Monetary Policy Report

April 2017

BANCO CENTRAL
DE LA REPÚBLICA ARGENTINA

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ISSN 2313-9552
Online edition

Publication date | April 2017

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Contents and edition | Economic Research Deputy General Management

Publishing design | Communication Senior Management

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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.

In line with this vision, the BCRA has formally adopted an Inflation Targeting Regime, effective as from January 2017. As part of this new regime, the BCRA now releases its quarterly Monetary Policy Report. 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, April 18th, 2017.

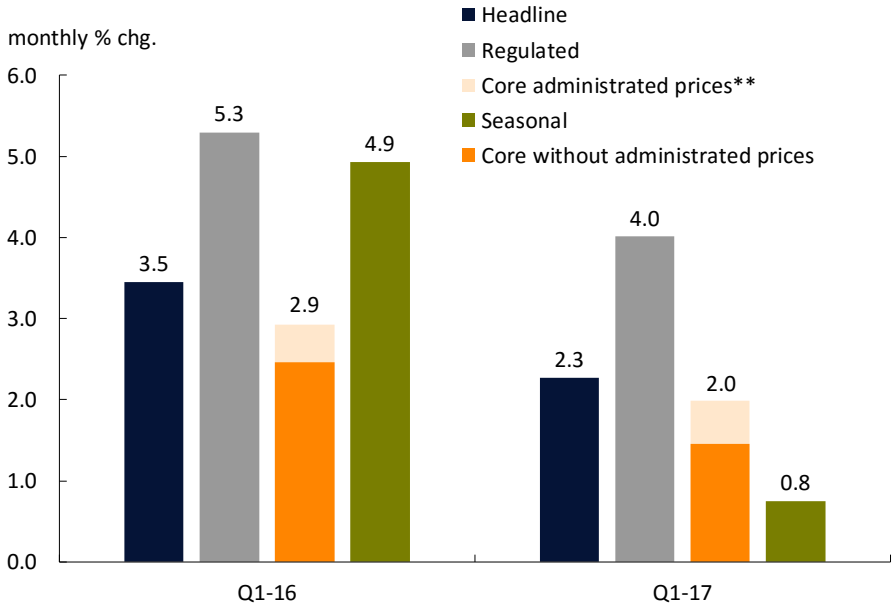
Contents

1. Monetary policy: Assessment and perspectives

In September 2016, the Central Bank of Argentina (BCRA) launched the inflation targeting regime. The targets are 12 percent to 17 percent for 2017, 8 percent to 12 percent for 2018, and 5 percent from 2019 on. This regime means that the Central Bank will use all available monetary policy instruments to accomplish its goals.

In Q1 2017, inflation was significantly lower than in the same period last year, in line with the marked disinflation experienced by the economy in the second half of 2016. This reduction was recorded in all components of the price index.

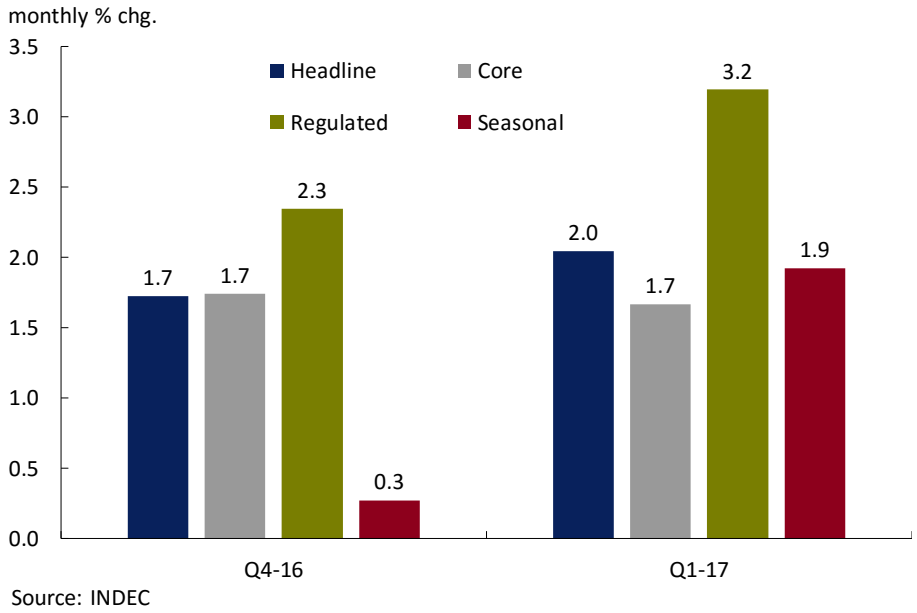
Figure 1 | Average monthly change by quarter. IPC-NP*



*The BCRA calculates the weighted average national consumer Price index (IPC-NP; see footnote 31). **Includes groups at level 3 of disaggregation, which encompass maintenance fees, domestic service, health insurance and ancillary services, and educational services.
Source: Statistical offices of San Luis, Córdoba and City of Buenos Aires

However, the inflation figure for Q1 2017 was above the figure for Q4 2016. The average monthly inflation, as measured by the Greater Buenos Aires consumer price index (IPC GBA) of the National Statistics Institute (INDEC) was 2.0 percent, 0.3 percentage points (p.p.) higher than in the previous quarter. The breakdown by category reveals that core inflation was the same in both periods (1.7 percent monthly), whereas the categories of regulated and seasonal goods accelerated its change rate and pushed headline inflation upwards.

Figure 2 | Average monthly change by quarter. IPC GBA



Source: INDEC

Although the behavior of regulated prices is as expected, the rest of the categories reported larger changes than was foreseen by the monetary authority.

When the BCRA noted that the disinflation process started shifting slightly above the expected path, it started to intervene through open-market operations with different types of LEBAC so as to withdraw excess liquidity and strengthen the transmission of the anti-inflationary policy bias to the other interest rates in the market. Seeing signs that April inflation might persist to be higher than the one compatible with the path established by the monetary authority, and after nine months during which core IPC GBA inflation fluctuated between a monthly rate of 1.3 percent and 1.9 percent, on April 11, the Central Bank decided to increase the policy rate by 150 basic points, to 26.25 percent. Thus, the BCRA maintains a clear anti-inflationary policy bias to ensure that the disinflation process continues toward its 12 percent to 17 percent inflation target in 2017.

Lower inflation improves income distribution and allows the economy to sustainably grow at a higher rate. In the Exhibit "The regressive impact of the inflationary tax" of the October 2016 IPOM, it was outlined that inflation reduces the purchasing power of the money saved by households, and reported that this impact is 2 to 4.7 times stronger —in terms of income— for the poorest sectors. In another exhibit of the same edition of the report, "Inflation and long-term growth", it was showed that those countries that have achieved lower inflation have been able to grow at higher rates than in the previous period. It is for these reasons —inequality reduction and robust growth— that the Central Bank is thoroughly committed to lowering inflation and meeting its targets.

Economic activity grew slightly in the third quarter of 2016 and expanded at a higher rate in the fourth quarter, in line with the projections included in the January 2017 edition of the IPOM. This recovery was reflected in a slight improvement of labor market conditions. A gradual recovery in formal employment in the private sector began in mid-2016. From May 2016 to January 2017,

93.300 private Jobs were created. Growth was accounted for by exports and the buildup of agricultural stocks, fueled by the record wheat harvest. Investment slowly began to come along with the recovery process since early 2017, and a gradual recovery of private consumption is expected for the rest of the year.

The productive sectors that led the cycle late last year —the agricultural sector, construction, transport and financial intermediation— were gradually joined by other sectors, such as the agricultural-industrial sector, commerce, and real estate activities. Growth will continue to expand over the course of 2017. Projected demand supports the expectation of the Market Expectation Survey (REM), which foresees an expansion in the economic activity of 2.8 percent in 2017.

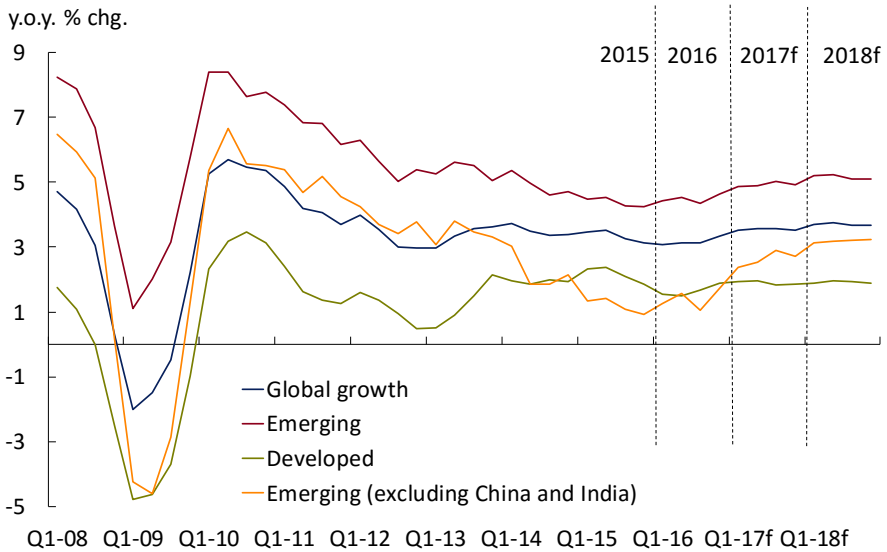
2. International Context

World trade and activity data showed greater dynamism in the last few months, both in advanced and emerging countries, in a context of lower volatility in financial markets. This year, a slight improvement is expected in global economic activity, with higher growth rates of emerging economies, excluding China and India (see Figure 2.1).

Regarding inflation, it has increased partially by the rise in the price of oil in 2016. Thus, inflation rates in advanced economies are in some cases close to their target levels. This increase in global inflation is expected to continue in 2017, driven by advanced economies, despite the lower inflation projected for emerging countries.

The main risks that may alter this landscape are: 1) a faster than expected by the markets increase in the monetary policy rate of the US Federal Reserve (Fed); 2) implementation of more protectionist trade policies; 3) an increase in political uncertainty in Brazil deteriorating activity level prospects; 4) a surge in geopolitical tensions in the Middle East impacting the markets; and 5) tensions in European markets due to queries regarding the block cohesion.

Figure 2.1 | Global growth. Emerging and developed countries

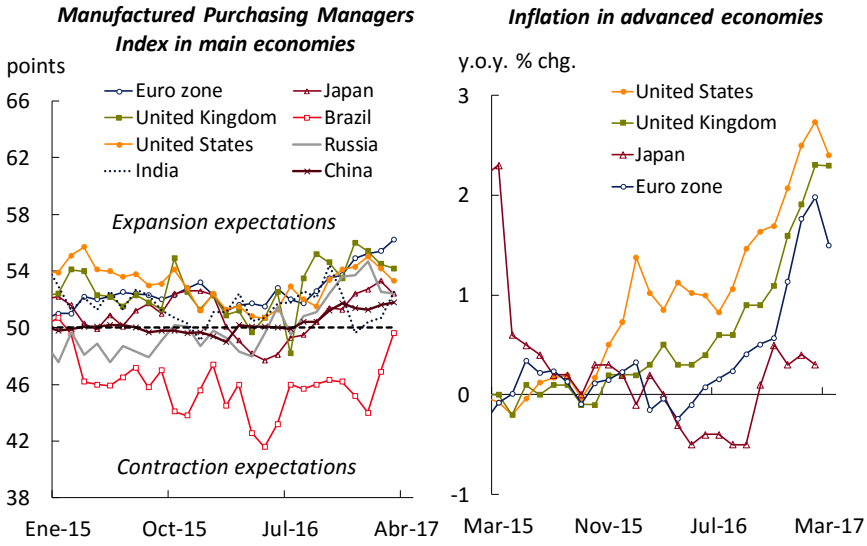


f: Forecast
Source: IMF IFS, IMF WEO, FocusEconomics and Brasil Central Bank Focus Survey

2.1 The world economic activity recovery is consolidated

During the first months of 2017, leading indicators show that the global activity level may have indeed consolidated, and the recovery which started in 2016 may have been accelerating. On the other hand, pari passu with the rise in oil prices which began in the second half of 2016, inflation rates in the main advanced economies continued increasing, and in some cases, such as the United States and the United Kingdom, it even exceeded the inflation target (despite the decrease in the last available data; see Figure 2.2).

Figure 2.2 | Manufactured Purchasing Managers Index in main economies

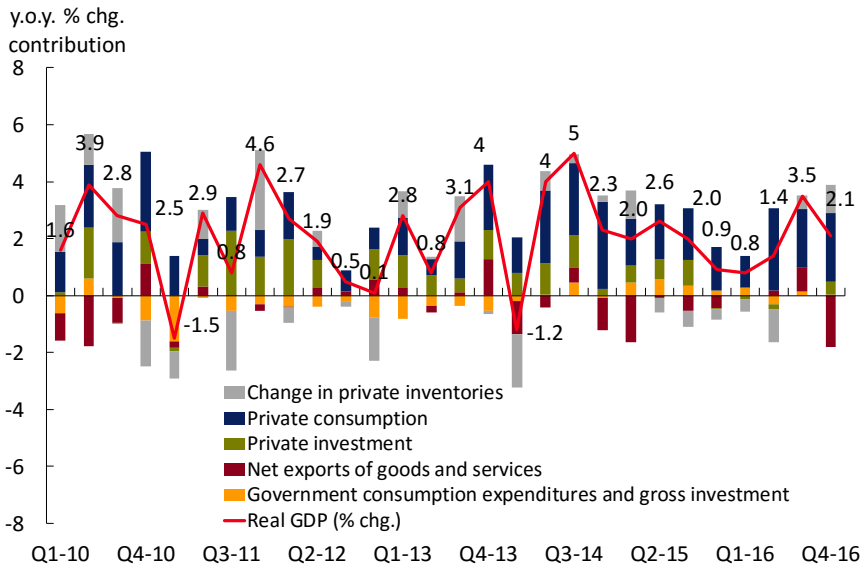


Source: Datastream

In the fourth quarter, the economy in the United States grew by 2.1 percent (annualized), virtually in line with market projections. The growth was mainly driven by private consumption, with a contribution of 2.4 percentage points, while net exports reduced growth by 1.8 percentage points. With the fourth quarter data, the U. S. economy growth reached 1.6 percent in 2016, the lowest growth in five years, mainly as a result of the performance of the first half of the year (see Figure 2.3).

On the other hand, since the U. S. economy is showing levels close to full employment (see Figure 2.4) and an inflation rate around the target[1], in its mid-March meeting the Fed decided to increase the reference interest rate target, the federal funds rate (FFR), by 0.25 percentage points, to the 0.75-1 percent range.

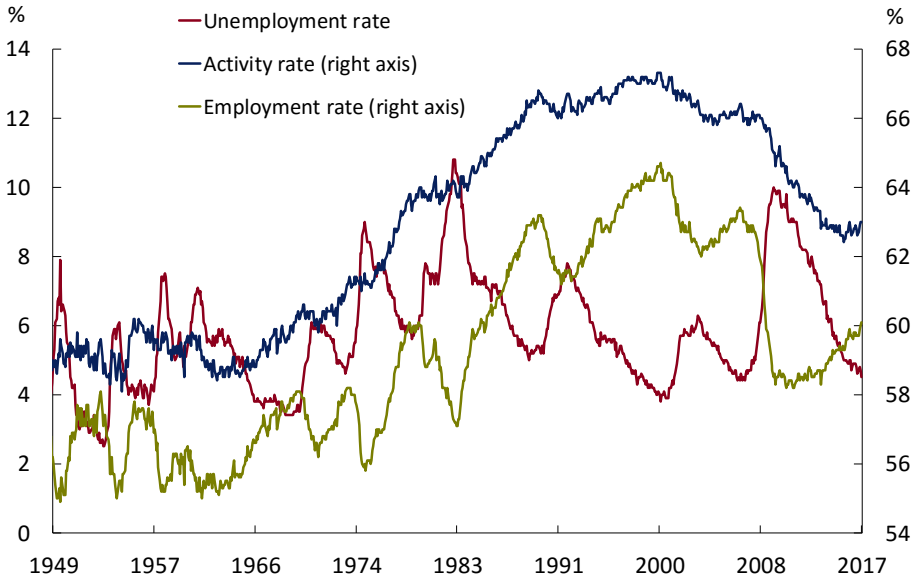
Figure 2.3 | United States GDP growth. Demand components desagregation



Source: Bureau of Economic Analysis

[1] The Fed does not follow a traditional Inflation Targeting Regime, but, in compliance with its mandate, it must promote the "highest" level of employment, moderate long-term interest rates, and stable prices. Regarding the stable prices goal, in the Federal Open Market Committee (FOMC) on January 25, 2012, a 2 percent annual variation target was set for personal consumption expenditures (PCE) in the long term.

Figure 2.4 | United States labor market indicators



Source: Bureau of Labor Statistics

Based on the last available projections of the IMF[2], the U. S. economy is expected to grow around 2.3 percent in 2017 (0.7 percentage points more than 2016), with a 2.6 percent inflation and an unemployment rate of 4.8 percent. However, considering the dynamics observed in the first months of the new US administration, the implementation of the fiscal stimulus measures announced during the election campaign will probably be delayed. In addition, as mentioned in the last IPOM, it persists the risk for the global economy that the United States may apply more protectionist trade policies.

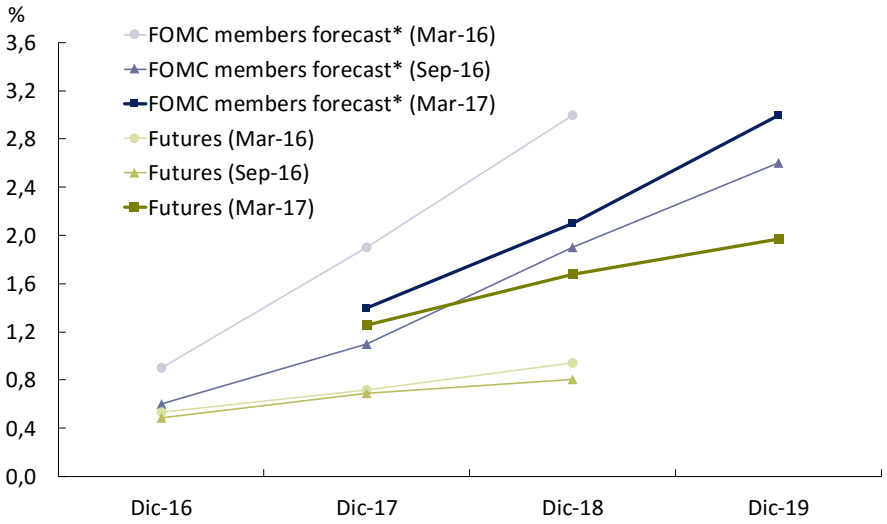
In this context, and considering the FOMC[3] releases and projections3, two more FFR target increases are expected in the rest of 2017 (by the end of the year, it would be in the 1.25 percent – 1.5 percent range; see Figure 2.5)[4]. Additional and unexpected increases of the FFR target may have a negative impact on the region, increasing the funding and capital outflow cost, particularly the latter, if they occur in a stagflation scenario. By contrast, an increase in the FFR target linked to higher growth rates in the United States, as mentioned in the last IPOM, would have a positive impact on the world economic activity, including an increase in capital flows towards the region, as shown by evidence[5].

On the other hand, the Chinese economy context improved as compared to the previous IPOM, although there persist some risks related to high levels of indebtedness and high real estate prices, with their potentially disruptive effects on the financial system. However, activity data of late 2016 confirms that China achieved its growth target for that year (6.5 percent – 7 percent.), while the early 2017 indicators

[2] *World Economic Outlook*, January 2017 and October 2016.
[3] Corresponding to the last meeting in March, 2017.
[4] According to the FOMC March meeting minutes, the Fed might start reducing its balance sheet by the end of 2017. To that end, it would stop reinvesting the capital and interest incomes from maturity of Treasury securities and mortgage-backed securities, totally or partially. However, liquidity injections of the main central banks will continue being expansionary in marginal terms. See: Davies, G. (2017): "The end of global QE is first approaching", Financial Times, March 26.
[5] See: Felices, G. and B. Orskaug (2008): "Estimating the determinants of capital flows to emerging market economies: a maximum likelihood disequilibrium approach", Working Paper No. 354, Bank of England, November; Forbes, K and F. Warnock (2011): Capital Flow Waves: Surges, Stops, Flights and Retrenchment, Working Paper 17351, NBER, August; De Vita, G. and K. Ky-aw,(2008): "Determinants of capital flows to developing countries: a structural VAR analysis", Journal of Economic Studies, Vol. 35 Iss 4, and Calvo, G., L. Leiderman, and C. Reinhart (1993): "Capital Inflows and Real Exchange Rate Appreciation in Latin America: The Role of External Factors," IMF Staff Papers, Vol. 40, No. 1.

show a sustained economic growth level. Indeed, the Chinese GDP increased by 6.7 percent in 2016, slightly below the growth in 2015 (6.9 percent). For 2017, the IMF projects a growth around 6.5 percent.

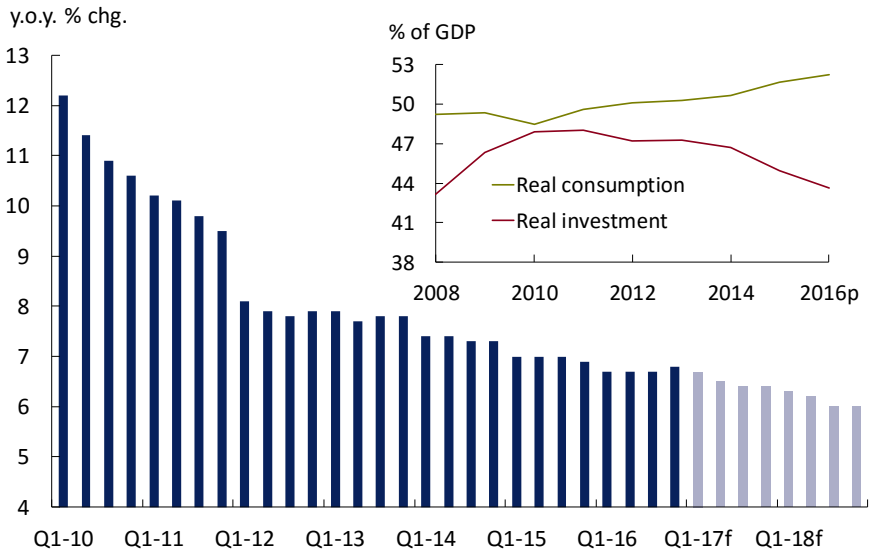
Figure 2.5 | United States. FOMC members forecast and futures of the Fed Funds target



*Median of the Federal Open Market Committee
Source: Bloomberg

So far, the Chinese economy has been performing, with a certain degree of success (without an abrupt slowdown in the economy)[6], the rebalancing process from a growth based on high levels of investment, exports, and savings to one with a higher private consumption rate[7] (see Figure 2.6).

