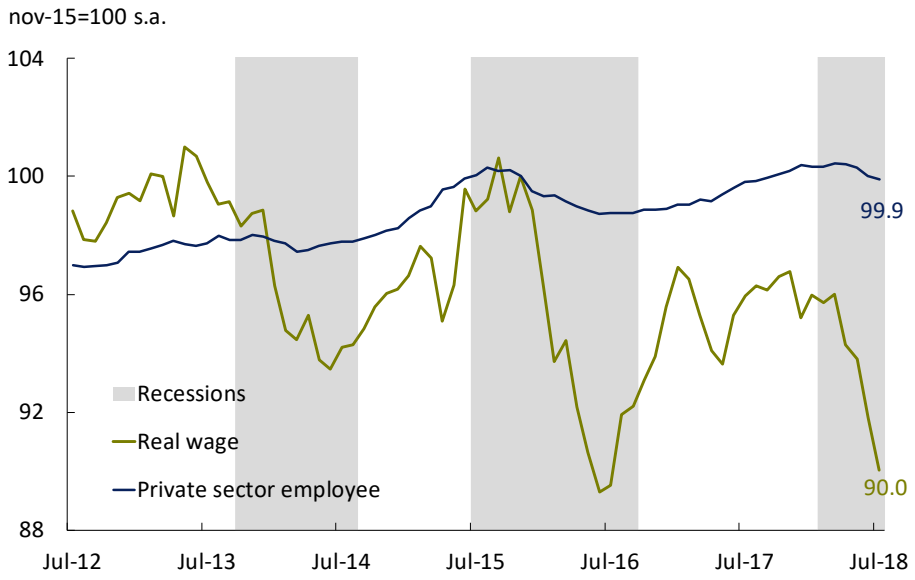
Source: Employment secretariat

This was a predictable evolution at the beginning of a contractionary phase. Like in other recessions, companies tend to opt for reducing the rate of new hires[17], for underusing the labor factor through suspensions and reduction of hours worked and/or for delaying the adjustment of nominal wages before making the decision to reduce staffing (see Figure 3.12). This behavior is even stronger in case of a flexible exchange rate since it allows for a higher adjustment of the real wage and a lower contraction of employment.

The procyclical nature of the real wage also contributes to minimizing job losses, thus mitigating the harmful effects created by unemployment for any economy in the long-term. In the current adverse scenario, the exchange rate flexibility facilitates the absorption of the shock mainly through prices rather than layoffs.

[17] Companies start by not replacing the employees that leave the company (due to resignation, retirement, contract termination, etc.).

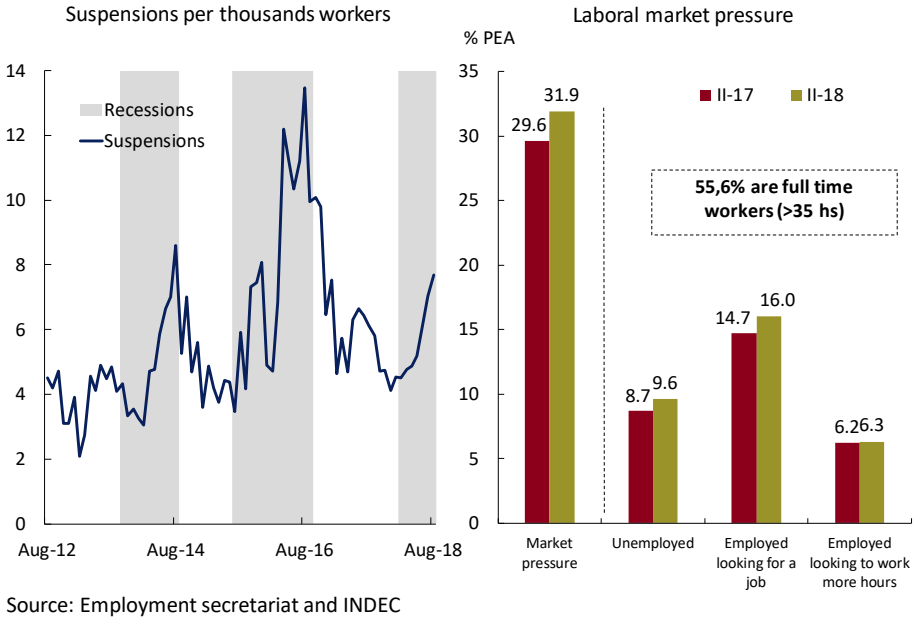
Figure 3.12 | Employment and real salary indicators



Source: Employment secretariat and INDEC

The increase of suspensions together with the reduction of working hours and the drop of the wage purchasing power gave rise to more pressures on the labor market: the number of persons who were not working but decided to seek a job, those who were employed or underemployed and seek another job and/or those who are willing to work more hours, rose in year-on-year terms (see Figure 3.13).

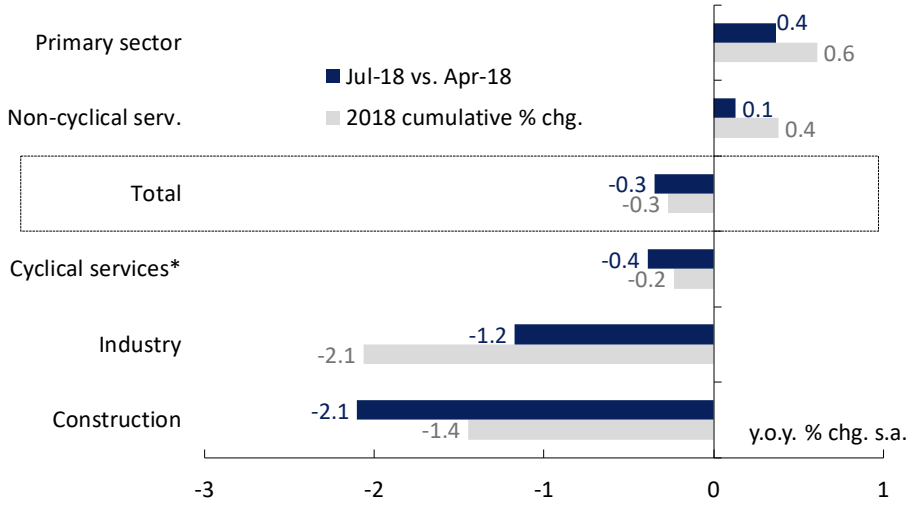
Figure 3.13 | Suspensions and laboral market pressure



Source: Employment secretariat and INDEC

On a sector-by-sector basis, employment was particularly affected in the following sectors: construction, industry and, to a lesser extent, services related to GDP cycle, such as transport, trade, hotels and restaurants. In turn, job positions in the primary sector remained stable despite the impact of the drought on the activity (see Figure 3.14).

Figure 3.14 | Formal salaried employment by sector



*Cyclical services: Commerce and repairs, Hotels and restaurants, Transport, storage and communications, Financial intermediation and real state.
Source: Employment secretariat

The total employment growth rate continued evidencing positive records in yearly terms: the employment rate increased 0.4 p.p. in the second quarter (standing at 41.9%). In turn, job creation pace was faster than population growth pace (2.2% y.o.y. and 1.1% y.o.y., respectively). Besides, the unemployment rate rose by 0.9% p.p. (to 9.6% of the labor force) due to the increase in the number of persons seeking a job (3.2% y.o.y.) who failed to get it.

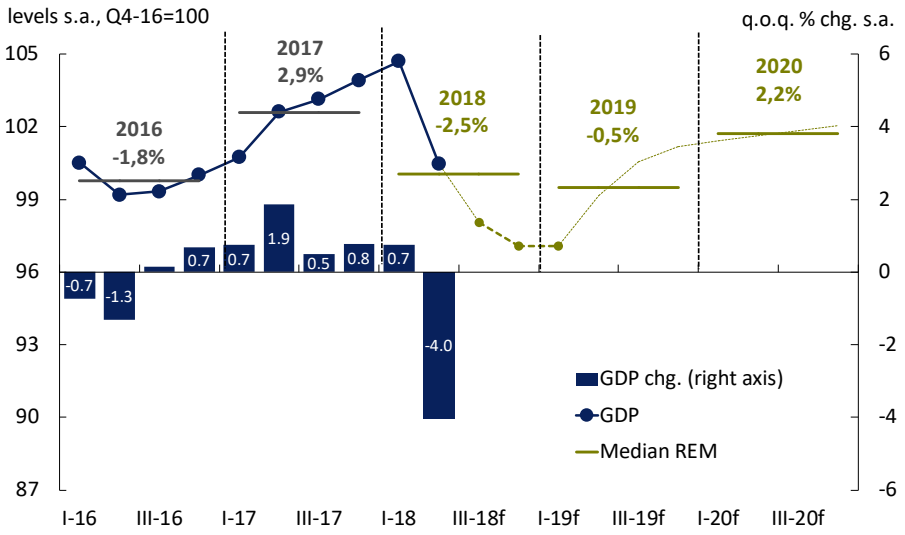
Perspectives for job creation in the next few months deteriorated in line with the contraction of the economic activity in the third quarter. Data from the Labor Indicators Survey (EIL), prepared by the Secretariat of Labor and Production, corresponding to August, showed a reduction in employment net expectations, standing at 0.2%[18] (1.4 p.p. against the previous month).

3.2 Prospects

The macroeconomic projections included in the 2019 National Budget Bill consider a 2.4% drop of GDP in 2018 and the beginning of a recovery process in 2019. This gradual recovery path of the economy is shared by market analysts surveyed by the REM, who anticipate changes of -2.5%, -0.5% and 2.2% for the 2018-2020 period (see Figure 3.15).

[18] The amount of respondents who expect a staffing reduction in the next three months virtually matched the number of businessmen who anticipate an increase.

Figure 3.15 | GDP scenarios



Note: q.o.q. % chg. of Q3-18 and from Q2-19 to Q4-20 are implicit in REM annual projections.
Source: INDEC and REM-BCRA of september 2018 f: Forecasted

These projections are consistent with the baseline scenario of the BCRA, which foresees the beginning of an expansionary phase in 2019 due to a better performance of the exporting sector and a normal operation of financial markets, thus contributing to the correction of the current account imbalance.

On the fiscal front, the broad set of measures announced by the Executive Branch in September aims at a sharp reduction of public accounts imbalance –with lower capital spending, cuts to subsidies in public utility rates and other expenses–, thus removing an uncertainty factor which will help reduce gradually the financing cost for the private sector. This will facilitate the rebalancing of growth sources towards a higher share of tradable goods and services producing sectors.

In turn, the energy sector will continue exhibiting a remarkable performance because its investment and expansion plans have not been affected by the changes in market conditions. The estimated increase in the production of gas and oil for the next years will allow to reduce the external deficit (see Exhibit 1. Progress in the Energy Sector). For 2019, according to the 2019 National Budget Bill, there will be investments for over 16 billion pesos through the PPP system. The purpose of these projects is to extend and improve the efficiency of the energy matrix[19].

The outlook of the agricultural production is also highly promising. Soybean and corn harvests are expected to reach, at least, the levels of the 2016/2017 cycle, and this implies rises of around 45% and 24% y.o.y., respectively. Moreover, the production of beef meat is also expected to continue growing[20].

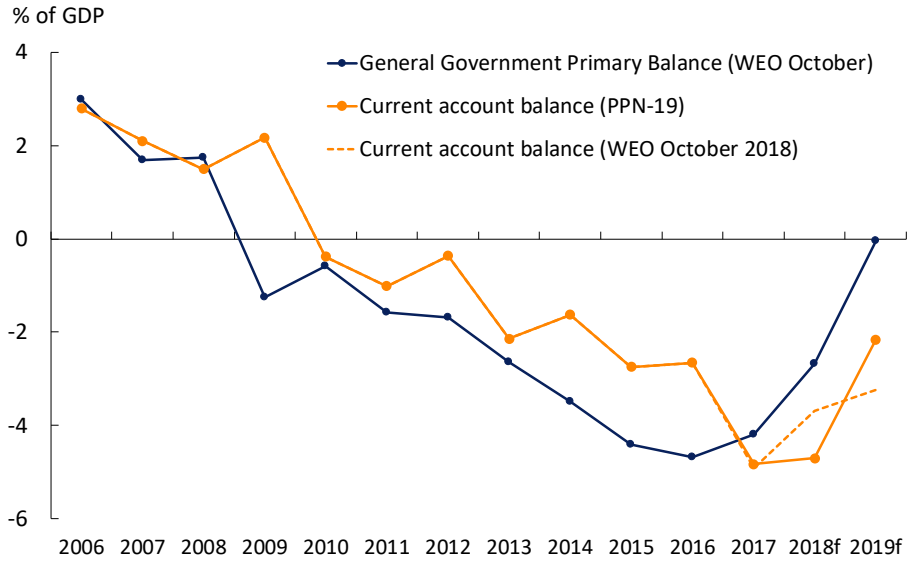
Exports in general will be a strong pulling force for the economic activity since, with more favorable relative prices, the main trading partners of Argentina are expected to have the highest growth rate of the last 8 years in 2019 (see Chapter 2. International Context). Nevertheless, there is still volatility with reference to the performance of the international financial markets.

[19] In the gas sector, projects are focused on increasing transport and distribution. In the case of electricity, investments are focused on enlarging power generation units as well as on transport and distribution.

[20] Between August 2016 and August 2018, the production of beef meat accumulated a 17.2% rise, driven by exports (EMI data from INDEC).

Within this context, the current account forecasts –from both the 2019 National Budget Bill and the IMF– estimate a sharp reduction of the external deficit that will allow for removing a systematic source of vulnerability and for improving growth sustainability over time (see Figure 3.16).

Figure 3.16 | Current account and fiscal balance



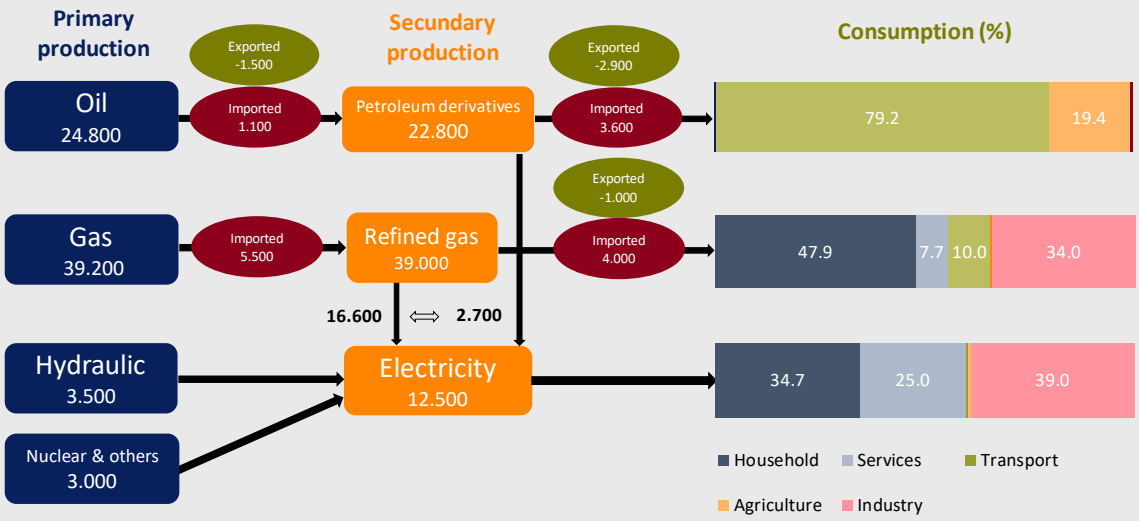
Source: IMF World economic outlook (October 2018) and PPN-2019 f: Forecasted

Exhibit 1 / Progress in the Energy Sector

The Argentine energy matrix is heavily dependent on gas. The production of refined gas —which accounts for nearly half the secondary production of energy— is not sufficient to meet the needs of an increasing demand; this means that 25% of the gas consumed annually needs to be imported.

Almost two thirds of such imports come from the Bolivian state-owned company[21] but when consumption reaches its maximum peaks in winter, Argentina needs to resort to more expensive supply sources, such as the purchases of liquefied natural gas (LNG). The vessels with LNG coming from Qatar, Trinidad and Tobago, Nigeria or Australia arrive at the regasification plants located in the ports of Escobar and Bahía Blanca, and inject more gas to the network[22]. Furthermore, due to the lack of gas from April to September, power plants use liquid fuels (more expensive and less efficient), such as diesel oil and fuel oil, which are purchased abroad. In terms of demand for natural gas, these power plants come first, followed by household and industrial consumption (see Figure 1).

Figure 1 | Simplified energy balance. In tons of oil equivalent



Source: 2017 Energy balance, Secretariat of Energy

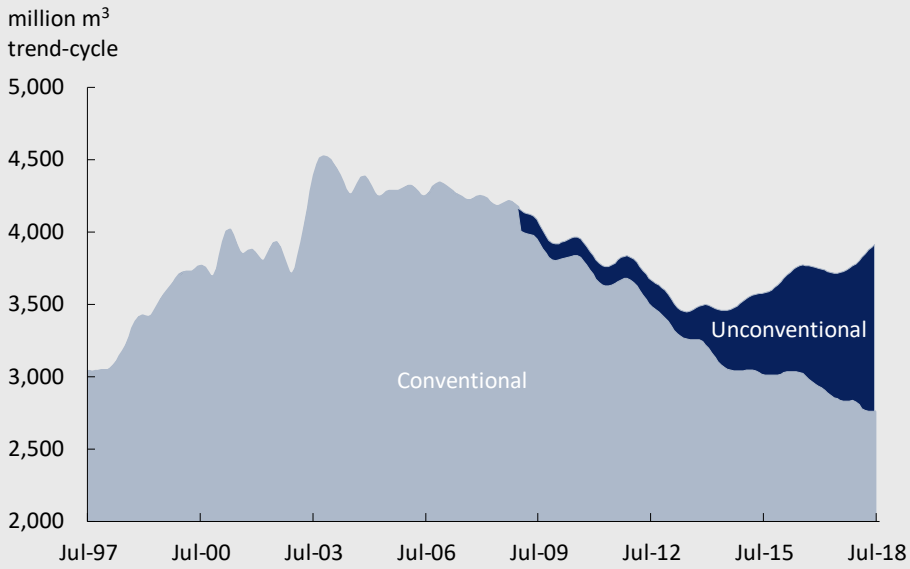
The energy policy adopted during the 2003-2015 period played a key role in the erosion of the surplus of both external and fiscal accounts (Navajas, 2015[23]). Over time, the widespread subsidies to energy resulted in an increasing share in government spending, while relative price distortions became an incentive for demand and a discouragement for supply; the consequence of this combination was an increase in energy imports to cover the consumption gap.

