

Monetary Policy: Assessment and Outlook

Since October 2018, the Central Bank of Argentina (BCRA) has been implementing a scheme based on monetary base control and on the definition of intervention and non-intervention zones for the exchange rate. The monetary base zero growth target has been overcomplied every month after its implementation. Likewise, in January and February 2019, the exchange rate stood below the lower bound of the non-intervention zone, resulting in foreign currency purchase by the BCRA vis-à-vis a higher demand for domestic currency.

The new scheme managed to reduce the nominal volatility in place during last year: after the peak seen in September (6.5%), the monthly inflation rate started to decline. However, the inflation rates recorded in February and March 2019 have been higher than expected by the BCRA. The reasons for the increase lie, in part, in the rises of regulated prices and in the delayed impact of exchange rate depreciation. Added to this, there was higher foreign exchange volatility as from late February.

To prevent the persistence over time of the inflation rates recently recorded, the Monetary Policy Council (COPOM) of the Central Bank has adopted a series of measures to strengthen the monetary scheme. The monetary base zero growth target was extended until the end of the year; June seasonal adjustment of the monetary base was eliminated; February overcompliance of the target was rendered permanent; and the bounds of the non-intervention zone were set until year end at the level in place as of the date of issue of this report (39.75 – 51.45 Argentine pesos per dollar). Likewise, the BCRA will refrain from purchasing foreign currency when the exchange rate stands below the lower bound of the non-intervention zone until June 30, 2019.

Under the current monetary policy, the interest rate reacts quickly to changes in monetary market conditions: if inflation or inflation expectations increase, or if there is a higher risk perception, financial institutions require a higher interest rate to keep their positions in pesos. This becomes rapidly evident in the rate resulting from the auctions of Liquidity Bills (LELIQs). The quick reaction of the rates helps reduce exchange rate volatility and increase the contractionary bias in the face of inflationary unexpected events. In order to make this evolution more predictable, the Central Bank has also decided to absorb the liquidity required to keep an annual minimum rate of 62.5% during April. In turn, it has also adopted several measures for the benchmark interest rate to translate into a higher yield in pesos for savers, thus encouraging more competition among banks to receive deposits in domestic currency.

Keeping a contractionary bias in the monetary policy is critical to prevent a permanent impact of the temporary factors behind the current inflation rate, such as the increase in regulated prices and the exchange rate fluctuations. The monetary policy has a response lag while inflation also has an inertial component; but, keeping monetary conditions under control ensures that price changes only have temporary effects, rather than permanent ones. Thus, the monetary policy contractionary bias will stand throughout 2019. The benchmark interest rate is expected to decline gradually and only to the extent that the inflation rate goes down.

These measures have been adopted within an economic context that shows incipient signs of recovery, as evidenced by the indicators of the first quarter of the year. Nevertheless, this scenario might be affected by some potential risks: a new episode of volatility in the global financial conditions or the usual uncertainty that characterizes all electoral processes. The Central Bank is better prepared to face them: it has a sounder balance

sheet; the real exchange rate is more competitive; there has been an adjustment in the external sector; the fiscal deficit is declining without funding from the Treasury; and regulated utilities prices have been largely corrected.

The Central Bank's stock of remunerated liabilities in pesos is low, relative to both GDP and international reserves. Even assuming that LELIQs' real interest rate stands at the current level until the end of the year, the remunerated liabilities-to-GDP ratio would remain relatively stable at around 5.3%. On the other hand, facing an even more extreme scenario where the LELIQs' nominal interest rate would stand at around 68% annually, the weight of remunerated liabilities on GDP would reach 6% in December 2019; this means that it would still stand 4.6 percentage points (p.p.) below the maximum value recorded in March last year.

Meanwhile, the real exchange rate is currently standing 60% above the level it had before the unification of the foreign exchange market in December 2015 and is consistent with that of late 2011, when the current account was close to equilibrium. The current level of the real exchange rate is contributing to balance the external accounts: the current account deficit of the last quarter of 2018 (seasonally adjusted and annualized) was 2.4% of GDP, i.e. down 4 points against the figure of the previous quarter.

Most of the initiatives to control inflation in our country have coexisted with high fiscal deficits but, in recent times, progress has been made to correct this imbalance. The national public sector's primary deficit went down from around 5% of GDP in 2015 to 2.4% of GDP in 2018 and will go down to zero in 2019. Likewise, as from June 2018, there is no monetary issue to finance the Treasury.

Lastly, the prices of regulated utilities have been largely corrected, to put an end to the previous lag in their cost. Even though this has entailed a higher inflation rate in the short term, the reduction of subsidies contributes to fiscal solvency and leads to a lower inflation rate over time.

Beyond the concrete characteristics of the current scheme, the institutional strengthening of the Central Bank is critical to ensure that it contributes to stability on a long-lasting basis. To this effect, the Executive Branch has sent to National Congress a bill on the reform of the Central Bank's Charter which, among other distinctive features, proposes to define price stability as a primary objective of the Central Bank and to prohibit the monetary authority from funding the Treasury.

The Central Bank of Argentina considers that everything is in place now for a more sustainable monetary policy: without resorting to shortcuts such as lags in the exchange rate or the price of utilities, and moving forward towards a fiscal and external balance, the monetary policy will effectively manage to attain a long-lasting reduction of inflation. This process takes time and is conditioned by short-term disturbances. But, keeping a contractionary monetary bias that may ensure that these disturbances are only temporary will help reduce inflation and provide an environment of stability and growth for both households and companies.