Figure 2.6 | China. Growth, consumption and investment

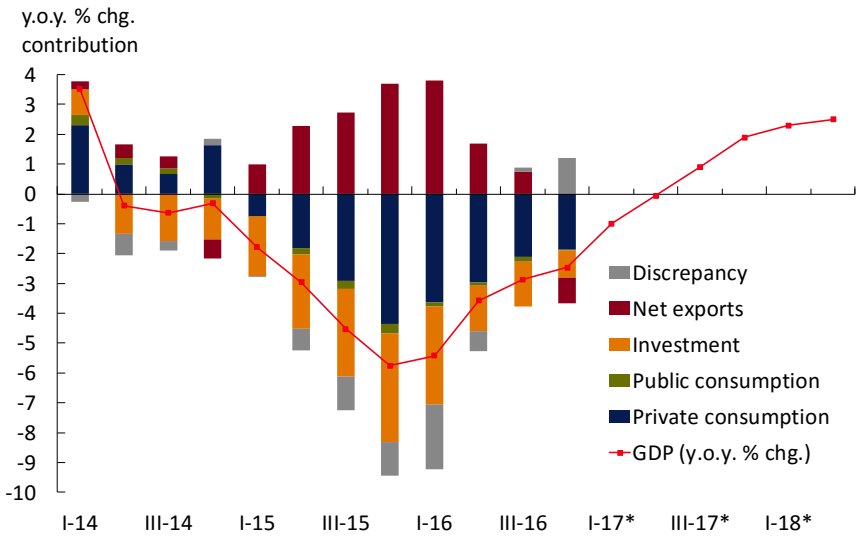


f: Forecast
Source: IMF, FocusEconomics and Quandl

[6] However, it should be noted that the growth in 2016 was in part driven by a strongly expansionary bias in the monetary policy and an increase in fixed gross domestic public investment versus lower private investment growth rates.
[7] Nevertheless, some analysts claim that this process would not be sustainable. See Wolf, M. (2017): "China faces a tough fight to escape its debt trap", Financial Times, April 11.

Brazil, the main economy in the region, continued in recession in 2016, although prospects for this year are better. The Brazilian economy contracted by 3.5 percent last year (after a 3.8 percent reduction in 2015), with projections of a slight growth in 2017 (around 0.2 percent) which would start during the second half of the year [8] (see Figure 2.7). The Central Bank of Brazil (BCB) is expected to continue with the process of monetary policy rate reduction , the Selic rate target, which in 2016 was reduced by 2 percentage points to 12.25 percent[9], in a disinflation context. Therefore, the inflation rate went from 10.7 percent in late 2015 to 6.3 percent in late 2016, returning to the inflation target of the BCB (4.5 percent ± 2 percentage points). In addition, according to the last market expectations survey, inflation would be around 4.1 percent by the end of 2017, while the BCB would reduce the Selic target to 8.5 percent. The fiscal imbalance is also expected to continue with its reduction process. An eventual progress in the process of impeachment of the President (being conducted in the Superior Electoral Court) could alter the aforementioned scenario.

Figure 2.7 | Brazil. GDP growth contribution

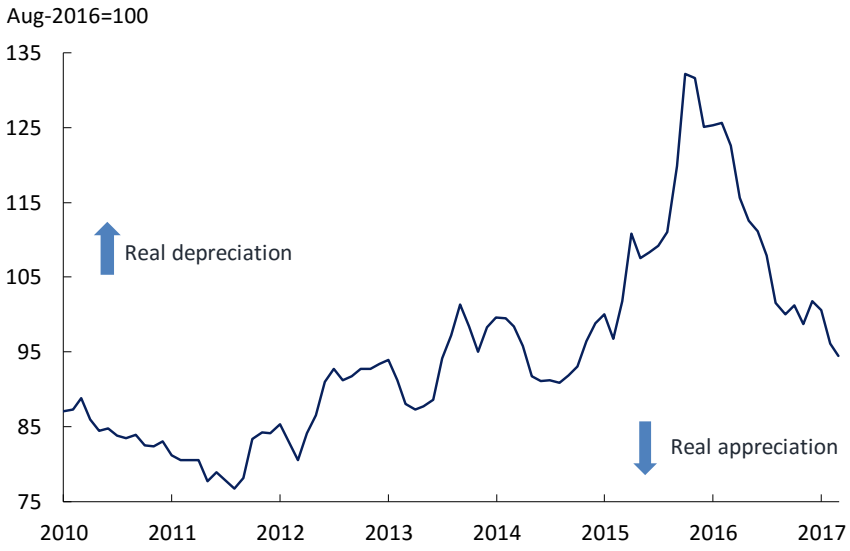


Source: LCA Consulting and Brasil Central Bank Focus Survey

In the last few months, in the face of a better growth prospects for Brazil, the real exchange rate appreciation, both multilateral and bilateral with the U. S., continued. Indeed, the Real appreciated 28.5 percent and 25.8 percent, respectively, since September 2015 (see Figure 2.8).

[8] The previous IPOM anticipated a recovery of the activity level starting as from the first quarter of 2017.
[9] On April 12, 2017, the BCB reduced the Selic rate target to 11.25 percent.

Figure 2.8 | Brazil real exchange rate evolution

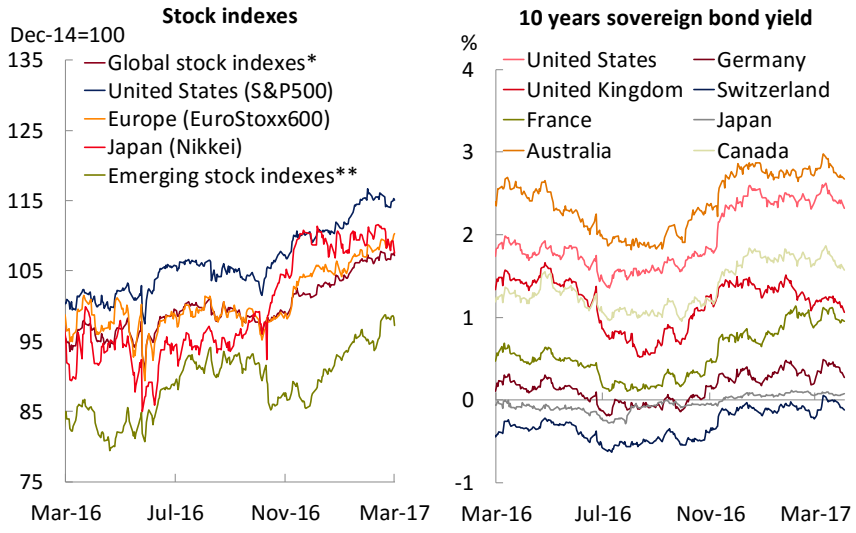


Source: BIS

2.2 A certain improvement was observed in international financial markets

The uncertainty period that arose in international financial markets after the results of the U.S. elections changed towards one where investors are expectant regarding: 1) which of all the measures announced during the U. S. election campaign[10] may be effectively implemented; 2) the Fed's monetary policy decisions in the next months; 3) questions about the European Union future; and 4) geopolitical risks in the Middle East. Most stock market indexes continued showing an upward trend, while sovereign debt securities yields continued relatively constant (see Figure 2.9).

Figure 2.9 | Stock indexes and 10 years sovereign bond yield

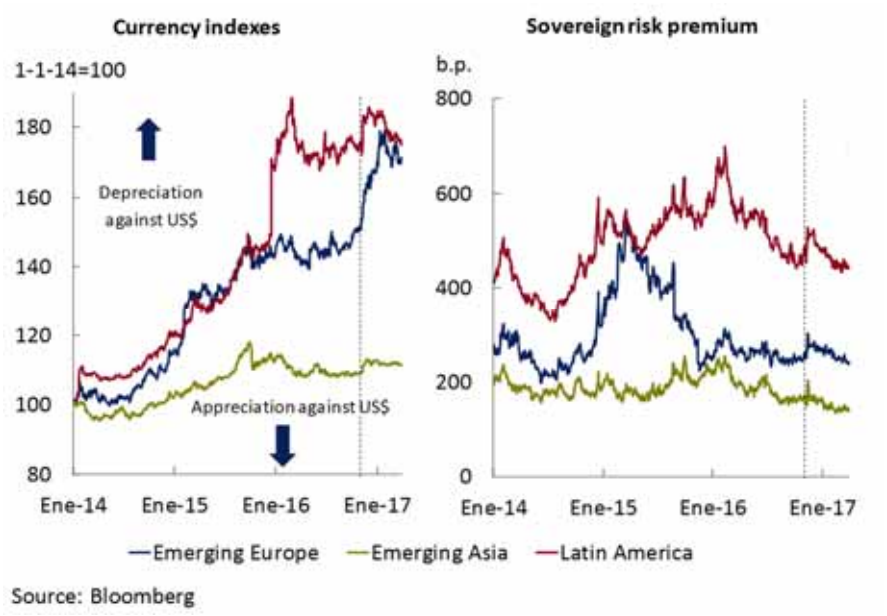


*MSCI global; **MSCI emergentes
Source: Bloomberg

[10] According to the campaign announcements, policy changes were expected as regards globalization, specifically in policies related to trade flows, decisions on real investment flow allocation, and immigration.

In this scenario, emerging Europe and Latin America currencies, those which had depreciated the most against the U. S. dollar after the elections in the United States, showed values around the ones observed before the election, while the currencies in emerging Asia continued to be relatively stable. A similar behavior was observed in sovereign risk premiums, although, in all cases, they were reduced as regards pre-elections values (see Figure 2.10.

Figure 2.10 | Emerging countries. Financial indicators

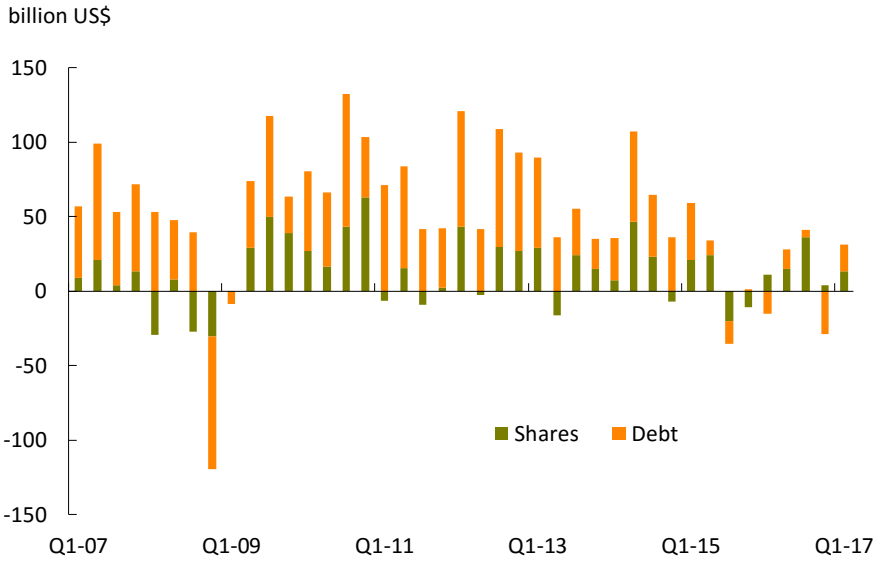


Source: Bloomberg

These investor changes were reflected, *pari passu* with the evolution of the exchange rate, in the short-term capital flows to emerging countries. Therefore, short-term capital net inflows returned to emerging economies during the first quarter of 2017 (see Figure 2.11).

To sum up, prospects for the next months are of higher growth and, particularly in advanced countries, higher inflation. In this context, a tightening of the Fed's monetary policy is expected. However, the monetary policy bias at a global level will continue to be expansionary, and exceptional liquidity conditions will continue to exist in emerging countries.

Figure 2.11 | Capital short term flows to emerging economies



Source: Institute of International Finance

Exhibit 1 / Interest rate hike in the US and capital flows: what impact would it have in Latin America?

With the US economy near full employment and inflation around the established target, the Federal Reserve resumed its interest rate hike cycle in late 2016 (see section 2.1). This was coupled with an improved outlook for global growth (supporting the expectation that the European Central Bank will start withdrawing its monetary stimulus, for example) and several political events (the Brexit vote, the new US administration) to increase the risk of a reversion of capital flows to emerging countries. This box analyzes the potential impacts on capital flows to Latin America.

The factors that are external to the region, such as world growth and interest rates, are significant drivers of capital flows to Latin America. Following Calvo and others (1993), the main components of international reserves, the balance in the capital and financial accounts (as an approximation to net capital flows) and the real exchange rate were calculated for a sample of Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay). The main component of a set of series is a new series that "summarizes" the set's variability, thus making it possible to represent its behavior. The first main component of each of these variables (reserves, capital account balance, real exchange rate) was correlated to the US gross domestic product (GDP), the yields of 3-month and 10-year US Treasury bonds, and the US multilateral exchange rate index for the 1994-2016 period. The choice of two interest rates is based on the fact that one of these is more linked to monetary policy (3-month rate) and the other, to medium-term economic conditions (10-year rate).

Results (see Table 1) show a high positive correlation between the capital account balance and international reserves and the US GDP, and a high negative correlation between the former two components and interest rates. The correlation between reserves and capital flows, on the one hand, and the US dollar, on the other, is negative, but lesser in magnitude. The real exchange rate, in turn, shows essentially null correlations. Thus, US growth is associated with capital flows to Latin America and reserve accumulation in the region, whereas interest rate hikes –both in the short and the long term– are associated with capital outflows and decreased international reserves, which is also the case, although to a lesser extent, with dollar appreciation.

Table 1 | Correlation of main components of reserves, capital flows and real exchange rate in Latin America with selected variables

First main component	US GDP	US multilateral exchange rate	US Treasury 10-year bond yield	US Treasury 3-year bond yield
Internacional Reserves (0.8319)	0.83	-0.29	-0.86	-0.76
Capital and financial account balance (0.6378)	0.73	-0.35	-0.8	-0.72
Real exchange rate (0.3274)	-0.02	0.04	-0.05	0.03

Countries included in the sample, 1994-2016: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay.

This may be interpreted as follows:

- By making US bond yields more attractive than those of Latin American financial assets, higher interest rates are associated with a capital outflow from the region. At the same time, this causes the US dollar to appreciate.

- US growth entails not only higher consumption in the country, but also higher savings and a channeling of those savings to regions such as Latin America.

This exercise suggests that interest rates and external growth operate in opposite directions, the final outcome not being predetermined beforehand. If growth prevails, then that would bring a capital inflow toward the region; if, on the other hand, higher interest rates dominate, capital outflows are to be expected.

3. Economic Activity

The Argentine economy has consolidated the beginning of its expansive phase in the fourth quarter of 2016, in line with the projections of the January 2017 IPOM. The recovery in the activity was reflected in a slight improvement of the labor market conditions. Formal employment in the private sector has gradually improved since mid last year. From May 2016 to January 2017, 93,300 new private jobs were created, without taking into account the self- employees.

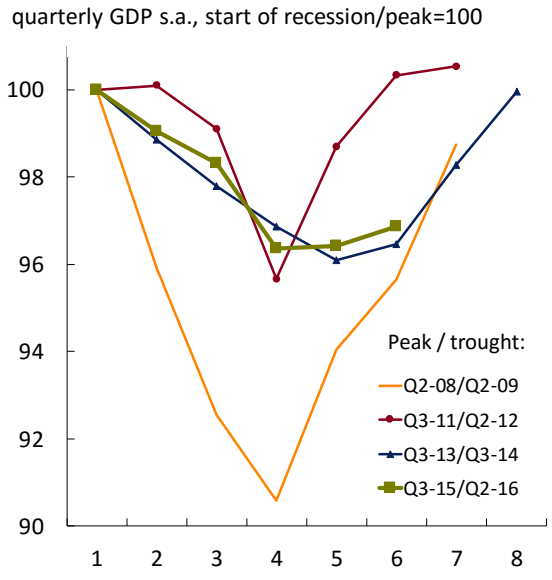
Growth was accounted for by exports and the accumulation of agricultural inventories, favored by the record wheat harvest. Investment slowly joined the reactivation process since early 2017, and a gradual increase in private consumption is expected for the rest of the year. Investment will continue to be boosted by the implementation of public infrastructure work, benefited by the incentives adopted for imports of capital goods and strategic agreements in certain sectors, such as energy, in a framework of improved funding conditions. Private consumption will be favored by an increase in the real income for families, thanks to the decrease in inflation. The productive sectors that led the cycle late last year —agriculture, construction, transport and financial intermediation— have now been joined by the agricultural-industrial sector, commerce and real estate activities. Growth will continue to spread throughout 2017. The demand projected behavior mantains the expectation of the Market Expectation Survey (Relevamiento de Expectativas de Mercado, REM), which foresees a 2.8 percent expansion of the economic activity in 2017.

3.1 A gradual consolidation of the economic recovery

3.1.1 In end-2016, recession was left behind

In the fourth quarter of 2016, the economy consolidated the beginning of its recovery phase. In this period, the GDP recorded a growth of 1.9 percent yearly (0.5 percent quarterly, seasonally adjusted), in line with the market expectations and the projections from the last IPOM. The official data have confirmed that the economic recession came to an end in the second half of 2016, as anticipated by the BCRA's Leading Activity Index (ILA-BCRA). Between the third quarter of 2015 and the second quarter of 2016, the beginning and end of recession, the accumulated decrease of the product reached 3.6 percent (see Figure 3.1). Thus, the recession that led to a 2.3 percent economic contraction in 2016 was left behind.

Figure 3.1 | Real Gross Domestic Product

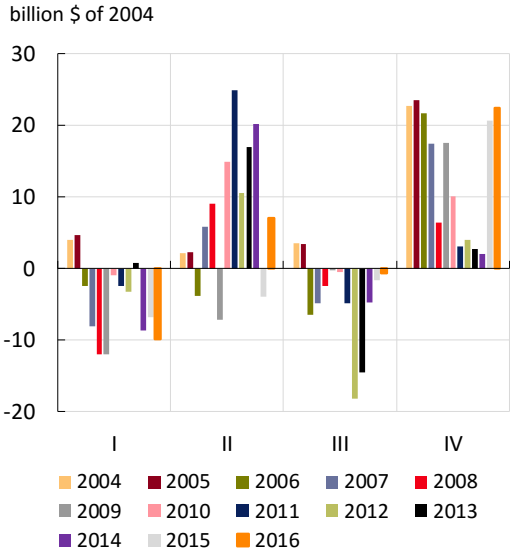


	2014	2016
	y.o.y. % chg.	
GDP at constant prices	-2.5	-2.3
Private consumption	-4.4	-1.4
public conseumtion	2.9	0.3
Gross domestic fixed investment	-6.8	-5.5
Construction	-3.6	-12.8
Durable equipment	-10.3	1.4
Goods and services exports	-7.0	3.7
Goods and services imports	-11.5	5.4
Net exorts (p.p.)*	0.6	-0.6
stock chg. and discrepancy (p.p.)*	0.1	0.4

Source: INDEC

The recent reactivation was accounted for by exports of goods and services, unlike the 2013-2014 cycle. During the fourth quarter of 2016, external sales bounded sharply (3.2 percent seasonally adjusted),mainly from the agricultural-industrial and the automotive sectors —in the case of the latter, due to the influence of higher demand from Brazil. The record wheat harvest —62.7 percent higher than the previous campaign— impacted both in the evolution of exports, which benefited from the opening of new markets, and in the accumulation of agricultural stock (see Figure 3.2).

Figure 3.2 | GDP change in inventories

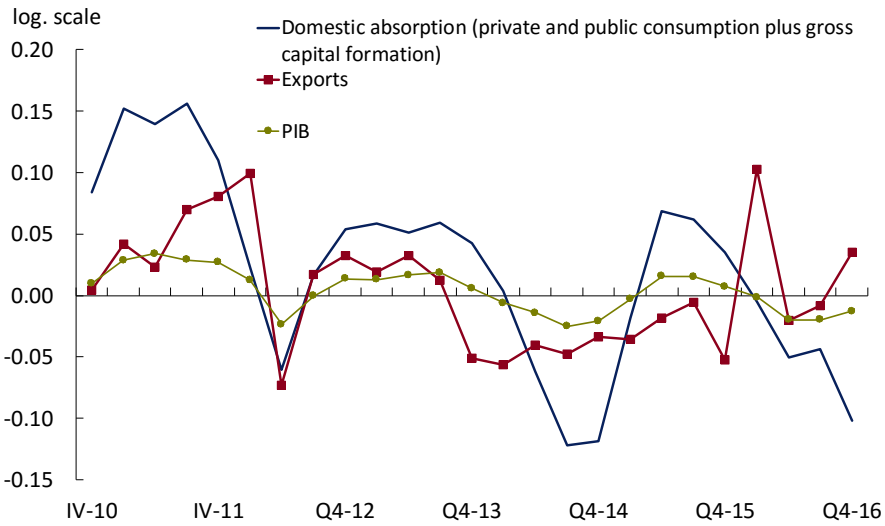


	Q4-16	
	q.o.q. % chg. s.a	Contrib. in p.p. to q.o.q. % chg. s.a.
GDP constant prices	0.5	0.5
Private consumption	-0.9	*-0.7*
Public consumption	-2.5	*-0.4*
Gross investment	-1.5	-0.3
-Construction	-3.0	-1.1
-Durable equipment	1.8	1.0
Exports	3.2	*0.6*
Imports	2.5	*-0.7*
Net exports	0.2	*-0.0*
stock chg. and discrepancy	589.3	*1.8*

Source: INDEC

The internal absorption contracted during the fourth quarter of 2016 (-1.2 percent seasonally adjusted —s.a.—; see Figure 3.3) relative to the previous quarter. This performance, which did not meet the BCRA's expectations, was mainly accounted for by the retraction of private consumption (-0.9 percent s.a.) and, to a lesser degree, by investment (-1.5 percent s.a.). Within the latter, investment in durable production equipment stood out, with a quarterly growth of 1.8 percent s.a. boosted by heavy vehicles purchases (+16.9 percent s.a.).

