Monetary Policy Report

October 2019

BANCO CENTRAL
DE LA REPÚBLICA ARGENTINA

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Prefacio

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

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

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

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

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

Autonomous City of Buenos Aires, October 16th, 2019.

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Access the data series through the following link.

1. Monetary Policy: Assessment and Outlook

The main risks identified in the previous Monetary Policy Report (IPOM), i.e. the uncertainty related to the result of the primary elections and the worsening of the international trade war, finally held true during this quarter.

After the primary elections, the risk perception related to the Argentine assets went up, thus leading to a deterioration of the public sector's capacity to renew short-term debt obligations at maturity. This caused a sharp drop in the price of all Argentine assets (corporate and sovereign bonds, shares of stock and other), added to a depreciation of the exchange rate and a drop of deposits in dollars.

Against this backdrop, the Ministry of Economy announced that it seeks to extend the maturities (reprofiling) of the Treasury's short-term debt and sent a bill to Congress for the purpose of mitigating the schedule of maturities for the rest of the year and for the 2020-2023 period.

The Central Bank of Argentina (BCRA) kept its contractionary monetary policy and it also implemented a series of measures to regulate the access to the foreign exchange market and to reduce the demand for dollars. The new regulations do not affect foreign trade transactions, travels, payment of debt in foreign currency or the freedom to withdraw pesos and dollars from bank accounts. The measures are mainly intended to limit the formation of foreign assets for no specific use, especially in the case of legal persons, and also to establish the obligation of clearing into the country the collections from the exports of goods and services.

In August and September, the increase of the exchange rate observed after the primary elections put a halt to the declining trend of inflation in previous months. The measures implemented by the BCRA served to stabilize the exchange rate and helped inflation resume its downward path as from October. As financial volatility started to slow down, the drop of deposits in dollars and the fall of international reserves were mitigated as well.

The temporary increase of inflation resulted in a reduction in real money supply while the implementation of exchange regulations allows for anticipating a higher demand for money than originally expected until the end of the year. In order to prevent an excessive monetary contraction, the Monetary Policy Committee (COPOM) adjusted its monetary base targets, which now foresee a monthly growth of 2.5% in September and October, and will be adjusted on the basis of the net foreign exchange transactions to be made by the BCRA.

The targets have been adjusted within a context where the forecasts of the demand for money may lose accuracy. Consequently, in order to ensure the contractionary bias of the monetary policy, the COPOM increased the floor of the interest rates of Liquidity Bills (LELIQs) from the current 58% to 78% in September. For October, this floor was set at 68%, in line with market forecasts.

Despite the high volatility faced by the Argentine economy, the financial system has managed to keep its soundness, with a low exposure to the public sector and without significant mismatches (see Exhibit 4. The relevance of consensus in macroprudential regulations). More than 15 years ago, the Central Bank of Argentina implemented some regulations that strongly limit bank exposure to the public sector and divided the banking system into two segments, dollars and pesos, which, in practice, are almost entirely isolated. The regulation also established that, as a precautionary measure, banks must keep very high levels of liquidity, well above those recommended by international standards. Since then, all administrations have complied with these principles. This is an example of how basic consensus helps to strengthen economic robustness and to protect savers.

The high levels of liquidity have enabled banks to face the withdrawals of foreign currency deposits in a satisfactory manner. As a result of the absence of mismatches, the increase of the exchange rate did not impact on banks' equity. In turn, all of the above contributed to regain depositors' confidence: the drop pace of deposits in foreign currency slowed down gradually, while deposits in pesos remained stable.

In terms of some geopolitical factors that are impacting on the international context, the trade conflict between the United States and China has continued to worsen, a Brexit without an agreement is now more likely to occur, and the disputes between Iran and some advanced economies have intensified. This context led to a deceleration of the global economic activity. Thus, even though the central banks of some advanced economies adopted new expansionary measures, global liquidity conditions have worsened and a recomposition of portfolios is observed to the detriment of emerging economies' assets.

Argentina is facing a more adverse scenario than that of the previous quarter due to lower growth expectations worldwide. On the other hand, even though global liquidity conditions for emerging countries have recently worsened, they do not have a significant impact on Argentina since, given its current high sovereign risk premium, for the time being the country has no access to international markets.

The Central Bank of Argentina will continue to make all efforts required to preserve the country's monetary and financial stability. The exchange rate increase after the primary elections put a halt to the disinflation process that had been observed until mid-August. Therefore, the BCRA will keep its contractionary monetary policy based on compliance with the targets and on keeping positive and high real interest rates, in order to resume the disinflation process.

2. International Context

During the third quarter of 2019, some of the factors mentioned in the previous Monetary Policy Report (IPOM) finally held true and impacted on the global economic activity due to an increased uncertainty. Among other geopolitical factors, the trade conflict between the United States and China has continued to worsen, a Brexit without an agreement is now more likely to occur, and the disputes between Iran and some advanced economies have intensified, resulting in a deceleration of the activity level worldwide.

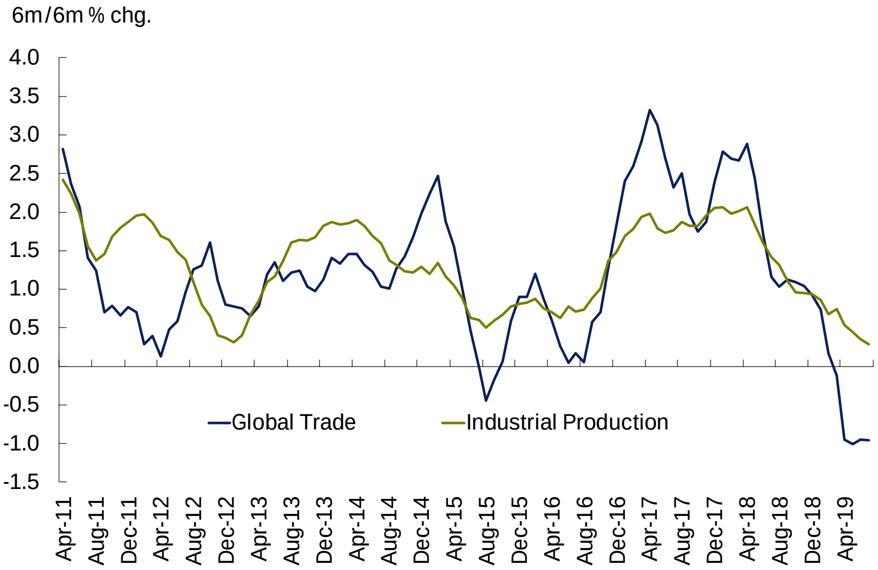
The monetary authorities of some advanced economies have adopted new measures with an expansionary bias, a trend that expanded to some emerging economies during this quarter. However, global liquidity conditions have worsened as from the previous IPOM due to trade and geopolitical tensions, which resulted in a recomposition of portfolios that impacted on the emerging economies' asset prices. Thus, the flight to quality process prevailed over the central banks' stimulus during the last three months.

Argentina is facing a more adverse international context than in the previous quarter due to an outlook of lesser growth at global level. However, a faster growth pace is still expected in Brazil (and other trading partners) for 2020, which would entail a positive boost to trade. On the other hand, even though global liquidity conditions for emerging countries have recently worsened, they do not have a direct impact on Argentina since, given its current high sovereign risk premium, for the time being the country has no access to international markets. The main risk factor of the international context is a deepening of the trade and geopolitical tensions, since they would impact on the trade channel.

2.1 The ongoing deterioration of the global activity level has a negative impact on our main trading partners

The signs of a decelerating global economic activity have remained in place as from the publication of the previous IPOM. According to the most recent data, global trade has been falling at a rate of 1% every six months, seasonally-adjusted (see Chart 2.1). Meanwhile, industrial production has slowed down markedly, even though its growth rates continue to be positive.