[21] Argentina is the second largest market for Bolivian gas, after the Brazilian market. According to the current contract with the state-owned company Yacimientos Petrolíferos Fiscales Bolivianos (YPFB), Bolivia has to send a minimum volume of 20.9 million m³ per day in winter (from May to October) and 17.2 million m³ per day in summer.
[22] This year, the National Government will not renew the contract with the regasification vessel moored in the Port of Bahía Blanca, in operation since 2008. The price that the state-owned company IEASA (Integración Energética Argentina, resulting from the merge between ENARSA and Emprendimientos Energéticos Binacionales S.A.) pays for the imported LNG is variable and depends on each specific bidding process. Including costs of transport, at present, around US$ 7 are paid per MBTU.
[23] *"Subsidios a la energía, devaluación y precios"*, by Fernando Navajas, Working Paper No. 122, FIEL

In the gas sector, the decreasing trend of our domestic production as from 2008 led to an ongoing deterioration of the sector's trade balance which, in 2014, resulted in a deficit equivalent to 1.1% of GDP (see Figure 4). In turn, this impacted on public accounts, due to higher energy imports by domestic companies and increasing subsidies to demand[24].

This declining trend in the production of gas started to reverse progressively as from 2014 through the adoption of several stimulus plans meant for investment[25]. Thus, from the minimum levels observed in 2014 to the levels of July 2018, total gas production increased 19.5%. This remarkable momentum was mainly accounted for by the extraction of unconventional gas[26], and now total production is standing at levels similar to those of 2009, even though still below the historical maximum figures (see Figure 2).

Figure 2 | Natural gas production

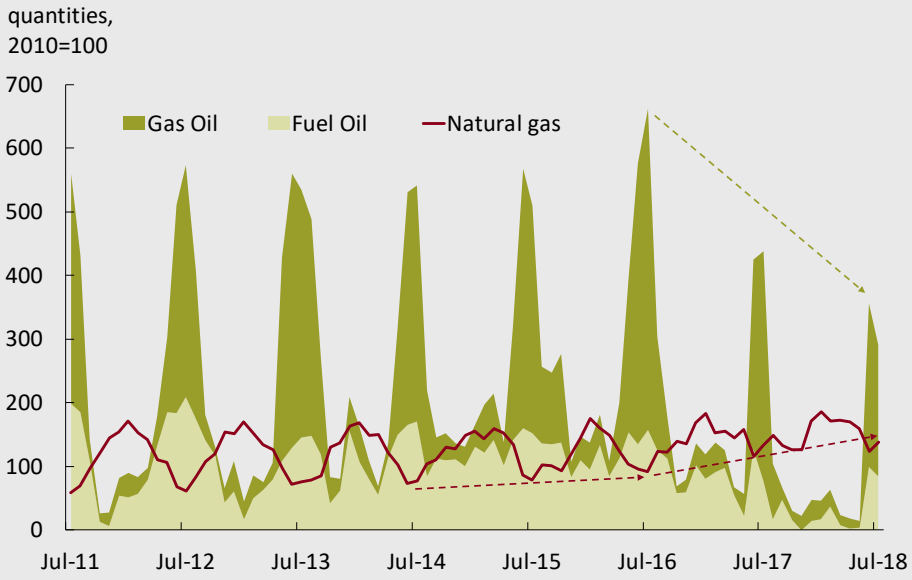


Source: Secretariat of Energy

As a result of the rebound of the gas domestic production in the 2015-2017 period, 8% of the imported volumes was replaced with local production[27], while the external purchases of liquid fuels for power generation in winter reduced considerably. According to data provided by CAMMESA, the availability of gas in thermal power plants in June and July went up 32.2% y.o.y. in 2017 and 5.1% y.o.y. in 2018, thus reducing imports of diesel oil (which has been mostly imported) by 50% in the last two years (see Figure 3).

[24] Made by IEASA and Compañía Administradora del Mercado Mayorista Eléctrico (CAMMESA) for power plants.
[25] By means of the Stimulus Program for Natural Gas Injection Surplus (Resolution 1/2013), the National Government ensured a price of US$7.5/MBTU for any type of gas —conventional, tight, shale and off-shore—injected to the domestic market on top of the baseline injection of each company. As from 2017, the Program applies only to unconventional investment projects, and the method to book the subsidized production and the penalties in case of non-fulfillment were changed (Resolution E 46/2017). Thus, a minimum price of US$7.50/MBTU in 2018, US$ 7.00/MBTU in 2019, US$6.50/MBTU in 2020 and US$6.00/MBTU in 2021 has been ensured.
[26] Unconventional gas production currently accounts for around 25% of total production.
[27] Imports of energy are computed in tonnes of oil equivalent (TOE) in order to standardize units (Source: *Balances Energéticos* 2014 and 2017).

Figure 3 | Final consumption for power generation



Source: CAMMESA

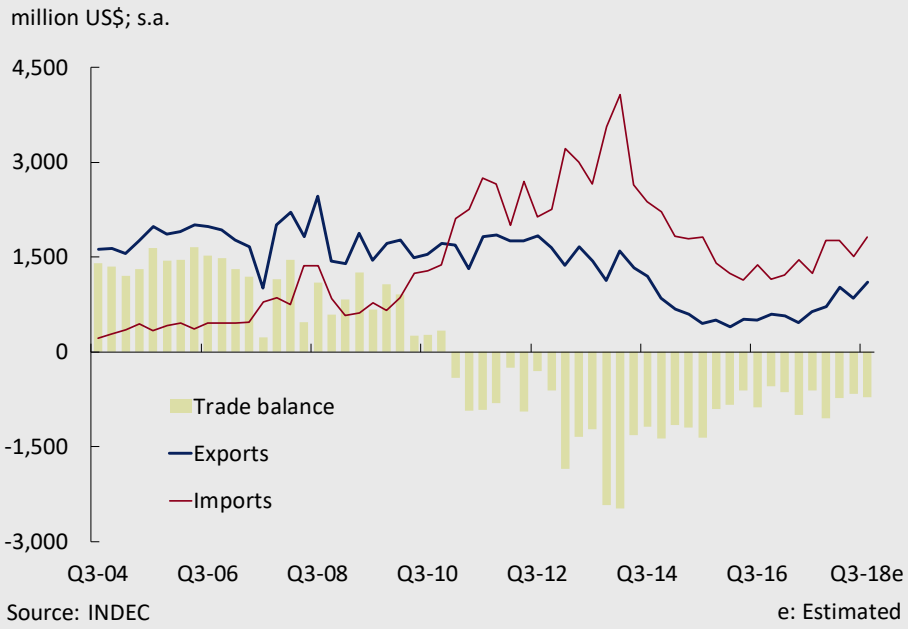
In order to expand gas production and replace LNG imports during the peaks of domestic consumption in winter and given its scarce storage capacity, producers need an increase of external demand in the months when consumption falls in Argentina. To this effect, gas exports to Chile[28], which were suspended in 2004, and electricity exports to Brazil[29] started once again.

The potential of Vaca Muerta —the second largest reservoir of unconventional gas worldwide— anticipates an optimistic outlook for the energy sector in the medium term while, in the short term, the potential increase in total gas production relies on unconventional extraction, considering the number of horizontal wells already in a production stage and their high yield. Thus, in 2020, the production of conventional and unconventional gas is estimated to stand, at least, close to the maximum levels of the historical series, and this means an annual growth rate of 5%[30].

With these perspectives in terms of the domestic production of gas, the sector is likely to continue contributing to the equilibrium of our external accounts and then to start to generate a surplus in the medium term. Even though it still shows a negative sign, the trade balance of the energy sector has gone down since 2014 by an amount equivalent to 0.5 p.p. of GDP (see Figure 4).

[28] The National Government authorized Total Austral, Pan American Sur and Compañía General de Combustible to sell up to a total volume of 479.5 million m3 to the Chilean company Methanex until June 1, 2020 (Resolution 104/2018).
[29] CAMMESA started to sell electricity to the Brazilian entity ONS (600 MW).
[30] For further details, see the documents of the Ministry of Energy *"Escenarios Energéticos 2030"* at http://datos.minem.gob.ar/dataset/9e2a8087-1b49-446a-8e86-712b476122fb/resource/04dbee7f-0b6f-48d0-b460-8d7fa3b282c7/download/minem-documento-escenarios-energeticos-2030pub.pdf and "Argentina Energy Plan" https://www.argentina.gob.ar/sites/default/files/plan_energetico.pdf

Figure 4 | Trade balance of fuel and energy



Apart from promoting the domestic production of gas, the energy policy faces important challenges such as expanding the transport and distribution networks, promoting a more efficient and sustainable use among each demanding group, and developing the enormous potential of renewal sources to generate electricity[31], with relative prices that may attract investments in the sector.

[31] In this sense, the Distributed Generation Act (27424) was enacted in December 2017 and allows households and businesses to generate their own energy from renewable sources and then inject it to the network.

4. Prices

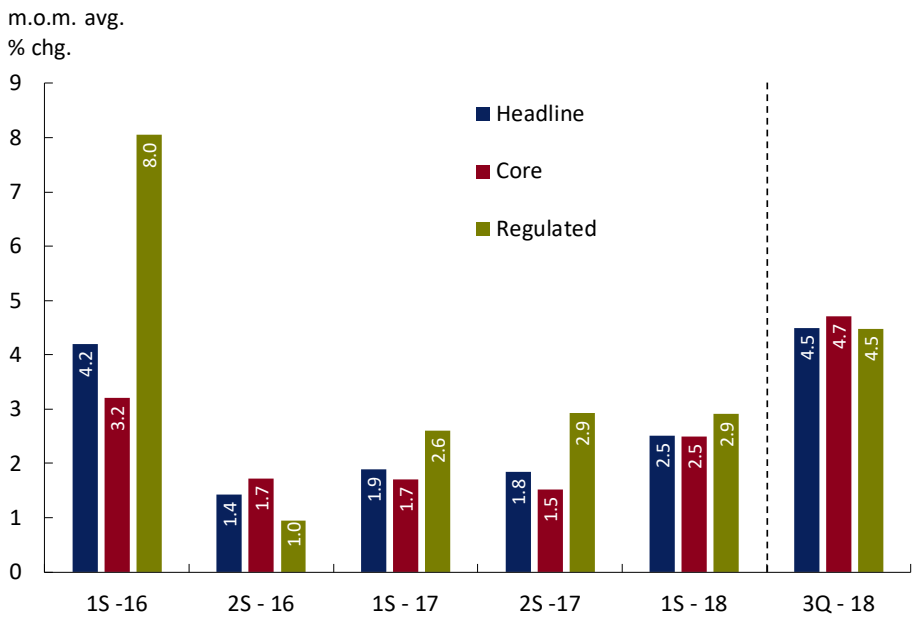
The inflation rate accelerated during the third quarter of 2018, reaching a monthly average of 4.5%. Headline inflation mainly mirrored the rise of core inflation, which went up against previous months, driven by a new episode of depreciation of the Argentine peso. This resulted from the deterioration of the global financing conditions for emerging economies which, in the case of Argentina, was more marked due to domestic vulnerabilities. This new episode posed the risk of a larger disanchoring of inflation expectations. To address this situation, the Central Bank of Argentina (BCRA) adopted a new monetary policy regime based on the strict control of the monetary base. The new regime aims at recovering the nominal anchor for inflation expectations.

Inflation would continue to be high in the short term due to the pass-through to prices of the nominal exchange rate increase observed in recent months and to pending adjustments of relative prices in some public utilities. For the rest of the year, the Market Expectations Survey (REM) anticipates an inflation deceleration of up to 3% per month in December 2018. With the new monetary policy regime, market analysts' expectations anticipate a moderation of inflation in 2019 and 2020.

4.1 Prices accelerated once again driven by the depreciation of the Argentine peso

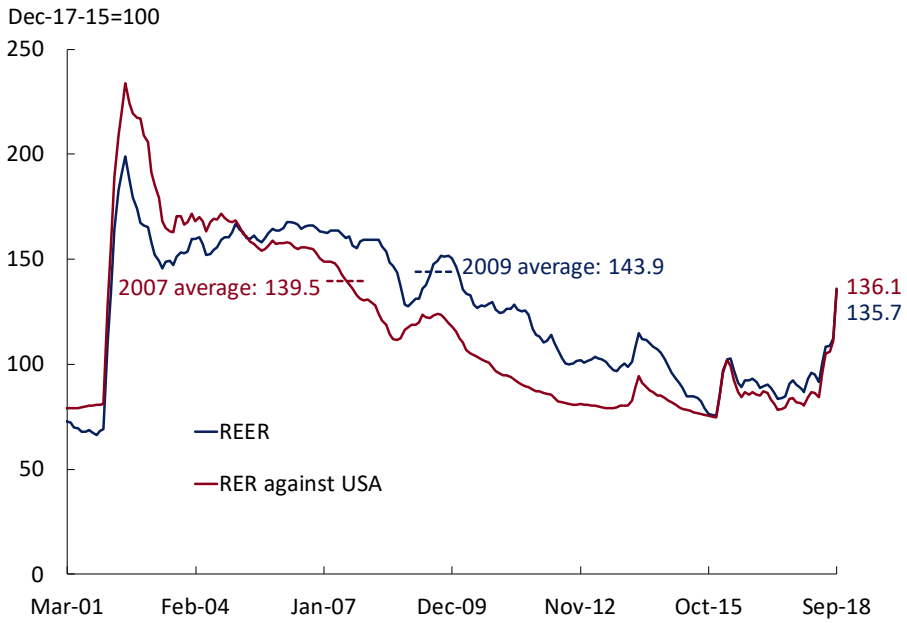
During the third quarter of the year, the inflation rate accelerated and reached a monthly average of 4.5% (see Figure 4.1). Prices went up 32.4% from January to September and are standing 40.5% above the levels recorded one year ago. The depreciation of the Argentine peso was the main reason behind the acceleration of prices.

Figure 4.1 | CPI. Headline and Core



Note: CPI of national coverage from Dec-16, linked with the CPI of Greater Buenos Aires and the CPI of the City of Buenos Aires.
Source: Statistical office of the City of Buenos Aires and INDEC

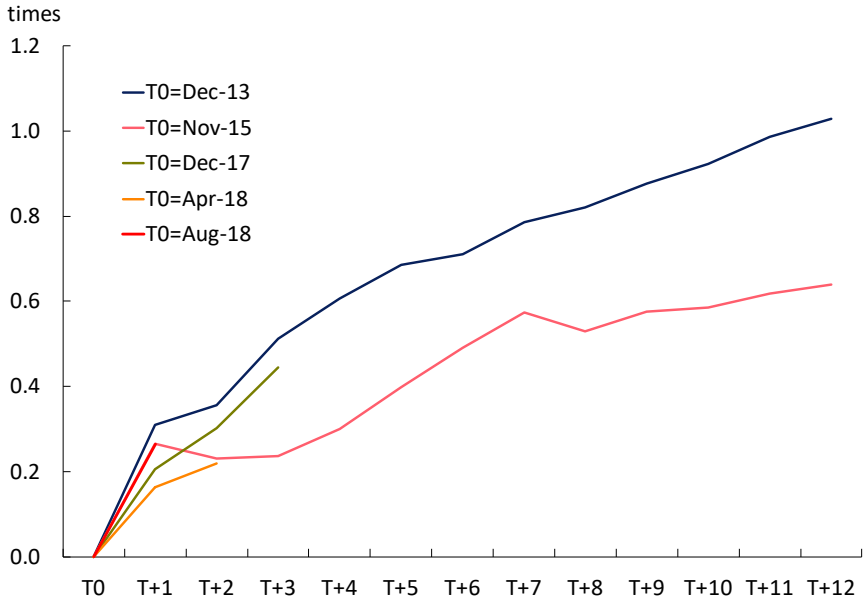
Figure 4.2 | Real exchange rate



Source: BCRA

In 2018, there were two significant episodes of domestic currency depreciation. The accumulated effect of both shocks led to an exchange rate rise considerably higher than the increase of inflation, thus paving the way for a depreciation of the real exchange rate to similar levels than those observed in 2007 (see Figure 4.2). In the first episode, the bilateral nominal exchange rate with the US dollar went up 35% at a gradual pace between mid-April and mid-June. In turn, the second episode involved a steep rise of the exchange rate by the end of August (a depreciation of around 30%). Even though these increases are similar in terms of magnitude, they impacted differently on prices (see Figure 4.3). The second episode deepened uncertainty, gave rise to a greater price correction and posed the risk of a broader disanchoring of inflation expectations. In order to reduce uncertainty and recover the anchor on expectations, the BCRA changed its monetary policy regime. The new scheme has defined a zero growth target of the monetary base up to mid-2019 (see Chapter 5. Monetary Policy).

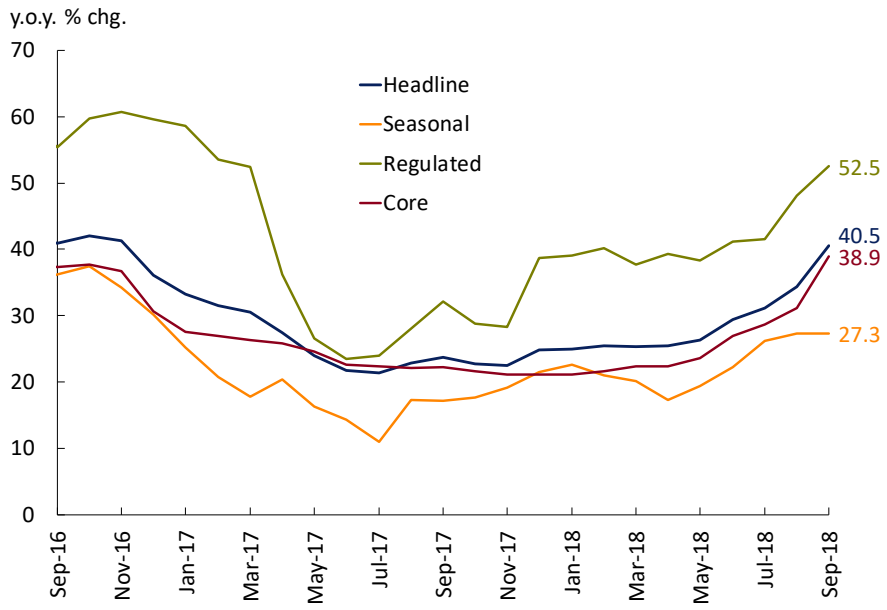
Figure 4.3 | Nominal exchange rate and core inflation



Note: Ratio between the accumulated variation of the core CPI and the accumulated variation of the nominal exchange rate.
Source: BCRA and INDEC

Core inflation kept going up and it was the inflation component that impacted the most on headline inflation. Thus, in the third quarter of 2018, this inflation reading (that excludes regulated and seasonally-adjusted prices) averaged monthly rises of 4.7%, standing 1.8 p.p. above the average rate of the previous period. In September, this component recorded a change rate of 7.6% (the highest since April 2002), thus accumulating a 33.1% increase so far this year and a 38.9% rise in year-on-year terms (see Figure 4.4).