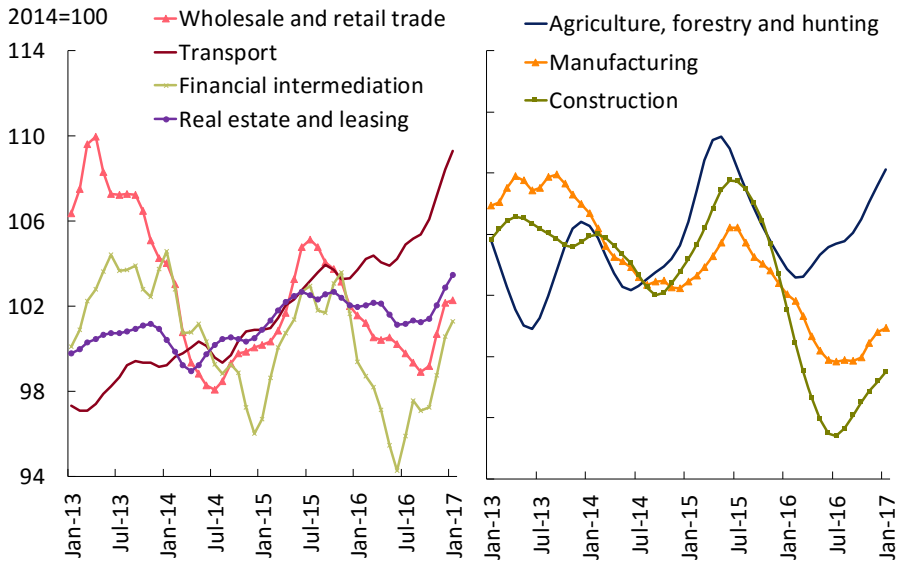
Figure 3.3 | GDP and demand components



Source: INDEC

The economic recovery was accompanied by a higher spread of growth across productive sectors. Based on the new Monthly Estimator of Economic Activity, recently released by the INDEC, the agricultural sector, construction and financial intermediation have led the increases, and later the reactivation expanded to cover other activities as well (see Figure 3.4). From June to January 2017 (latest available data), activity in the agricultural sector increased around 7.7 percent s.a.; in financial intermediation 8.2 percent s.a., and in construction, 10.7 percent s.a. from the bottom reached in April. Industry accumulated a 2.9 percent growth relative to October, pulled up by agricultural-related categories, with quarterly increases in over 70 percent of industrial branches. In the services sector, transport accelerated its growing trend since September 2016, whereas commerce and real estate activity entered an expansive phase during the fourth quarter of 2016.

Figure 3.4 | Monthly Economic Activity Estimator (EMAE) by sectors



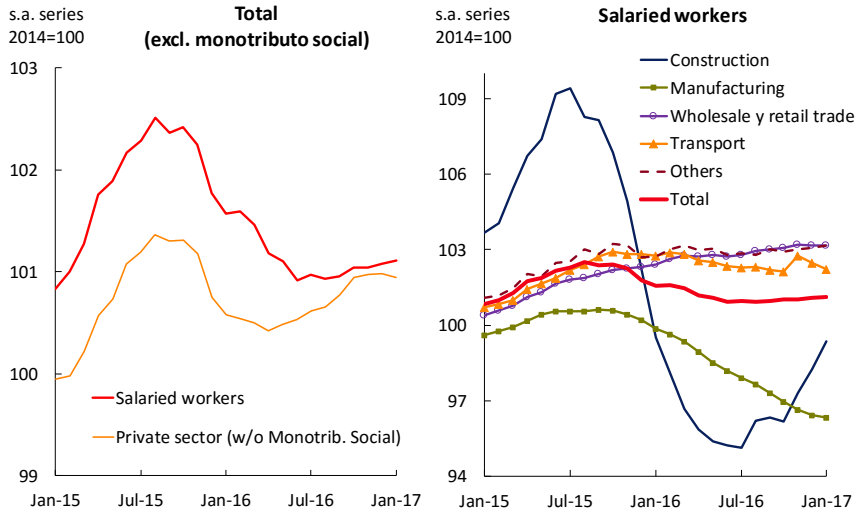
Source: INDEC

The recovery of activity translated into an improvement of labor market conditions. Formal employment in the private sector[11] has gradually increased since mid-year. Thus, from May 2016 to January 2017, 93,300 formal jobs were created, without taking into consideration the self- employees (0.5 percent after deducting seasonal effects). At the sectoral level, private formal employment has accompanied the economic recovery, fueled by the agricultural sector, construction, and services, such as commerce, real estate, and transport activities. Industry has been the only exception, but the consolidation of the reactivation is expected to start creating jobs in this sector in the second half of the year (see Figure 3.5).

According to the INDEC, the unemployment rate decreased from 8.5 percent in the third quarter of 2016 to 7.6 percent in the fourth quarter, although part of the dynamics reflected seasonal factors of the period. The outlook for the first quarter of 2017 is encouraging, according to the job-creation expectations survey for the next three months, carried out by the Labor Indicators Survey (EIL) of the Ministry of Labor, Employment and Social Security[12].

[11] According to data released by the Ministry of Labor, Employment and Social Security, which records the number of workers rather than job positions.
[12] EIL: Encuesta de Indicadores Laborales. From January to February 2017, the net job-creation expectation (the percentage of respondents who expect to increase their staff minus the percentage that expects staff reductions) was 6.8 percentage points, relative to the 4.6 percentage points average in the fourth quarter of 2016.

Figure 3.5 | Private formal employment level

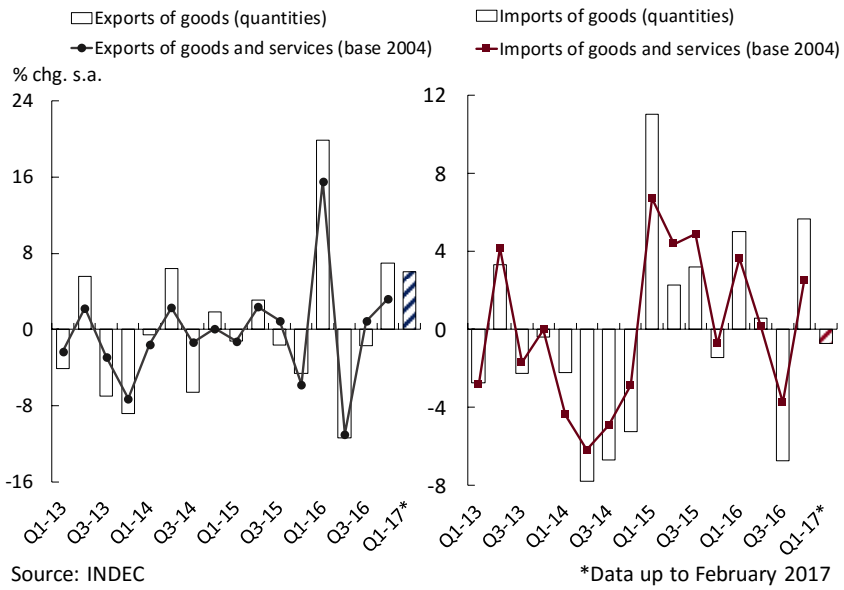


Note: Private sector includes salaried, monotributistas y self-employees.
Source: Ministry of Labor, Employment and Social Security

3.1.2 In 2017 the internal market is joining the recovery started by the external sector

In the first quarter of 2017, goods exports continued to boost demand, increasing 6 percent quarterly s.a.[13] (see Figure 3.6). Apart from wheat sales —whose stocks accumulated in the fourth quarter of 2016[14]—, this performance was due to plastic, biodiesel and common metal exports, among others. The decrease in imported goods (-0.7 percent s.a. in the first two months of the year) would ensure that net external demand makes a positive contribution to the growth of local activity in the first quarter of the year. Within external purchases, the largest category was spare-parts and accessories for capital goods and transport equipment, which increased 7.7 percent s.a. relative to the previous quarter.

Figure 3.6 | Exports and imports of goods and services at constant prices



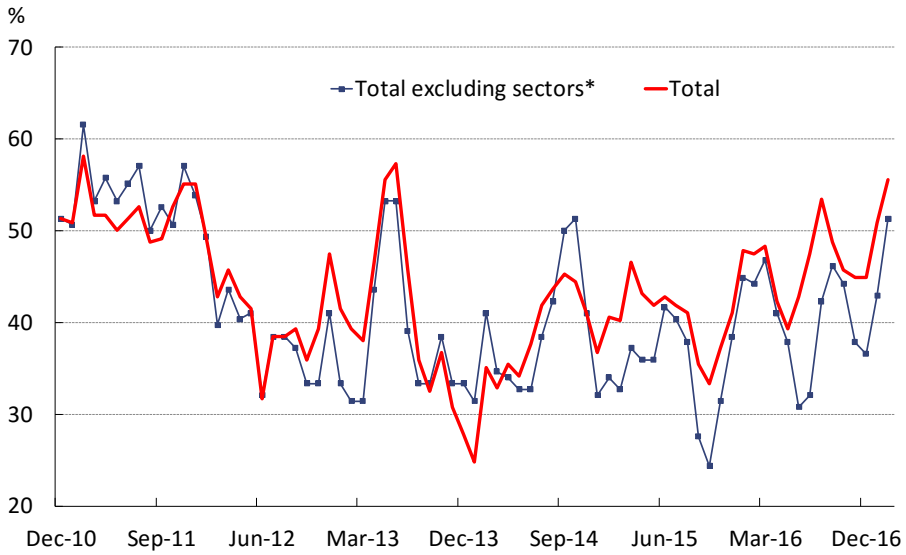
Source: INDEC

*Data up to February 2017

[13] Estimated based on official data on goods exports in the first two months of 2017, together with the evolution of shipments traded in March.
[14] An increase in exports with a trade-off of a decrease in stocks would not have a significant effect on the output variation. Given that the increase in stocks in the fourth quarter of 2016 was mainly accounted for by wheat production and that, excluding grains, export volumes increased 0.6 percent from January to February in seasonally-adjusted terms relative to the previous quarter, a positive incidence of exports on growth is expected for the first quarter of 2017.

The improvement in exports since end-2016 has been widespread. The year-on-year exports growth diffusion index showed that, in February, 61.5 percent of exporting sectors increased their external sales, the maximum level of growth diffusion since May 2013. This result is even better (65.4 percent) when excluding from the analysis the sectors that may respond to specific dynamics, such as those related to factor endowment (grains, oilseeds and precious metals) or to the external demand from a specific market (land transport material). This higher performance of most exporting sectors in the country since mid-last year reflects the positive impact of the economic measures adopted since end-2015 on companies' external insertion (see Figure 3.7).

Figure 3.7 | Exports diffusion index

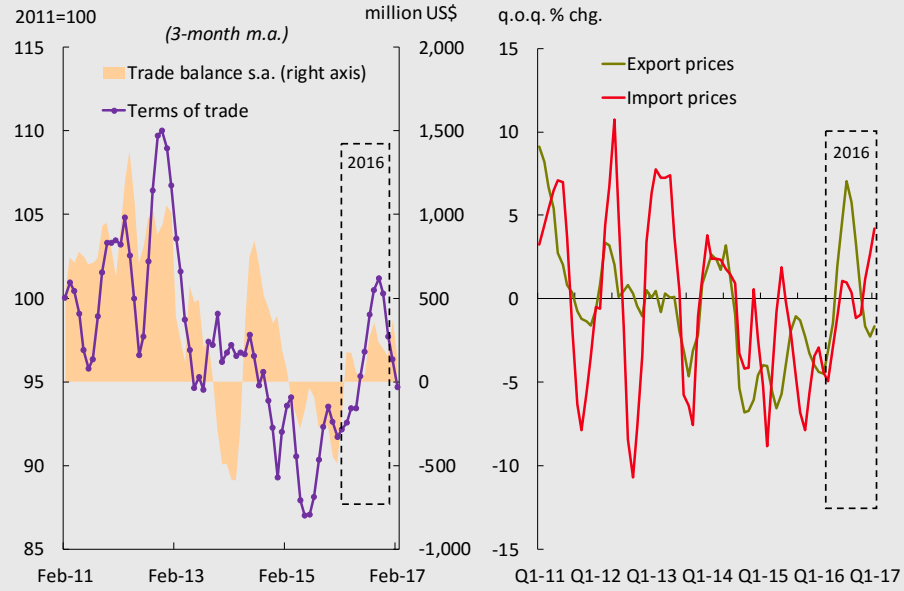


Source: INDEC

Box. Trade balance and terms of trade

During the first two months of 2017, the commercial balance continued to be positive in seasonally-adjusted terms. This was mainly accounted for by the strong growth of exports and the slight fall in imports in a context of lesser terms of trade (see Figure 3.8).

Figure 3.8 | Trade balance and terms of trade



Source: INDEC

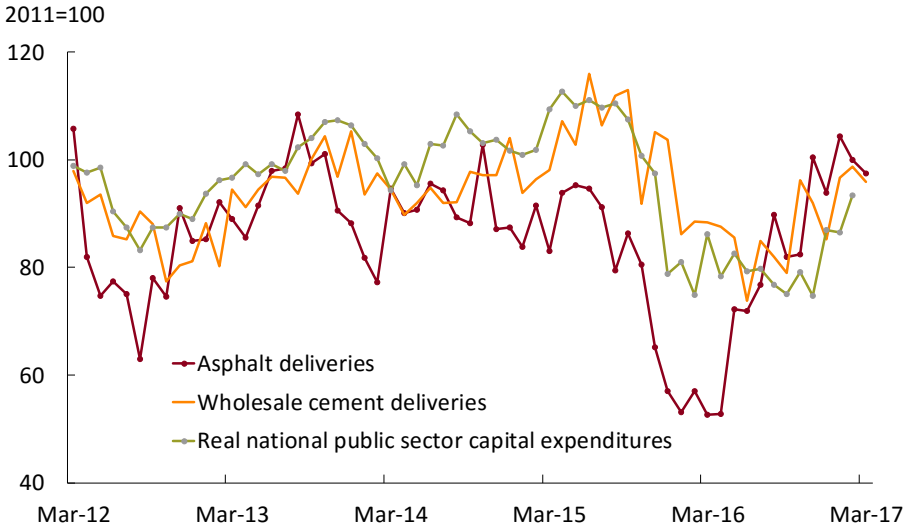
The worsening of the terms of trade was the result of an increase in import prices and a decrease in export prices, in line with the projections from the last IPOM. The increase in import prices reflects the global recovery of manufactured product prices experienced since mid-2016. For the second quarter, export prices are expected to perform better as a result of the price evolution of the main commodities exported by Argentina, which tend to impact export prices with a certain lag. Based on the commodity price index released daily by the BCRA, these have increased about 2 percent in the January-March average, basically in the price of oil and metals.

The dynamism of exports was accompanied by an additional impulse in investment and a marginal improvement of private consumption in the first quarter of 2017. The investment increase was due to the higher demand of industrial transport and the strengthening in public works. The shipments of bulk cement and asphalt —the latter, with high consumption levels for roadways— continued to increase sharply, particularly in the first quarter (3.1 percent and 9.1 percent quarterly, s.a., respectively) fueled by the execution of works awarded in 2016, both in national, provincial and municipal levels[15]. The capital expenditure in the national non-financial public sector increased 12 percent s.a. in real terms[16] in the first two months of the year relative to the fourth quarter of 2016 (see Figure 3.9). From the point of view of investment funding, corporate

[15] The amount tendered in public works during the first quarter of 2017 was close to 58,000 million pesos, according to Construar data: http://www.construar.com.ar/ . These tenders take some time to impact construction indices.
[16] Deflacted by the Construction Cost Index.

debt issuance in international markets regained dynamism in the first quarter, whereas it remained stable in the domestic market[17].

Figure 3.9 | Asphalt sales, cement in bulk and national public sector capital expenditures



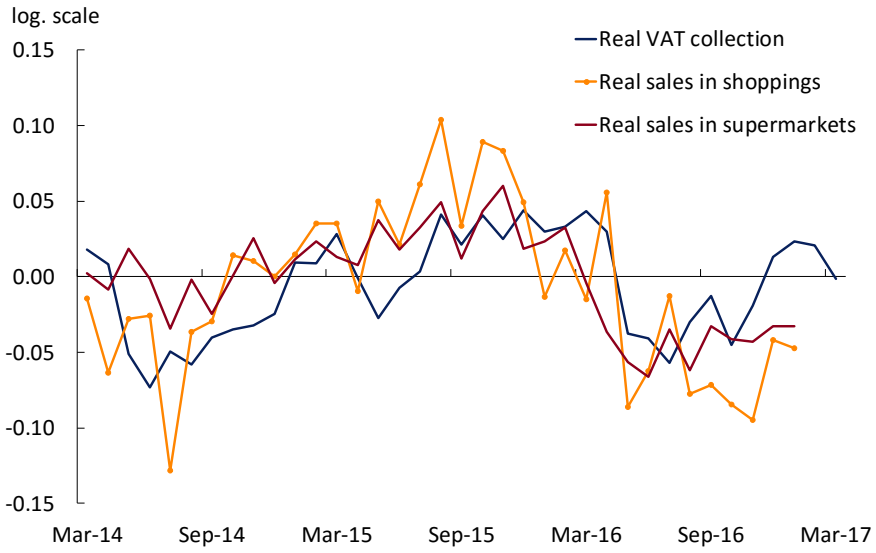
*Real direct investment and capital tranfers to non-financial national public sector deflated by construction cost index.
Source: INDEC, Energy and Treasury Secretariat

Partial consumption indicators anticipate a moderate recovery for the first months of 2017. Gross VAT collection in real terms increased 0.8 percent s.a. in the first quarter, as did household appliance sales, measured in volume[18]. Motor vehicles sales in the internal market increased 5.8 percent s.a. in the first quarter; imported volumes of consumption goods grew 0.3 percent s.a. in average in January-February, and deflated sales in shopping malls increased in three consecutive months, and in January reached 2.8 percent above the fourth quarter of 2016 figure, without taking into account the seasonal effect. On the other hand, real sales in supermarkets fell, although they show a slight improvement after discounting the long-term trend (see Figure 3.10).

The expansion of household income will foster consumption growth in 2017. The improvement in real wages[19], coupled with the expected increase in employment, will result in an increase of the payroll. The increased consumption credit demand will foster household expenditure, whereas the real increase in retirement payments, other pensions and social transfers should encourage expenditure in sectors with a high propensity to consume. In the first quarter, the consumption credit flow —both in the form of personal loans and bank credit cards— increased 5.8 percent s.a. in real terms relative to the fourth quarter of 2016, whereas social security expenditure increased 3.8 percent s.a. from January to February.

[17] Corporate funding through debt issuance in external voluntary debt markets accounted for over US$ 2.4 billion in the first quarter of this year, a recovery relative to the fourth quarter of 2016 (US$ 1.1 billion), after Trump's electoral victory in the United States, and relative to the first quarter of 2016 (US$ 1.36 billion), before the holdouts agreement. Of the overall debt issuance in early 2017, 75 percent concentrated in the energy and banking sectors, although their destinations were more diversified than in 2016, when they were mostly used to improve the maturity profiles of firms' financial liabilities.
[18] According to retail sales survey carried out by the Argentine Medium-Sized Business Confederation (Confederación Argentina de Mediana Empresa, CAME), with seasonally-adjusted data by the BCRA staff.
[19] See Chapter 4. Prices.

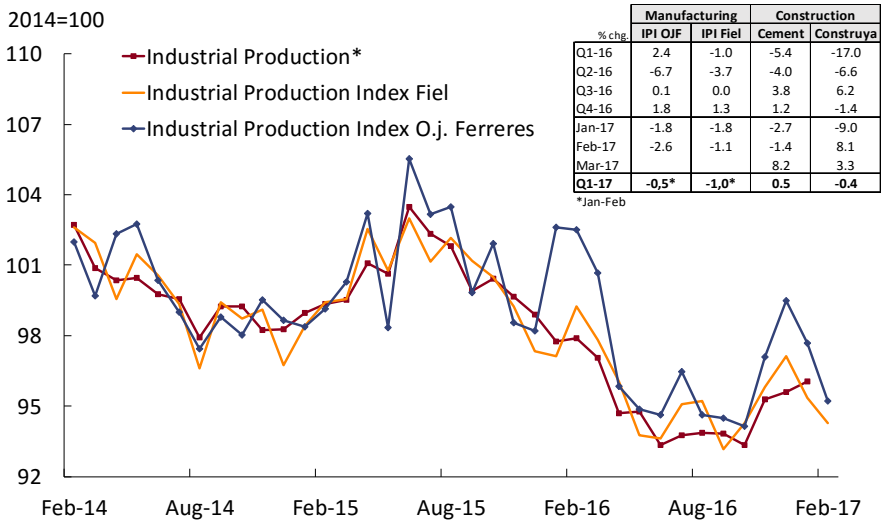
Figure 3.10 | Consumption indicators



Source: INDEC and Treasury Secretariat

The gradual impulse from internal demand is expected to have positively impacted in the productive sectors during the first quarter of the year. Although the industry has shown unfavorable signs according to private indicators, the outlook is mostly encouraging for construction (see Figure 3.11). Livestock indicators have shown increases in breeding activities based on the rise in slaughtering, while harvest advances suggest a good quarter for agriculture. Lastly, real estate and the private segment of construction have been favored by the growing demand of UVA-indexed mortgage loans, which accounted for approximately $ 3.4 billion from the launch of the instrument to February 2017[20].

Figure 3.11 | Industrial production



	Manufacturing		Construction	
% chg.	IPI OJF	IPI Fiel	Cement	Construya
Q1-16	2.4	-1.0	-5.4	-17.0
Q2-16	-6.7	-3.7	-4.0	-6.6
Q3-16	0.1	0.0	3.8	6.2
Q4-16	1.8	1.3	1.2	-1.4
Jan-17	-1.8	-1.8	-2.7	-9.0
Feb-17	-2.6	-1.1	-1.4	8.1
Mar-17			8.2	3.3
Q1-17	**-0,5***	**-1,0***	**0.5**	**-0.4**

*Jan-Feb

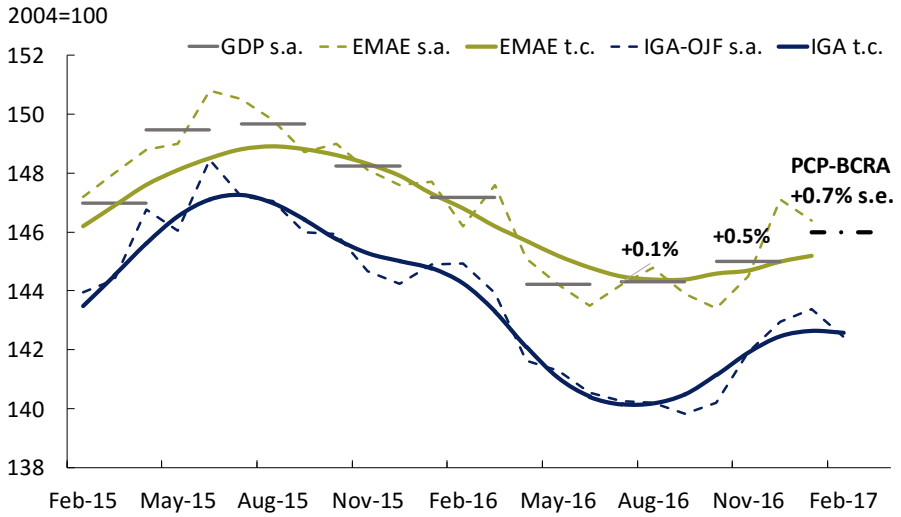
Source: INDEC, Fiel y O.J. Ferreres, Asoc. Fabricantes de Cemento Portland and Grupo Construya

[20] Only 11 months after its launch, in April 2016, UVA-indexed loans already account for 43.8 percent of total mortgage loans granted during February. Purchase transactions of property through mortgage loans have grown significantly over the last months. In the Autonomous City of Buenos Aires, mortgages recorded annual increases of 150 percent in December 2016, and 159 percent and 165.5 percent in January and February 2017, respectively. In the Province of Buenos Aires, operations funded by mortgage loans increased 60.3 percent in the first two months of the year.