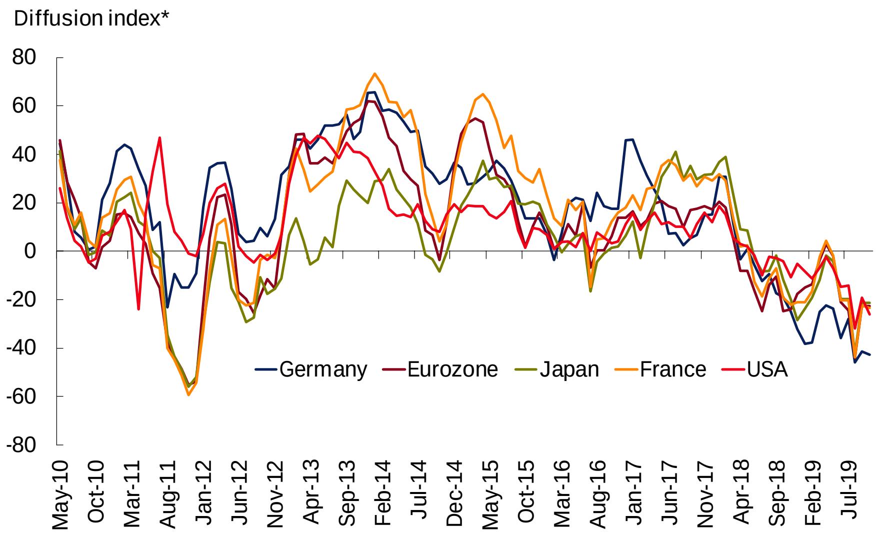
Figure 2.1 | Global trade and industrial production (s.a.)



Source: BCRA from CPB Netherlands Bureau for Economic Policy Analysis

The uncertainty caused by trade tensions and its impact on corporate confidence (see Chart 2.2) continues to be one of the main factors behind the slower growth pace at global level, because of its adverse effect on investment. This is clearly seen in the Global Manufacturing PMI[1], the Global Services PMI and the Composite PMI (see Chart 2.3), where the first one has been within the contraction zone since May 2019, while the other two have a clear declining trend.

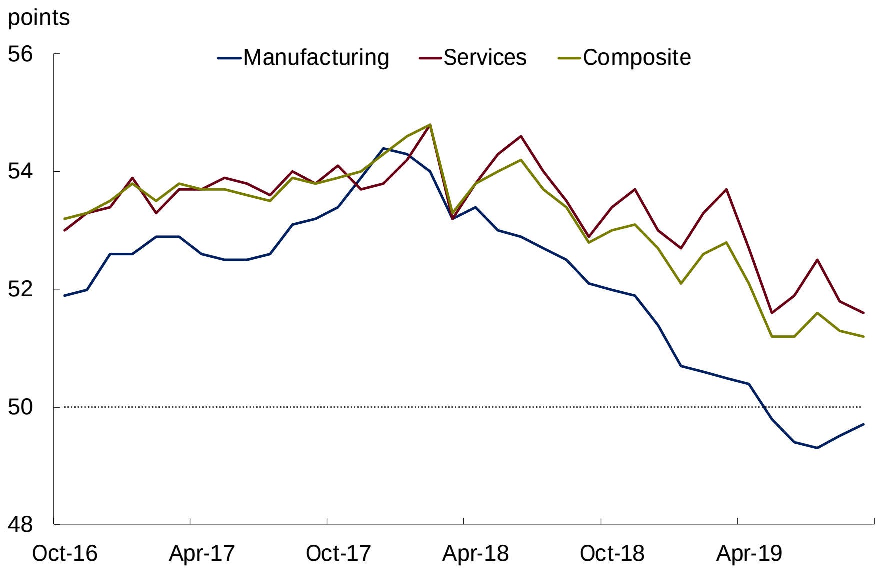
Figure 2.2 | Economic Sentiment in advanced economies



Indicator of Economic Sentiment. * Percentage difference between positives and negatives answers. Source: BCRA from ZEW, Thomson Reuters and Bloomberg

1 Purchasing Managers' Index

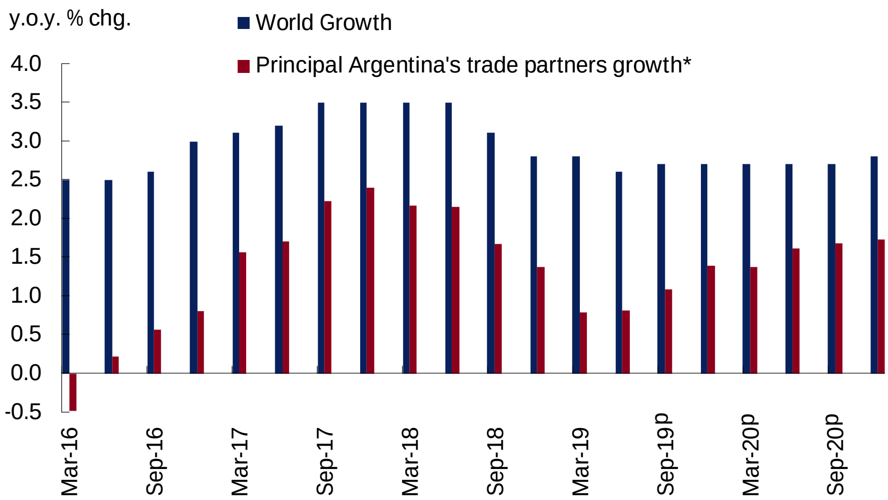
Figure 2.3 | PMI global indexes



Source: BCRA from Bloomberg

The outlook of lesser growth also applies to Argentina's main trading partners. The economic activity level expected for 2019 is the lowest of the last four years. Anyway, the performance of these economies is expected to improve in 2020 (see Chart 2.4).

Figure 2.4 | World and principal Argentina's trade partners growth



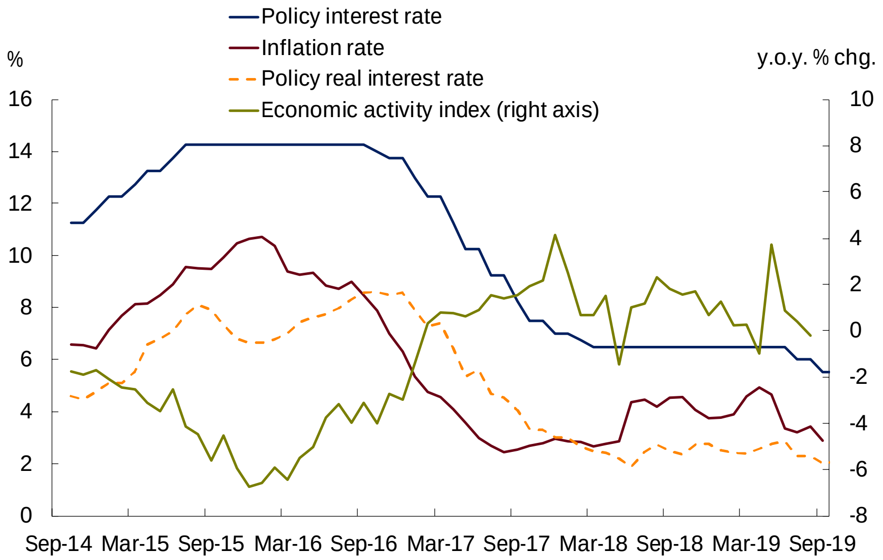
p: Projected
*Weighted by their participation in the exports of Argentine manufactures.
Source: BCRA from FocusEconomics, Bloomberg and national statistics offices.

Brazil, our main trading partner, recorded a 0.4% quarter-on-quarter growth seasonally-adjusted in the second quarter (with a positive carryover for 2020), which stood above the private sector's forecasts of a 0.2% increase. This growth pace followed the 0.1% drop of the activity level in the first quarter[2]. This better performance in the second quarter was mainly due to a recovery of investment, which recorded a 3.2% quarter-on-quarter growth seasonally-adjusted after an accumulated drop of 2.8% in the previous two quarters. In turn, household consumption reached its tenth consecutive quarter of sustained growth which was underpinned, according to the Central Bank of Brazil (BCB), by the growth of the wage bill and a higher household indebtedness.

In the same line, the monthly economic activity data measured by the BCB's IBC-Br Index, which had been negative from January to April, showed that the economy grew in May and, to a lesser extent, in June (1.6% and 0.3% monthly, seasonally-adjusted), even though in July it contracted again by 0.2%. The data corresponding to September manufacturing production, which were recently published, show that this sector's activity would be growing at the fastest pace of the last seven months, after the poor performance of the first half of the year.

On the other hand, the most recent estimates of the BCB's Focus Survey anticipate a 0.9% growth rate year-on-year (y.o.y.) for 2019, up 0.1 percentage points (p.p.) against the forecast of July. The BCB's official projections have estimated the same figures. This better performance anticipated for the remaining months of 2019 would be related to a higher fiscal deficit. In turn, for 2020, the forecasts of both the BCB and the Focus Survey anticipate a higher growth rate (1.8% and 2%, respectively).