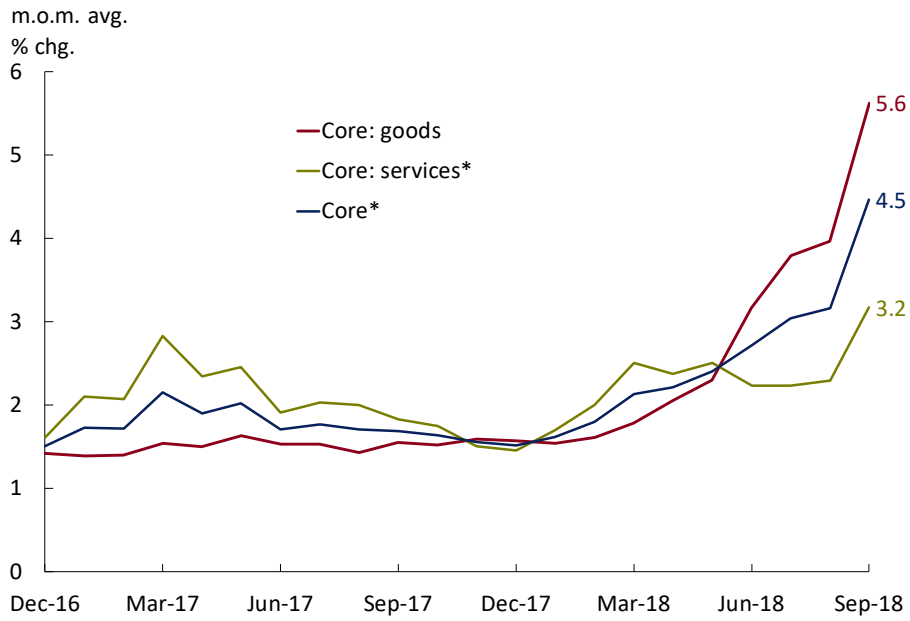
Figure 4.4 | Interannual inflation



Note: CPI of national coverage linked with the CPI of Greater Buenos Aires and the CPI-NW calculated by the BCRA.
Source: INDEC and Statistical Offices of the City of Buenos Aires, San Luis and Córdoba

The goods included in core inflation, particularly food, were the main factors behind inflation acceleration in the last two quarters (see Figure 4.5). Given their tradable nature, these products are more sensitive to currency depreciation. In turn, private services recorded more limited price increases during the period. Moreover, the rises of public utility prices impacted indirectly on both goods and services.

Figure 4.5 | Core inflation. Desagreggated by goods and services (3m mobile average)



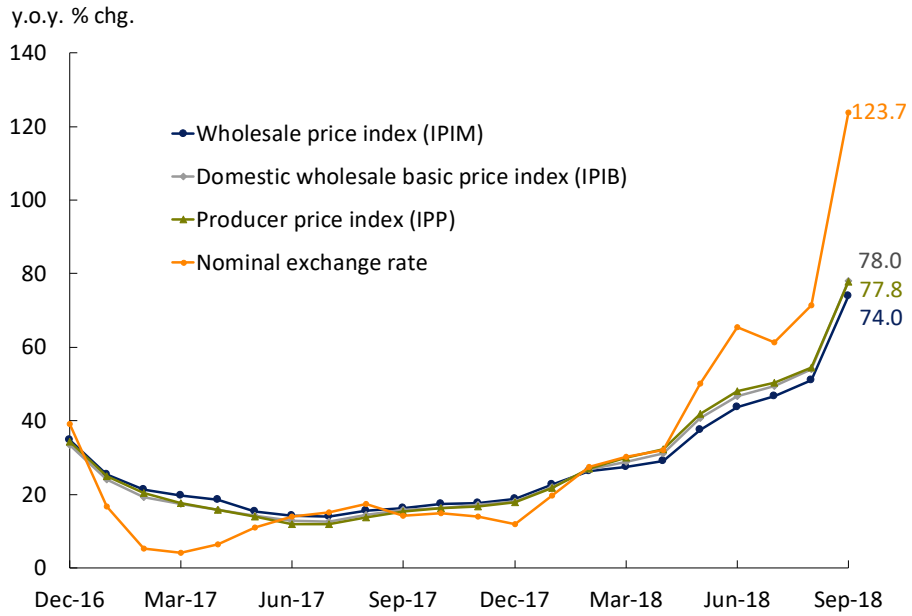
* Excludes Education and Health insurance (Classification used by INDEC).
Source: Statistical office of the City of Buenos Aires

Regulated goods and services also contributed to inflation acceleration. In the third quarter, they went up at a pace similar to that of core inflation, even though they recorded higher increases in year-to-date terms. Likewise, fuels for automobiles, public transport and electricity recorded the most significant price increases. Gasoline, the price of which has been deregulated, evidenced an increase that exceeded the inflation rate. Fuel prices were impacted by the depreciation of the peso and the rise arranged in internal taxes. By mid-August, a new 3-month staggered price increase scheme for buses and trains in Greater Buenos Aires became effective. This scheme entails a total increase of 35% and supplements the rises of the first half of the year. Thus, so far this year, buses and trains recorded a hike in the price of their tickets (92% and 74%, respectively). Regarding electricity, the new rates corresponding to the six-month update of this utility became effective in August. In year-on-year terms, regulated goods and services grew around 51.7% y.o.y.

In turn, wholesale prices recorded higher increases than consumer prices and averaged a monthly rise of 8.4% in the third quarter (+3.2 p.p. above the monthly average increase of the second quarter of 2018). This performance results from the high contemporaneous correlation between wholesale prices (the basket is almost exclusively made up by goods) and the Nominal Exchange Rate. Wholesale indexes and the goods included in the consumer basket were impacted more adversely by the peso depreciation due to their tradable nature[32] (see Figure 4.6).

[32] It is worth stating that the wholesale basket has a lower component of services than the retail goods basket. As a result, the former is expected to increase more than the latter in case of an exchange rate shock.

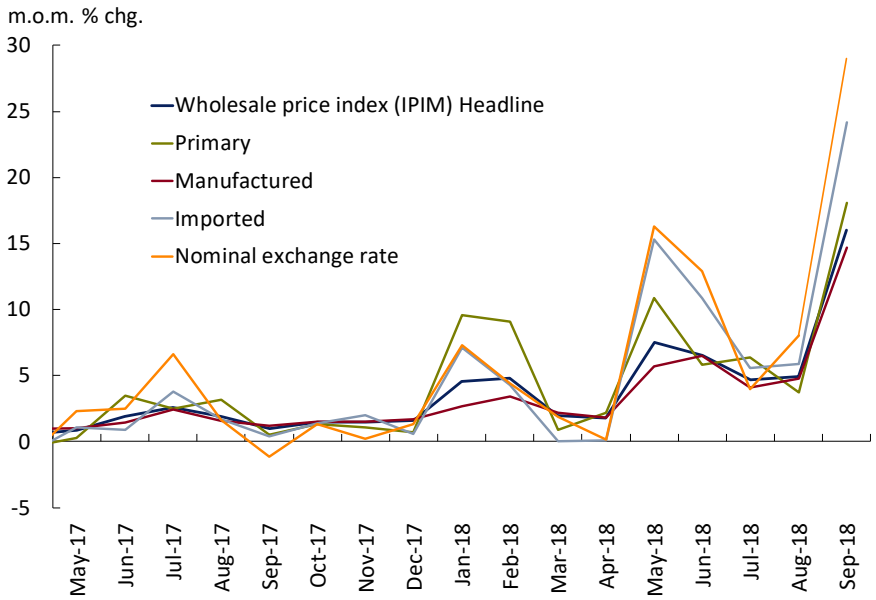
Figure 4.6 | Wholesale prices and nominal exchange rate



Source: INDEC and Com. "A" 3500 - BCRA

The acceleration of the Domestic Wholesale Price Index (IPIM) during the third quarter of 2018 was mainly due to the evolution of manufactured product prices (see Figure 4.7). The price hikes of Chemical Substances and Products, Refined Petroleum Products, Food and Beverages, Motor Vehicles and Machinery and Equipment had the strongest impact on the price rises of manufactures. Besides, there were new increases in Agricultural Products in pesos, on which the depreciation of the domestic currency played a key role. The crude oil and gas component also recorded high rises during the period, mainly due to the increase of crude oil price (at a monthly average rate of 2% in dollars), which was compounded by the depreciation of the domestic currency. Once again, imported products evidenced the highest increases in prices and were directly affected by the evolution of the exchange rate. Nevertheless, it is worth highlighting that this component has a more limited impact on the IPIM due to its low weight in the index. The monthly acceleration of wholesale prices during the second quarter of 2018 resulted in significant changes in the year-on-year rates, which went up to values close to 60% y.o.y. in the third quarter of 2018.

Figure 4.7 | Wholesale prices by components

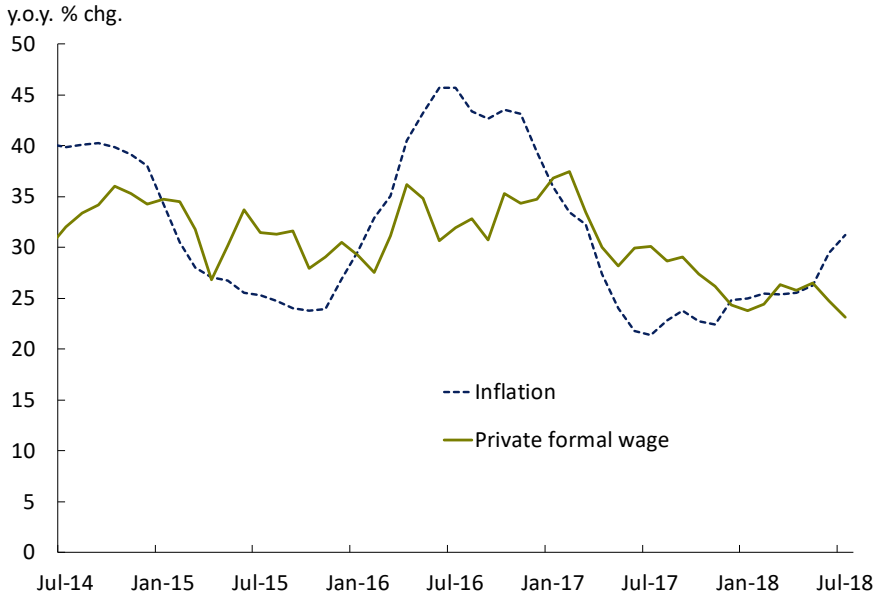


Source: INDEC and Com. "A" 3500 - BCRA

4.2 Wage guidelines continued evidencing limited changes

By mid-2018, the nominal wages of the registered private sector exhibited a change of around 25% against 2017, according to data from the Secretariat of Labor and Employment. Most collective bargaining agreements corresponding to 2018 mirrored a nominal wage increase of 25.6% y.o.y. in the second quarter, down 5 p.p. against the figures of the same period of 2017. For the third quarter of the year, wages would grow at a similar pace. An acceleration of the nominal increase of salaries is expected for the last part of the year due to the update of tranches, the wage adjustment clauses and the special increases to make up for price acceleration. Nevertheless, wages would end 2018 with a year-on-year change rate below that of retail prices (see Figure 4.8).

Figure 4.8 | Nominal wages



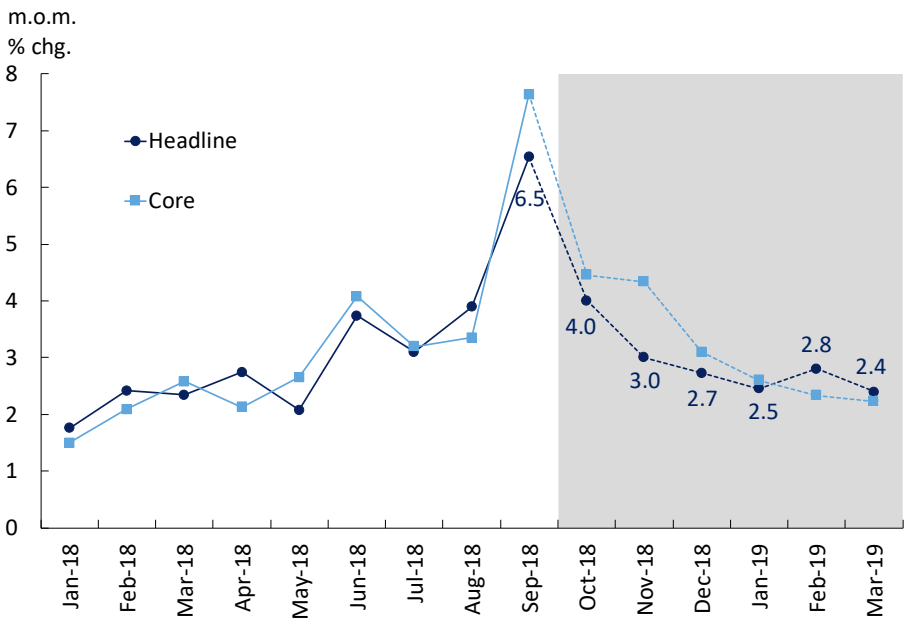
Source: Secretary of Labor (OEDE) and INDEC

Wage guidelines for 2019 would include a backdated adjustment for compensation purposes in the first quarter and would then be in line with the market's inflation expectations. Anyway, the wage negotiations of each sector will depend on their economic situation and outlook.

4.3 Markets analysts revised their inflation expectations upwards within a context of greater dispersion in the forecasts

The Market Expectations Survey (REM) anticipates a gradual deceleration of monthly inflation rates for the last quarter of 2018. According to the REM, consumer prices would go up at a rate close to 3% in December (see Figure 4.9). Given this evolution, 2018 would end with an inflation rate of 44.8% y.o.y., which entails a 14.8 p.p. upward revision against the information released in the previous Monetary Policy Report (IPOM).

Figure 4.9 | Monthly inflation expectations as for the REM analysts*



*Corresponds to the September report.
Note: The solid line corresponds to observed data published by the INDEC. The dotted line corresponds to REM's projections.
Source: REM-BCRA and INDEC

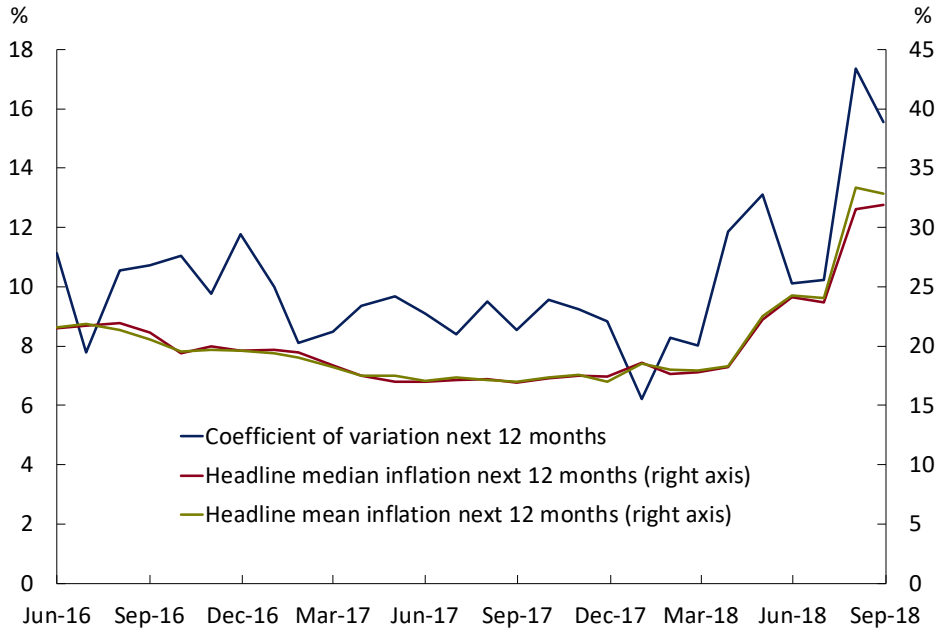
Within the context of the new monetary policy regime involving a quantitative target on the monetary base[33], the expectations of the market analysts captured in the REM anticipate a moderation of inflation in the short and medium terms.

In line with the REM, the BCRA also foresees a gradual reduction of inflation for the coming months. This is due to the fact that some factors would continue to add upward pressures to prices. On the one hand, there will still be an exchange rate pass-through to prices, particularly in tradable goods. On the other, relative prices will be subject to pending adjustments to be implemented in the short term.

[33] Monetary aggregate on which the BCRA has a direct control.

For the next 12 months, the average of REM analysts' projections anticipates a 32.9% price change, down 0.5 p.p. against the previous survey. As from January 2018, the higher inflation expected for the following 12 months has been particularly related to a greater uncertainty about the future evolution of inflation. The relative standard deviation[34] of the answers has exhibited an upward trend since January (signaling a potential disanchoring of expectations), even though a drop was observed in the latest reading (see Figure 4.10).