3.2 Outlook

The first quarter of 2017 should end with a new GDP expansion, in line with the projections based on public and private activity indicators. According to the latest BCRA contemporary forecast (PCP-BCRA), when this edition is closing, GDP should grow 0.7 percent seasonally-adjusted during the first quarter of 2017[21], whereas O. J. Ferreres' General Activity Index, based on data until February, shows a statistical carry-forward that is similar in magnitude (see Figure 3.12).

Figure 3.12 | Economic activity



Nota: EMAE: monthly Economic Activity Indicator INDEC. IGA-OJF: General Activity Index released by Orlando J. Ferreres . PCP-BCRA: Nowcast BCRA. s.a.: seasonally adjusted. t.c.: trend-cycle.

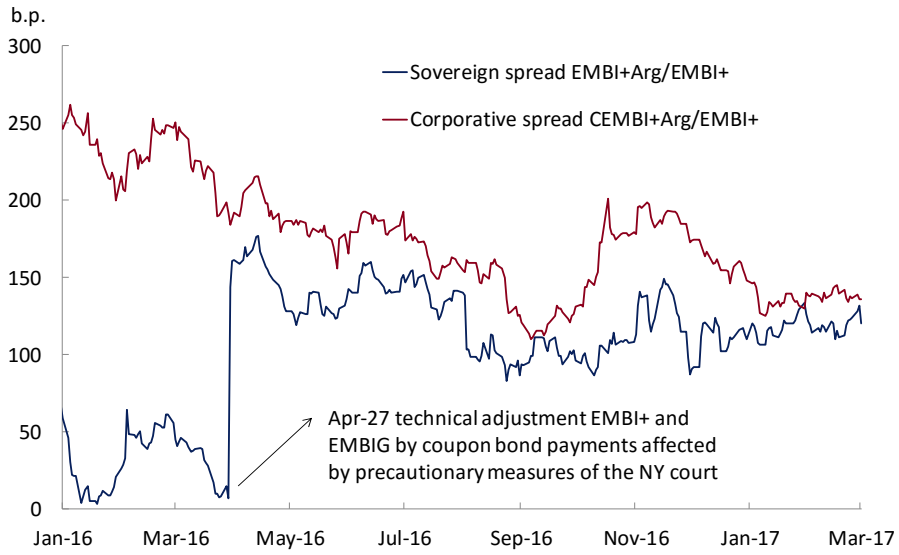
During the rest of the year, exports will continue to foster the growth cycle, led by agricultural production, as a result of higher investment levels in the sector achieved through the adopted economic measures. Industrial activities oriented to the external market will also contribute, thanks to a higher demand from our trading partners, particularly Brazil (see Chapter 2. International Context).

Investment will gradually appear as another factor of economic traction. In the next months, the strong impulse of public works will continue. The incentives for capital goods purchases[22] and the re-launch of the ProCrear credits[23] for housing construction are some of the factors that will strengthen the private investment rate. At the regulatory level, the passing of the Law of Public-Private Partnership[24], the productivity agreement for the exploitation of Vaca Muerta[25] and the awarding of alternative energies production projects within the framework of RenovAR[26], among others, will favor the development of infrastructure, technology and energy projects.

[21] The average of the five available growth forecasts is 0.77 percent seasonally-adjusted for the first quarter of 2017.
[22] The elimination of import tariffs for products relating the IT sector, coupled with the implementation of the simplified regime for importing used capital goods, should boost investment in durable equipment.
[23] The launch of the new ProCrear Plan includes 30-year credit lines for purchasing and building first housing units. These credits will adjust by UVA.
[24] Law n° 27,328. Public-private partnership constitute an alternative to traditional public works contracting systems and aims at carrying out projects in the areas of infrastructure, housing, activities and services, productive investment, applied research, and/or technological innovation. Based on several projections, they will enable funding of over US$ 40 billion for infrastructure works.
[25] This sectoral agreement creates higher productivity at lower costs, with a projection of US$ 5 billion in investment related to new drilling and associated infrastructures only in 2017.
[26] Law n° 27,191 recognized as national interest the generation of electric power through renewable energy sources aimed at public service provision, as well as carrying out research for technological development and equipment manufacturing to that end. Although Argentina

Increased corporate access to the voluntary debt market, allowed through the holdouts agreement, eases the recovery of investment flows in the short run. Since then, with the only exception of the period of uncertainty over the US elections, the external financing cost for Argentine firms has contracted relative to other emerging countries. Argentina is estimated to still have room to keep benefiting from the extraordinarily low international interest rates as it continue to undergo its process of macroeconomic realignment (see Figure 3.13).

Figure 3.13 | Argentina´s sovereign spread premium relative to other emerging markets



Source: Bloomberg and Reuters

The availability of private sector funding has also increased in the local market since the recent capital inflows that resulted from the Tax Amnesty Regime[27] and the expansion of the local financial system's lending capacity in foreign currency. The latter was allowed by the normalization of the exchange market, as well as a set of measures targeted at loosening and widening the application of lending capacity for productive activities, without losing sight of the currency mismatch risk assumed by debtors. In particular, funding conditions for pre-financing exports have improved, and now includes the possibility to fund exporters' suppliers (including service providers) and investment projects in the cattle breeding and energy sectors, among others[28].

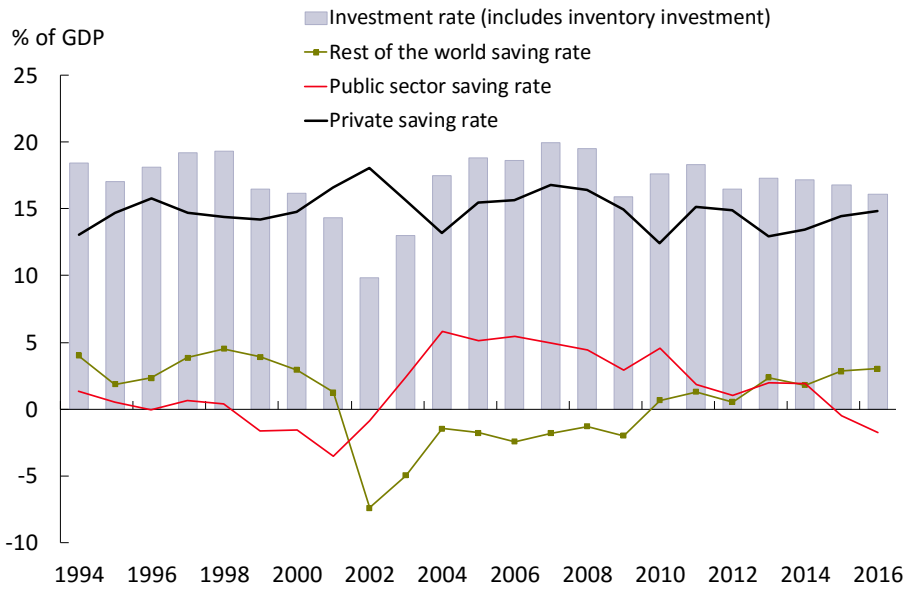
In general, conditions are gradually consolidated to reverse the downward trajectory of the investment rate in the last years (see Figure 3.14). First, the domestic savings is stimulated with positive real interest rates and lower expected inflation rates. This increase in domestic assets drives the development of the local capital and financial markets that can channel domestic savings to various investment projects. Second, the gradual realignment of the public accounts enables a reconstruction of the levels of domestic savings. Third, the liberalization of trade and financial flows enables the local corporate sector —which has low indebtedness ratios— to access external funding in a context of high international liquidity and a potential increase of the share of Argentine debt in international investor portfolios, currently at low levels.

currently has an installed capacity of close to 800 megawatts (MW) for renewable energy generation, the goal is for renewable energy sources to contribute up to 8 percent of the national electricity consumption by 2018, and 20 percent by 2025. Thus, the country has set for itself the goal of reaching 10,000 renewable megawatts within a ten-year horizon. Through the Rondas 1 and 1.5 tenders, the private sector should invest US$ 4.0 billion to install over 2,400 MW of wind and solar energy.

[27] Based on data from late March 2017, the Tax Amnesty Regime (Law n° 27.260) has accumulated reported assets of US$ 116.8 billion, and has contributed about $148.6 billion to the tax authority

[28] Communications "A" 5908, 6031, 6105, and 6162.

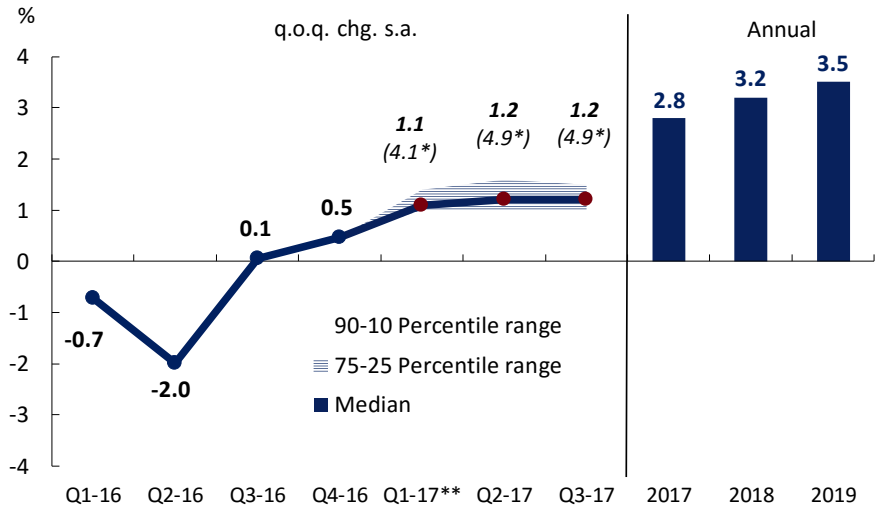
Figure 3.14 | Saving and investment rates



Source: INDEC and Treasury Secretariat

Household consumption, representing about 70 percent of GDP, will continue to be driven by the growth in real household income in a context of disinflation and moderate employment recovery, jointly with the dynamism recorded by consumption loans and social security expenditure.

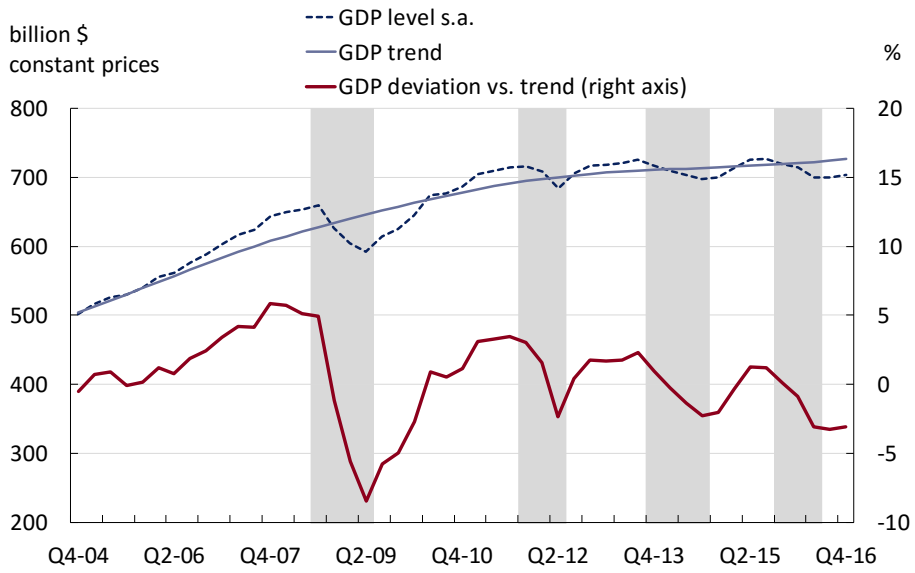
Figure 3.15 | Growth expectations



*annaulized q.o.q. growth rates **Data correspond to Feb-17 REM
Source: BCRA and INDEC

The consolidation of the exports sector, the strengthening of investment and the recovery of consumption should fuel the growth expected by the market according to the REM (see Figure 3.15). Such growth would not entail challenges in terms of inflationary pressures on the demand side, given the current capacity underutilization. The expected improvement in productivity would trigger an increase in potential GDP (see Figure 3.16).

Figure 3.16 | GDP and output gap



Source: INDEC

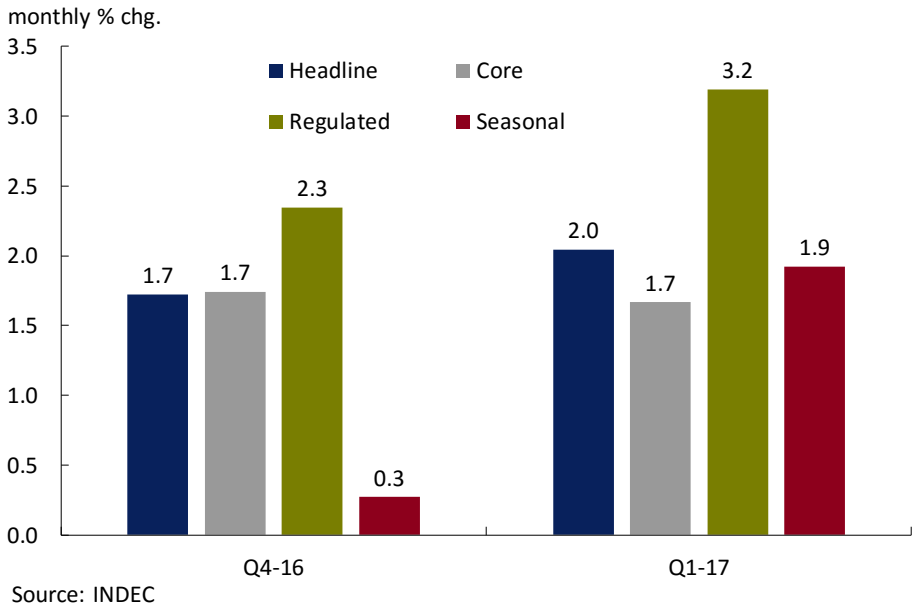
4. Prices

The first-quarter monthly average inflation in the Greater Buenos Aires was 2 percent, 0.3 percentage points higher than the previous quarter's. This behavior accounts for a core inflation of 1.7 percent, a regulated-price inflation of 3.2 percent, and a seasonal-price inflation of 1.9 percent. Core inflation failed to slow down in the first months of the year, partly due to the indirect impact of new updates in the prices of regulated utilities. Thus, the accumulated core inflation of the first quarter was slightly above the disinflation path presented in the previous edition of the IPOM. The decrease in inflation relative to the first quarter of 2016 made it possible for the year-on-year national inflation rate to decrease to 32 percent in March, 2017, decreasing 4.6 percentage points relative to December, 2016, and 12.3 percentage points relative to the peak reached in June, 2016. The IPC GBA accumulated 24.2 percent in the last eleven months, a pace equal to an annual inflation of 26.7 percent. The market analysts´ expectations of the Survey of Market Expectations (Relevamiento de Expectativas de Mercado, REM) fall outside the annual inflation target bands set by the BCRA (12-17 percent).

4.1 First-quarter inflation was boosted by the increase in regulated prices.

In the first quarter of 2017, the impact of the updates in certain regulated prices slightly increased the IPC GBA inflation rate[29], reaching a 2 percent monthly average (see Figure 4.1). These accounted for about 40 percent of the overall price increase in the period. Within the group of regulated prices, the increase in electric rates (of approximately 90 percent) was the most relevant (see Figure 4.2). With data available as of March, the IPC GBA accumulates 24.2 percent in the last eleven months, a pace equal to an annual inflation of 26.7 percent.

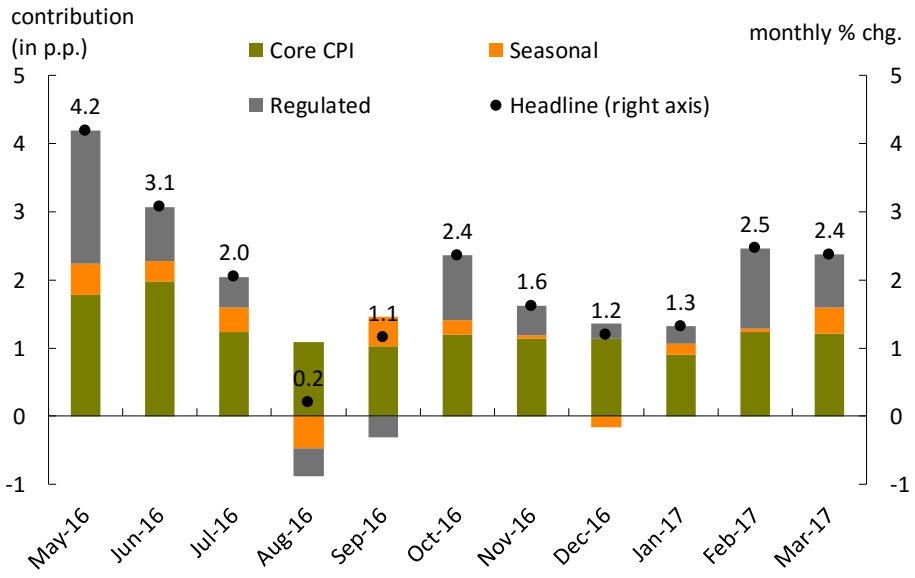
Figure 4.1 | Greater Buenos Aires IPC



Source: INDEC

[29] This has the broadest geographic coverage of all the consumer price indices prepared by the INDEC, so it is used as a benchmark for monetary policy.

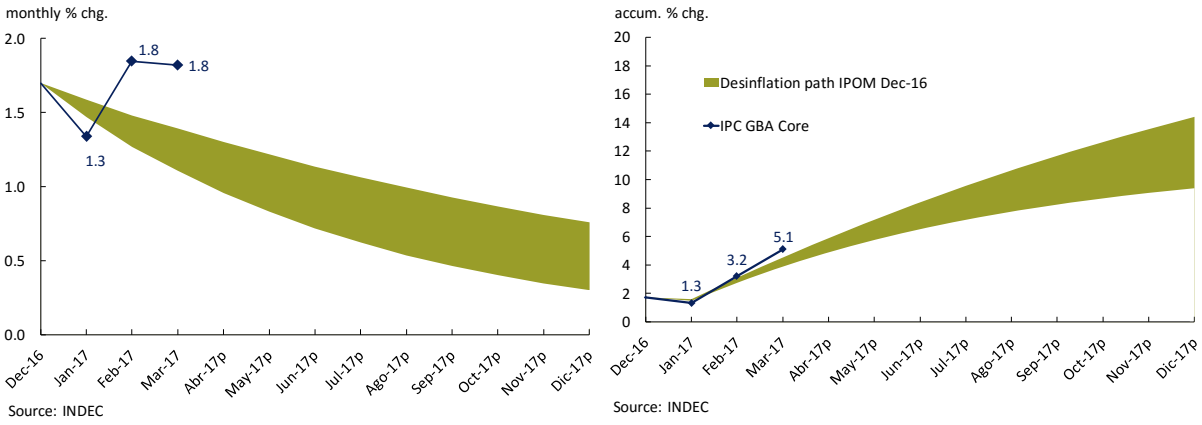
Figure 4.2 | Greater Buenos Aires IPC



Source: INDEC

The IPC GBA core inflation[30]remained stable in the first quarter of 2017 relative to the last months of 2016, and accumulated a 5.1 percent increase. Volatility, exacerbated by the incidence of certain regulated prices over other prices in the economy, positioned core inflation above the disinflation path presented in the last IPOM. This theoretical path assumes a constant slowdown rate over time. However, there are other possible trajectories for monthly core inflation, in which the slowdown rate is not uniform (see Figure 4.3).

Figure 4.3 | Core IPC. Disinflation path

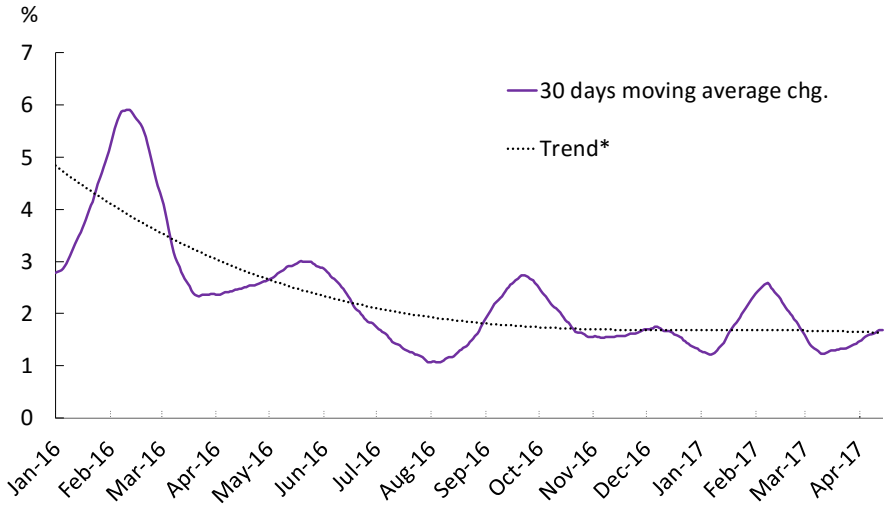


Source: INDEC

The high-frequency price index prepared by PriceStats, which makes it possible to anticipate the monthly variation in retail prices, showed that the April inflation might remain at a higher level than that consistent with the path set by the monetary authority. With data as of April 15, the average monthly increase in the last 30 days was below 1.7 percent (see Figure 4.4).

[30] Consumer prices indices can be broken down into three categories: 1) "seasonal-price indices", which capture prices mostly affected by seasonal factors (such as tourism-associated services); 2) "regulated-price indices", which include those with a strong tax or regulatory component (such as utility prices); and 3) "core- or remaining-price indices", which identify the underlying or core inflation, that is, the more permanent price evolution.

Figure 4.4 | High frequency price index



*3rd degree polynomial adjustment
Data up to Apr-15-17
Source: State Street' PriceStats Aggregate Inflation Series

4.2 Inflation in other subnational districts grew due to the increase in regulated prices and core inflation

During the first quarter of 2017, the monthly inflation in other subnational districts also reflected the increase in regulated prices. The Weighted National IPC (IPC-NP)[31], which summarizes this information, averaged a 2.3 percent monthly increase between February and March, a higher rate than that of the last months of 2016.

The IPC-NP[32] core inflation accelerated relative to end-2016, boosted by the indirect impact of the new electricity rates and some specific increases subject to certain types of regulation and/or administrative decision[33].The building operating and maintenance costs reflected the increase in the electricity rates and the janitors' collective bargaining agreement. Moreover, there were certain increases that are concentrated in the first months of the year, as is the case with educational services. Lastly, there were increases in pre-paid medical plans, and also in home services, linked to a wage increase for domestic workers. The remaining components of core inflation also showed a slight price increase relative to the previous quarter. In this line, alternate measures of core inflation[34] prepared by the BCRA to capture the series' trend behavior, show that the disinflation process was temporarily interrupted during the first quarter of 2017, due to the indirect impact of the readjustment of relative prices over the rest prices of the economy (see Figure 4.5 and Figure 4.6).