Figure 2.5 | Brazil. Macroeconomic indicators



Source: BCRA from Central Bank of Brazil

One of the risks the Brazilian economy was potentially exposed to was an unfavorable change in the investors' perception about the structural reform process. This risk seems to have largely faded away: the Brazilian

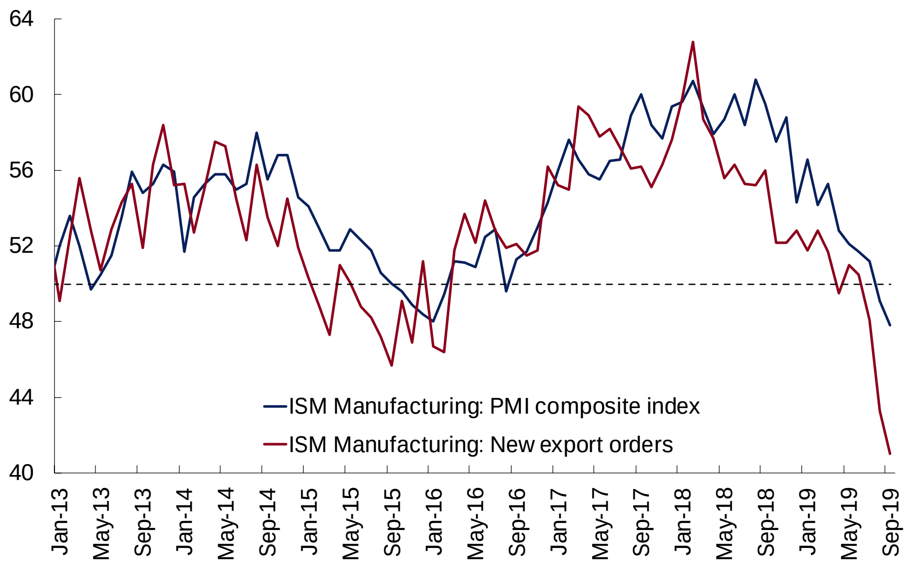
2 In this quarter, the economic activity would have been adversely impacted by a sharp drop of the mining activity due to an environmental accident.

Congress enacted the pension reform, which was the most relevant change expected by the market among the reforms announced by the current president during his electoral campaign.

The most recent data about inflation in Brazil (corresponding to September) was 2.9% year-on-year, standing below the middle of the target (4.25% ± 1.5). In recent months, the main reason behind the deceleration of the inflation rate was the evolution of fuel and food prices. In turn, the analysts surveyed by Focus anticipate that inflation will end 2019 at a rate of 3.3%, down 0.5 p.p. against the forecasts estimated at the time of publication of the previous IPOM. In this context, the BCB changed its monetary policy interest rate (SELIC) for the first time in 16 months, with a reduction of 0.5 p.p. by the end of July and an equal reduction by the end of September, resulting in a current rate of 5.5%. Focus' analysts estimate that there will be an additional reduction of 0.75 p.p. over the year.

Regarding the United States, the most recent data about its economic activity show that the GDP growth rate decelerated to 2% in the second quarter (against the previous quarter, annualized and seasonally-adjusted), down 1.1 p.p. against the first quarter but up 0.2 p.p. against market expectations. As it has already been stated, this deceleration is mainly related to the trade conflict with China and, to a lesser extent, to the fact that the tax cut incentives implemented by the Republican Administration at the time of taking office (2017) would no longer have an impact. On the demand side, the main contributor to GDP growth was private consumption (3 p.p.), followed by consumption and public investment (+0.8 p.p.), while there was a contraction in the activity level of inventory change (-0.9 p.p.), net exports (-0.7 p.p.) and private investment (-0.3 p.p.). The preliminary data of the manufacturing activity measured by the Purchasing Managers' Index (PMI) reveal that, in September, both production and export orders fell to the lowest levels of the last 10 years (see Chart 2.6).

Figure 2.6 | USA Manufacturing PMI



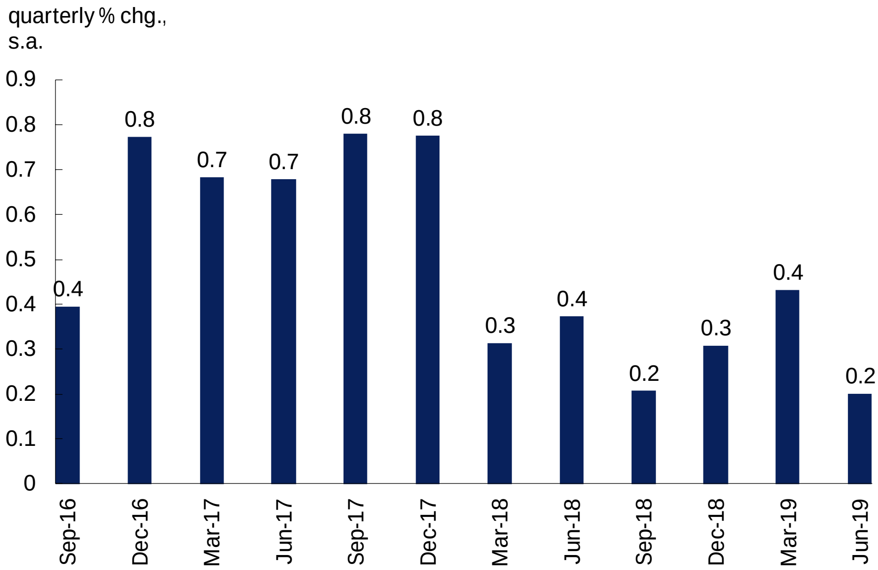
Source: BCRA from Bloomberg

In turn, the Federal Open Market Committee (FOMC) of the US Federal Reserve (FED) revised its growth forecasts downward once again and increased its unemployment estimates for 2019 (-0.1 p.p. and +0,1 p.p., respectively), leaving the inflation projections unchanged. Against this backdrop, at the meeting held in September, the FED reduced its benchmark interest rate to a range between 1.5% - 1.75%, marking the second reduction of the rate since late 2008 (after the decrease of July 31(see Exhibit 1. Reasons for the US Interbank Market Volatility). In principle, taking into account FOMC's estimates and also the private sector's forecasts, new reductions of the benchmark interest rate by the FED are not likely to occur this year, despite the political pressures in this respect.

In the Euro Zone, the pace of the economic activity slowed down in the second quarter to 0.2% quarter-on-quarter, seasonally-adjusted (see Chart 2.7), in line with market expectations (0.3%), and stood 0.2 p.p. below the figures of the previous quarter. This was mainly due to the sharp deceleration of export growth. In turn, domestic demand continued to be the main economic growth factor in the Euro Zone. At country level, especially remarkable were the drop of the German GDP by 0.1% and the increase of the Italian GDP by 0.1%, after two quarters of contraction (0.1% in each quarter).

High frequency indicators of the Euro Zone would be anticipating a remarkably moderate growth pace for the third quarter. In September, the manufacturing activity of the Euro Zone contracted at the fastest pace in nearly seven years, and this would be starting to impact adversely on the services sector as well. Thus, the European Central Bank (ECB) revised slightly downwards its growth forecasts for 2019 (1.1%, -0.1 p.p.) and 2020 (1.2%, -0.2 p.p.).

Figure 2.7 | Eurozone GDP growth

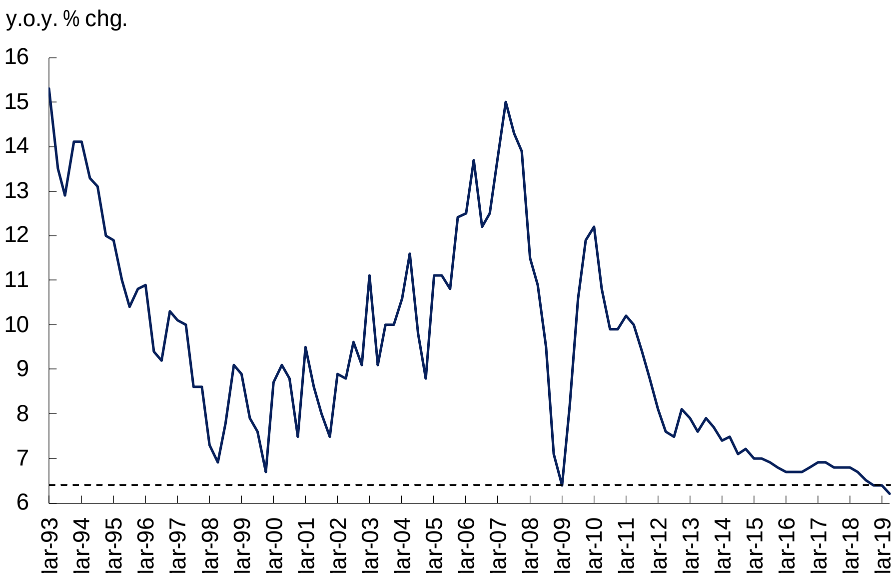


Source: BCRA from Bloomberg

Given the current context of the Euro Zone, and after giving signs that it would be ready to adopt expansionary measures, the ECB has now decided to effectively put them into practice. In this respect, it reduced the interest rate on the deposit facility of its corridor by 10 basis points (bp), while it left unchanged both the interest rate on the credit facility at 0.25% and the reference interest rate (MRO) at 0%. In addition, it has resumed its assets purchase program at a pace of €20 billion per month as from November 1, after putting an end to the program by late 2018.

