Monetary Policy: Assessment and Outlook

The COVID-19 pandemic has continued to exert an adverse effect on economic activity and employment dynamics globally in the last few months. Health measures and economic policy responses to the COVID-19 pandemic remained focused on countering the effects of the crisis and creating the conditions for a sustainable recovery. The pandemic spread across Argentina on a heterogeneous basis. The infection rate in the Metropolitan Area of Buenos Aires gradually decreased during the third quarter, stepping up across the rest of the country until mid-October to decline ever since. The metropolitan area's greater relative share in the GDP shows that the economy recovered in part during the third quarter as new activities were resumed in the region. The set of policies developed by the National Government and the BCRA since the pandemic was declared in March favored domestic demand recovery by protecting the most vulnerable segments of the population, and keeping employment level and household income stable.

The year-on-year inflation kept on following a downward trend in the third quarter, standing at 37.2% in October, down 16.6 p.p. against last December. The ongoing gradual process of decline in the inflation rate agreed with a somewhat nonlinear and heterogeneous dynamics among CPI items. A series of factors had a bearing on lower inflation as favored by a reduced exchange rate volatility: health isolation and distancing measures, low levels of consumption, freezing of utility rates, and price administration policies developed by the National Government, just to mention a few. Going forward, the price formation process would be affected by several events, such as the recovery of the relative price of services, collective bargaining, and the recovery of retail trade margins in some sectors. However, a coordinated effort by the National Government and different sectors of the economy is expected to let inflation continue to go down on a sustainable basis.

Thus, economic conditions towards the end of the third quarter changed considerably against the first part of the year when the pandemic broke out. A better performance of the domestic economy—involving economic activity recovery and a decrease in the inflation rate—was hand in hand with a successful restructuring of the foreign public debt to private holders. The BCRA adjusted its monetary, exchange and credit policy guidelines[1] in early October to lay the foundations for managing the new reality that comes in the aftermath of the pandemic.

In this new scenario, **monetary policy** plays an essential role as an instrument of financial and external stabilization. Since the outbreak of the pandemic, the benchmark interest rate policy served two main purposes: to provide households and businesses with liquidity during the pandemic emergency and to protect savings in pesos. Once the most critical stage of the crisis was over, the BCRA began to follow an interest rate harmonization process with the view of developing savings and investment instruments in domestic currency with positive return over both inflation and the exchange rate.

1 http://www.bcra.gob.ar/PoliticaMonetaria/Politica_Monetaria.asp.

With staggered increases, the BCRA fixed the cost of overnight repos with financial institutions at 32% APR (37.69% EAR). Also, 7-day repos were resumed, currently negotiated at 36.5% APR (43.87% EAR). Initially, an increase in the reverse repo interest rate was accompanied by two falls in LELIQ bills interest rates, which were reversed by mid-November. Thus, the LELIQ bills interests rate stood at 38% APR (45.44% EAR). Concurrently, the limits to LELIQ bills holdings were changed to get down the cost of monetary sterilization. The BCRA enhanced its policy on interest rates harmonization by increasing the minimum return of 37% APR (44% EAR) by the end of October for 30-day time deposits of up to $1 million made by natural persons, and of 34% APR (39.8% EAR) for all other deposits.

Thus, the BCRA seeks, in coordination with other public bodies, to estimate an interest rate curve in pesos that may streamline and strengthen the operation of capital markets. The BCRA is ready to intervene in the market through open market transactions with the aim of increasing liquidity, and fostering sovereign debt markets' depth and transparency. These measures are intended to underpin a new stage in which domestic capital markets will increasingly stand out from other players as to the public sector's financing. In this vein, the National Treasury placed new bonds in the domestic market in October, thus reducing the amount owed to the BCRA for temporary advances by $125.780 billion. It has announced that it will not draw on this line for the rest of the year. In addition, it undertook to continue undergoing the early cancellation process as long as it can finance more than 110% of the total debt service falling due in 2020.

The **exchange policy** has the structural objective to keep the real exchange rate competitive and stable. Additionally, the BCRA follows a short-term strategy that seeks to actively address any temporary imbalances that may occur in the exchange market. Early this year, it set up a managed float exchange rate regime with the aim of lowering the exchange rate volatility. Thus, the current real exchange rate is up 3.3% against the historical average recorded since January 1997, which makes it consistent with a surplus in trade balance and the current account, and will allow to strengthen international reserves. Lower debt service in foreign currency following the successful swap of instruments held by private creditors and, to a lesser extent, the refinancing of the private external debt moved in the same direction. Foreign exchange market regulations are part of a short-term strategy that seeks to prevent temporary imbalances from affecting the international reserves position. Regulations are essential instruments to coordinate individual decisions taken in furtherance of the fiscal, external and monetary position. Likewise, macroprudential regulations are sought to be consistent with increased capital inflows being channeled to the real economy in the medium term.