[31] The BCRA computes the IPC-NP based on the consumer price indices of the City of Buenos Aires and the provinces of San Luis and Córdoba, weighted based on the National Household Expenditure Survey for the 2004-05 period (ENGHo 2004/05). Based on the distribution of regional consumer spending taken from the aforementioned survey, the City of Buenos Aires IPC has a weight of 44 percent (representative of the GBA price evolution), and the remaining 56 percent represents the rest of the country. Based on the share of the Pampas Region, Córdoba's IPC has a weight of 24 percent, and the rest of the country is represented by the IPC evolution of the province of San Luis (22 percent).
[32] Unlike the core component of the IPC GBA, this includes formal education and health systems (according to the classification of seasonal prices, regulated prices, and remaining prices used by the IPC GBA, base 1999=100). In the IPC GBA, Dec-15=100, formal education and health systems are included in the regulated price component.
[33] The discrepancy with the dynamics shown by the IPC GBA core inflation prepared by the INDEC during the first quarter of 2017 can be explained by the differences in the items included in this aggregate and different criteria used to estimate some services with high weights. Among the latter, the component of building operating and maintenance costs stands out, which is estimated by the INDEC on an accrual basis, while the City of Buenos Aires, for example, estimates it on a cash basis.
[34] Core inflation is computed to identify the trend component of inflation, discarding temporary deviations from that trend. That trend or permanent component of inflation is the one that should be monitored for monetary policy decisions. See D'Amato, L.; Sanz, L. and Sotes Paladino, J.M. (July 2006). *Evaluación de medidas alternativas de inflación subyacente para Argentina. Estudios BCRA*, 1, 1-48

Figure 4.5 | Consumer prices monthly % chg. National IPC

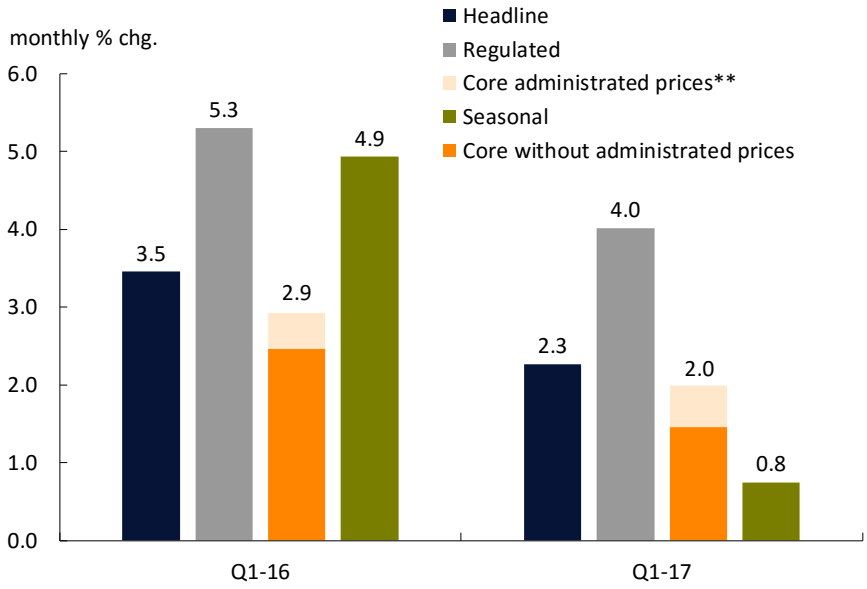
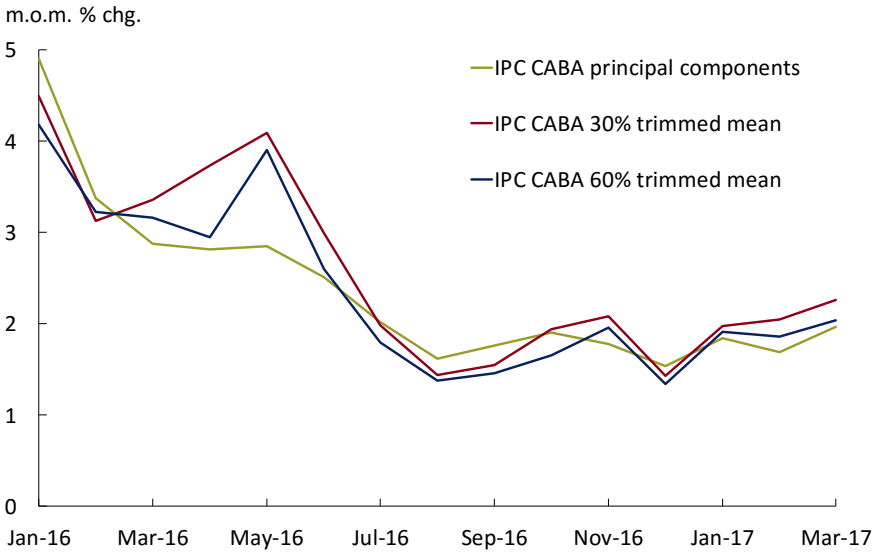


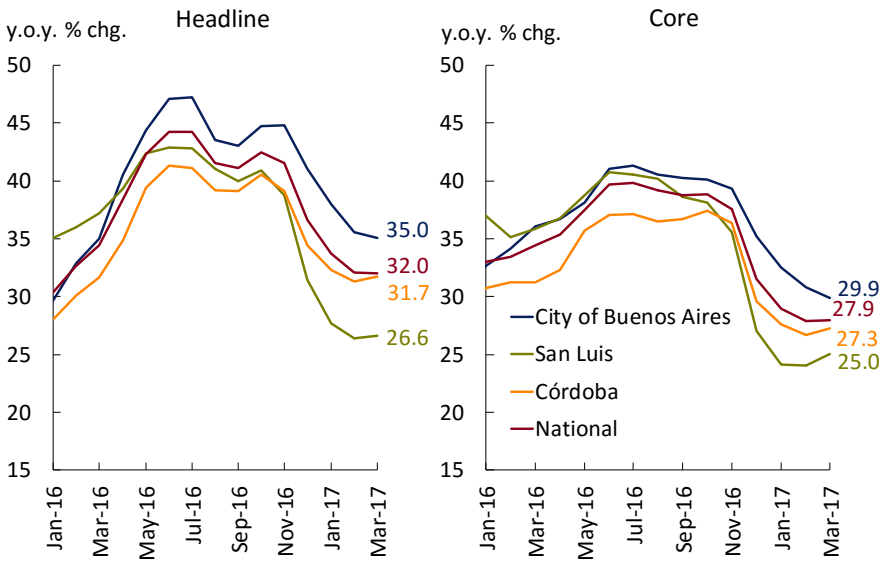
Figure 4.6 | CABA core IPC means



Source: Statistical offices of City of Buenos Aires

In the first months of 2017, the year-on-year variations of retail price indices in the subnational districts showed a slowdown trend. The general level of the IPC-NP increased 32 percent year-on-year in March, 2017, 4.6 percentage points less than in December, 2016, and 12.3 percentage points less than the peaked reach in June, 2016. Inflation in the different districts hovered between 26.6 percent year-on-year and 35 percent year-on-year, largely reflecting the different magnitudes in the regulated utilities updates and different shares of those items in the districts' baskets. In March, 2017, the IPC-NP core inflation slowed down and reached 27.9 percent year-on-year, with year-on-year decreases at the district level of 2-5.3 percentage points relative to December, 2016, and of 10-15 percentage points relative to the peak of July, 2016 (see Figure 4.7).

Figure 4.7 | IPC Headline



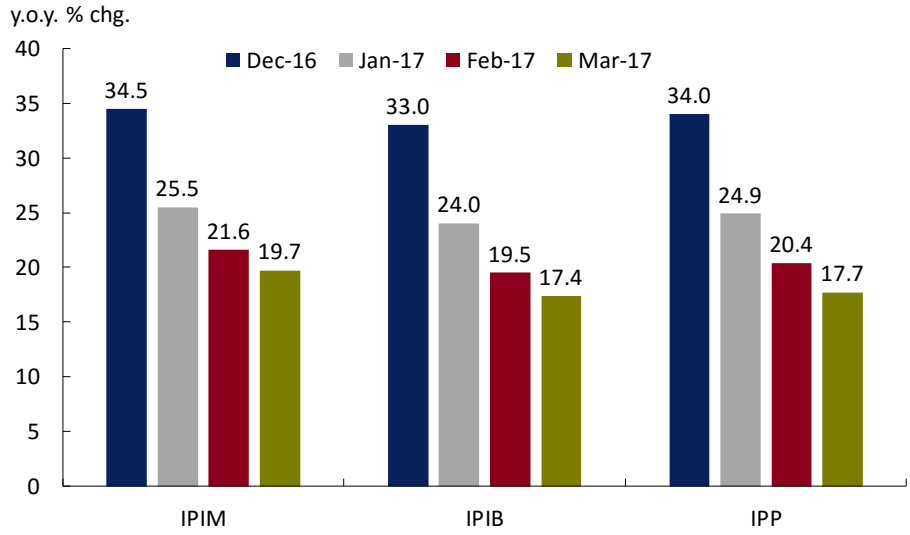
Source: Statistical offices of San Luis, Córdoba and City of Buenos Aires

4.3 Costs

4.3.1 Wholesale prices are trending below retail prices

The year-on-year variations in wholesale prices are noticeably lower than retail prices. All indices reduced their year-on-year increase rate in the first quarter of the year to levels of less than 20 percent in March 2017 (see Figure 4.8). According to the Domestic Wholesale Price Index (Índice de Precios Internos al por Mayor IPIM), domestic products increased 21 percent year-on-year, while imported products increased 5.6 percent year-on-year. The dispersion in the increases of wholesale/retail and imported/domestic prices reflects that the economy is undergoing a disinflation process, with a readjustment of relative prices.

Figure 4.8 | Wholesale price index system (SIPM)

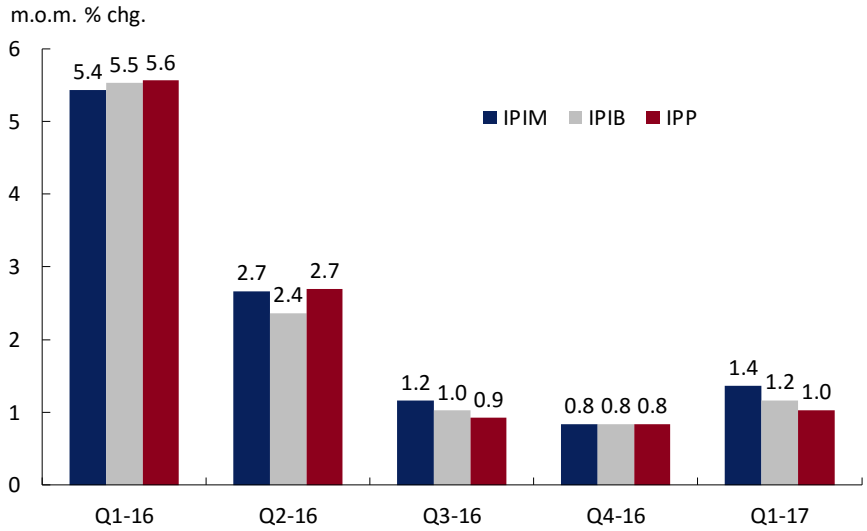


Source: INDEC. Domestic wholesale price index (IPIM), Basic industrial price index (IPIB), Basic producer price index (IPP).

In the first quarter of 2017, the increase in wholesale prices averaged between 1-1.4 percent monthly (below retail indices). Just as in the case of retail prices, there was an acceleration in the growth rate of wholesale prices, mainly explained by the dynamics of regulated prices[35], particularly electricity. Additionally, there was a faster dynamism in the prices of agricultural products, which, after falling in the last quarter of 2016, increased in the first months of the current year, due to the behavior of beef. On the other hand, domestic prices of imported products continued to slowdown, reducing their pace of increase in the first months of 2017, while dollar-prices of imported goods increased slightly[36] (see Figure 4.9).

During the first quarter of the year, the Construction Cost Index (ICC-INDEC) increased 1.8 percent monthly average, slowing down relative to the last months of 2016. This evolution reflected the labor component, which moderated its increase relative to the last months of 2016, due to the specific features of the sector's collective bargaining. The other components showed a greater pace of increase, especially the overall expenditures, which were affected by the increase in electricity rates. In year-on-year terms, construction costs grew 32.7 percent in March, slightly below the variation of December, 2016. This dynamics synthesizes two conflicting behaviors, with increases in materials (21 percent year-on-year) significantly below the increase in labor costs (38.1 percent year-on-year). Other indices of construction costs, such as those prepared by the Autonomous City of Buenos Aires, the province of Córdoba, and the Construction Chamber, showed similar evolutions.

Figure 4.9 | Wholesale price index system (SIPM)



Source: INDEC. Domestic wholesale price index (IPIM), Basic industrial price index (IPIB), Basic producer price index (IPP).

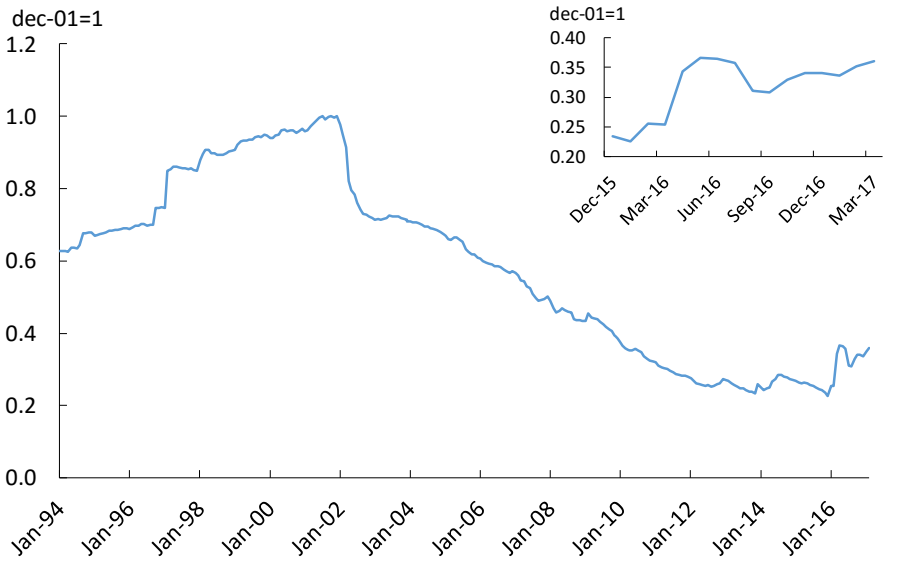
[35] Regarding regulated prices, increases in electricity and refined petroleum products were the most important, appearing as a common factor in all the indices. In the case of the IPIM, there was an important contribution from the increase in the price of tobacco.
[36] According to the Trade Import Price Index, prices of imported goods increased 3.7 percent year-on-year in the first two months of 2017, after falling average 10.6 percent year-on-year on average in 2016.

4.4 Relative prices

4.4.1 The prices of regulated utilities continue to be lagged relative to the prices of the remaining products

Starting in February, 2016, the government launched a process to update the price of utilities, which showed an increasing lag relative to the remaining prices of the economy since 2002[37].While the recovery of the ratio between the prices of utilities and the rest of the prices in the IPC is expected to continue, other factors, such as technological changes and relative improvements in productivity, prevent knowing where the ratio will ultimately converge[38] (see Figure 4.10).

Figure 4.10 | Public services prices and rest of consumer prices relative evolution



Source: INDEC and statistical offices of San Luis, Córdoba and City of Buenos Aires

The lag in utility prices affected both households and companies. The increase in the price of utilities has a direct impact on the IPC and an indirect impact, through an increase in companies' production costs. The impact on costs depends on the degree of utility intensity. The magnitude of the indirect impact is also determined from a set of factors, such as domestic and external supply and demand conditions of the different products, and their degree of external tradability[39] (exposure to external competition) and inflation expectations.

The role of the BCRA's monetary policy is to limit the effects of the utility prices increase on the rest of the prices of the economy, and to influence over expectations, in order to continue with the disinflation process.

[37] In order to carry out the historical analysis, the utilities series was computed based on the opening published for each of the involved indices (IPC CABA, IPC San Luis, and IPC GBA, base 1999 and 1988). The series of private services was computed excluding utilities from the published services series. The series of interest computed for each index were spliced as follows: IPC GBA (base 1988=100 and base 1999=100) from 1994 to December, 2006; IPC San Luis (base 2003=100) from January, 2007 to July, 2012, and then the IPC CABA (base jul-11-jul-12=100).

[38] The magnitude of the update of utility prices needed in each region differs: the metropolitan area of Buenos Aires was the one with the greatest lag in December, 2015, particularly regarding electricity.

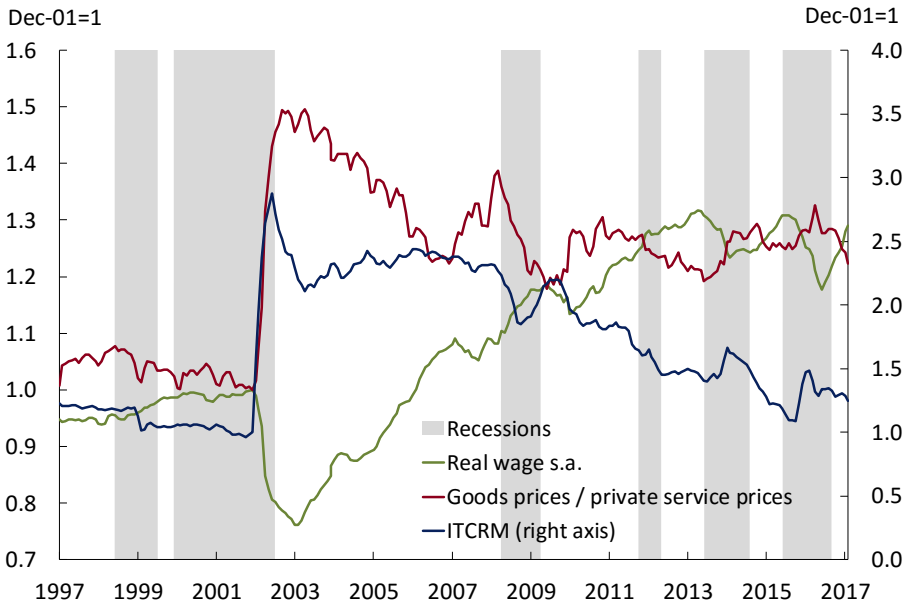
[39] "Tradable" refers to a product's capacity to be traded in international markets. Goods tend to be more tradable than private services. Wages are a non-tradable component of costs, with a higher incidence in the prices of private service than in the prices of goods.

4.4.2 The prices of private services are recovering since the second semester

The ratio between the prices of private goods and services is an approximation of the relative evolution of tradable product prices as compared to non-tradable products. In a longer-term perspective, this ratio remained relatively stable since 2010, in spite of the peso's real multilateral appreciation, in a period dominated by exchange rate and trade flow controls.

Starting in the second half of 2016, the prices of private services have shown a recovery relative to those of goods. This fall in the measure is inversely related to the improvement in real wages. The BCRA considers that the decreasing trend in this ratio will continue gradually in line with the expected recovery in productivity, in a context of greater openness of the economy (see Figure 4.11).

Figure 4.11 | Evolution of real exchange rate, formal sector real wages and private relative prices



In year-on-year terms, there was also a relative improvement in the prices of private services relative to that of goods. In March, 2017, most of the categories that increased beyond the annual variation in overall prices imply private services. Goods made a greater contribution to the slowdown of inflation in the last year (see Figure 4.12).

Table 1 | City of Buenos Aires retail prices by groups and classes (levels 2 and 3)

March 2017		y.o.y. % chg.		y.o.y. % chg.
1-	Bebidas alcohólicas	59.2	24- Servicio de telefonía móvil	29.2
2-	Servicios financieros	58.1	25- Artículos para la recreación, jardines y animales	28.8
3-	Otros servicios telefónicos	50.4	26- Joyería y relojes	28.7
4-	Servicios de transporte automotor	49.8	27- Prendas de vestir y materiales	28.2
5-	Gastos comunes por la vivienda y/o cochera y otros gastos	47.2	28- Restaurantes y comidas fuera del hogar	26.6
6-	Libros	45.6	29- Calzado	26.3
7-	Educación no formal	44.1	30- Alimentos	26.1
8-	Seguros médicos	39.3	31- Otros aparatos, articulos y productos para la atencion personal	25.0
9-	Servicios para pacientes externos	38.4	32- Materiales de escritorio y de dibujo	23.0
10-	Otros servicios	37.4	33- Bienes para el hogar no durables	22.1
11-	Seguros	36.0	34- Muebles, accesorios, alfombras y otros materiales para pisos	20.5
12-	Educación formal	35.4	35- Mantenimiento y reparación de la viviensa	18.3
13-	**NIVEL GENERAL**	**35.0**	36- Vajilla, utesilios, loza y cristalería	17.4
14-	Alquiler de la vivienda y otros servicios de alojamiento	34.1	37- Otros efectos personales	15.9
15-	Hoteles	33.5	38- Artículos textiles para el hogar	15.7
16-	Salones de peluquería y establecimientos de cuidados personal	32.8	**39-** Herramientas y equipos para el hogar y el jardín	15.0
17-	Funcionamiento de equipos de transporte de uso del hogar	31.8	40- Vehículos	12.8
18-	Servicios domésticos y para el hogar	31.8	41- Aterfactos para el hogar	11.6
19-	Diarios y publicaciones periódicas	30.8	42- Paquetes turísticos y excursiones	9.1
20-	Servicios recreativos y culturales	30.8	43- Aparatos electricos para el cuidado personal	8.9
21-	Bebidas no alcohólicas	30.6	44- Equipos audio-visuales, fotográficos y de procesamiento de la información	7.2
22-	**RESTO**	**29.9**	45- Equipos telefónicos	3.0
23-	Productos medicinales, artefactos y equipos para la salud	29.8	46- Servicios de transporte aéreo	1.4

Nota: No incluye servicios regulados
Fuente: Dirección de Estadísticas de la Ciudad de Buenos Aires

4.4.3 Real wages recovered in the last months

Wages started to recover in real terms starting in the second half of 2016, due to the slowdown of actual inflation. The rate of recovery decreased in the first quarter of 2017, due to the increase in inflation caused by the update in regulated prices.

Wages in the private registered sector increased slightly in real terms in the first quarter of 217, partially recovering from the decrease observed in 2016. According to data by the Federal Administration of Public Revenue (Administración Federal de Ingresos Públicos, AFIP), these compensations showed an average monthly increase of 2.4 percent between January and March in seasonally-adjusted terms[40], above the inflation of the period (2.3 percent monthly average, as per the IPC-NP).This moderate improvement in real wages is accounted for by the consolidation of the disinflation process in a context of collective bargains in the second half and, particularly, the last quarter of 2016.