Figure 4.10 | Inflation expectations next 12 months

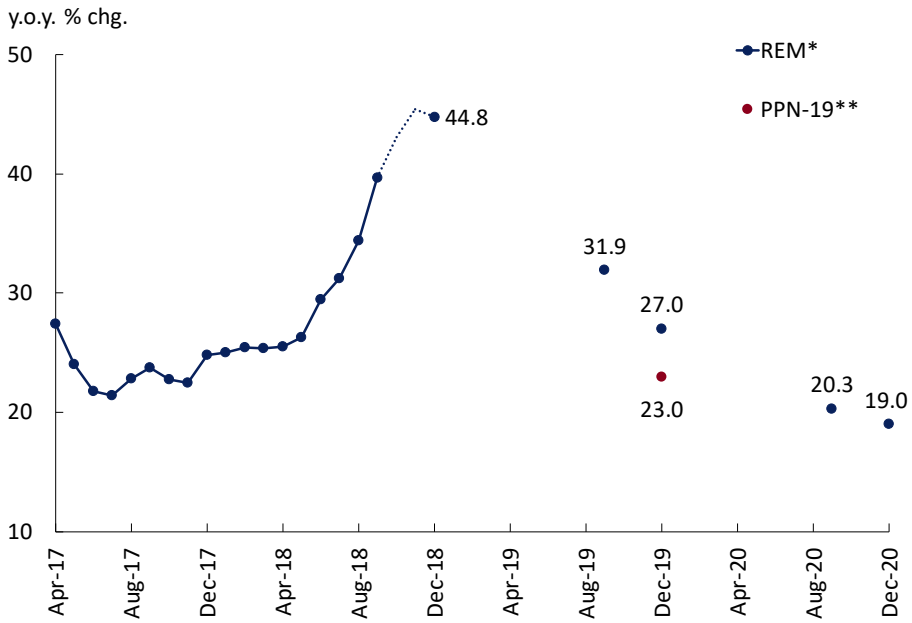


Source: REM-BCRA

The different inflation forecasts for the next two years have shown a deceleration. The market analysts' estimates, captured in the REM, anticipate a rise of 27% y.o.y. for 2019 and of 19% y.o.y. for 2020. In turn, the National Budget Bill considers a 23% price hike for late 2019. Finally, in the World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasted a 20.2% inflation rate for the same period.

[34] Calculated as the ratio of the standard deviation from to the mean of answers for each period.

Gráfico 4.11 | Inflation expectations next 12 months



*Corresponds to the September report.
** Detailed in the federal government budget draft 2019 (PPN-19).
Source: INDEC, National Budget Bureau (Ministry of the Treasury) and REM-BCRA

5. Monetary Policy

During August, some foreign exchange tensions occurred again as a result of a new combination of both external and domestic factors. Against this backdrop, the Central Bank of Argentina (BCRA) took several measures aimed at easing the pressures on the exchange market and their effects on inflation: increases of the benchmark interest rate, interventions in the foreign exchange market, increases of legal minimum reserve requirements, gradual reduction of the stock of LEBACs and elimination of temporary advances and transfer of profits to the Treasury.

However, vis-à-vis the evolution of the exchange rate and its pass-through to prices by the end of September, there was risk of a larger disanchoring of inflation expectations. Therefore, as from October 1, under a new agreement with the IMF, the Central Bank decided to implement a new monetary policy regime based on a monetary base target accompanied by a definition of foreign exchange intervention and non-intervention zones.

Hence, the inflation targeting regime which had been implemented since September 2016 was set aside. Such regime is widely used all over the world by both advanced and emerging economies, and has enabled such economies to have low inflation rates. However, in Argentina the application of such regime was hindered by the conditions of the economy at the beginning of its implementation: high and persistent inflation, a relative price correction pending (exchange rate and public utility rates) and a high deficit of public accounts partly funded with transfers from the Central Bank. All this in addition to a demanding disinflation path defined as from late 2015.

Thus, with the goal of establishing a more concrete and powerful commitment to price stability in the short run which could be easily verifiable by the public in general, the Central Bank committed not to increase the monetary base level until June 2019 as a nominal anchor. This monetary aggregate was chosen because it is under the direct control of the BCRA. The zero nominal monthly growth target of the monetary base was defined on the monthly average of daily balances and will be seasonally-adjusted in December and June, when money demand increases. Upon establishing a target on the money supply, the benchmark interest rate (the rate for LELIQs) is to be determined by the liquidity supply and demand and will stand at the level consistent with the zero monetary base growth commitment. Operatively, the monetary target is implemented through daily auctions of Liquidity Bills (LELIQs) with the banks.

Acknowledging the benefits of exchange flexibility does not entail ignoring that excessive volatility of the exchange rate may turn out to be a problem, especially in our country, where the exchange rate plays a key role in forming inflation expectations, significantly influences the public's portfolio decisions and may create huge uncertainty episodes adversely affecting the activity level of economy. Therefore, the monetary target is supplemented with the definition of exchange rate intervention and non-intervention zones. The non-intervention zone is initially defined between $34 and $44, where the peso may freely float, and it is adjusted daily at a monthly rate of 3% until the end of 2018.

Upon implementation of the new monetary regime as from October, calmness returned to the foreign exchange market, thus achieving an appreciation of the peso during the first operative

days within the non-intervention zone, together with an interest rate increase and a stable evolution of the stock of LELIQs. Meanwhile, the average of daily balances of the monetary base during the first three weeks of October stood below the target of the month.

Even though inflation expectations, measured by the Market Expectations Survey (REM) conducted by the Central Bank, have gone up since the beginning of the exchange turbulence and are currently high, it should be noted that the market still foresees a deceleration of inflation in the period of 12 and 18 months ahead, also taking into consideration that the last survey corresponding to September was conducted after the announcement of the new monetary regime. In this context, it is anticipated that the monetary contraction resulting from the monetary policy scheme, together with the ratification of the primary result decreasing path and the BCRA's commitment not to fund the Treasury any longer, may lead to a drop of inflation expectations and of the inflation rate in the next few months.

5.1 New financial turbulence episode in August – September and the response of the monetary and foreign exchange policy

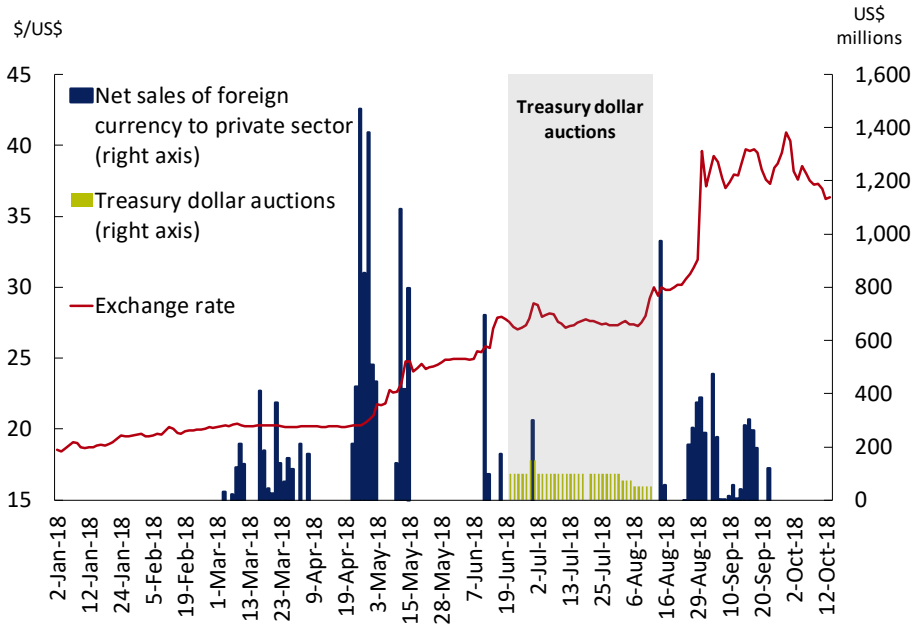
5.1.1 New exchange tensions were observed in August

During August, some exchange rate tensions occurred again as a result of a new combination of both external and domestic factors, which found the economy still exposed to the abrupt reversal of capital flows. Among the external factors, the financial instability in Turkey stood out, causing a contagion effect on most emerging currencies (see Chapter 2). As regards domestic factors, the doubts about sustainability of the tax convergence path and of the financial program announced in the first agreement with the IMF and the uncertainty created by the judicial investigation of corruption cases were the most relevant instability factors[35].

The financial turbulence intensified by the end of August since, on day 30, the exchange rate rose 24%, to then remain stable at around $ 38.5 per US dollar during September and to reach $ 40 per US dollar by late September. Thus, the US currency price accumulated a 42% increase from late June to the end of September (see Figure 5.1).

[35] For further details on the first agreement entered into with the IMF in June this year, see the Monetary Policy Report (IPOM) of July 2018.

Figure 5.1 | Foreign Exchange rate, Central Bank FX interventions, Treasury FX auctions



Source: BCRA

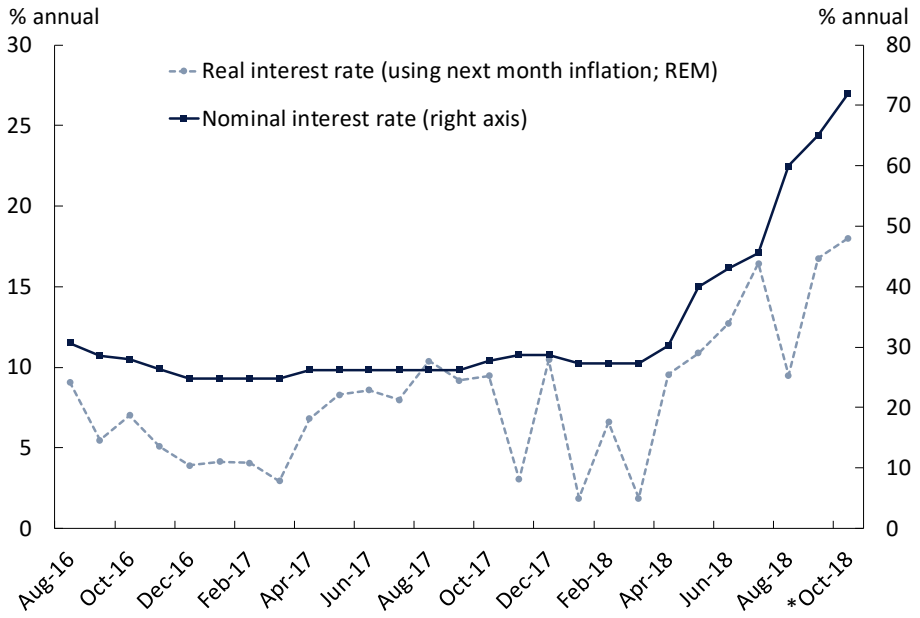
5.1.2 The monetary policy response and the new agreement with the IMF

The Central Bank's response to deal with the exchange rate turbulence focused on several fronts. On the one hand, several decisions were made to increase the monetary policy rate, from an annual rate of 40% to 45% on August 13, and then to an annual 60% on August 30 (see Figure 5.2). Simultaneously, the Central Bank sold foreign currency to the private sector for an amount of US$ 4.53 billion during August and September to mitigate the exchange rate volatility (see Figure 5.1).

In turn, for the purpose of supplementing the contractionary bias of interest rate decisions with a more careful follow-up of monetary aggregates, successive increases were established for minimum cash requirements for both sight and time deposits in pesos, with various modalities for compliance with such requirements. The increases were implemented on August 16 (3 p.p.) for financial institutions with higher assets (which could be satisfied in pesos), on August 30 (5 p.p.) for the same ensemble of institutions effective as from September (which could be satisfied in pesos, LELIQs or NOBACs) and on September 14 (5 p.p.) effective as from September 19, for banks having at least 1% of private deposits (which could be satisfied in pesos for sight deposits and in LELIQs or NOBACs for time deposits)[36].

[36] For further details, see Communications "A" 6550, "A" 6556 and "A" 6569, respectively.

Figure 5.2 | Reference interest rate (nominal and real)[37]

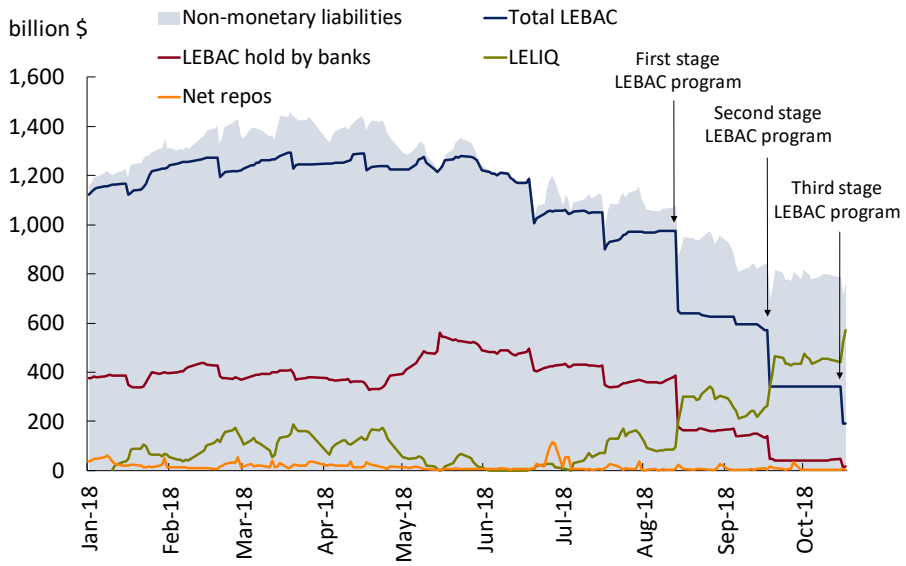


Note: the real interest rate is calculated using one month ahead inflation expectations (source: REM-BCRA). (*) Real interest rate at mid-October calculated using a nominal interest rate of 72% in annual basis and inflation expectations of 4,5% in a monthly basis.
Source: BCRA

Besides, in mid-August, a program for cancellation of LEBACs was announced, in order to eliminate a source of instability that was at the center of the stage during the exchange rate turbulence commencing in April. This stock had resulted from the sterilization of fiscal deficits until December 10, 2015, the sterilization of monetary surpluses from exchange restrictions and the losses from sales of dollar futures contracts prior to December 10, 2015, as well as the acquisition of international reserves by the monetary authority as from December 10, 2015, and it stood at around one trillion pesos by mid-August. To implement this reduction, it was established that in each auction the Central Bank would offer LEBACs to non-banking institutions for an amount lesser than the amount at maturity, whereas banks would be offered only 1-year NOBACs and LELIQs for the total amount at maturity (LELIQs may only be acquired and traded by financial institutions)[38]. This action was supplemented with auctions of Treasury Bills in pesos by the Ministry of Economy on the maturity dates for LEBACs, seeking to create an appealing investment alternative in pesos. After three auctions, the stock of LEBACs fell by $ 786.19 billion to $ 190.58 billion by mid-October. On the other hand, LELIQs gained ground, consolidating as the main instrument of intervention by the Central Bank. Thus, the total of interest-bearing liabilities (net repos, LEBACs and LELIQs) fell from around $ 1.078 trillion down to $ 715.1 billion in the same period (see Figure 5.3).

[37] Until December 2016, the benchmark interest rate was the interest rate of 35-day LEBACs. As from January 2, 2017 and until May 2, 2018, it was the mid-band of the 7-day repo interest rates corridor. As from August 8, 2018, the benchmark rate was the interest rate of Liquidity Bills (LELIQs). Finally, as from October 1, 2018, the benchmark rate was defined as the average rate resulting from LELIQ daily transactions with financial institutions.
[38] In addition, it was defined that banks could only take part in primary auctions of LEBACs for the account and on behalf of non-banking third parties, and they could not sell their remaining LEBACs in the secondary market to non-banking entities.

Figure 5.3 | Central Bank non-monetary liabilities in pesos (net repos, LEBAC and LELIQ)



Source: BCRA

Finally, during September, the National Government negotiated a new agreement with the International Monetary Fund aimed at clearing up any doubts regarding the financial program for 2018 and 2019 and to drive away the uncertainty prevailing in the domestic market. Thus, the agreement reached with the IMF staff, announced on September 26, strengthened the financing from such international organization to the National Government, increasing the available resources by US$ 19 billion until the end of 2019, and raising the total amount available under the program up to US$ 57.1 billion until 2021. The resources available under the program will no longer be considered precautionary lending and the authorities intend to use the funds provided by the IMF for the purposes of budget support. In turn, the National Government committed to hasten fiscal convergence by one year, with zero primary fiscal balance next year and a primary surplus of 1% of GDP as from 2020; whereas in the monetary sphere, a new monetary-exchange rate regime was defined.

5.2 The new monetary policy regime

As from October 1, the Central Bank started to implement a new monetary policy regime based on monetary aggregates targets supplemented with the definition of exchange rate intervention and non-intervention zones, the main purpose of which is to reduce the inflation rate. Thus, the inflation targeting regime operative since 2016 was left aside. Even though such regime is widely used all over the world, by both advanced and emerging economies, and has enabled them to have low inflation rates, in Argentina the application of such regime was hindered by the conditions of the economy at the beginning of the implementation. Such initial conditions included: high inflation, a relative price correction pending (exchange rate and public utility rates) and a high deficit of public accounts partly funded with transfers from the Central Bank. All this in addition to a demanding disinflation path defined as from late 2015.

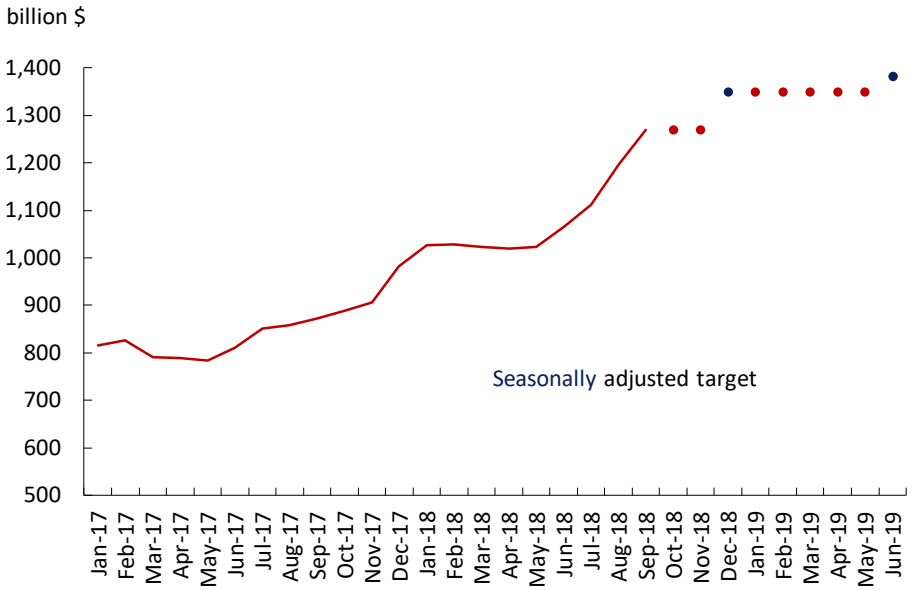
5.2.1 Monetary aggregates target as nominal anchor for the economy

In recent months, the inflation rate increase and the loss of credibility in the Central Bank's ability to meet inflation targets, evidenced by the rise of inflation expectations, made it necessary to recover the nominal anchor of economy (see Chapter 4). This required defining a more powerful and clearer guideline for

pricing. Therefore, the BCRA chose to start applying a strict control on money supply. There is conclusive evidence throughout history of the strong relationship between money and prices[39]. This link is even more solid in case of economies with high inflation levels and low financial development[40]. Hence, many stabilization plans have been based on controlling the amount of money. For instance, in advanced economies during the 1980s, this type of plans resulted in a sustained decrease of inflation and caused such economies to enter an environment of higher nominal stability[41].