On the other hand, the deceleration of the Chinese economy is still in process, since it has grown at a rate of 6.2% y.o.y. in the second quarter of 2019 (against 6.7% y.o.y. in the same quarter of 2018), the slowest expansion pace since 1993 (see Chart 2.8). The Manufacturing PMI continued to be within the contraction zone (below 50) in September for the fifth consecutive month, while new export orders have declined for 16 months in a row. In addition to the trade conflict with the United States, an impact is observed of the still-failed attempt by the authorities to balance aggregate demand, by promoting private consumption to the detriment of investment. One of the most affected sectors is automobile production which, from January to September, accumulated an 11.4% drop against 2018, mainly impacted by the expiration of tax incentives to the purchase of cars and the effective implementation of new standards on the emission of contaminating particles.

Figure 2.8 | China GDP growth



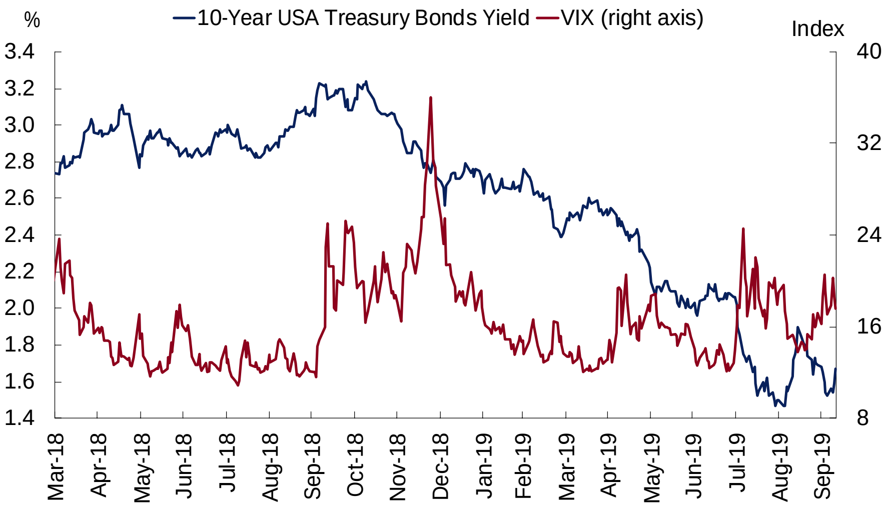
Source: BCRA from Bloomberg

Despite this context, the analysts participating in the Focus Economics survey consider that the growth rate is likely to be within the 6%-6.5% range for the rest of 2019 and in 2020. In this respect, the People's Bank of China adopted measures to keep an adequate volume of loans and announced a new benchmark interest rate for new loans up to one year, which was slightly reduced in the last two months. In addition, the banks' minimum cash requirement was reduced for the third time this year, thus releasing 900 billion yuan (US$126.35 billion) to underpin the economy. The recent measures might create more doubts about the soundness of the Chinese banking system, since three banks had to be rescued in three months and there is uncertainty about the likelihood that other institutions might also be at risk.

2.2 In recent months, global risk has been reassessed

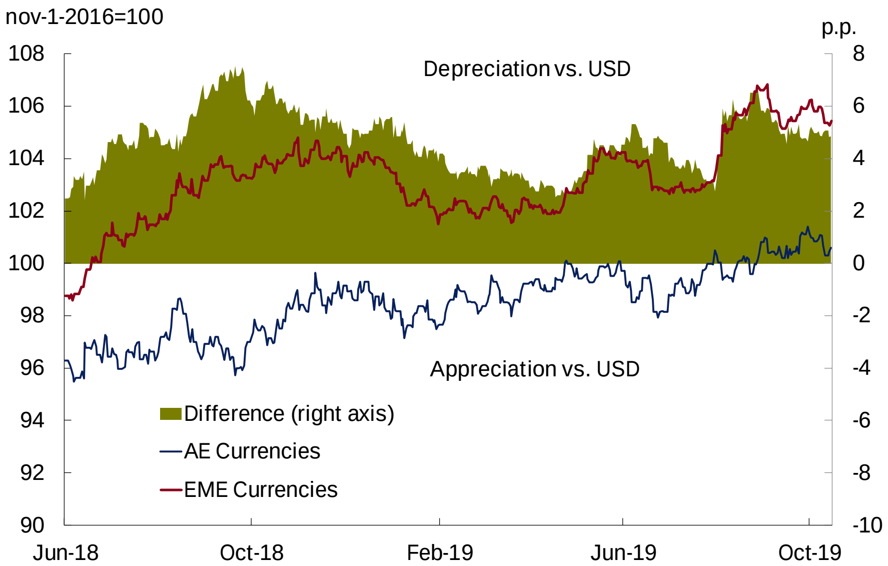
The uncertainty related to trade and geopolitical tensions, added to a slower expected growth pace in world economy, resulted in a higher risk perception and a flight to quality (see Chart 2.9). The counterpart of this context was a higher depreciation, against the US dollar, of the domestic currencies of both advanced economies and emerging economies, even though with a higher impact on the latter (see Chart 2.10, and Exhibit 2. The Supply of Safe Assets and the Role of the US Dollar in International Markets).

Figure 2.9 | 10-Year USA Treasury Bond and VIX index



Source: BCRA from Federal Reserve Bank of St. Louis

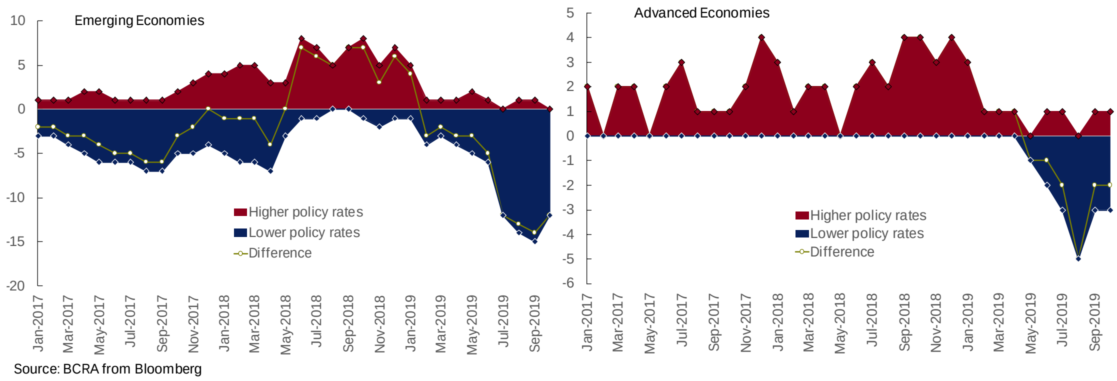
Figure 2.10 | Advanced and emerging currencies vs. US dollar



Source: BCRA from Bloomberg and World Bank

The monetary authorities of the largest economies continued to apply monetary policies with an expansionary bias. Something similar is observed in emerging countries, even though the expansionary bias started to be adopted later than in advanced economies (see Chart 2.11). It is likely that the effect of this context characterized by better liquidity global conditions for emerging countries will be more than offset by the real impact of a lower economic growth.