The collective bargaining closed in 2017 was innovative in that they were based on expected inflation[41], rather than on past inflation, as in previous years. This shows the relevance of the inflation targets adopted by the BCRA as a tool to coordinate the expectations of economic agents. Another new aspect was that some agreements included adjustment clauses for potential deviations in actual inflation relative to expected inflation (see box "Expected inflation and trigger clause"). Lastly, in some regions, the agreements have included wage adjustment clauses based on indices prepared by the local statistical institutes. This aspect is relevant in periods in which inflation in the different regions may differ due to the magnitude and incidence of the pending updates in regulated utility prices[42].

Expected inflation and trigger clause

The collective bargaining closed in 2017 were innovative in that they included expected inflation in line with the BCRA's disinflation targets, unlike those of previous years in which past inflation was dominant[43].

This paradigm change reflects the role of inflation targets[44]as a benchmark for the bargaining of nominal contracts. Another new aspect of wage negotiations closed based on the 2017 BCRA's targets was the inclusion of adjustment clauses for potential deviations of actual inflation relative to the expected inflation implicit in the agreement.

The trigger clause is a useful input in wage negotiations when there is a dissent between parties regarding future inflation. The clause acts as an insurance, reducing uncertainty due to potential differences between the contract's expected purchasing power and the actual one[45].

From the BCRA's perspective, the emergence of these clauses is important, as it automatically transfers the disinflation projected by the monetary authority into the new contracts negotiated. This element breaks the agents' inertial expectations, based on the belief that the current year's inflation rate will repeat the dynamics of last year's inflation.

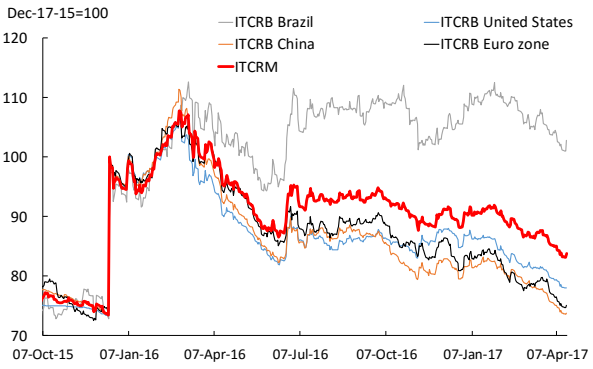
[40] The seasonally adjustment of the data was made by the AFIP.
[41] Such is the case of the banks, sales, ports, and different provincial public administrations unions in which 2017 inflation expectations role was highlighted.
[42] In the province of Córdoba, the wage negotiation of provincial government employees includes a clause to readjust the agreement based on that province's price index.
[43] The high cost of negotiating collective contracts acts as an incentive to expand their horizon, making the parties' inflation expectations a central part of these agreements.
[44] The BCRA adopted the inflation targeting regime in September, 2016.
[45] The greater the uncertainty as regards inflation, the greater the risk in wage contracts negotiations. The potential error in expected inflation increases, which increases in turn the potential deviation of real wages relative to expected wages (Holland, 1984).

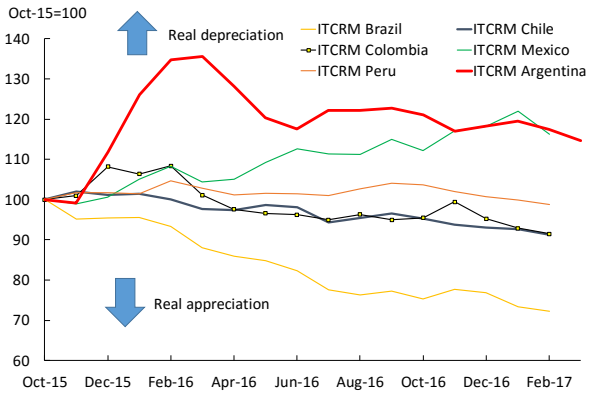
The use of the BCRA's inflation targets as a benchmark in nominal contracts minimizes potential costs of the disinflation process, as it reduces the unwanted distortions between the evolution of prices and wages. This change in the way contracts are negotiated reinforces the BCRA's commitment as regards converging towards the targets.

4.4.4 The real exchange rate in Argentina couples its behavior to the rest of Latin America

After the normalization of the foreign exchange market, the Multilateral Real Exchange Rate Index (Índice de Tipo de Cambio Real Multilateral, ITCRM[46]) of Argentina remained relatively stable, even during episodes of increasing international uncertainty, in line with other countries in the region[47]. This performance of the ITCRM included a path of bilateral real appreciation relative to the United States, the euro area and China, and a depreciation relative to Brazil (see Figure 4.12). The differential behavior of the country's main commercial partner was due to the fact that during this period, since 2015, Brazil's multilateral real exchange rate appreciated sharply (see Chapter 2. International context).

Figure 4.12 | Argentina real exchange rates: multilateral and bilaterals and selected latin american countries real multilateral exchange rates



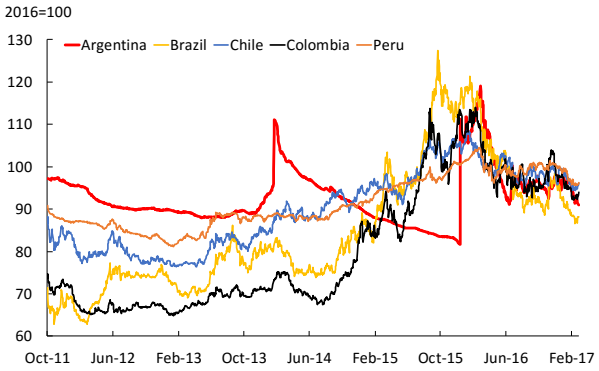


Source: INDEC; Statistical office of the City of Buenos Aires, Statistical office of the Province of San Luis, Thomson Reuters and REM-BCRA

The adoption, in late 2015, of a floating exchange rate regime caused the real value of the Argentine peso relative to the dollar to follow the fluctuations seen in other currencies of the region, particularly Brazil, the country's main trading partner (see Figure 4.13). Previously, the managed exchange rate regime in Argentina led to a negative and weak correlation with the bilateral real paths of other Latin American currencies relative to the dollar, which showed strong co-movements among themselves.

[46] Multilateral Real Exchange Rate Index (ITCRM), computed daily by the BCRA. The data covering the period between March, 2017, and this edition of the report is provisory. See: http://www.bcra.gob.ar/PublicacionesEstadisticas/Indice_tipo_cambio_multilateral_i.asp.
[47] For instance, different episodes in the exit of Great Britain from the European Union, or the presidential elections in the United States.

Figure 4.13 | RER against United States. Selected latin american counties



Source: INDEC; Statistical office of the City of Buenos Aires, Statistical office of the Province of San Luis, Thomson Reuters, REM-BCRA and BIS

Correlation coefficient
Dec-17-15 - Feb-28-17

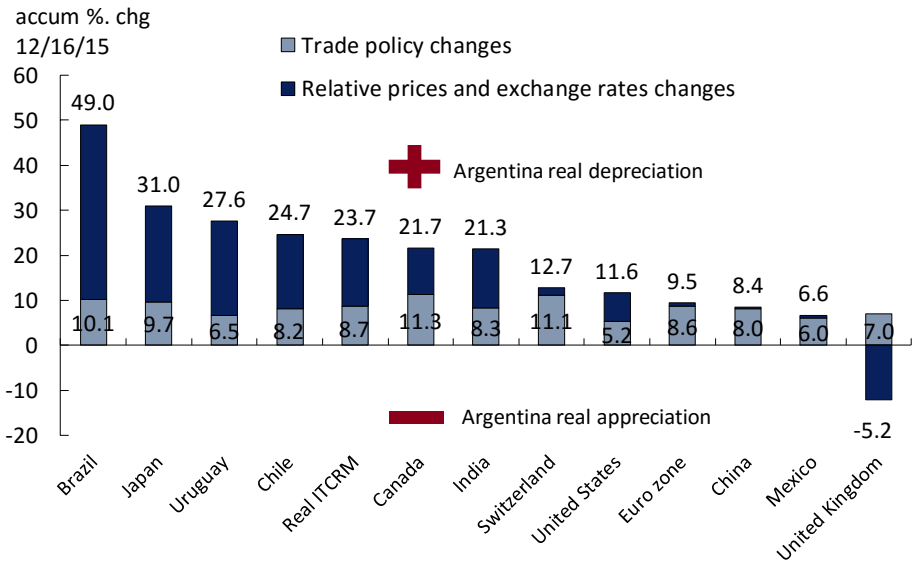
	Argentina	Brazil	Chile	Colombia	Peru
Brazil	0.85				
Chile	0.66	0.90			
Colombia	0.79	0.90	0.85		
Peru	0.67	0.67	0.69	0.79	
Uruguay	0.75	0.84	0.71	0.64	0.41

Correlation coefficient
Nov-1-11 - Dec-16-15

	Argentina	Brazil	Chile	Colombia	Peru
Brazil	-0.59				
Chile	-0.32	0.88			
Colombia	-0.55	0.95	0.91		
Peru	-0.44	0.89	0.94	0.93	
Uruguay	-0.37	0.74	0.76	0.74	0.78

From the perspective of the external sector's competitiveness, to the effect of the variation in relative prices and nominal exchange rates, we should add at least the boost exporters received through the removal and/or reduction of export duties since late 2015. The real effective exchange rate —which considers the aforementioned tax changes— recorded a cumulative growth of 24 percent since December 16, 2015, of which approximately 9 percentage points are accounted for by the change in the trade policy (see Figure 4.14).

Figure 4.14 | Exports effective real exchange rates (multilateral and bilateral)

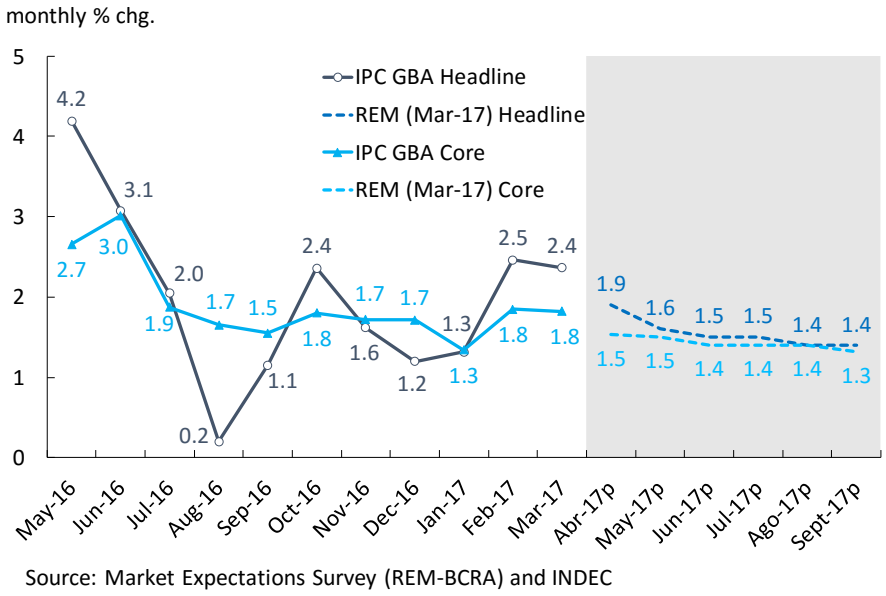


Source: INDEC; Statistical office of the City of Buenos Aires, Statistical office of the Province of San Luis, REM-BCRA

4.5 Outlook

For the next six months, the analysts who take part in the BCRA's REM estimate that monthly inflation will slow down. According to the survey, the IPC GBA average monthly variation rate would be 1.7 percent in the second quarter and fall to a monthly 1.4 percent in the third quarter. This dynamics assumes lower increases in utility rates starting in July. The median of projections about the IPC GBA core inflation is 1.5 percent for the second quarter of 2017, and slightly slows down to 1.4 percent for the third quarter (see Figure 4.15).

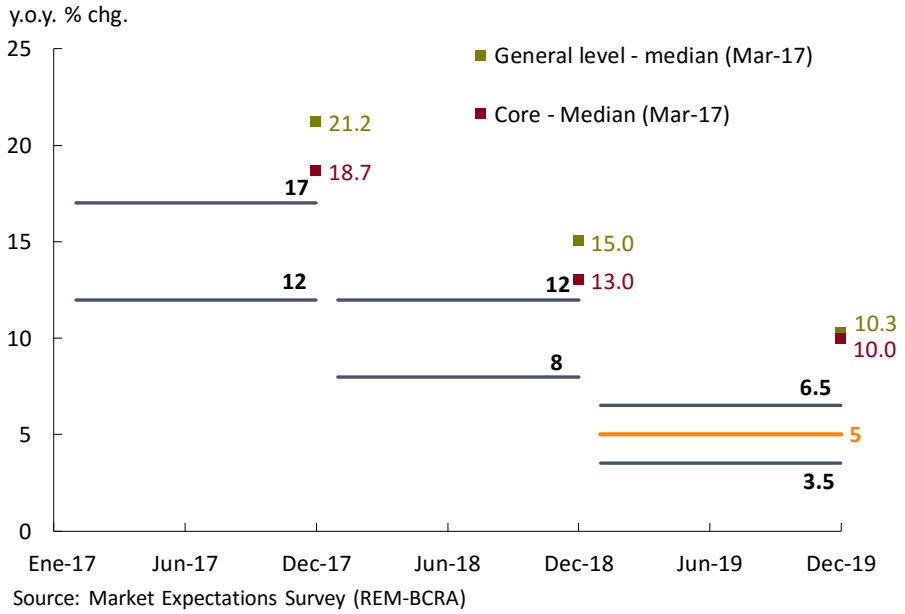
Figure 4.15 | IPC. Market expectations survey



Source: Market Expectations Survey (REM-BCRA) and INDEC

Private projections of the IPC GBA inflation remain above the Central Bank targets for 2017 and 2018, though they appear to be anchored at 21.2 percent (+4.2 percentage points) and 15 percent (+3 percentage points), respectively (see Figure 4.16). Inflation expectations for the next 12 months are at 18.9 percent.

Figure 4.16 | Inflation targeting and expectations



Source: Market Expectations Survey (REM-BCRA)

The BCRA will keep the disinflationary bias of its monetary policy in order to deep the disinflation process, consistently with its multi-year 2017-2019 targets (see Chapter 5. Monetary Policy).

5. Monetary Policy

In January 2017, the Central Bank formerly adopted an inflation targeting regime, with a decreasing inflation range over time: 12 percent to 17 percent for 2017, 8 percent to 12 percent for 2018, and 5 percent from 2019 on. It has also established that the index to assess compliance with the target should be the IPC released by the INDEC that has the widest scope (initially, the IPC for the Great Buenos Aires —IPC GBA—, to be replaced later by the national coverage index).

Simultaneously to the implementation of the inflation targeting regime, the BCRA made two changes in the way it conducts its monetary operations: (i) it changed its policy instrument, from the 35-day LEBAC rate to the center of the 7-day repo corridor, an instrument with which the Bank is willing to provide and withdraw liquidity without a predetermined ceiling. And (ii) it replaced the weekly LEBAC tenders with a monthly tender system in order to give more liquidity to these instruments.

This operational change occurred in a period when a series of specific factors temporarily increased liquidity conditions and, despite the fact that the policy rate stood unchanged, drove certain market interest rates downward. In early March, in order to manage its liabilities' maturity profiles and strengthen the transmission of its policy's anti-inflationary bias to the rest of the market's interest rates, the BCRA started to operate in the open market with different kinds of LEBAC. This triggered a reduction in its swap stock with financial entities and, consequently, an increase in the stock of LEBAC.

After nine months during which the core inflation of the IPC GBA fluctuated between monthly percentages of 1.3 and 1.9, and given the signs that, in April, inflation might continue on a path above the one established by the monetary authority, on April 11, the Central Bank decided to increase the monetary policy rate in 150 basic points, to 26.25 percent. The BCRA will maintain a clear anti-inflationary bias to ensure that the disinflation process continues toward its goal of 12 percent to 17 percent by 2017.

5.1 The Central Bank's policy during the first quarter

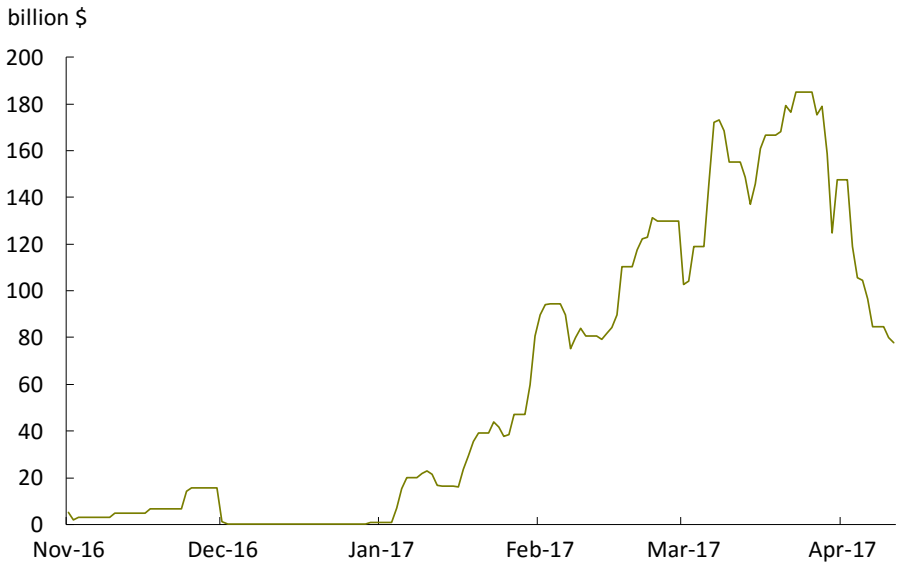
In January 2017, the Central Bank formally adopted an inflation targeting regime, with a target range that decreases over time: 12 percent to 17 percent by 2017, 8 percent to 12 percent by 2018, and 5 percent from 2019 on. It also established that the index used to assess compliance with the targets will be the IPC released by the INDEC with the widest scope (initially, the IPC GBA, later to be replaced by the national index).

Simultaneously to the formal implementation of the inflation targeting regime, the BCRA changed its policy instrument: instead of the 35-day LEBAC rate, it adopted the mid-band 7-day swap rate. During most of 2016, the monetary policy interest rate was the 35-day LEBAC, for which the BCRA performed weekly tenders. As from January 2017, the Bank started using the center of the 7-day repo corridor as its monetary policy rate. The repo corridor is the interest rate at which the Central Bank is willing to provide or withdraw liquidity from banks without a predetermined limit. Thus, the interest rate of reverse repos works as a minimum level for the interbank interest rates, since, for banks, it would not be rational to place funds at a third party that pays less for them than the BCRA. Similarly, the repo interest rate works as a ceiling for the interbank market interest rates, since banks would not pay more for funds than what the Central Bank charges for them. These windows are permanent facilities and operate as automatic liquidity regulators. In situations of abundant liquidity, banks may use this permanent facility to place their excess liquidity with

the BCRA. When liquidity is scarce, banks have access to a permanent facility in the BCRA to obtain liquidity.

In the first quarter of 2017, several specific factors injected liquidity into the system (see Chapter 2. International Context), which was automatically absorbed by the BCRA's liquidity reception facility. In January and February, the BCRA took 98 billion pesos[48] (at an annual 24 percent rate in the 7-day repo and an annual 22.75 percent 1-day rate). As from March 2, 2017, the monetary authority started withdrawing liquidity through open-market operations. As a result of these liquidity-absorption operations through LEBACs, their yield rose, and banks moved the excess liquidity from BCRA reverse repos to LEBACs. Thus, after having reached 185 billion pesos by the end of March, the 7-day reverse repo stock at the BCRA began a downward path (see Figure 5.1).

Figure 5.1 | Stock of 7 day reverse repo



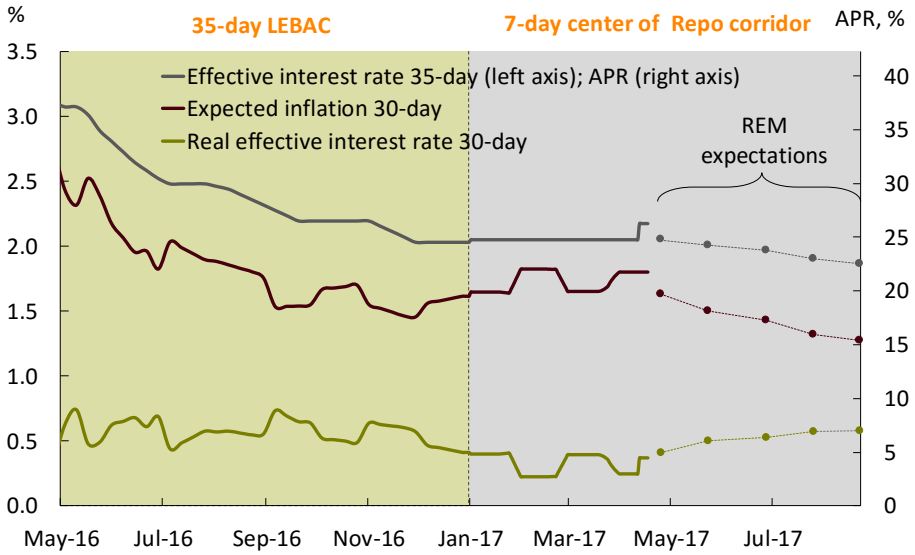
Source: BCRA

In this new operational framework, at each monetary policy meeting, the Central Bank establishes the adequate level of its baseline interest rate, which is the center of the repo corridor. To determine the adequate level, the Monetary Policy Council assesses the path of inflation expectations and selects a level for the monetary policy rate that results in a real expected interest rate that is positive enough to reduce the inflation rate based on the path of the announced targets.

During 2016, in a context of decreasing inflation expectations, and to maintain the contracting nature of its monetary policy, the BCRA has gradually reduced its nominal policy rate to 24.75 percent starting in November 2016. In early 2017, the change of instrument did not entail any changes in the level of the policy rate, which the BCRA kept stable at 24.75 percent until April, 2017 (see Figure 5.2). Finally, after nine months of IPC GBA core inflation fluctuating between monthly rates of 1.3 percent and 1.9 percent, and given the signs that April inflation might continue at a higher level than that in line with the path established by the monetary authority (see Chapter 4. Prices), on April 11, the Central Bank decided to increase the monetary policy rate in 150 basic points, to 26.25 percent. Thus, the BCRA will maintain a clear anti-inflationary bias in order to ensure that the disinflation process continues toward its target of a 12 percent to 17 percent inflation rate by 2017.

[48] The difference between the monthly average of reverse swap stocks in February 2017 and the monthly average in December 2016.