Despite the current account surplus observed this year, there was an increase in the demand for foreign currency by companies to cancel foreign liabilities, and by households for saving purposes. The higher business demand was explained by high levels of external private sector indebtedness incurred during the previous administration and by a relaxation in the financial conditions resulting from the measures adopted to support the private sector during the COVID-19 pandemic. At the same time, these measures intended to sustain the income of the lower segments of the population—in a context of restricted consumption as a result of the pandemic crisis and greater precautionary savings— caused natural persons' build-up of net foreign assets to increase. During the third quarter, this trend was reinforced due to the volatility of the exchange rate spread on securities, and of the official exchange rate.

In this context, the BCRA has made some progress on measures for defusing tensions in the forex market, which supplemented the monetary policy strategies mentioned above. Regarding the nominal exchange rate, determined in the managed float regime, the BCRA exited the standard nominal depreciation mechanism, thus granting greater relative volatility to the peso depending on the needs in the economic environment. Furthermore, a round of negotiations in the Electronic Open Market (MAE in Spanish) was held to purchase Renminbi for foreign trade transactions only. On another note, the BCRA took, in coordination with other national agencies, several measures in September to improve the allocation of foreign currency and lay down the guidelines for refinancing the private-sector external debt in symphony with the normal operation of the forex market. All in all, refinancing by various companies that followed the guidelines set by the Central Bank evidenced the success of the scheme.

Regarding **the credit policy**, the BCRA decided against continuing to compensate for negative real interest rates, and focused on the needs of the new stage. During the economic and health emergency, the policy followed by the BCRA led to an unprecedented countercyclical performance of the productive financing, especially to MSMEs, members of the simplified tax regime, and self-employed workers. Most of the credit was channeled to MSMEs for working capital and to health service providers, amounting to $538.381 billion by early November. Subsidized credit lines for the payment of salaries (up to 120% of the minimum wage per worker) granted to companies whose turnover had grown below inflation year on year, accrued $5.124 billion by early November (reaching 8,631 companies and 245,512 employees). Meanwhile, $2.683 billion were granted under the line for companies with no bank financing—MiPyME Plus—since the credit was implemented. Zero-rate financing to members of the simplified tax regime, and self-employed workers reached $65.515 billion by mid-November. Under the new circumstances, the BCRA approved a financing scheme for the productive sector in October. These credit lines are intended for capital investment (30% APR as a maximum), and for working capital (35% APR as a maximum). In addition, they are targeted at health service providers of hospital services in the context of the COVID-19 emergency, and companies in need of machinery and equipment produced by MSMEs.

The BCRA will continue to closely monitor the development of monetary aggregates within the liquidity management framework. During 2020, the BCRA's policy has had an expansionary trend, aimed at meeting the liquidity needs of the private sector—in the context of the pandemic emergency—and financing the extraordinary measures adopted by the National Government to support business and households as well. The growth in the demand for money, standing at historically low levels before the pandemic, has contributed to sterilize a significant portion of the resources injected into the economy. The M2 to GDP ratio reached its peak of 17.1% in June as a result of the expansion of liquidity—which, in turn, stemmed from the financial aid offered during the pandemic emergency—, and a sharp GDP contraction in the second quarter. However, the M2 to GDP ratio has been going down since July on a phased basis accompanied by lower dynamics of the means of payment and a weaker recovery of economic activities. In this context, M2 is expected to stand at around 14% of GDP by the end of the year, only 1.0 p.p. above the 2010-2019 average. In turn, the Monetary Base would end the year at a level comparable to 8% of GDP, down 0.5% against the 2010-2019 average. The BCRA will remain committed to keep liquidity at an adequate level during the post-pandemic normalization period. Therefore, it will draw on all available instruments to support the economic recovery against the backdrop of a decreasing inflation.

Based on the foregoing, it is worth to note that the gradual normalization of the economy—which has allowed the BCRA to move forward in the harmonization of its policy interest rates—, together with a reasonable real exchange rate, allows to develop a scenario with consistent paths for interest rates, exchange rate, and price dynamics.

The BCRA holds that the monetary, exchange and credit policies formulated in coordination with the National Government will contribute to continue letting the economy return to normal, which is meant to be the macroeconomic foundation for economic development with social equity.