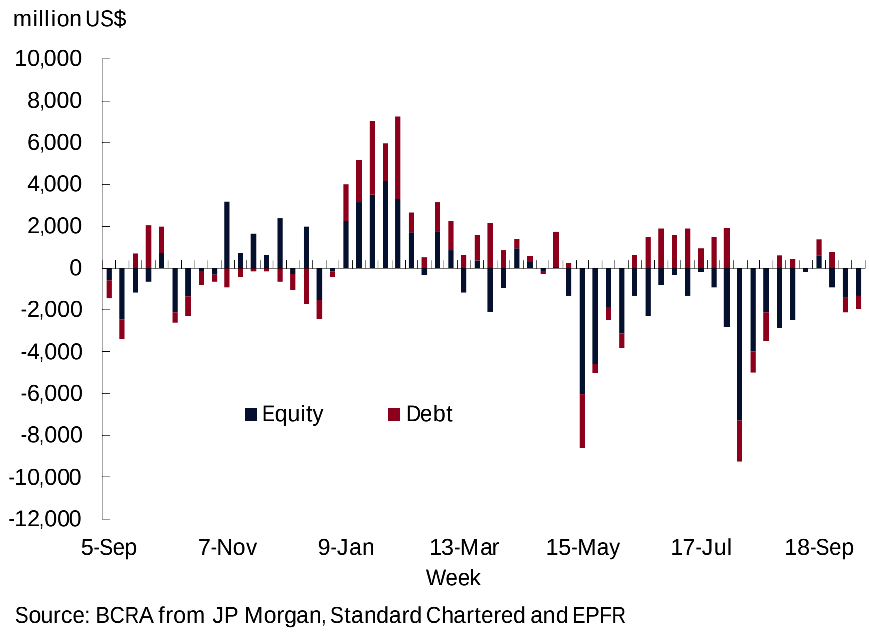
Figure 2.11 | Countries that changed their policy rate



As from the previous IPOM, there have been negative flows in the funds specialized in emerging countries' assets (see Chart 2.12). Despite this, the yield spread required in secondary debt markets of emerging countries, in terms of both sovereign and corporate bonds, remained almost unchanged if compared to the previous IPOM, and stood at around 400 bp for sovereign bonds and 340 bp for corporate bonds.

These risk premiums are standing 10% above the average of 2018. Despite this, debt issues of emerging countries are standing at historically high levels, for both sovereign bonds and corporate bonds.

Figure 2.12 | Capital flows to emerging markets



During July and before the economic turbulences in Argentina after the primary elections, there had been four bond issues in international markets by companies belonging to the electricity and telecommunications sectors, for a total amount of US$1.18 billion, within a context where the CEMBI (Corporate Emerging Markets Bond Index) for Argentina was showing a downward trend towards levels similar to those of February (around 600-700 bp). Since then, no issues were made by companies in international markets, after the sharp increase in the perceived risk which, measured by the Argentine CEMBI, exceeded 1,200 bp by mid-October.

2.3 Real Exchange Rate and Terms of Trade

After the sharp nominal depreciation of the peso in the second week of August, the exchange rate recorded a slight appreciation in real terms. By the end of September, the Multilateral Real Exchange Rate Index (ITCRM) stood at levels similar to those of the first half of 2011 (-10% y.o.y.) (see Chart 2.13).

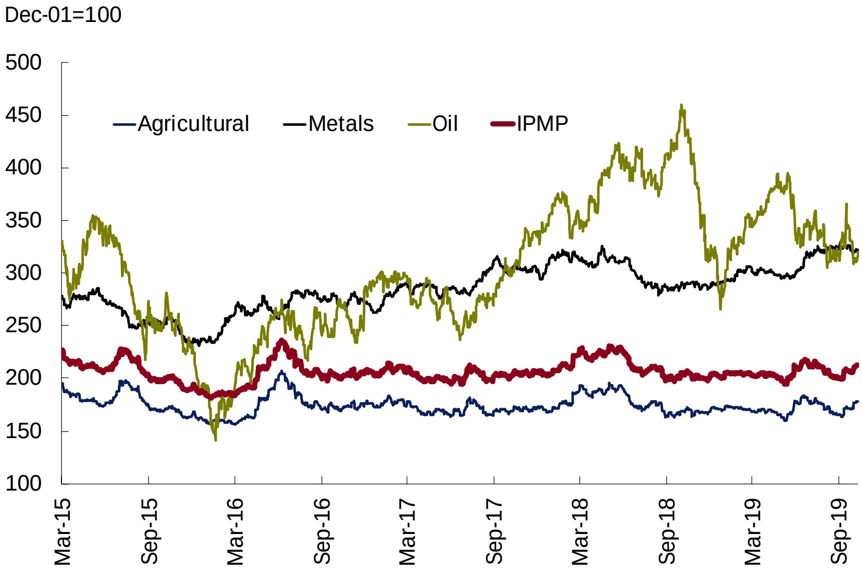
Figure 2.13 | Real effective exchange rate

Source: BCRA

On the other hand, in the third quarter of the year, the international prices of commodities measured in dollars[3] remained stable (up 0.6%) against the second quarter, while the average international prices of agricultural commodities remained virtually unchanged (even though, in general terms, they followed a declining trend over the quarter). Likewise, while oil international prices went down in the quarterly average, metal prices went up. There was an increase on the margin of crude oil and agricultural commodity prices which, if sustained, would result in higher export prices for Argentina during the last quarter of the year. In year-on-year terms, the Commodity Price Index (IPMP) of late September 2019 rose around 3%, with improvements in the prices of the agricultural and metal sectors, and a reduction in the case of crude oil price (see Chart 2.14).

3 According to the Commodity Price Index (IPMP), published daily by the BCRA. Such Index shows the evolution of Argentina's main export commodities.

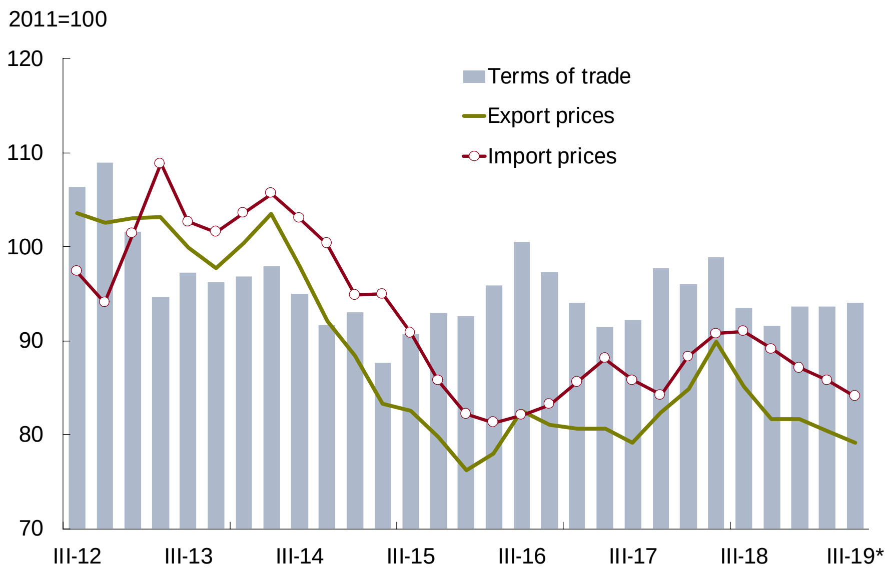
Figure 2.14 | International commodity prices



Source: BCRA from INDEC and Datastream

With partial data as of August 2019, the prices related to Argentina's foreign trade, measured in dollars, dropped for the fourth consecutive quarter. In the July-August period, export prices fell 1.6% against the previous quarter mainly due to the reduction of commodity prices in dollars in such period (-5%). In turn, import prices went down 2% in the first months of the third quarter, after the strong impact of the reduction of intermediate goods prices in dollars. As a result, the terms of trade rose slightly (0.4%) and stood around the average level of the last three years (see Chart 2.15).

Figure 2.15 | Terms of trade



Source: BCRA from INDEC

*Data up to aug-18

In short, as from the previous IPOM, some of the risk factors mentioned in such publication finally held true, which impacted on the global activity level because of an increasing uncertainty. These factors include the tensions related to the trade conflict between the United States and China, the likelihood of a disorderly Brexit, and the disputes between Iran and some advanced economies. Thus, in the last months, there was a reassessment of global risk and a flight to quality process in the assets markets. Against a backdrop of greater deceleration of the world activity level, the monetary authorities of some advanced and emerging economies adopted once again expansionary measures. As a result, Argentina is facing a more adverse context than in the previous quarter due to an outlook of lesser global economic growth and, in particular, of its main trading partners for the rest of 2019. However, for 2020, the positive growth forecasts of our main trading partners are signaling a more favorable scenario for external demand. The main risk factor of the international context is a deepening of the trade and geopolitical tensions, since they would impact on the trade channel.