Specifically, the nominal anchor was established in the commitment not to increase the monetary base level until June 2019 (see Figures 5.4 and 5.5). The monetary base consists of banknotes and coins issued by the Central Bank (held by the public and by banks) and of deposits in banks' current accounts with the Central Bank (under the minimum cash regulatory requirement). This monetary aggregate was chosen because it is under direct control of the Central Bank. The zero nominal monthly growth of the monetary base was defined on the monthly average of daily balances and will be seasonally-adjusted in December and June, when money demand increases, thus preventing an excessive contractionary bias in the monetary policy (the monetary base will be allowed to rise 6.2% monthly and 2.45% monthly in such months, respectively).

Figure 5.4 | Monetary base targets (October 2018 – June 2019). Monthly averages



Source: BCRA

The monetary aggregates target implemented by the BCRA entails a significant contraction in money growth, since the monetary base has shown a monthly expansion above 2% seasonally-adjusted in recent months, while it will cease to increase from now onwards (see Figure 5.5). In addition, due to the recent

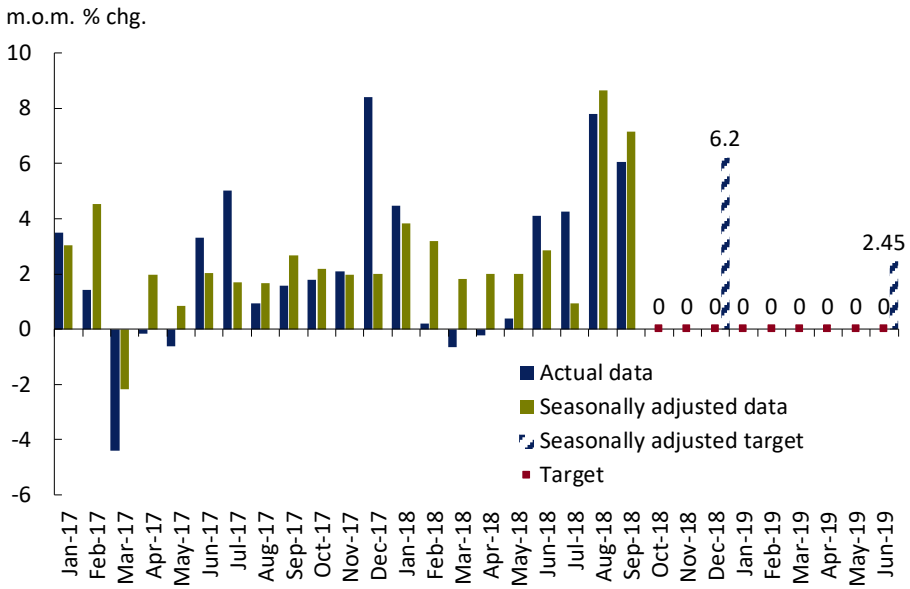
[39] For further analysis on the relationship between money and inflation worldwide, see: McCandless, G. and W. Weber (1995). "Some Monetary Facts". Quarterly Review. Federal Reserve Bank of Minneapolis. For further analysis on money and inflation in Argentina, see: Basco, E., L. D'Amato and L. Garegnani (2006). "*Crecimiento monetario e inflación: Argentina 1970-2005*". Working paper No. 2006/13. Central Bank of Argentina.

[40] To observe the effect of the level of inflation rate on the relationship between money and inflation in Argentina see: Basco, D'Amato and Garegnani (2006), and Teles, P. and H. Uhlig (2013). "Is Quantity Theory Still Alive?". Working paper No. 1605. European Central Bank.

[41] For further analysis of the use of monetary aggregates in advanced economies see: Bernanke, B., and F. Mishkin (1992). "Central Bank Behavior and the Strategy of Monetary Policy: Observations from Six Industrialized Countries". In Olivier Blanchard and Stanley Fischer, eds., NBER Macroeconomics Annual, Cambridge, MA: MIT Press, 183-238.

evolution of the exchange rate, the market expectations survey forecasts that inflation in the next months will be high (but decreasing), so the monetary base will shrink in real terms.

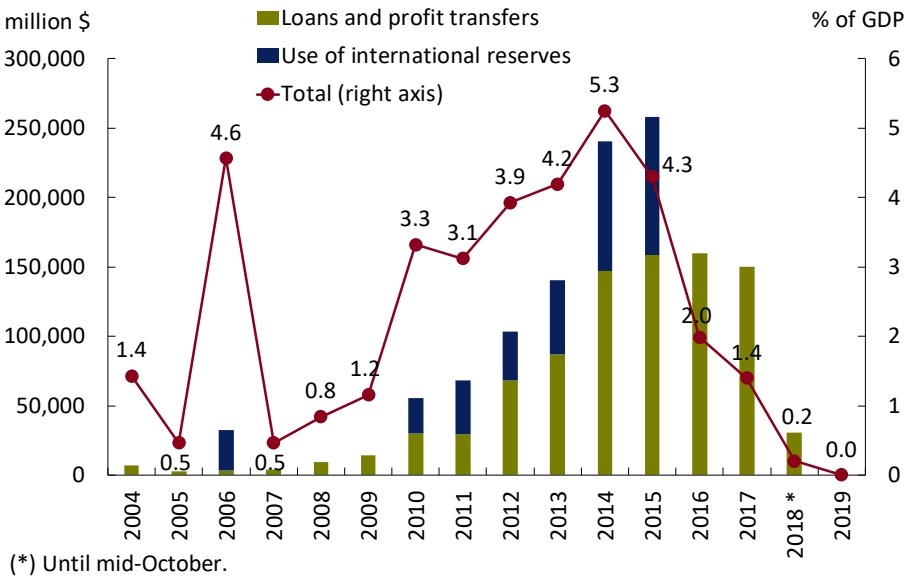
Figure 5.5 | Monetary base monthly % nominal chg. (up to September 2018 and October 2018-June 2019 targets)



Source: BCRA

The new monetary policy is consistent with the target of a zero primary fiscal balance in 2019 and the 2020 surplus target set under the new agreement with the IMF. As announced in June 2018, the Central Bank will no longer make transfers to the Treasury. Until such date, total transfers had amounted to $ 69.9 billion; however, as from such date, temporary advances have been let to mature for $ 39.4 billion, and therefore, the amount transferred until mid-October reached 0.2% of GDP and will fall down to zero in the next years (see Figure 5.6). The removal of this source of monetary expansion reinforces the commitment to a decreasing inflation over time.

Figure 5.6 | Central Bank's transfers to National Treasury



(*) Until mid-October.
Source: BCRA and INDEC

From the operative point of view, the monetary target is implemented through daily auctions of Liquidity Bills (LELIQs) with banks[42]. Thus, the benchmark interest rate started to be defined as the average rate resulting from daily transactions. In turn, the monetary authority may inject or absorb liquidity through purchases or sales of LELIQs in the secondary market and limited its intervention in the repo market to overnight transactions[43].

Upon establishing a target on money supply, the interest rate of LELIQs started to be determined by the supply and demand of liquidity, up to reaching a level consistent with the monetary base zero growth commitment. Anyway, as long as there is no evidence of a drop of inflation expectations 12 months ahead, the Central Bank will not let the interest rates of LELIQs stand below an annual rate of 60%.

In addition, the fact that the benchmark rate is now determined by the monetary market liquidity conditions might result in an increased variability of such rate. However, no pass-through effect is expected to higher volatility of deposit and loan rates of the financial system due to several factors. First, the starting point was a historically high level in terms of volatility of short-term interest rates (interbank call, repos and 7-day advances). This is due to the fact that when the Central Bank determined the monetary policy rate, the decision was made to expand the repo rates corridor several times as from May, and then the ceiling of such corridor was eliminated, and this contributed to increase the variability of market rates. Second, in previous episodes of high volatility of shorter-term interest rates, no significant rises were recorded in the interest rates of deposits or loans with longer terms.

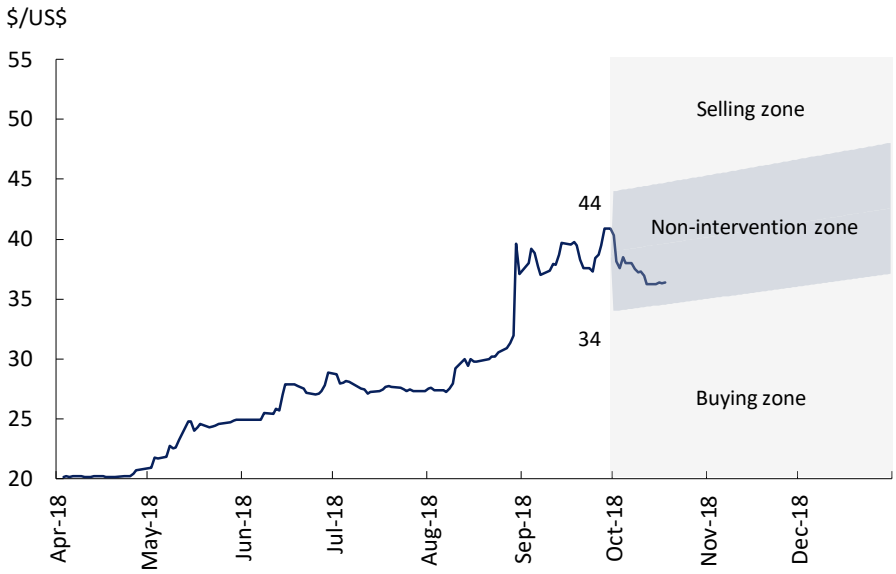
One of the drawbacks faced by the implementation of the monetary policy in previous months was the existing stock of LEBACs. The economic agents' concern as to the risk of renewal, in particular of the non-financial private sector's holdings, had turned into a financial instability factor that was at the center of the stage during the exchange turbulence commencing in April 2018. In this regard, the Central Bank will continue with the unwinding of LEBACs started in August to completely eliminate the stock by December this year. The monetary expansion resulting from the reduction of LEBACs will continue to be absorbed by the Central Bank through minimum reserve requirements and LELIQs to meet the growth target of the monetary base. In addition, the Treasury will continue contributing to this unwinding process by issuing Bills, the collection of which will be largely deposited with the Central Bank, through deposits in current accounts with the monetary authority or the purchase of LELIQs by Banco de la Nación Argentina.

5.2.2 Definition of intervention and non-intervention zones in the foreign exchange market to supplement the monetary base target

The exchange rate flexibility allows countries to adjust to several external conditions or to domestic shocks (for example, a drought), which minimizes the cost in economic activity and employment. Instead, a negative shock entailing the need of an increase of the real exchange rate in a context of fixed exchange rate results in the hard path of price deflation, as it was observed on several occasions in the past. However, acknowledging the benefits of exchange rate flexibility does not entail ignoring that excessive volatility of the exchange rate may turn out to be a problem, especially in our country, where the exchange rate plays a key role in forming inflation expectations, significantly influences the public's portfolio decisions and may create huge uncertainty episodes adversely affecting the activity level of the economy. Therefore, the monetary target has been supplemented with the definition of exchange rate intervention and non-intervention zones. On October 1, the non-intervention zone was established between $34 and $44, and in such zone the peso may freely float, and is adjusted daily at a monthly rate of 3% until the end of 2018, and this change will be adjusted in early 2019 (see Figure 5.7).

[42] In LELIQ auctions, the Central Bank announced an estimated amount and the minimum placement rate. Once the bids are received, the monetary authority determines the cut-off rate and the award is made on a multiple sale price.
[43] In addition, the repo rate started to be defined on a daily basis as a result of multiplying a ratio of 1.01 to 1.5 times the maximum rate paid for outstanding LELIQs, whereas the reverse repo rate started to be the result of multiplying a ratio of 0.5 to 0.99 times the minimum rate announced for outstanding LELIQs. For further details, see Communication "A" 6576.

Figure 5.7 | FX intervention and no-intervention zones



Source: BCRA

In the event the exchange rate stands above the non-intervention zone (a sign of drop in the demand for financial assets in pesos), the Central Bank may conduct daily auctions of foreign currency for up to US$ 150 million. These sales result in subtracting pesos from the economy in order to correct an excessive pressure towards the depreciation of the peso.

In the event the exchange rate stands below the non-intervention zone (a sign of increase in the demand for pesos), the Central Bank may purchase foreign currency to prevent an excessive appreciation of the peso. Upon this sign of a rise in money demand, the monetary authority may decide to increase the monetary base beyond the targets, and support such expansion through an increase of international reserves.

It is important to underline that the bounds between the intervention and non-intervention zones are not fixed exchange rates committed by the Central Bank; instead, they must be interpreted as guidelines on the Central Bank's behavior to be expected in each zone. This scheme of intervention and non-intervention zones combines the benefits of a floating exchange rate with the benefits of preventing excessive exchange rate fluctuations. The Monetary Policy Committee will review the slope and width of the non-intervention target band at year end.

5.2.3 Consistency of the new monetary scheme

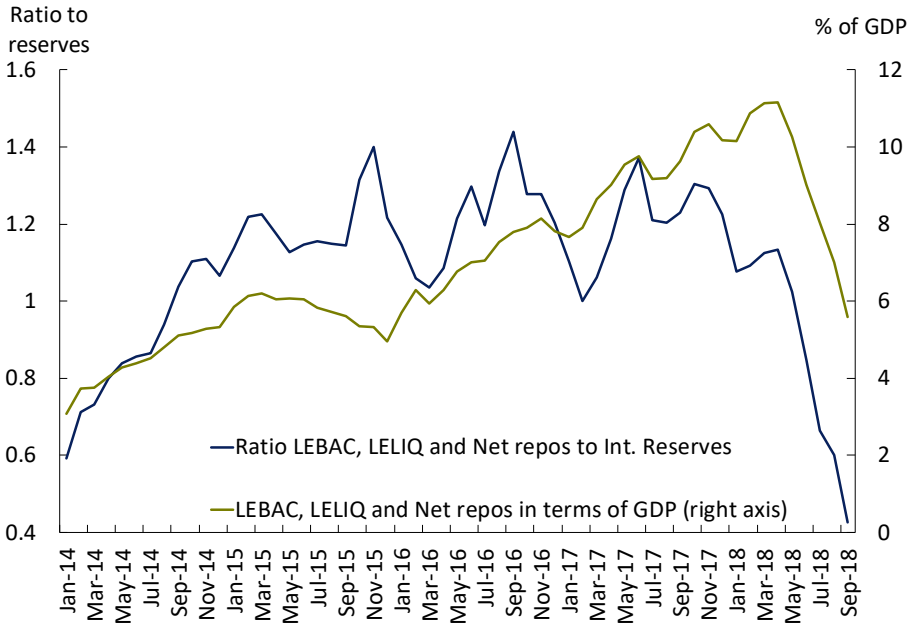
A series of factors are described below which show that the new monetary scheme is sustainable and provides reasonable room to maneuver for the Central Bank to meet its objectives.

Sustainability of interest-bearing liabilities in pesos of the Central Bank

The new monetary regime provides for the use of LELIQs as an instrument regulating liquidity of the economy. In this context, there are several factors underpinning the sustainability of these monetary authority's liabilities. First, in recent months, the stock of bills, notes and repos of the Central Bank shrank in terms of both GDP and international reserves; therefore the starting point gives the new monetary policy greater room to maneuver. Thus, between April and September, the stock of interest-

bearing liabilities fell from 11.2% of GDP down to 5.6% of GDP, whereas the ratio to international reserves went from 1.1 down to 0.4 (see Figure 5.8). This evolution was driven, first, by the fall in the demand for LEBACs by the non-banking private sector after commencement of the financial turbulence in April and, then, by the LEBAC stock unwinding program implemented by the Central Bank as from August. In the case of the ratio of interest-bearing liabilities to international reserves, the impact of the increase in the exchange rate in such period should be added.

Figure 5.8 | Non-monetary liabilities in terms of international reserves and GDP

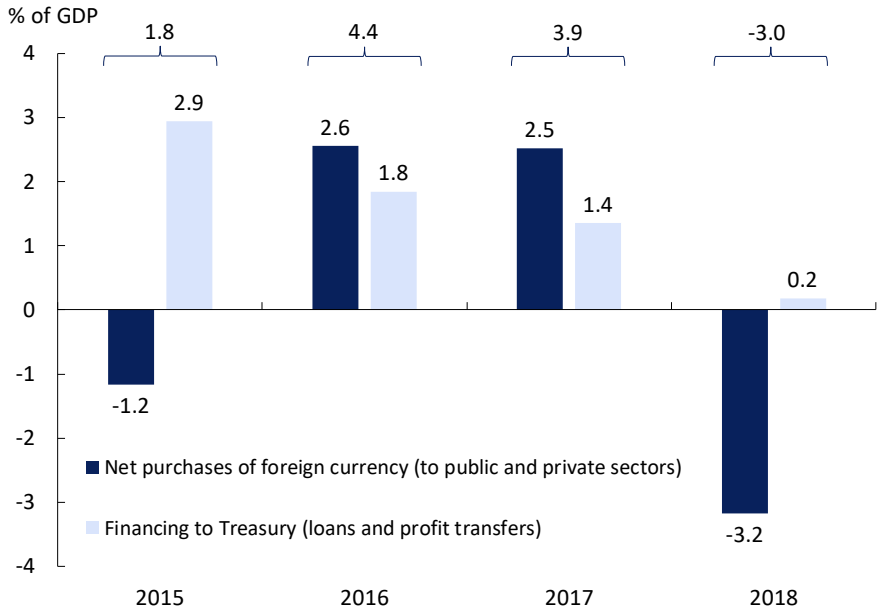


Source: BCRA

Besides, the factors of monetary base expansion that, in the past, were behind the increase of interest-bearing liabilities due to the need of sterilizing a portion of such expansion will not be present in this new stage. Thus, whereas the net purchase of foreign currency (mainly from the public sector) and the transfers to the Treasury as temporary advances and transfers of profits were close to 4% of GDP between 2016 and 2017 (years in which the stock of LEBACs went up), no purchase of foreign currency and no transfers to the Treasury are estimated for the next years, in a context where the National Government has also committed to stabilizing the primary result in 2019 and reaching a surplus as from 2020 (see Figure 5.9).