Figure 5.2 | Nominal and real monetary policy rate

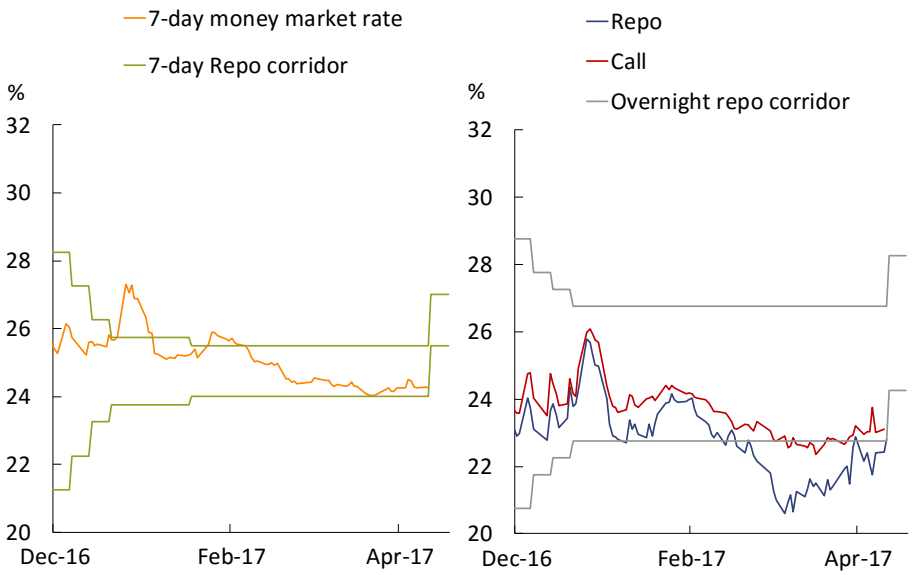


Source: BCRA

5.2 Liquidity conditions during the first quarter

In the first quarter, a series of specific factors temporarily increased the liquidity conditions and, despite the fact that the Central Bank kept its policy interest rate unchanged, drove certain market interest rates downward, which slightly relaxed monetary conditions. Monetary market interest rates were close to the lower bound of the repo corridor, and even, due to technical reasons in the market, below the BCRA repo corridor (see Figure 5.3). The strong demand for certain securities used as underlying instruments in these operations motivated a number of transactions with interest rates below the band, which, therefore, did not accurately reflect the cost of money.

Figure 5.3 | Overnight repo rate corridor and interbank interest rate



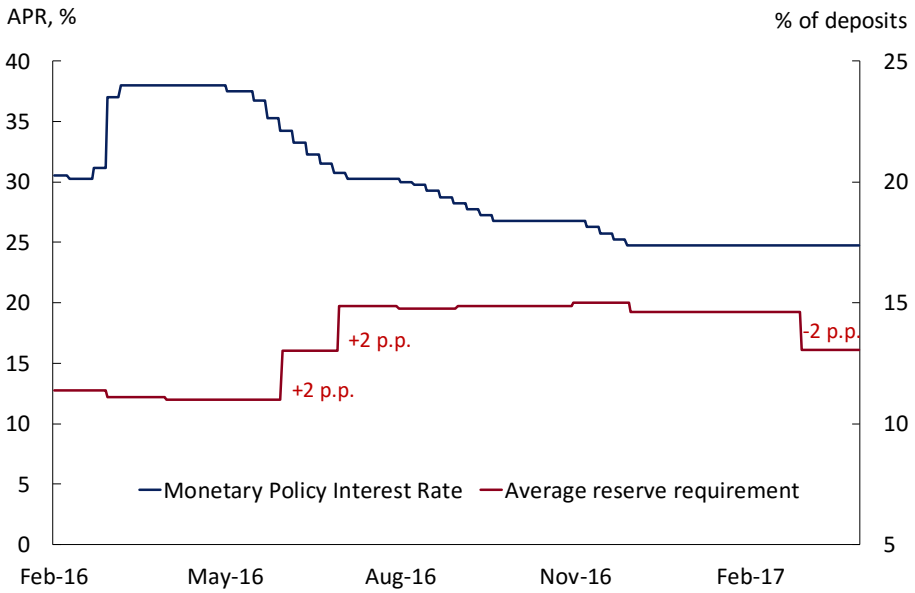
Source: BCRA

The factors that injected liquidity into the market during the first quarter was: (1) bank's management of their quarterly statutory reserves position; (2) the lowering of the statutory reserves ratio; (3) the BCRA's foreign currency purchases; (4) the BCRA's funding of the National Treasury; and (5) the changes in bank's cash management.

In the first place, the regulation of statutory reserves provides banks with more flexibility to comply with the regulation between December and February. Banks must comply with reserves requirements through a deposit with the Central Bank of a share of their deposits. This requirement, which generally must be verified in terms of average monthly stocks, is computed as a quarterly average in December-February. This allowed banks to reduce their stocks in January and February after having recording an excess in December 2016, which resulted in a release of resources of nearly 3 billion pesos in the first two months of 2017.

In the second place, in March, the BCRA resolved to lower the reserves ratios of 2 percent of deposits, which partially offset the two increases from mid-2016, of 2 percent each. The purpose of the hikes had been to share with the banks the sterilization and interest rate increase effort faced by the Central Bank due to its anti-inflationary policy. Similarly, as the economy started its disinflation process and nominal interest rates were gradually decreased, the recent ratio reduction mitigated this burden (see Figure 5.4). The reduction of statutory reserves in March resulted in the release of resources of nearly 30 billion in March.

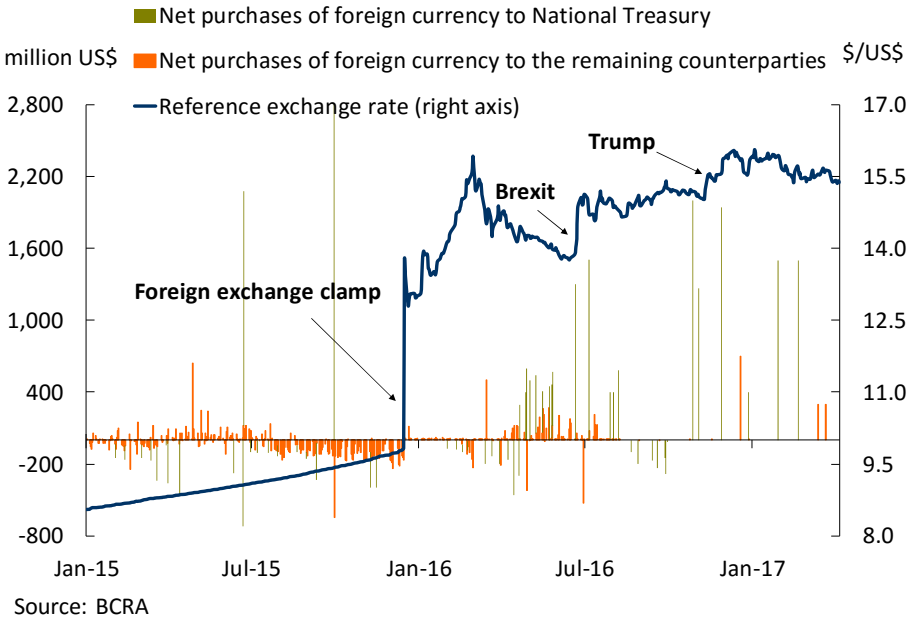
Figure 5.4 | Minimum reserve requirements and monetary policy interest rate



Source: BCRA

In the third place, in March, the BCRA once again purchased foreign currency in the foreign exchange market. As it adopted the inflation targeting regime, in December 2015, the BCRA also started migrating to a floating exchange rate regime, which allows the economy to more naturally assimilate external shocks. Nevertheless, the BCRA has reserved the right to occasionally operate in the exchange market to strengthen its balance sheet. In these isolated interventions, operations are arranged at market price. During the first quarter, the Central Bank made purchases of 3.6 billion US dollars (see Figure 5.5), which implied a liquidity injection in the market of an additional 63 billion pesos.

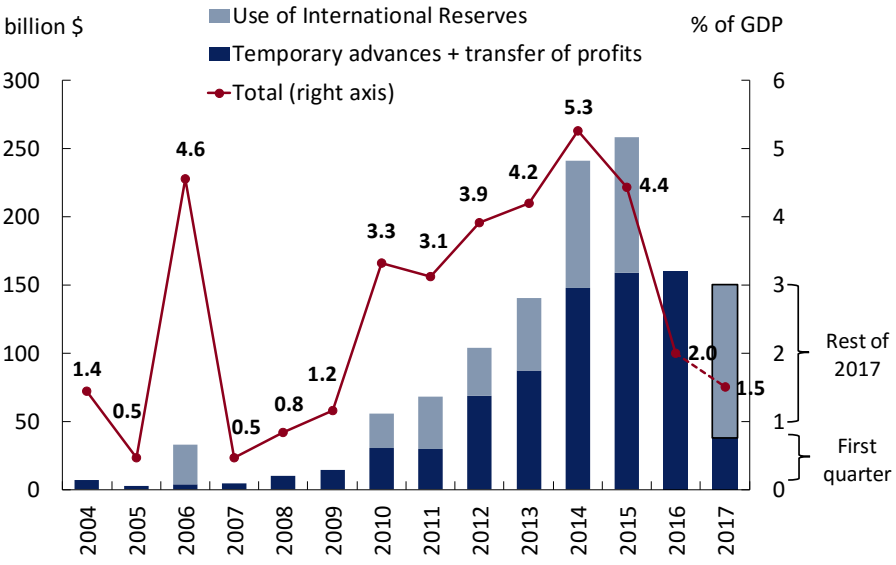
Figure 5.5 | BCRA purchases and sales on the exchange market



Source: BCRA

In the fourth place, the Central Bank continued transfering resources to the National Treasury, within the predetermined limits. In order to eliminate the possibility of fiscal dominance, the BCRA and the Ministry of Economy had agreed on a ceiling of 150 billion pesos for resource transfers to the National Treasury in 2017. In previous years, annual resource transfers from the BCRA to the Treasury (through the net granting of temporary advances, utility transfers and use of international reserves) had shown an upward trend, from 0.5 percent of GDP in 2007 to 4.4 percent of GDP in 2015 (almost 260 billion pesos). However, in 2016, resource transfers were close to 100 billion pesos lower, 2.4 percentage points less in GDP terms. For 2017, the limit agreed on is 10 billion pesos lower in nominal terms, and represents a 0.5 percentage points decrease in GDP terms (see Figure 5.6). In the first quarter so far, 37.5 billion pesos have been transferred out of the expected 150 billion.

Figure 5.6 | BCRA transfers to Treasury and use of reserves

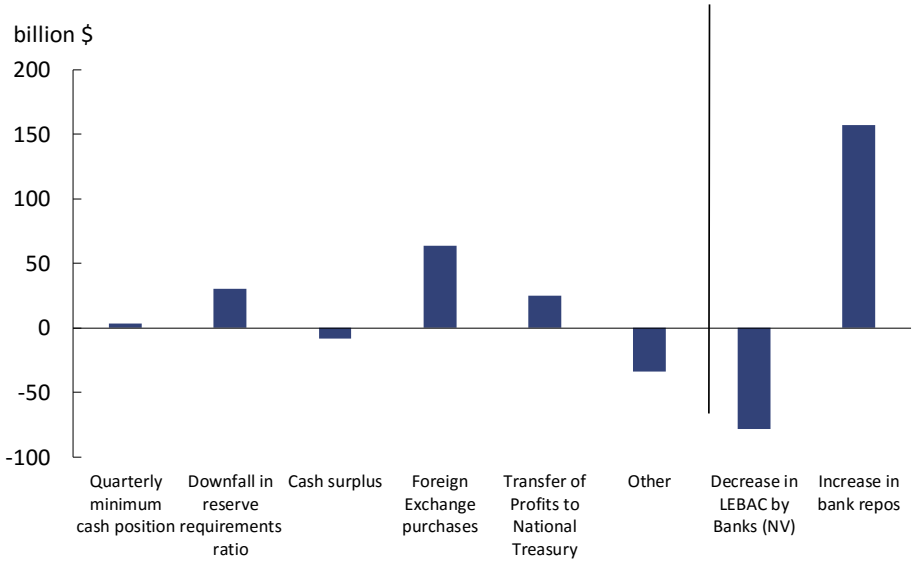


Source: INDEC and Treasury Secretariat and Bank estimates

Lastly, the BCRA has changed some operational procedures relating to the use of cash, which led banks to keep larger cash stocks than usual. The change was that the Central Bank temporarily stopped taking banknotes in good condition from banks and created, instead, a market to encourage bilateral cash exchange between banks. Not being able to place their excess cash with the Central Bank, banks recorded an exceptional increase in their cash stocks. When the Central Bank started to speed up the process of banknote destruction, which reverted in part the buildup. This costed bank liquid resources of approximately 9 billion pesos in March.

All of the aforementioned factors created an expansive monetary effect over the course of the quarter which, in an endogenous monetary system, was automatically absorbed. Given that the Central Bank was implementing its new policy instrument, this allowed those resources to be channeled mainly to reverse repos to contribute to the development of its new instrument (see Figure 5.7).

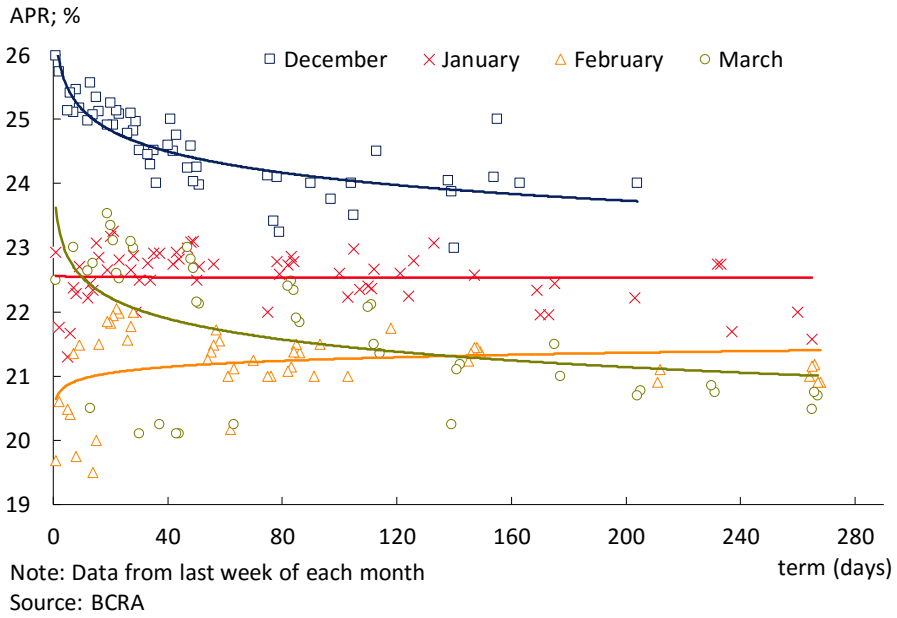
Figure 5.7 | Effects on liquidity during first quarter



Source: BCRA

Additionally, after replacing the LEBAC rate with repo interest rates as the policy instrument in early 2017, the Central Bank interrupted its operations in the LEBAC secondary market, which allowed the market to more freely express the yield curve (see Figure 5.8).

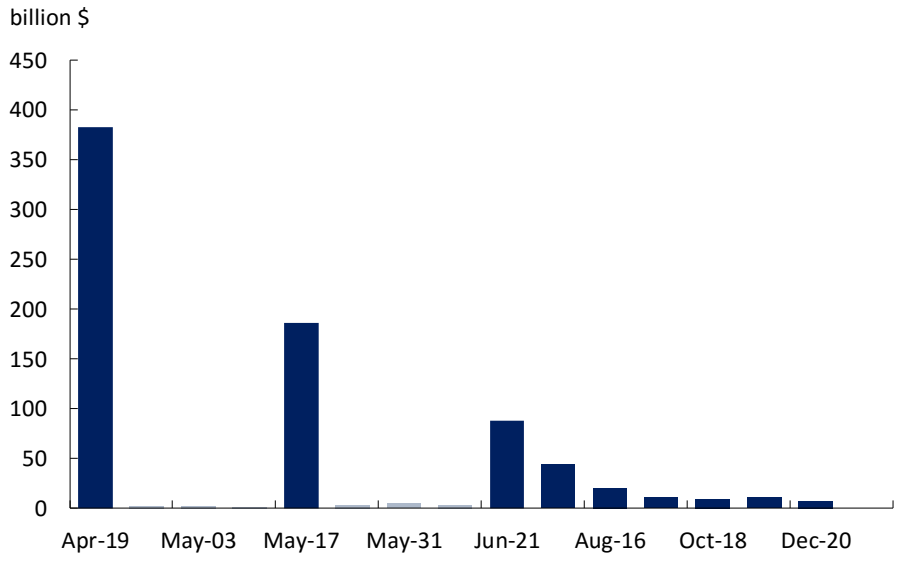
Figure 5.8 | LEBAC interest rate curves in secondary market



Note: Data from last week of each month
Source: BCRA

However, the Central Bank has continued to tender LEBACs as part of its management activities for liabilities and market liquidity conditions. LEBAC tenders started to be carried out monthly, and the tendered types adopted a single monthly maturity, on the third Wednesday every month (see Figure 5.9). This contributed to creating more liquidity for each of these types, which will thus go from the current 36 maturities in circulation to only 9.

Figure 5.9 | LEBAC maturity profile



Source: BCRA

5.3 The macro-prudential role of the Central Bank's balance sheet

The Central Bank's international reserves have a macro-prudential role, since they ensure liquidity and the proper functioning of the exchange market in turbulent times and they provide a funding cushion for potential blocks in access to the international capital market. Thus, the stock of reserves of the Central Bank is a key element in the assessment of countries' credit risk (see Box 2).

During 2016, the BCRA accumulated a significant amount of international reserves, which, as of December 31, 2016, amounted to US$ 38.772 billion. The scarce level of international reserves as of December 2015 and the vast capital inflows after the resolution of the default by the Argentine government in April 2016 provided an adequate context to achieve this goal.

Table 5.1 shows the capital flows in 2016. During this period, the BCRA absorbed US$ 13.725 billion, US$ 29.131 billion of which were net inflows to the country, whereas US$ 15.024 billion were allocated to funding the current account deficit. The table reveals that the main source of capital inflows was net borrowing by the non financial public sector (both at the national and the sub-national levels). Lesser contributors included foreign direct investment funds and the sales of local financial instruments to nonresidents in a context of larger private debt placements in international markets.

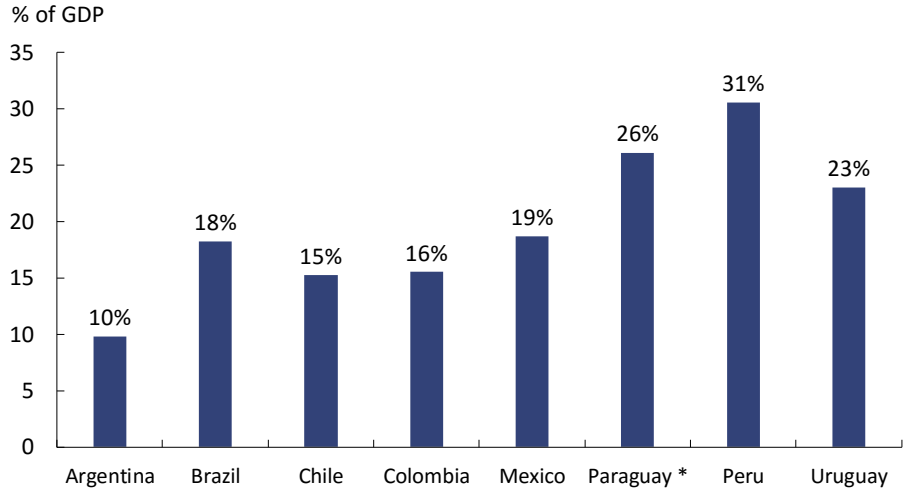
Table 5.1 | BCRA non monetary liabilities and foreign exchange purchases

Sectors	2015	2016	2016 / 2015 chg.
Current account	**-16,806**	**-15,024**	**1,782**
Capital and financial account	**13,203**	**29,131**	**15,929**
Financial capital account, q.o.q. accum. (% of GDP)	2	5	3
Capital account	51	237	186
Financial account	**13,152**	**28,894**	**15,743**
Financial sector	**9,025**	**-4,153**	**-13,177**
BCRA	7,580	-607	-8,187
Other financial entities	1,445	-3,546	-4,991
Non-financial public sector	**-2,855**	**28,320**	**31,175**
Non-financial private sector	**6,981**	**4,727**	**-2,255**
Errors and omissions	**-1,330**	**-382**	**948**
International reserves change	**-4,933**	**13,725**	**18,658**

Source: INDEC

Despite the fact that international reserves at the BCRA are at a record level for the country, they are relatively low when compared with those in other countries in the region (see Figure 5.10), which implies that there is room for further accumulation.

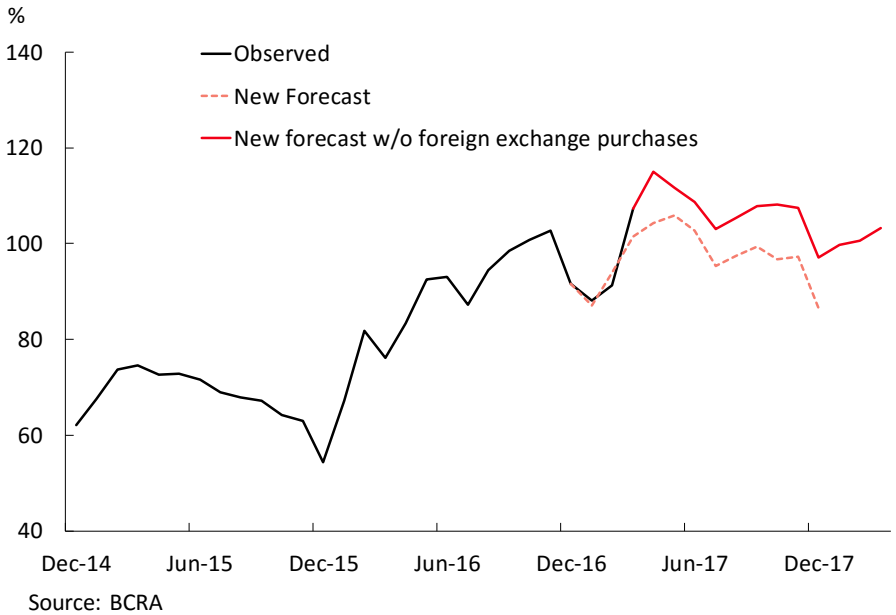
Figure 5.10 | International reserves



Note: Due to statistical availability from different countries, the relation between international reserves is taken as of February 2017 and GDP in 2016.*International reserves at the end of 2016.
Source: IFM Special Data Dissemination Standard and national statistics institutes

Given that the projected increase in money demand for 2017 is over the 150 billion pesos the monetary authority agreed to transfer to the national Treasury during 2017 as temporary advances and profits, this increase in demand may also be met by purchasing foreign currency, which would make it possible to continue to accumulate international reserves. Foreign currency purchases that exceed the increase in money demand will be automatically absorbed by increases in the BCRA's non-cash liabilities (see Figure 5.11).

Figure 5.11 | LEBAC and repo operations in $ as percentage of the monetary base



Source: BCRA

In 2016, foreign currency was purchased for the equivalent to 230 billion pesos. If deducted from the balance of LEBACs and swaps at year-end, the balance of monetary liabilities would have decreased from 6.3 percent of GDP in 2015 to 5.9 percent of GDP in 2016, which illustrates the improvement in balance quality (see Table 5.2).