Exhibit 1 / Reasons for the US Interbank Market Volatility

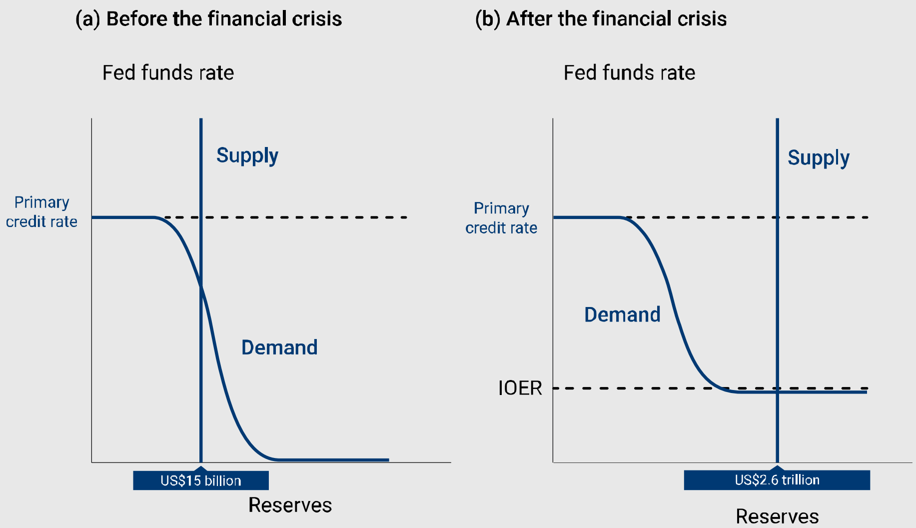
The benchmark interest rate of the US Federal Reserve (FED) is established as a target of the Effective Federal Funds Rate (EFFR) also known as Federal Funds Rate, which is one of the interest rates of the interbank market. The Federal Reserve sets a target related to such market rate, called Target Federal Funds Rate (TFFR), and then it uses the monetary policy instruments available to take the EFFR to a value close to the target. At present, the TFFR is a range between 1.75 and 2%. On infrequent and few occasions, the EFFR moves away from the TFFR and, when it does, it is only by just a few basis points (bp). But, by mid-September, the 99th percentile[4] of the EFFR detached nearly 1.9 p.p. from the TFFR. There were immediate warning signs given the similarities with the trigger that gave rise to the Great Financial Crisis (GFC) in August 2007.

Before the GFC, the US financial system operated with a structural liquidity deficit, i.e. the FED was a net creditor of banks. This structural deficit enabled the FED, by means of Open Market Operations (OMOs) which, because of their nature, were operations with a temporary impact on liquidity), to pump the liquidity required for the EFFR to stand at values close to the TFFR[5]. The intersection between liquidity demand and supply occurred at the market equilibrium rate (EFFR) (see Figure 1[6]).

After the GFC and the quantitative easing measures, the US financial system abandoned the structural liquidity deficit and adopted the structural liquidity surplus. Under these conditions, the bank reserves liquidity of the financial system went from US$15 billion up to US$2.6 trillion, even though it started to go down gradually due to the balance sheet normalization policies implemented by the FED. Together with this balance sheet normalization process, the FED had to adjust its operational framework: due to the structural liquidity surplus it could no longer take the EFFR to values close to the TFFR by means of OMOs, as it did before the Great Financial Crisis. This could have made it more difficult to increase the TFFR when it wanted to adopt measures with a contractionary bias.

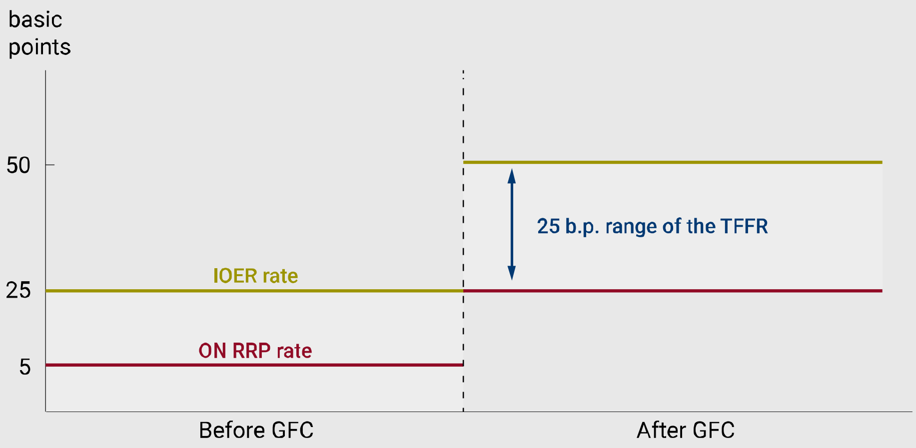
4 On September 17, the average of operations in the fed funds market was 2.3%, slightly above the ceiling of the TFFR corridor, while in previous days it used to stand close to the floor. Taking into account the distribution of operations in the fed funds market that day, 1% of the distribution of the EFFR operations traded at a lowest interest rate reached a rate of up to 2.05% while, in the other end, 1 % of the operations with the highest interest rate (99[th] percentile) recorded a rate over 4%. For further details, see this link.
5 The Primary Credit Rate is the interest rate at which the FED provides liquidity to some institutions and it stands above the EFFR, in order to encourage the institutions to meet their liquidity needs first in the fed funds market. It is a credit line that serves to mitigate the liquidity needs of the institutions that could not meet them in the fed funds market.
6 The explanation of the FED's monetary policy operational framework before and after the GFC is a simplification of the scheme introduced in the paper by Ihrig et al, *Monetary Policy 101: A Primer on the Fed's Changing Approach to Policy Implementation,* Staff working papers in the Finance and Economics Discussion Series (FEDS), Federal Reserve Board, Washington, D.C., June 30, 2015. Figures 1 and 2 are a reproduction of Figures 5 and 7 of this paper.

FIgure 1 | Measures adopted by the FED



In part, one of the measures adopted by the FED to solve this situation was to start remunerating the excess reserves (minimum reserve requirements) of the financial system (Interest Rate On Excess Reserves - IOER). In addition, it started to use its Overnight Reverse Repo Program (ON RRP) on a daily basis (before, there were only sporadic interventions) and vis-à-vis a much larger group of counterparties (See Figure 2).

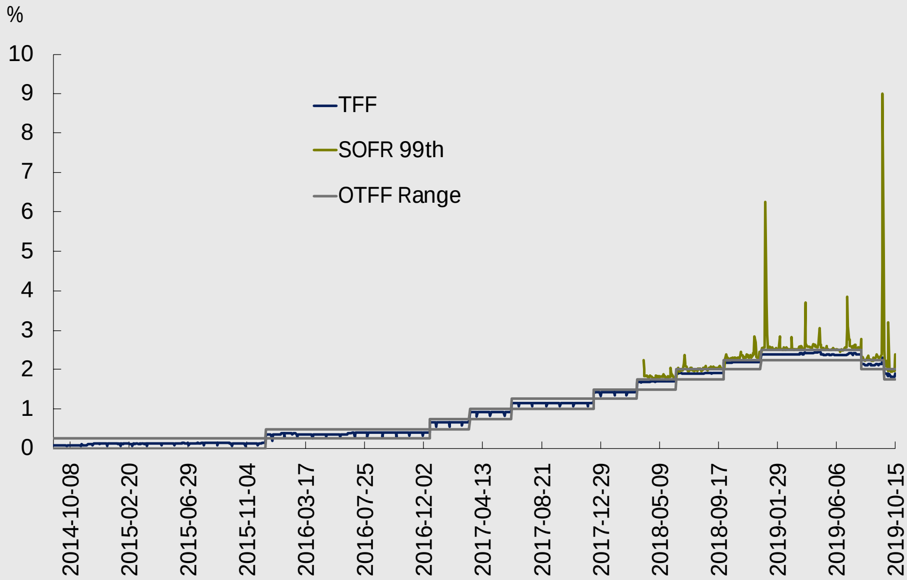
Figure 2 | Measures adopted by the Fed



Source: Ihrig et. al (2015)

Since the time when the TFFR started to go up in December 2015, only under exceptional circumstances did the FED have problems to keep the EFFR within the range of the TFFR, but none of these circumstances can be compared to that of mid-September (see Figure 3).