Simultaneously, LELIQs, unlike LEBACs, may only be acquired by banks, so their demand is more stable if compared to the rest of economic agents, due to the regulations that must be satisfied by financial institutions and which are imposed by the Central Bank.

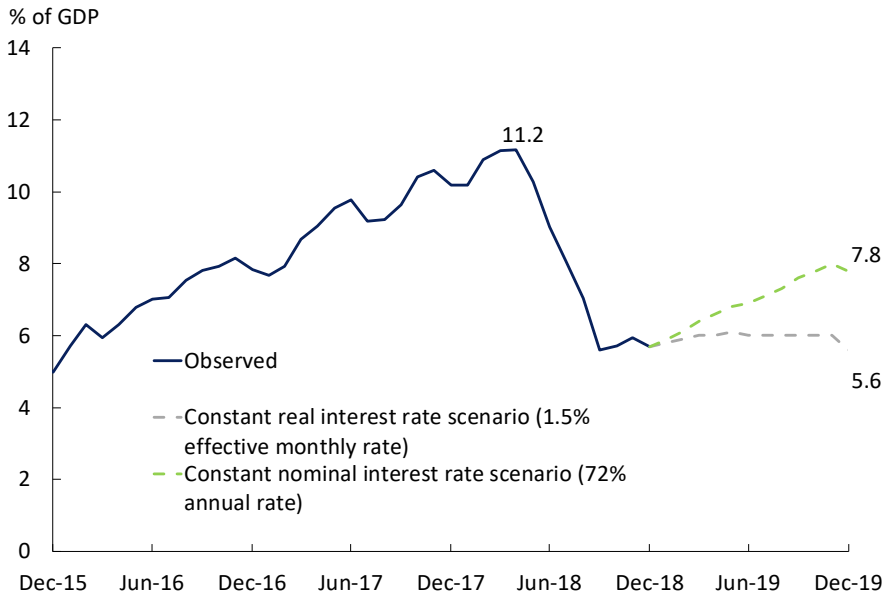
Figure 5.9 | Components of monetary base expansion related to operations with the Treasury



Source: BCRA

Finally, compliance with the monetary base target might require an increase of LELIQs interest rate which would contribute to increase their stock due to the need not to issue money for interest payment in order to meet the monetary target. Even assuming an extremely adverse scenario where the real interest rate of LELIQs remains at current levels until the end of 2019 (1.5% monthly effective real rate), the ratio of interest-bearing liabilities to GDP would remain virtually stable at around 6%. Besides, if taking into account an even more extreme scenario, in which the nominal interest rate of LELIQs remains at current levels of an annual 72%, the weight of interest-bearing liabilities on GDP would reach 7.8% in December 2019, and this value still stands 3.4 p.p. below the maximum value recorded in April 2018 (see Figure 5.10).

Figure 5.10 | Non-monetary liabilities of the Central Bank to GDP with scenarios of constant real and nominal interest rates



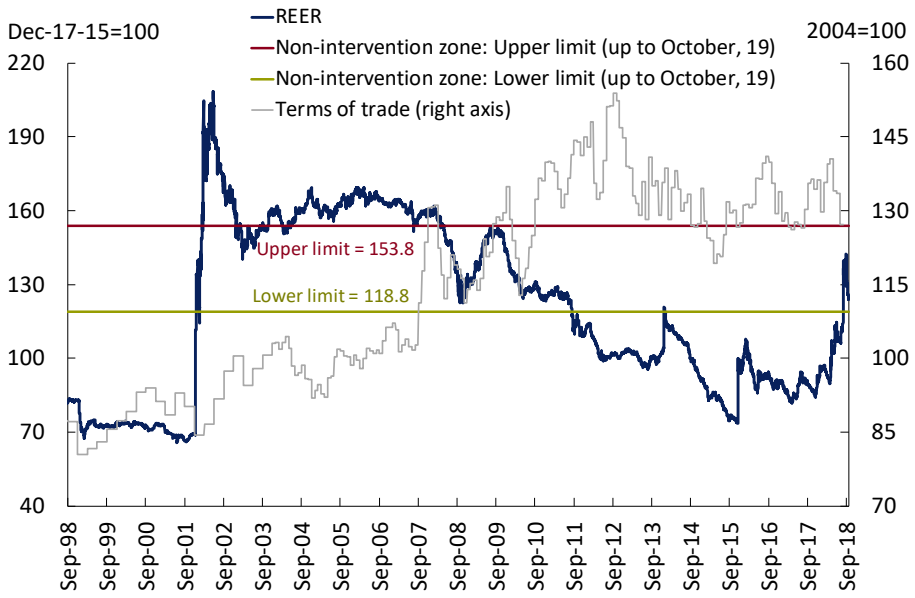
Source: BCRA

Sustainability of the foreign exchange scheme: real exchange rate level and daily auctions of foreign currency

As regards the foreign exchange scheme, there are various factors contributing to the consistency of the exchange rate values chosen to define the intervention and non-intervention zones, and of the daily auctions scheme in case the exchange rate may exceed the upper bound of the non-intervention zone.

Following the nominal exchange rate increase recorded this year, the real exchange rate stands at levels more consistent with macroeconomic equilibrium. Against this backdrop, the multilateral real exchange rate in the upper bound of the non-intervention zone stands at levels of 2003, when the exchange rate had overreacted to the collapse of the Currency Board (Convertibility regime). In addition, the terms of trade stand at present 35% above the terms of trade recorded at that time, and this would entail the need of a lower real exchange rate than in 2003 to balance external accounts. In turn, the multilateral real exchange rate corresponding to the lower bound of the non-intervention zone stands at levels similar to those in mid-2011, when the economy recorded an imbalance of the current account balance substantially lower than the current imbalance, and with terms of trade at levels similar to levels at present (see Figure 5.11).

Figure 5.11 | Real effective exchange rate, terms of trade and no-intervention limits[44]



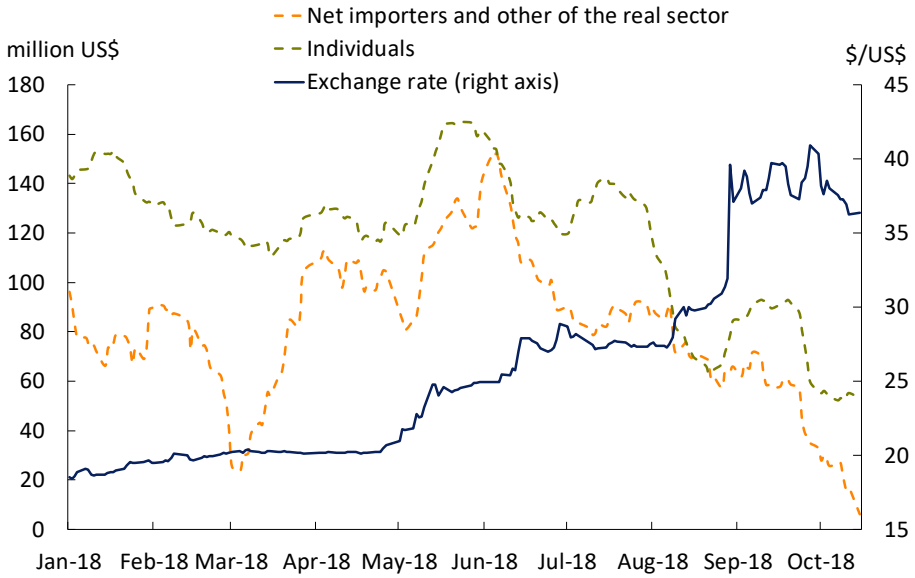
Source: BCRA

In turn, the current level of the real exchange rate is contributing to the adjustment of external accounts, added to the impact of the lesser economic activity on the demand for imports (see Chapter 3). Indeed, in recent weeks, a lower daily demand was observed for foreign currency by net importers and for saving and tourist purposes, which are very relevant sectors behind the outflow of foreign currency from the economy (see Figure 5.12)[45]. In addition, not only is it expected that the dollar supply will positively react to the new level of the real exchange rate, but also that exports of grains and oilseeds next year will help leave behind

[44] For the multilateral real exchange rate corresponding to the upper and lower bounds of the non-intervention zone, the values taken into account were those announced on October 1, $ 34 and $ 44 per dollar, adjusted at a 3% monthly rate until October 19.
[45] These headings correspond to "Net Importers and Real Sector, Other" and "Natural Persons" of the foreign exchange statistics prepared by the Central Bank (see the report on Evolution of the Foreign Exchange Market and the Exchange Balance of the BCRA).

the impact of the drought. The above is added to an inflow of US dollars agreed with international organizations, as a result of the recent agreement executed with the IMF. Thus, during the rest of 2018, the Treasury will receive approximately US$ 13.44 billion in disbursements of the IMF Stand-By loan and US$ 1.51 billion from other organizations, whereas in 2019 it will receive approximately US$ 22.82 billion in disbursements of the IMF Stand-By loan and around US$ 3 billion from other multilateral organizations.

Figure 5.12 | Exchange rate and daily foreign currency demand of net importers and individuals (20 days moving average)



Source: BCRA

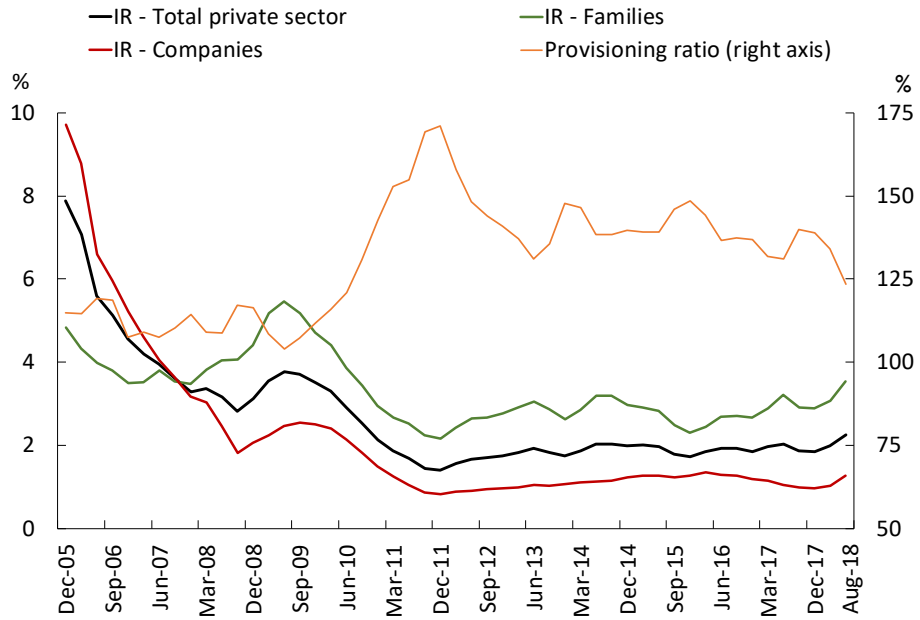
Regarding the mechanism of the BCRA's daily auctions of foreign currency, defined for the upper bound of the non-intervention zone, the closest precedent are the daily auctions of the National Treasury implemented during July and in early August. These auctions that, in general, were for amounts below US$ 150 million, succeeded in stabilizing the exchange market in a context of a less competitive exchange rate and with levels of foreign currency demand much higher than current levels (see Figures 5.1 and 5.12). These newly implemented auctions were not accompanied by interventions of the Central Bank and, unlike Treasury auctions, they have the potential to reduce the monetary base, also contributing to stabilize the exchange market.

Limited impact of the new monetary regime on the financial system

The financial system has proved to be sound throughout the exchange rate turbulence commencing in April, as evidenced by the good performance of deposits in domestic currency and in foreign currency during the period (see Section 5.3.3). Within this context, there are at present several characteristics of the financial system suggesting that there is room to maneuver in the monetary and foreign exchange policies so that the objective may be met without affecting banks significantly.

First, even though some increase of delinquency rates in the financial system is expected as a result of the current levels of interest rates and the lower economic activity level, the non-performing portfolio is standing at low levels both in historical terms and if compared to international values; at the same time, banks record high provisioning levels exceeding the amount of non-performing loans (see Figure 5.13).

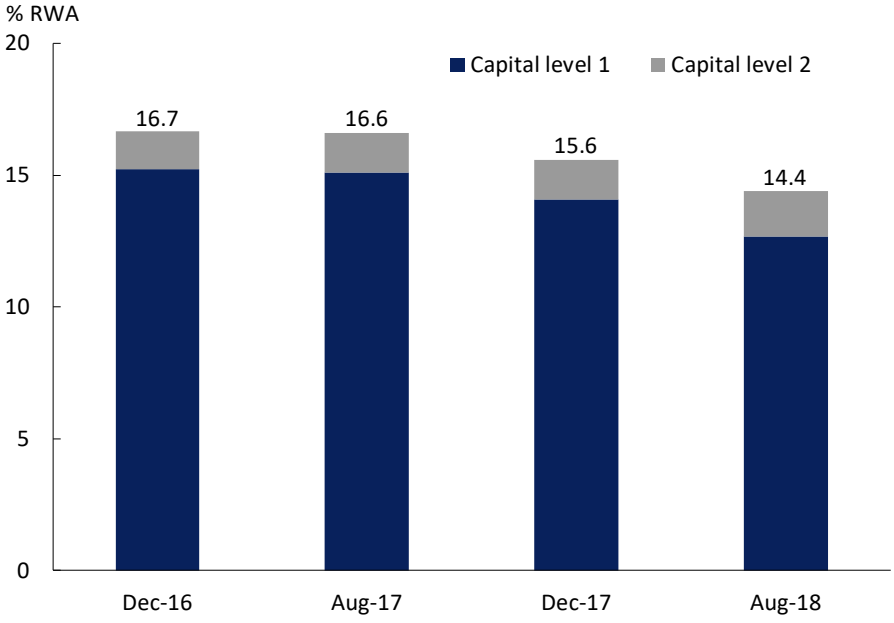
Figure 5.13 | Credit irregularity ratio (IR) to private sector (*) and provisioning (**). Financial system



* Irregular portfolio / Total portfolio. ** Provisions / Irregular portfolio.
Source: BCRA

Besides, the rise of domestic interest rates and the increase of the minimum reserve requirement ratios deriving from the policy measures required to meet the new monetary base targets occur in a context where the financial system profitability has been preserved. In addition, the financial system is showing high solvency indicators, and the ensemble of financial institutions records an excess capital compliance against the minimum cash requirement under the prudential regulation (see Figure 5.14).

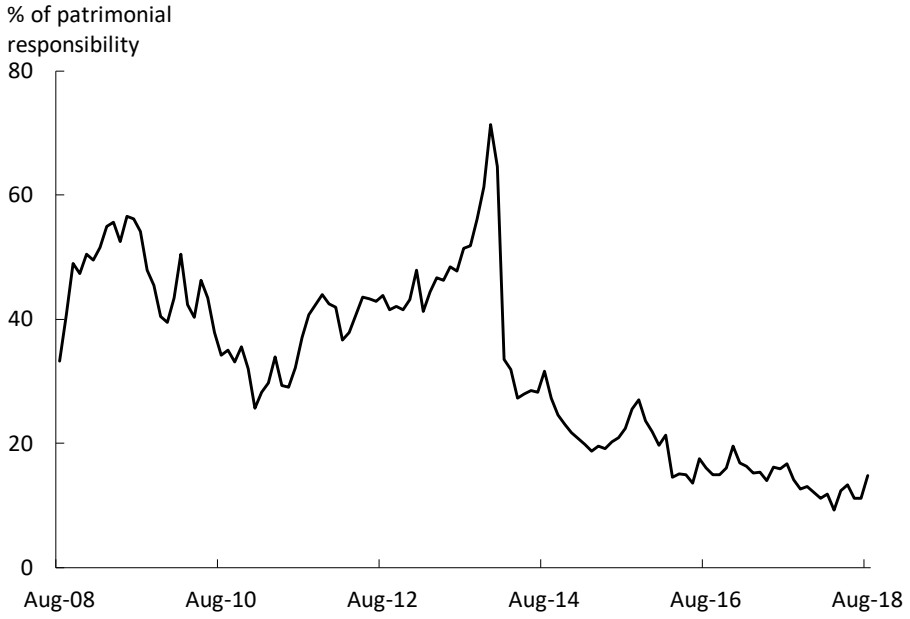
Figure 5.14 | Solvency of the financial system (integration of regulatory capital in terms of risk-weighted assets)



RWA: Risk-Weighted Assets.
Source: BCRA

Finally, the low foreign currency mismatch and the low dollarization levels of the financial system's balance sheet are consistent with the exchange rate flexibility implicit in the new scheme of intervention and non-intervention zones, and therefore any potential movement of the exchange rate would have no disruptive impact on the sound condition of banks. Thus, the currency mismatch, measured as foreign currency assets less foreign currency liabilities plus foreign currency forward net purchases, reached 14.9% of the adjusted stockholders' equity (RPC) and 0.9% of the assets of banks in August (see Figure 5.15).

Figure 5.15 | Currency mismatch (Assets FC – Liabilities FC + Net term purchases)



FC: Foreign Currency.
Source: BCRA

Limited impact of potential interest rate increases on the National Treasury's funding needs

As regards the potential impact of a restrictive monetary policy on the sustainability of public accounts, the debt in pesos of the National Public Sector, which is subject to the domestic interest rate risk, recorded a low share in the total debt held by private creditors of around 18% (latest available data) by the end of March 2018, out of which 5% correspond to variable rate debt and 13% to fixed rate debt (including CER-adjusted and non-CER-adjusted debt). In this sense, an increase of the interest rate in pesos of 10 p.p. would result in an interest payment rise of only 0.07% of GDP for debt at variable rate, and 0.17% of GDP on the maturity of short-term debt in domestic currency over a net payment of debt interest of 3.2% of GDP projected for 2019 according to National Budget data.