Table 5.2 | BCRA non monetary liabilities and foreign exchange purchases

	million $	% of GDP
LEBAC and net repos at the end of 2016 (1)	705,442	8.8%
Reserves comparison (2)	228,362	2.8%
LEBAC and net repos of acquired reserves 2016 (1-2)	477,080	5.9%
LEBAC and net repos at the end of 2016 (3)	371,501	6.3%

Source: BCRA

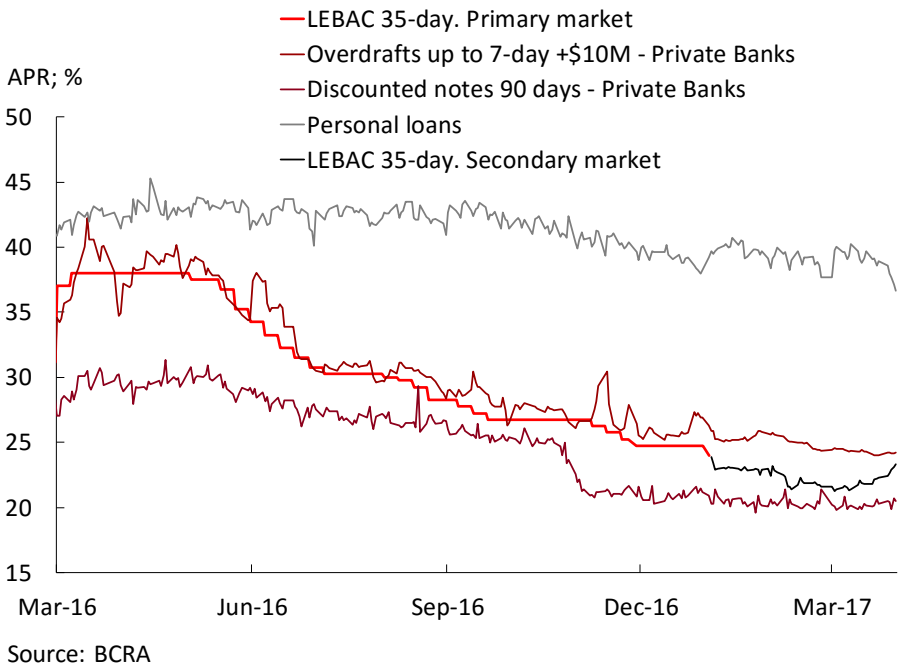
Several countries with inflation targeting regimes have taken advantage of periods of abundant capital to accumulate international reserves (see Box 3 / Central Bank balance sheet strengthening: The experience of other emerging economies). These operations provide a safe framework, since the local currency typically depreciates relative to the reserve currency in times of financial tensions, which creates a capital gain for the monetary authority. This increases its ability to ensure the proper functioning of markets in turbulent periods. The cost of this "insurance" is the difference between the interest rate paid by the BCRA for non-monetary liabilities issued to purchase reserves, and their return in pesos. This should be zero in average, given that the arbitrage between currencies leads the interest rate in pesos paid by the Central Bank to converge to the expected return on reserves.

When the monetary authority acquires reserves within an inflation targeting regime, it should do so at the market exchange rate. Otherwise, it might incur in a significant quasi-fiscal deficit or fail to meet its inflation target. This stems from the fact that the real exchange rate is not under the control of the monetary authority and that, if the expected return between peso denominated and foreign currency denominated investments didn't converge, investors would take advantage of the arbitrage opportunities available. Under an inflation targeting regime, the monetary authority chooses the interest rate in order to achieve its target. The inflation target implies a path for the price level and, implicitly, establishes a path for the nominal exchange rate, which depends on the value of other variables, such as the terms of trade, productivity, or public expenditure. With the future exchange rate given by the real exchange rate and the price level as determined by the inflation target, and with the interest rate established by the monetary authority, if the Central Bank purchased reserves in an attempt to depreciate the local currency by paying more than the market price for the foreign currency, it would incur in loss through the sterilization operation. And the depreciation required to avoid this loss would be inconsistent with the inflation target.

5.4 The transmission to the rest of the market interest rates

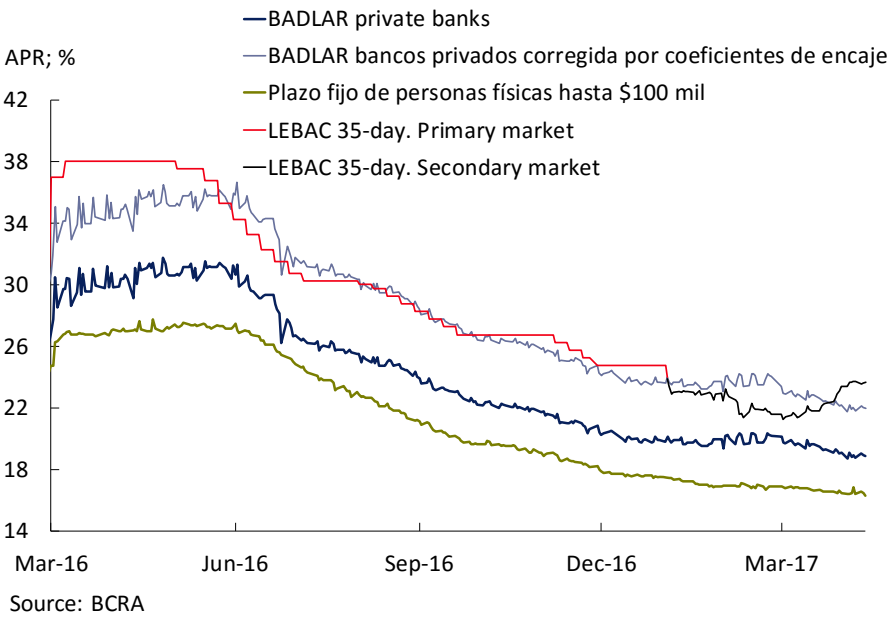
By establishing its policy interest rate, the BCRA seeks to affect the other interest rates and all financial instruments in the market. Liquidity conditions in the first quarter drove the repo rate close to the lower bound of the BCRA repo corridor, and led to decreases in the LEBAC rates in the secondary market.

Figure 5.12 | Monetary policy rate, lending rates and deposit rates



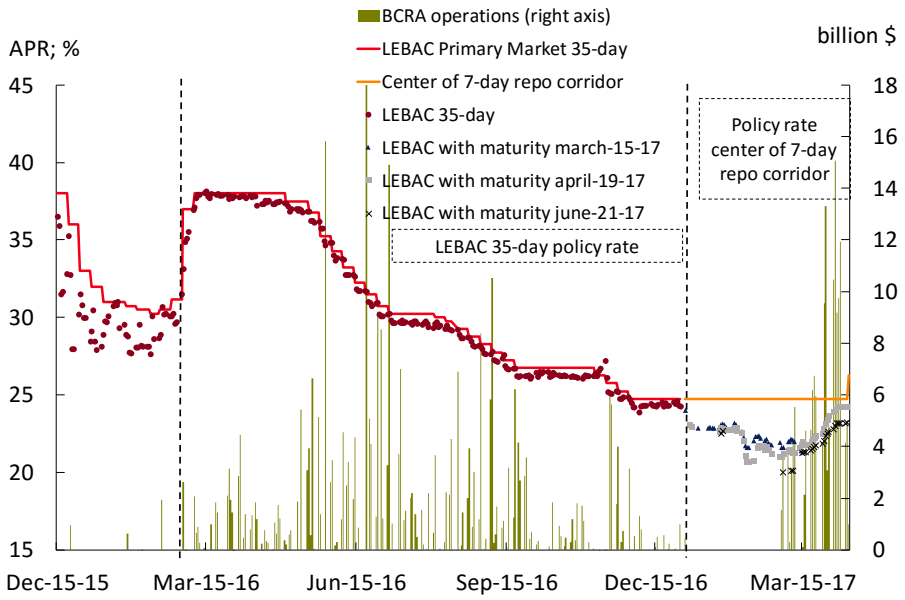
During the first quarter of 2017, the interest rates of deposits recorded drops of 0.3 percentage points for private banks' BADLAR and 0.5 percentage points for retail placements (see Figure 5.12). As regards lending rates, the transmission was less homogeneous, with barely a 0.2 percentage points fall for discounted notes and a 1.7 percentage points fall for retail personal loans (see Figure 5.13).

Figure 5.13 | Monetary policy rate, lending rates and deposit rates



Given the fall in certain interest rates, in early March, when the BCRA noticed that the disinflation process was slightly above the expected path, it started to intervene in the LEBAC secondary market to withdraw the excess liquidity that had been channeled to reverse repo operations with the BCRA and to strengthen the transmission of its policy interest rates to the rest of the market, so as to ensure that the disinflation process would converge to its inflation target of 12-17 percent for 2017. Thus, the LEBAC interest rates in the secondary market recovered 2 percentage points (see Figure 5.14).

Figure 5.14 | BCRA LEBAC secondary market operations



Source: BCRA

Exhibit 2 / International reserves at the BCRA and their management

International reserves management objectives for central banks

International reserves are the international liquidity insurance every economy has in order to absorb or smooth shocks to its balance of payments, thus underpinning confidence in monetary and exchange policy, and providing a certainty that the country is able to fulfill its external obligations, which reduces the probability of a crisis.[98]

Central banks manage their reserves based on the objectives they pursue in maintaining them. Soundness, liquidity and investment performance are the three main pillars that define investment guidelines in every central bank. These interact as follows: being public funds, central banks make sure, first, that their international reserves investments are prudent and safe. Second, given that the need for reserves may arise suddenly, it is very important that the investments are liquid. Lastly, due to the size of the managed portfolios, their performance cannot be overlooked[99]. In fact, the performance of the managed portfolio is one of the drivers of the long-term growth rate of the resources available to every economy. Similarly, it is also important to consider the potential correlation between the managed portfolio and the scenarios in which those resources would most likely be used to absorb or smooth shocks to the balance of payments.

Based on these guidelines, all central banks manage their international reserves aiming for an optimal balance between soundness, liquidity and investment performance.

International reserves at the BCRA

The BCRA may keep part of its external assets in deposits or other interest-accruing operations with foreign banking institutions, or in securities of proven soundness and liquidity, payable in gold or in foreign currency (Charter, Article 33). These conditions are supplemented by the prohibition to place excess domestic or foreign currency in instruments that lack an immediate, substantial liquidity (Charter, Article 19, section h) or to purchase shares, except those issued by international organizations (Charter, Article 19, section f). Consistently, Article 6 of Law N° 23,928 allows reserves to be invested in deposits or other interest-accruing operations, or in public securities payable in gold, precious metals, US dollars or other similarly sound currencies, calculated at market values.

Based on the current policy framework and the international standards that establish the requirements to be met by "reserve assets"[100], the Board of the BCRA determines and regularly reviews the main guidelines for international reserve investment.

Currently, international reserves at the BCRA can only be invested in Financial Action Task Force (FATF) member countries with the highest credit rating. Similarly, they may be invested in assets payable in gold, in IMF special drawing rights (SDR), and/or in 14 currencies, among them those comprising the SDR basket (US dollar, euro, British pound, yen and renminbi) and nine other currencies included among the most representative globally in terms of daily transacted volumes and of their share in international payments (see Table 1).

[98] See main references in Nugée, J. (2000) "Central Bank Reserves Management", in Sovereign Assets and Liabilities Management, Chapter 9; Borio C., J. Ebbesen, G. Galati, and A. Heath (2008) FX Reserve Management: Elements of a Framework, BIS Papers, N°38; and International Monetary Fund (2004) Guidelines for Foreign Exchange Reserve Management.
[99] Nugée, J. (2000) "Central Bank Reserves Management", in Sovereign Assets and Liabilities Management, Chapter 9.
[100] International Monetary Fund (2009) Balance of Payments and International Investment Position Manual, sixth edition (MBP6), Chapter 6F Reserves.

The US dollar is the main exposure for BCRA international reserves. Exposure in other currencies, though allowed, the potential mismatch between BCRA assets and liabilities in foreign currency is restricted.
The BCRA may invest its international reserves in the same types of assets often used by other central banks[101], which focus mainly on fixed asset instruments, such as securities issued by governments, agencies, supranational organizations, banks, etc. It may also use derivatives to manage currency risk and interest rate risk in each portfolio.

Table 3 | Selected currencies for the BCRA reserves

	Currency	Currency code
1	US Dollar	USD
2	Euro	EUR
3	Renminbi	CNY
4	Japanese Yen	JPY
5	Sterling Pound	GBP
6	Swiss Franc	CHF
7	Canadian Dollar	CAD
8	Australian dollar	AUD
9	New Zealand Dollar	NZD
10	Hong Kong Dollar	HKD
11	Singapore Dollar	SGD
12	South Korean Won	KRW
13	Norwegian Krone	NOK
14	Swedish Krona	SEK

Recent changes

Since the changes in the risk scenario for this Central Bank seen in late April, 2016[102], the BCRA started a gradual normalization in the investment of its international reserves. One of the main objectives was the increase in the number of counterparties, in order to enhance competition between entities and the prices of investments.

To that effect, the BCRA selected those banks pertaining to eligible countries for reserve investment that not only had the highest quality of credit, but which had also been designated as "systemically important" and, therefore, must meet additional capital requirements.

The quality of credit in each bank is monitored through three different indicators, whereby the international credit rating is complemented by the market valuation of its credit risk and, additionally, by the rating produced by a structural model based on financial ratios and on each bank's balance sheet. Thus, the BCRA

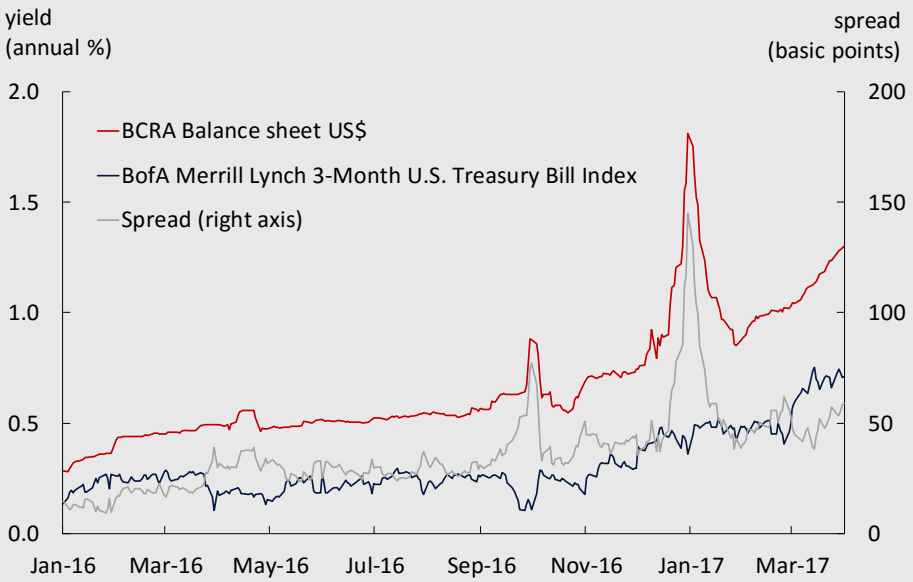
[101] Carver (2016) HSBC Reserve Management Trends 2016, Central Banking Publications, p.27.
[102] On April 28, 2016, the US Supreme Court certified the voluntary withdrawal by the parties, which restored the ruling from 2015, whereby the court of appeals had ruled that the BCRA was not the "alter ego" of the Republic and, therefore, was not responsible for its debts. Thus the BCRA ended almost eleven years of litigations at various US courts.

follows each bank's credit risk very closely, without having to rely exclusively on one particular criterion, as was traditionally the case with international rating agencies.

Currently, the BCRA may operate with over 30 counterparties to invest its reserves, compared to the previous, very limited number of potential counterparties, which only comprised official and supranational organizations.

The BCRA adopted a more proactive stance in the implementation of the different strategies available for the optimization of its portfolio investment, mainly by restoring its international reserves, which reached USD 52 billion towards the end of the first quarter of 2017, in line with the record level of mid-2011, before the launch of the strong regulation in the exchange market.

Figure 1 | BCRA Balance sheet yield vs. Treasury yield curve



Source: BCRA and Bloomberg

Not only did the process initiated by the BCRA make it possible to enhance competition and operation efficiency, but it also enabled a growing improvement in its portfolio performance. The yield of its liquidity portfolio in US dollars, the main currency in the BCRA portfolio, grew from an annual 0.3% in early 2016 to 1.3% late in the first quarter of 2017, thereby increasing its yield fourfold. Although part of this increase is explained by the rate hike in US dollars, the improvement observed in the BCRA portfolio can be traced to the yield spread versus other market indices with similar maturities. In early 2016, the BCRA's short-term dollar portfolio yielded +15 basis points above the US Treasury yield curve for up to 3-month bonds, whereas towards the end of the first quarter this year, its yield spread versus this index had reached +60 basis points.

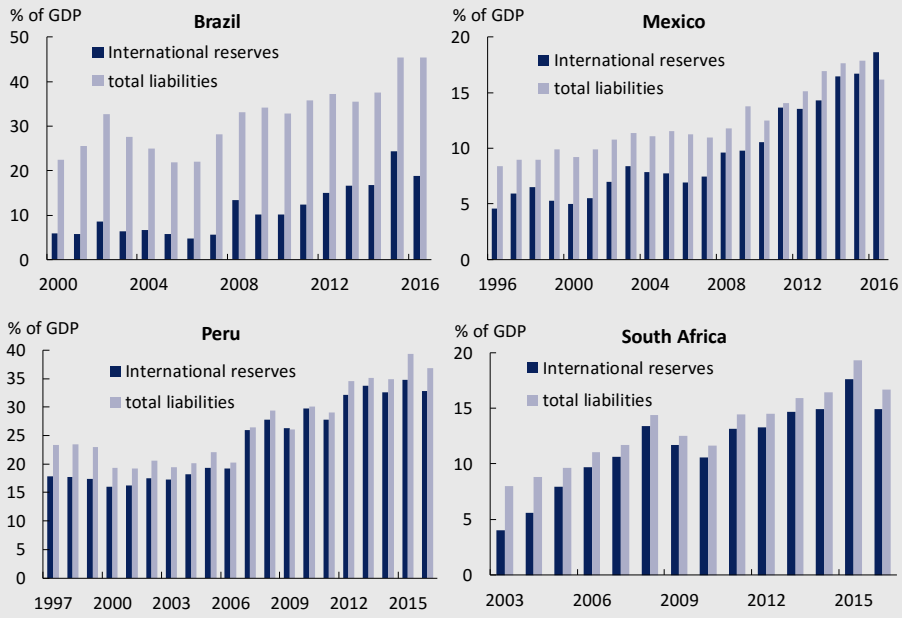
In the next few months, the BCRA will continue to move forward towards the normalization of its investment processes as well as with the changes required to optimize the investment of international reserves.

Exhibit 3 / Strengthening the BCRA balance sheet: the experience of other emerging economies

Over the course of the last decade, central banks in several emerging countries with inflation targeting regimes have taken advantage of the context of abundant capital inflows to build international reserves and strengthen the assets in their balance sheet. The increase in the external asset stock reduces the vulnerability of the domestic economy to the ups and downs of international markets, by acting as a sort of liquidity insurance in the face of potential turmoil, and ensuring stability in the local currency market.

The high global liquidity level of the last few years and the intense capital inflows to emerging economies have created a favorable context for the central banks of several emerging countries to attempt to increase their international reserves, funding these operations with local currency. The central banks of Brazil, Mexico, Peru and South Africa are some of the entities that have adopted this stance with a macro-prudential purpose (see Figure 1). Mexico and Peru have doubled their international reserves (measured in GDP terms) in the last ten years, whereas Brazil and South Africa have tripled their stock over the same period.

Figure 1 | International reserve stock and total liabilities in central banks

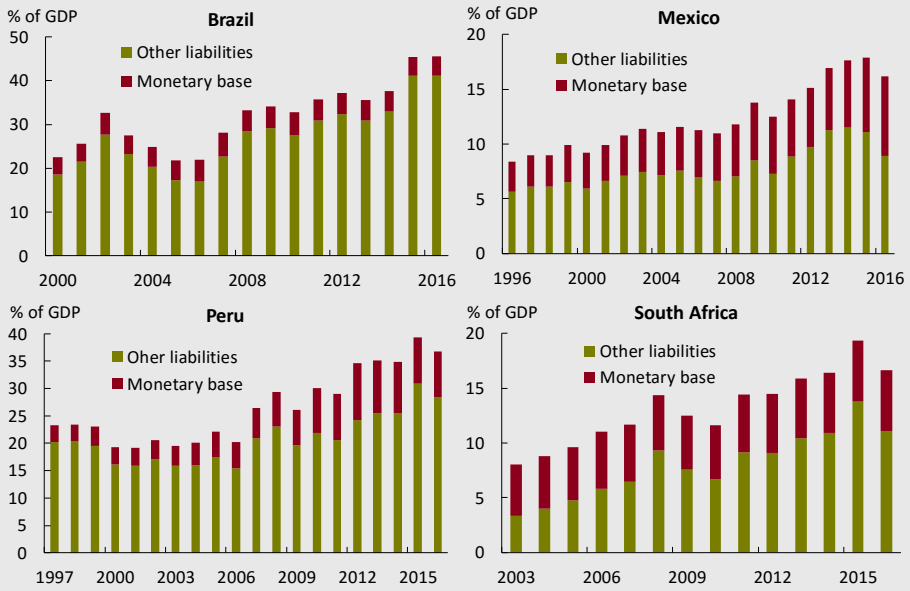


Source: Central Banks of the respective countries

This strategy has given rise to a marked growth in the balance sheet of these institutions, since the evolution of their assets has been reflected in their respective liabilities. Given that all of the aforementioned countries have inflation targeting regimes in place and use the interest rate as their main monetary policy instrument, the money issued for purchasing reserves that was not accompanied by a matching increase in money demand by the public was absorbed by the central banks through the issuance of non-monetary liabilities (similar to repos with financial entities and LEBAC, to make a comparison to the Argentine case). Thus, this mechanism accounts for the increase of similar magnitude in both assets and liabilities that became apparent from the review of the balance sheets published by these monetary authorities.

As regards its composition, most of the increase in liabilities that resulted from the purchase of reserves was accounted for by the increase in the non-monetary liabilities, whereas money demand from the public grew at a lower rate or remained relatively stable over time in GDP terms (see Figure 2). It should be noted that such a behavior is to be expected from money demand in contexts of relative stability in the inflation rate, as was the case in these economies.[103]

Figure 2 | Monetary base and other central bank liabilities



[103] This might constitute a deviation from the Argentine case, given that, in a context of disinflation, local money demand would be expected to grow.

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

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

Fed: United States Federal Reserve

FIEL: *Fundación de Investigaciones Económicas Latinoamericanas*

FOB: Free on Board

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

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

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 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

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

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

TN: *Tesoro Nacional*. National Treasury

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

US$: United States Dollar

UTA*: Unión Tranviarios Automotores*

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

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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