Figure 3 | Tasas del mercado interbancario de Estados Unidos



Source: BCRA from Federal Reserve data

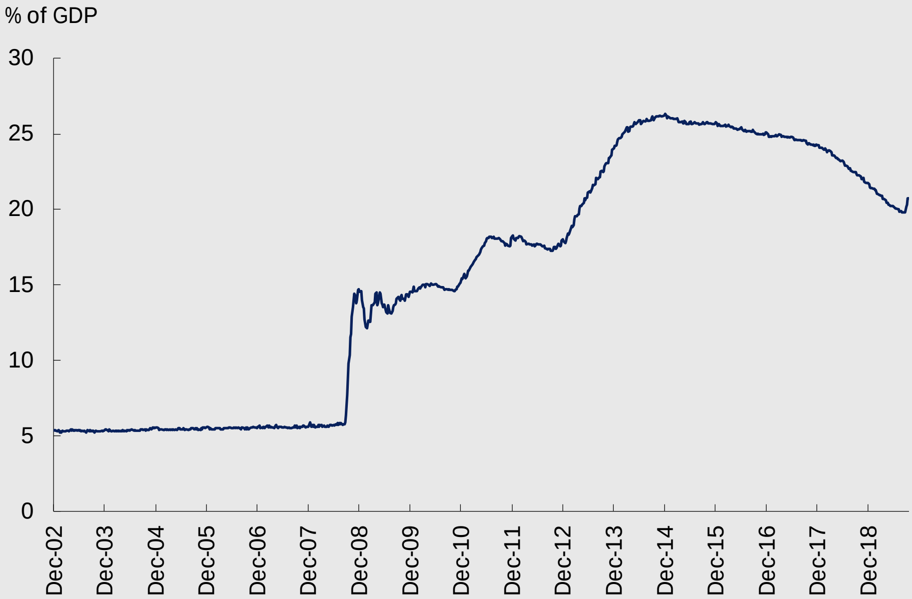
Something different took place on Monday, September 16, when the EFFR pierced the TFFR ceiling (at that time, the range was 2 – 2.25%, and then went down to 1.75 – 2%). The upward pressure of the EFFR and of the Secured Overnight Financing Rate (SOFR) was such that it forced the FED, for the first time in nine years, to make operations intended to pump liquidity by means of its own repo line. The 99th percentile[7] of the SOFR reached values close to 9%, 4.5 times the value of the TFFR, giving rise to a situation unheard of since the GFC. Against this backdrop, the FED conducted repo auctions, initially via overnight transactions and then also to a 14-day term. In addition, the FED decided to reduce the IOER[8] since the EFFR tends to stand slightly above the IOER and, when the latter is reduced, then the risk that the EFFR may stand above the TFFR goes down as well.

The phenomenon that took place in September is especially atypical given the fact that even though the FED started to normalize its balance sheet (by reducing its size), it has only reduced it by 16% against the maximum value reached by the end of 2014 (see Figure 4); therefore, the excess liquidity in the market seemed to more than exceed the required liquidity.

7 See Note 1 where an explanation is provided of the meaning of the 99th Percentile in the EFFR market. An analogous explanation applies to the 99th Percentile of the SOFR. For further details, see this link.

8 Before, the IOER used to stand 10 bp above the floor of the TFFR corridor. As from September 19, it was decided that it will stand only 5 bp above this value.

Figure 4 | Federal Reserve asset



Source: BCRA from Federal Reserve data

It is estimated that a series of independent and simultaneous events have converged to produce this phenomenon. In the first place, there was a high concentration of tax maturities of companies and, to a lesser extent, of individuals in that week, in the United States, for around US$100 billion which had been withdrawn from money market funds and other accounts of the financial system, as explained by the Federal Reserve Bank of Chicago in a recent paper. Added to that, there was an auction of Treasury Bonds for US$56 billion, which contributed to temporarily reducing the liquidity available. Since these factors can be easily predicted by the market, it would be difficult to believe that they were the only reasons behind this phenomenon[9].

This is why the FED is still analyzing this episode in order to determine if market frictions[10] hindered a more efficient distribution of liquidity from the *primary dealers* to other financial institutions with funding needs.

In order to prevent similar episodes, the FED has recently announced at an off-calendar meeting of the Federal Open Market Committee (FOMC) that it will continue conducting auctions of overnight repo transactions until at least January 2020, and also for a longer term if required. In addition, the FOMC announced that it will make operations tending to increase the liquidity available in the market on a permanent basis (rather than temporarily as is the case of liquidity injections by means of a repo transaction). To this effect, it has decided that it will purchase US$60 billion a month worth of short-term Treasury

9 The participants of the US repo market provide some additional explanations, such as the need of covering open positions by dealers after the sharp and unexpected increase of the oil price (after an attack in oil wells in Saudi Arabia) on Monday, September 16 (there was a downward trend up to that moment), combined with potential and unexpected withdrawals of money market funds by those affected by the temporary interruption of oil production.
Another factor, structural rather than junctural, which might also have contributed, is an interest rate arbitrage. The higher interest rates paid by the FED against the short-term interest rates paid by other countries with a similar risk would have led many central banks to place their international reserves denominated in dollars in the reverse repo for central banks and governments offered by the FED. These placements would reduce the excess liquidity in dollars even more.
10 In this respect, the participants of the US interbank market consider that an excessive concentration in the clearing and settlement services of the market known as “tri-party repo” might have been one of the market frictions that hindered a more efficient liquidity distribution.

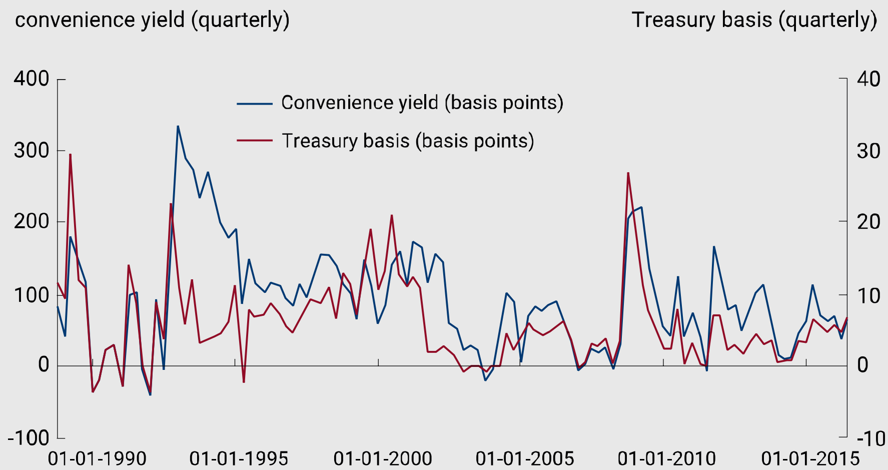
securities until at least the second quarter of 2020. However, the FED has emphasized that these measures are not intended to change its monetary policy bias but, rather, to prevent volatility episodes that impact adversely on the effectiveness of its monetary policy.

Exhibit 2 / The Supply of Safe Assets and the Role of the US Dollar in International Markets

The interconnectedness of central banks around the world was a hot issue at the recent annual symposium of the Federal Reserve (FED) held in Jackson Hole. One of the topics discussed has been present in numerous debates about international finance: the "privilege" that the FED would hold due to the issue of a global reserve currency (Gourinchas and Rey, 2007). At the beginning of this year, Blanchard (2019) illustrated the topic dramatically by resorting to the difference between the growth rate of the United States and the interest rate of a US Treasury bill with a one-year maturity: to the extent that the former exceeds the latter, the government's budget restriction is not operational and the issue of debt or currency to finance fiscal deficits is no longer a reason for concern. Is this a general characteristic of all governments issuing fiat currency or is it a characteristic of the United States only? The evidence about the special nature of the US dollar does not cease to mount.

In one of the papers presented in Jackson Hole, Krishnamurty and Lustig (2019) delve into the apparent enigma about the failure of the covered interest rate parity, stating that, in fact, it expresses the "rate of convenience" paid by investors when they purchase assets denominated in a currency that they consider to be safe (US dollar). Thus, the yield spread between the US Treasury bonds and comparable bonds issued by other G10 countries is systematically negative in the case of maturities from 3 months to one year. But interest rates spreads provide an incomplete picture of the true yield of dollar-denominated assets. Why? By means of its monetary policy, the Federal Reserve changes its supply of assets in dollars which are perceived as safe. For example, when the FED tightens its policy, investors in bonds infer that the supply of safe dollar assets will shrink. Its marginal readiness to pay for the safety and liquidity provided by these bonds increases: the convenience yield goes up and the dollar appreciates, even without an increase in the interest rates in dollars (FIgure 1).