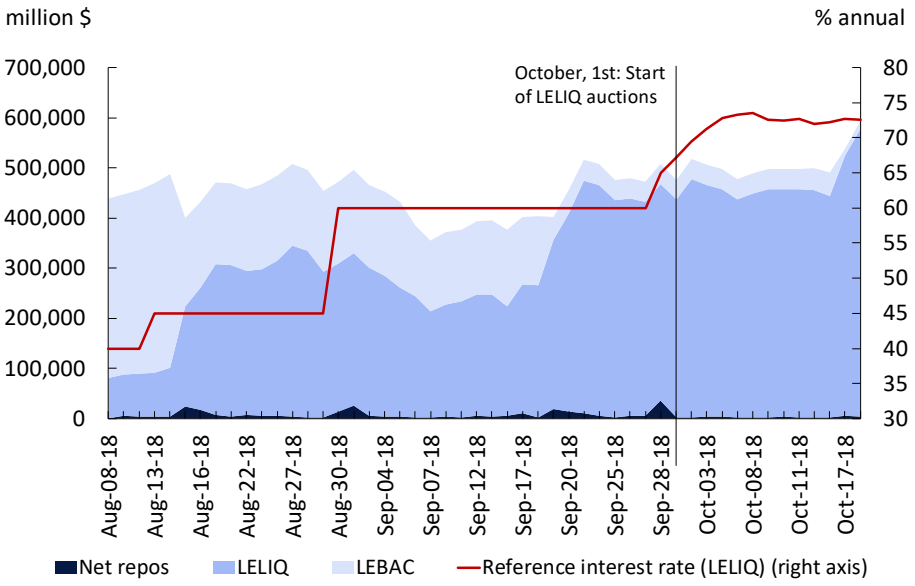
5.2.4 First results of the new monetary regime

Upon the implementation of the new monetary regime in early October, calmness returned to the foreign exchange market. The exchange rate moved downwards within the non-intervention zone, recording an 11% drop from September 28 to October 19 (see Figure 5.7). Thus, the exchange rate accumulates a 95% increase since late 2017, and therefore the (multilateral) real exchange rate stands at levels recorded in mid-2010 (see Figure 5.11).

As regards the monetary market, prior to commencement of the new monetary regime, on September 28, the Central Bank defined an increase of LELIQs interest rate (from an annual rate of 60% to 65%). To supplement the abovementioned measure and already foreseeing the unwinding of LEBACs that took place by mid-October, several measures were announced related to minimum cash requirements. On the one hand, it was decided to raise the minimum reserve requirement (3 p.p.) for larger institutions within the system, to be satisfied with NOBACs or LELIQs. On the other hand, it was determined that the total amount of the minimum cash requirement on the increase of time deposits could be satisfied with NOBACs or LELIQs, in order to encourage a rise in borrowing interest rates and foster the taking of new time deposits by financial institutions[46].

Finally, on October 1, the mechanism of LELIQs daily auctions started to be implemented, which is used by the Central Bank as the main instrument for compliance with the aggregates target. With this new scheme, the interest rate of LELIQs was raised up to a maximum of 73.52% (October 8) and then was reduced to an annual rate of 72.5% by the end of the third week of the month, which translates into a real interest rate (ex ante) standing at the maximum levels in recent years (see Figures 5.2 and 5.16). As a result of the auctions conducted, the stock of LELIQs stood almost stable at around $ 450 billion until the day prior to the third transaction for LEBACs unwinding (mid-October) (see Figure 5.16).

Figure 5.16 | Reference interest rate and stock of non-monetary liabilities of the Central Bank hold by banks (net repos, LEBAC and LELIQ)



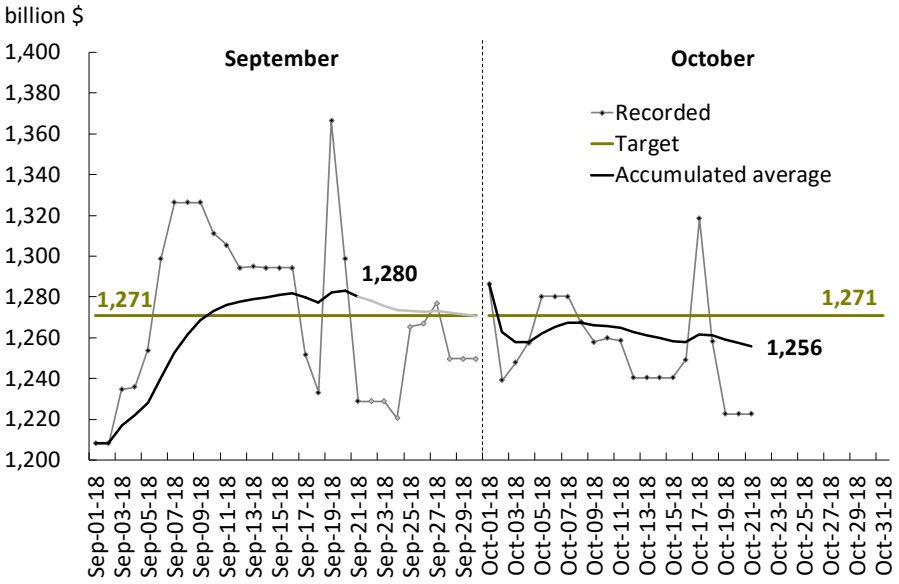
Source: BCRA

Within this context, the monetary authority has been complying with the monetary base target for October. Even though the target is defined for the monthly average of daily balances, a preliminary assessment of its fulfillment can be made for the first three weeks of the month. Thus, the average of daily balances until day 21 (around $ 1.26 trillion) is $ 15 billion below the average of daily balances recorded in September (around $ 1.27 trillion). Since the monetary base exhibits a marked intra-monthly seasonal

[46] As an additional measure to encourage the taking of time deposits, institutions were allowed to pay interest from time to time, but not for periods of less than 30 days, instead of payment in full at the end which was the only payment system allowed under the previous regulation. Simultaneously, the Central Bank decided to reduce the minimum daily position of the minimum cash requirement so that banks may participate more actively in LELIQs auctions when called by the monetary authority and thus to buffer the effect of the monetary base target on the variability of the monetary policy rate. Finally, entities were allowed to acquire BCRA's Cash Clearing Notes (NOCOM) with a portion of their holdings of banknotes not used for purposes of "Banknote Interbank Clearing", at an interest rate of 1/5 of the Central Bank's benchmark rate. For further details, see Communication "A" 6575.

performance (with a higher level at the beginning of the month than at the end of the month), it is useful, for the purposes of target monitoring, to compare the evolution of the monetary base against the same period of the previous months. Thus, the accumulated average of the monetary base during the first three weeks of October was $ 24.5 billion lower than in the same period of September (see Figure 5.17). In this period, the reduction required an additional effort since, in the first two weeks of September, the non-interest-bearing minimum reserve requirement ratio was lower. If the monetary base corresponding to September were adjusted by this factor, the average of October up to day 21 of the month would be lower by $ 60.5 billion than the amount recorded in the same period of September.

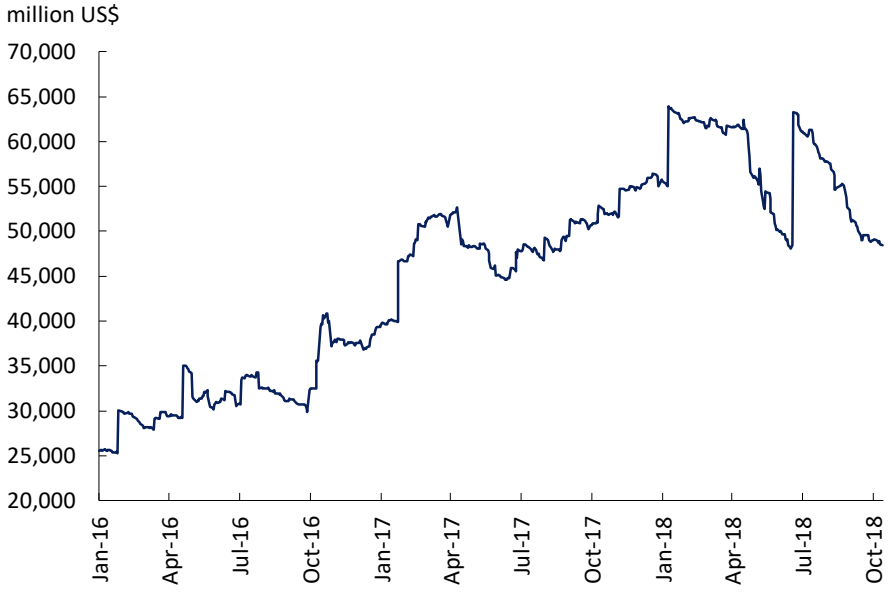
Figure 5.17 | Achievement of the monetary base target at October, 21



Source: BCRA

In turn, international reserves reached US$ 48.3 billion by mid-October, a level similar to the average amount of 2017 and similar to the floor recorded on June 21, prior to the first disbursement by the IMF of US$ 15 billion (see Figure 5.18).

Figure 5.18 | International reserves of the Central Bank



Source: BCRA

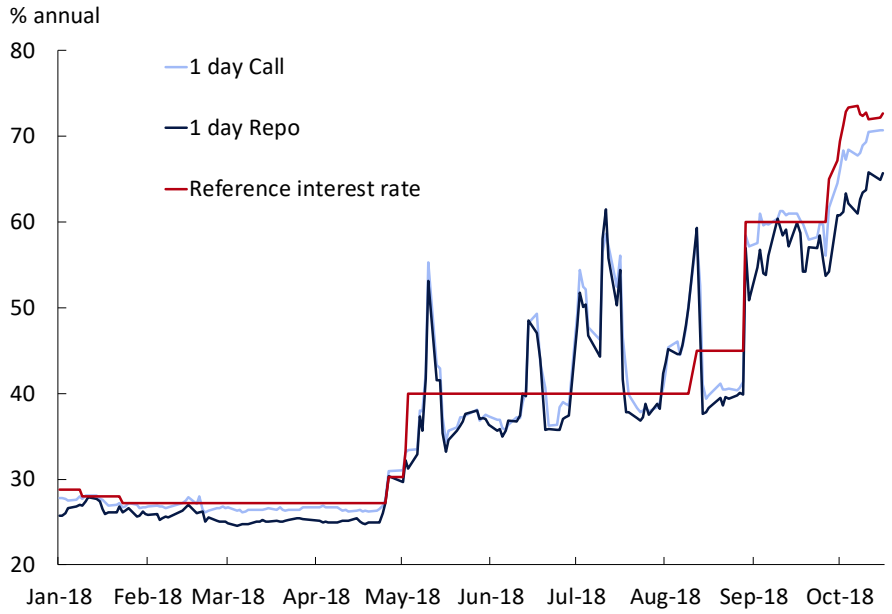
Even though inflation expectations, measured by the Market Expectations Survey (REM) conducted by the Central Bank, have gone up since the beginning of the exchange rate turbulence and are currently high, it should be noted that the market still foresees a deceleration of inflation in the period of 12 and 18 months ahead, also taking into consideration that the last survey corresponding to September was conducted after the announcement of the new monetary regime (see Chapter 4). In this context, it is anticipated that the monetary contraction resulting from the new monetary policy regime, together with the ratification of the primary result decreasing path and the BCRA's commitment not to fund the Treasury any longer, may lead to a drop of inflation expectations and of inflation rates in the next few months.

5.3 Impact of the exchange rate turbulence and of the Central Bank's measures on the financial system

5.3.1. Monetary market interest rates

Interest rates in the interbank market followed the rise of the benchmark rate, recording high volatility during the exchange rate turbulence in July and August, which moderated as from September following the decision made on August 30 to increase the rate for LELIQs up to an annual rate of 60% (see Figure 5.19). During the first days of October, when the implementation of the new monetary policy regime started, the LELIQ rate reached an annual average of 71.9%, up around 12 p.p. against the average of September. There was a partial transfer of this rise to overnight call and tri-party repo rates, which exhibited an average increase of around 9 p.p. and 7 p.p., respectively, during this period and accumulated an increase of 30 p.p. and 25 p.p. against June, respectively.

Figure 5.19 | Monetary market interest rates

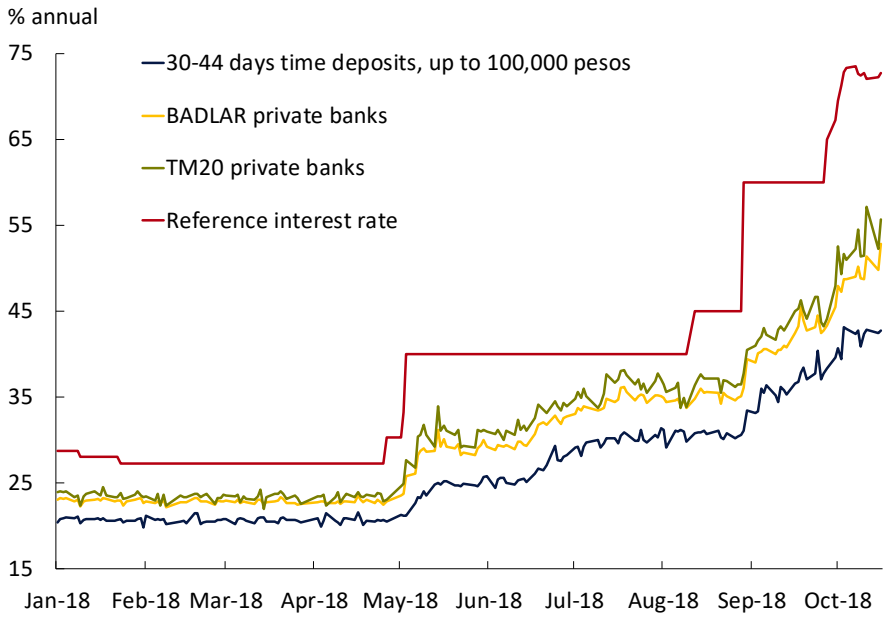


Source: BCRA

5.3.2 Deposit and loan interest rates

In line with the tightening of the monetary policy established by the Central Bank, interest rates of the private sector's time deposits in financial institutions showed an upward trend in the third quarter, and this rise speeded up in early October. It is worth mentioning that the policy to allow financial institutions to satisfy with LELIQs or NOBACs a portion of the minimum reserve requirements, mainly time deposits, encouraged the taking of this type of deposits, as evidenced by the borrowing interest rates of the system. Consequently, between June and early October, TM20 and Private Banks BADLAR offered by private banks went up 21 p.p. and 19 p.p., up to average annual rates of 53.2% and 49.6%, respectively, whereas the interest rate of retail time deposits went up 16 p.p. to an annual rate of 42.2% (see Figure 5.20)[47]. As regards the interest rate for UVA time deposits, the average rate stood at an annual rate of 4.7% in September, recording a rise of 0.5 p.p. during the quarter.

Figure 5.20 | Banking deposits interest rates

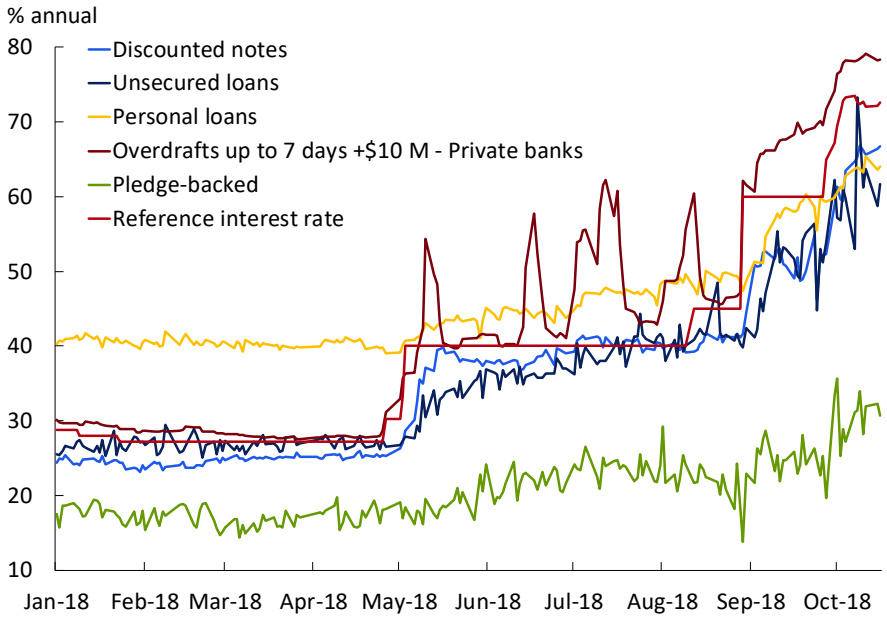


Source: BCRA

The interest rates of the financial entities' main credit lines were consistent with the rises observed in other monetary market rates, and the interest rate rises of short-term loans to companies stood out (see Figure 5.21). Thus, interest rates on advances, discounted documents and unsecured promissory notes rose by 34 p.p., 24 p.p. and 24 p.p. on average between June and early October, to average annual rates of 77%, 62% and 61%, respectively. In turn, the rates on personal and pledge-backed loans rose by 18 p.p. and 9 p.p. in such period, to average annual rates of 62% and 30% in early October. In relation to UVA loans, during the third quarter, the rate of mortgage loans stood at an annual rate of 6%, whereas personal and pledge-backed loans rates went up 1.6 p.p. and 1.4 p.p. in the period, reaching average annual rates of 14.5% and 14.7%, respectively.

[47] BADLAR is the interest rate for 30-day to 35-day time deposits over one million pesos; and TM20 is the interest rate for 30-day to 35-day time deposits over twenty million pesos.

Figure 5.21 | Banking credit interest rates

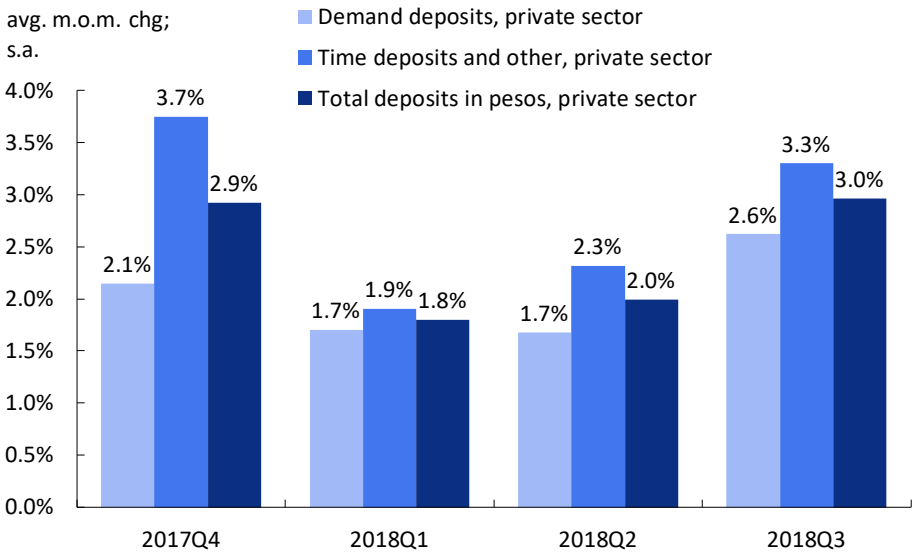


Source: BCRA

5.3.3 Deposits, loans and bank liquidity

The financial system has shown remarkable soundness in recent months. First, this was observed in the performance of private sector's deposits in pesos, which grew in nominal terms (3% monthly seasonally-adjusted) during the third quarter of the year, at a faster pace than that of the first half of 2018 (see Figure 5.22). This rise was recorded in both sight and time deposits, even though the latter, that better mirror savings decisions, exhibited higher momentum, with an average nominal monthly growth of 3.3% against 2.6% monthly for sight deposits. This increase of deposits during the third quarter may be attributed to the rise of borrowing interest rates and to the unwinding program for LEBACs. During the first 9 months of the year, the private sector's time deposits in pesos grew 24.9% against 19.5% of sight deposits (seasonally-adjusted values). In turn, the public sector's deposits in pesos also posted a marked upward trend during the third quarter, driven by dollar auctions conducted by the Treasury and the funds from the unwinding of LEBACs taken with Treasury Bills, growing at a monthly pace of 7.1% in nominal values and accumulating, from January to September, a 109% hike. Thus, total deposits in pesos went up at monthly average of 4.2% in nominal terms during the third quarter of 2018 (seasonally-adjusted).

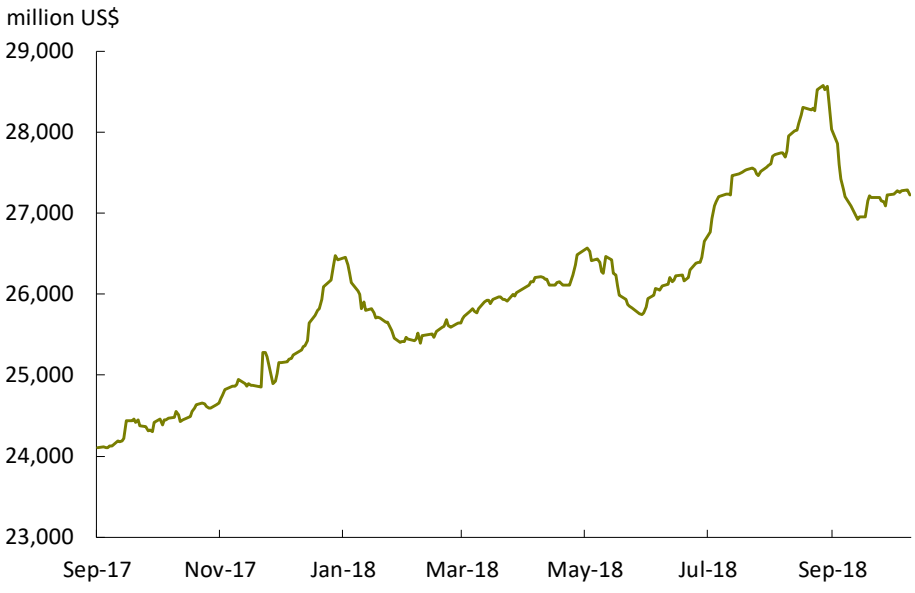
Figure 5.22 | Deposits of the private sector in pesos (average nominal monthly % chg. s.a.)



Source: BCRA

The private sector's deposits in dollars also posted an upward trend during the third quarter, going up 1.3% on average in original currency. Even though these deposits fell by the end of August and beginning of September, in line with the greatest exchange rate tension during the quarter, a reversal of this evolution started in mid-September, and continued during the first days of October (see Figure 5.23). Thus, the stock of private sector's deposits in foreign currency averaged US$ 27.2 billion in early October, around US$ 1.5 billion above the level exhibited by the end of 2017.

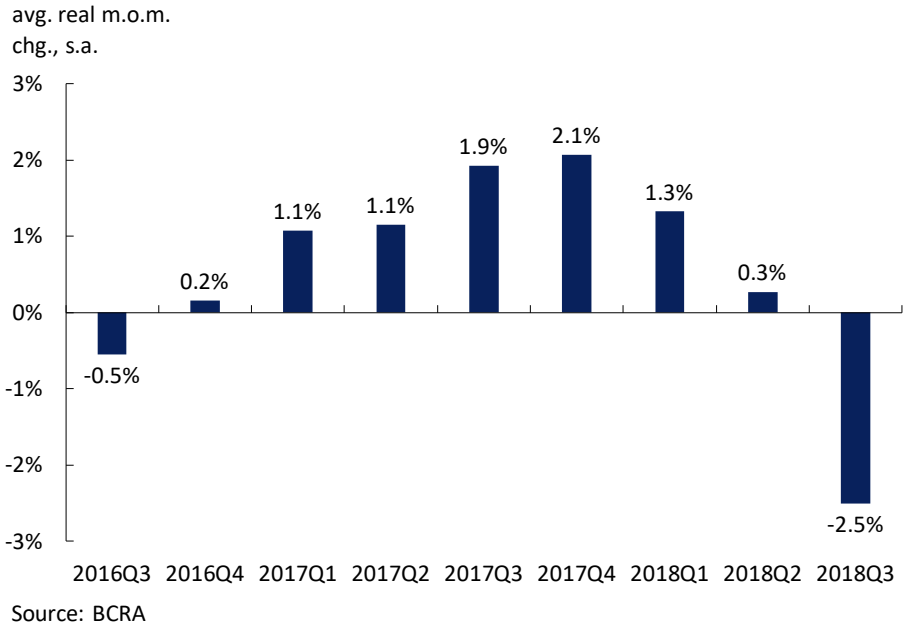
Figure 5.23 | Private deposits in foreign currency



Source: BCRA

In the third quarter, bank loans to the private sector exhibited lesser momentum than in previous quarters. In the segment in pesos, the average monthly nominal growth of the third quarter fell down to 1%, whereas in real terms it posted an average monthly contraction of 2.5% seasonally-adjusted (see Figure 5.24). Thus, the nominal year-on-year growth rate fell from 50% in June down to 39% in September. The contraction against the previous quarter was widespread in all credit lines, and the contraction was led by promissory notes, pledge-backed and personal loans. In turn, there was also a reversal in the loans in dollars, which had been showing an upward trend in previous quarters, leading to a monthly contraction of 0.5% on average in original currency during the quarter (against an average monthly expansion of 1.8% in the first half of 2018).

Figure 5.24 | Loans to private sector in pesos (average real monthly % chg. s.a.)

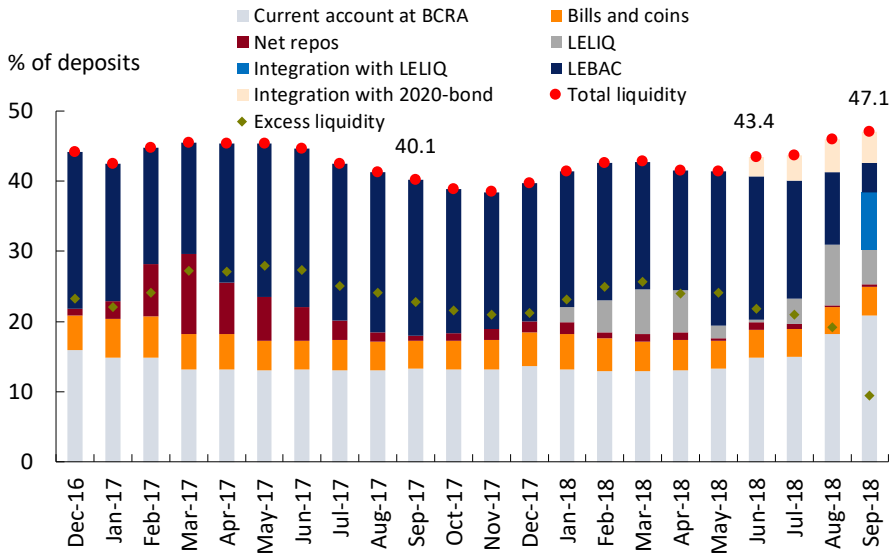


Source: BCRA

The rise of deposits and the lesser momentum of loans, together with the rise of minimum reserve requirements established by the Central Bank, continued to help increase broad liquidity in pesos of financial institutions during the quarter (+3.7 p.p.), to 47.1% in terms of deposits in September (see Figure 5.25)[48]. In addition, under the LEBACs unwinding program and the measures adopted to increase the minimum cash requirements (a portion of which may be satisfied with Central Bank's securities), there was a 12.7 p.p. increase in holdings of LELIQs, including holdings used to satisfy the minimum reserve requirements (+8.2 p.p.) and those of free availability (+4.6 p.p.), and also of current accounts with the Central Bank (+6 p.p.) to the detriment of LEBACs (-16.1 p.p.).

[48] Broad liquidity: deposits in current accounts with the Central Bank, cash, LELIQs, LEBACs, net repos and reserve requirement compliance with Bond 2020.

Figure 5.25 | Banking liquidity ratio



Note: LEBAC and NOBAC at effective value.
Source: BCRA

Finally, due to the above-stated rises in minimum reserve requirements, the surplus or voluntary liquidity of banks (net repos, LEBACs and LELIQs not used to satisfy minimum reserve requirements) fell 12.3 p.p. during the quarter, down to 9.5% of deposits in September.

Abbreviations and Acronyms

€: Euro

AFCP: *Asociación de Fabricantes de Cemento Portland*

AFIP: *Administración Federal de Ingresos Públicos*. Federal Administration of Public Revenues

APR: Annual percentage rate

AUH: *Asignación Universal por Hijo*. Universal Child Allowance

Avg.: Average

BADLAR: Buenos Aires Deposits of Large Amount Rate (Interest rates for deposits over 1 million pesos for terms of 30-to-35 days)

BCBA: *Bolsa de Comercio de Buenos Aires*. Buenos Aires Exchange

BCRA: *Banco Central de la República Argentina*. Central Bank of Argentina

b.p.: basis points

CABA: *Ciudad Autónoma de Buenos Aires*. Autonomous City of Buenos Aires

Bontes: *Bonos del Tesoro*. National Treasury bonds

CEMBI+: Corporate Emerging Market Bond Index Plus

CEMBI+AR: Corporate Emerging Market Bond Index Plus Argentina

CER: *Coeficiente de Estabilización de Referencia*. Reference Stabilization Coefficient

Chg.: Change

CNV: *Comisión Nacional de Valores*. National Securities Commision

CONADU: *Federación Nacional de Docentes Universitarios*.

CSJN: *Corte Suprema de Justicia de la Nación*. National Supreme Court of Justice

DJVE: *Declaraciones Juradas de Ventas al Exterior*. Export Sales Affidavit

ECB: *Banco Central Europeo*. European Central Bank

ECLAC: Economic Commission for Latin America and the Caribbean

EDP: *Equipo Durable de Producción*. Production durable equipment

EMAE: *Estimador Mensual de la Actividad Económica*. Monthly Economic Activity Indicator

EMBI+: Emerging Markets Bond Index Plus

EMBI+AR: Emerging Markets Bond Index Plus Argentina

EMBIG: Emerging Market Bond Index Global

EPH: *Encuesta Permanente de Hogares*. Permanent household survey

f: Forecast

FAECyS: *Federación Argentina de Empleados de Comercio y Servicios*

Fed: United States Federal Reserve

FEB: *Federación de Educadores Bonaerenses*.

FEDCAM: *Federación Nacional de Trabajadores Camioneros, Obreros y Empleados del Transporte Automotor de Cargas, logística y Servicios*

FESTIQyPRA: *Federación de Sindicatos de Trabajadores de Industrias Químicas y Petroquímicas de la República Argentina*

FGB: *Federación Gráfica Bonaerense*

FGPICD: *Federación Gremial del Personal de la Industria de la Carne y sus Derivados*

FIEL: *Fundación de Investigaciones Económicas Latinoamericanas*

FOB: Free on Board

FOMC: *Comité Federal de Mercado Abierto*. Federal Open Market Committee

FTCIODyARA: *Federación de Obreros Aceiteros y Desmontadores de la República Argentina*

GBA: *Gran Buenos Aires*. Greater Buenos Aires

GDP: Gross domestic product

IAMC: *Instituto Argentino de Mercado de Capitales*

IBIF: *Inversión Bruta Interna Fija*. Gross domestic fixed investment

ICC: *Índice de Confianza del Consumidor elaborado por la Universidad Torcuato Di Tella*. Consumer Confidence Index computed by the Torcuato Di Tella University

ICC-INDEC: *Índice del Costo de la Construcción*. Construction Cost Index

IGA-OJF: *Índice General de Actividad de Orlando J. Ferreres*. General Activity Index released by Orlando J. Ferreres

ILA: *Índice Líder de la Actividad*. Leading Activity Index

ILO: International Labour Organization

IMF: International Monetary Fund

INDEC: *Instituto Nacional de Estadística y Censos*. National Institute of Statistics and Censuses

INML: *Índice de Novillos del Mercado de Liniers*

IPC CABA: *Índice de Precios al Consumidor de la Ciudad de Buenos Aires*. Consumer price index for the City of Buenos Aires

IPC Córdoba: *Índice de Precios al Consumidor de la Provincia de Córdoba*. Consumer Price index for the Province of Córdoba

IPC-GBA: *Índice de Precios al Consumidor del Gran Buenos Aires*. Greater Buenos Aires Consumer price index

IPC-NP: *Indicador Nacional Ponderado*. Weighted national consumer price index

IPC San Luis: *Índice de Precios al Consumidor de la Provincia de San Luis*. Consumer price index for the Province of San Luis

IPIB: *Índice de Precios Internos Básicos*. Basic industrial price index

IPIM: *Índice de Precios Internos al Por Mayor*. Domestic wholesale price index

IPMP: *Índice de Precios de las Materias Primas*. Commodity price index

IPOM: *Informe de Política Monetaria*. Monetary Policy Report

ITCRM: *Índice de Tipo de Cambio Real Multilateral*. Real Multilateral Exchange Rate Index

LAC: Latin American Consensus Forecasts

LEBAC: *Letras del Banco Central*. BCRA bills

LELIQ: Central Bank Liquidity bills

LFPIF: *Línea de financiamiento para la producción y la inclusión financiera*

M2: *Billetes y monedas + cuasimonedas en circulación + cuentas corrientes en $ y cajas de ahorro en $*. Notes and coins + quasimonies + $ savings and current accounts

m.a.: moving average

MATBA: *Mercado a Término de Buenos Aires*

MERVAL: *Mercado de Valores de Buenos Aires*

MIP: *Matriz insumo-producto*. Input-output matrix

MOA: *Manufacturas de Origen Agropecuario*. Manufactures of agricultural origin

MOI: *Manufacturas de Origen Industrial*. Manufactures of industrial origin

MSCI: Morgan Stanley Capital International Index

MTEySS: *Ministerio de Trabajo, Empleo y Seguridad Social*. Ministry of Labor, Employment and Social Security

MULC: *Mercado Único y Libre de Cambios*. Single free exchange market

National IPC: *Índice de Precios al Consumidor Nacional*. National consumer price index

NOBAC: *Notas del Banco Central*. BCRA notes

OPEC: Organization of the Petroleum Exporting Countries

p.p.: Percentage points

PCP-BCRA: *Predicción contemporánea del BCRA*

PMI: Purchasing Managers' Index

PP: *Productos primaries*. Primary products

R$*:* Brazilian Real

REM: *Relevamiento de Expectativas de Mercado*. Market Expectations Survey

REPO: Repurchase Agreement

ROE: *Registros de Operaciones de Exportación*. Export operations records

Rueda REPO: Tasa de interés promedio de las operaciones a 1 día hábil entre entidades financieras en el mercado garantizado

s.a.: Seasonally adjusted

SIPA: *Sistema Integrado Previsional Argentino*. Argentine integrated social security system

SMATA: *Sindicato de Mecánicos y Afines del Transporte Automotor de la República Argentina*

SOESGYPE: *Sindicato Obreros de Estaciones de Servicio, GNC, Garages, Playas de Estacionamiento y Lavaderos de Autos de Capital Federal y Provincia de Buenos Aires*

SOIVA: *Sindicato Obrero de la Industria del Vestido y Afines*

STIA: *Sindicato Trabajadores de Industrias de la Alimentación*

SUTERH: *Sindicato Único de Trabajadores de Edificios de Renta y Horizontal*

TFP: *Productividad total de los factores*. Total factor productivity

TN: *Tesoro Nacional*. National Treasury

UATRE: *Unión Argentina de Trabajadores Rurales y Estibadores*

UCI: *Utilización de la capacidad instalada*. Installed capacity utilization

UOCRA: *Unión Obrera de la Construcción de la República Argentina*

UOM: *Unión Obrera Metalúrgica*

UOYEP: *Unión Obreros y Empleados Plásticos*

UPCN: *Unión Personal civil de la Nación*

US$: United States Dollar

***UTA**: Unión Tranviarios Automotores*

UTDT: *Universidad Torcuato Di Tella*. Torcuato Di Tella University

UTHGRA: *Unión de Trabajadores del Turismo, Hoteleros y Gastronómicos de la República Argentina*

UTICRA: *Unión de Trabajadores de la Industria del Calzado de la República Argentina*

UVA: *Unidad de Valor Adquisitivo*. Acquisition Value Unit

VAR: *Modelo de Vectores Autorregresivos*. Vector Autorregresive Models

VAT: Value added tax

VBP: *valor bruto de producción*. Gross production value

y.o.y.: year-on-year

YPF SA: *Yacimientos Petrolíferos Fiscales Sociedad Anónima*

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