Figure 1 | Estimated convenience yield on dollar safe assets

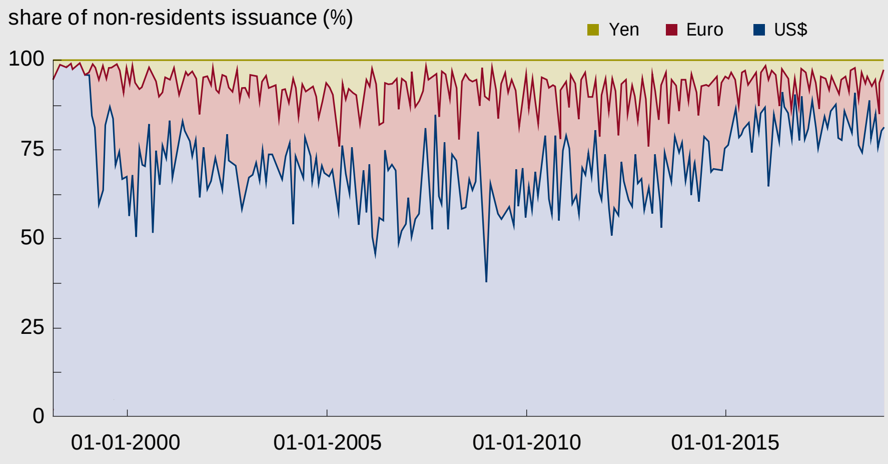


Source: Thomson One

According to the authors, the convenience yield would exist because the US dollar has some advantages even against other currencies which are also very safe and liquid, like the Euro or the Yen. The empirical evidence shows that the Euro and Yen exchange rates do not display the same dynamics in response to shocks of the "flight to quality" type when investors massively purchase assets they perceive as safer. This puts the US monetary authority in the unique position of managing the world's supply of safe assets. The US monetary policy decisions impact on other countries even in the absence of changes in the FED's benchmark interest rate, for example through unconventional monetary policy measures.

Through this channel, the US monetary policy spills over to other economies. Dollar liquidity is not only provided by US Treasury bonds but also by other governments issuing bonds in dollars, as well as banks and multinational companies. The convenience yield impacts on funding decisions both inside and outside the United States. Outside the United States, debt issuers in emerging countries seek to benefit from the funding advantages in dollars, leading to a potential currency mismatch, especially for companies or governments issuing debt in dollars but without income in that currency (and, in the case of governments because they cannot, by definition, issue dollars). If the FED implements a contractionary policy, the supply of safe assets shrinks and the dollar appreciates: Krishnamurty and Lustig find that in countries that rely more heavily on dollar funding, the domestic currency tends to depreciate more in response to an increase in the safe asset convenience yield, and the impact on their external debt burden is larger.

Figure 2 | Share of Non-resident bond issuance by currency denomination for Investment grade bonds



Source: Thomson One

In fact, the authors state that, since the 2008 financial crisis, the dominance of the US dollar in the safe assets markets has grown significantly. The issuance of dollar-denominated bonds and loans has increased relative to the issue in Euros and Yens (Chart 2). As a result, the "spillover" effects of the US monetary policy have gone up as well. These findings are consistent with the hypothesis according to which the changes in the international financial conditions are mainly related to the appreciation and depreciation cycles of the US dollar (Hoffmann, Shim and Shin, 2016).

This analysis confirms the virtually unique nature of the US dollar as reserve currency of choice: its convenience yield is systematically higher than that of other currencies. This puts forth very specific conditions for a government to finance with debt or currency without adverse consequences; and they are related to the fact that investors may wish to systematically keep dollar-denominated assets because they perceive them as safer over time. Lastly, the increasing dominance of the US dollar in the credit markets since the global financial crisis deepens the “spillover” effects of the FED’s monetary policy on other countries, especially emerging economies.

3. Economic Activity

The sizable downward correction of Argentine assets and the depreciation of the peso after the Primary Elections (PASO) impacted negatively on the economy, thus interrupting the incipient recovery of the economic activity.

Until July, most sectors were producing above the minimum level reached in November 2018. The impact on the activity from the record-high agricultural harvest and the exploitation of resources related to Vaca Muerta added up to the recovery of industrial and construction activities, among other sectors. During August, this incipient recovery process was interrupted by the increasing level of uncertainty and the drop of the purchasing power after the inflationary jump of August and September.

As a first response to this new context, the National Government implemented a series of measures aimed at sustaining households' income. Then, together with the BCRA, a series of measures to protect the monetary and financial stability were also adopted. The National Government decided to extend the maturities (reprofiling) of the short-term debt and, additionally, it sent a bill to Congress requesting authorization to change the terms and conditions of the national sovereign debt bonds issued under Argentine law. The BCRA implemented a set of measures intended to regulate the inflows and outflows of the foreign exchange market that will supplement its monetary program. These measures allowed for mitigating the exchange rate and financial volatility, thus reducing the economic uncertainty inherent in the electoral process (see Chapter 5. Monetary Policy).

The Argentine economy has made progress in term of correction the external and fiscal imbalances. The momentum of hydrocarbon production would continue improving the external balance of the energy sector to turn it into a positive balance in the short term. Nevertheless, the economic situation continues to pose great challenges that need to be faced in order to enable economic growth on a more sustainable basis.

3.1 The increased uncertainty after the Primary Elections (PASO) held in August delayed the exit from recession

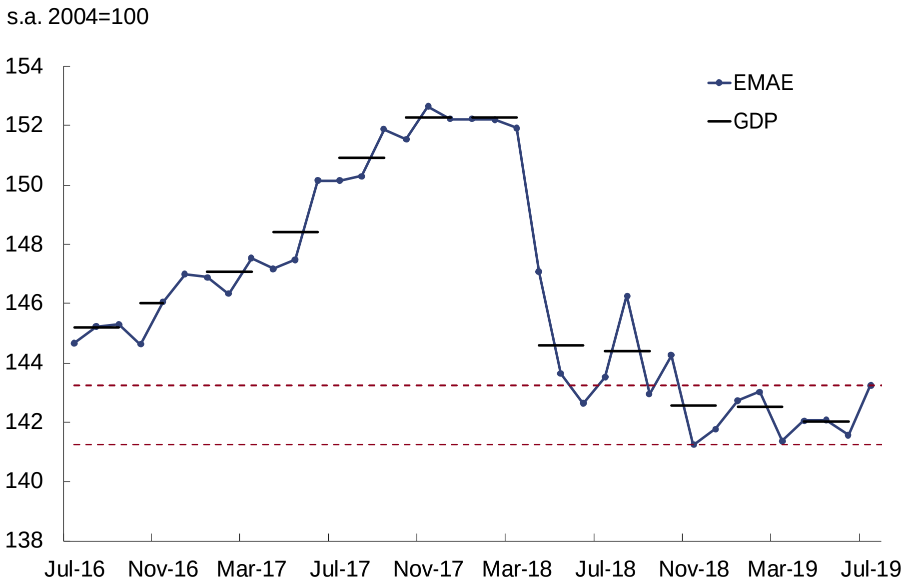
In the second quarter of 2019, the GDP contracted 0.3% quarter-on-quarter (q.o.q.) seasonally adjusted (s.a.) and grew 0.6% year-on-year (y.o.y.) as a result of the recovery of the agricultural sector after the 2018 drought. The result stood below the figures expected by the market analysts participating in the Market Expectations Survey (REM) which, after the end of the second quarter, estimated a 0.7% rise seasonally-adjusted[11].

In July, according to the Monthly Economic Activity Indicator (EMAE), the economic activity grew 1.2% s.a. with a widespread growth of all the blocks that are part of the Indicator[12] and accumulated a 1.4% rise s.a.

11 The forecast median for the GDP change, seasonally-adjusted, in the second quarter of 2019 was 0.7% in the REM of June.
12 Part of the growth recorded in July resulted from a reversal of the negative effects of the power blackout and the excess of rains that would have impacted negatively in June.

against the minimum value recorded in November 2018 (see Figure 3.1). As anticipated in the previous IPOM, the improvement would have been boosted by both the policies aimed at mitigating inflation and exchange rate volatility and the measures implemented since April by the Executive Branch to underpin household income[13].

Figure 3.1 | Economic Activity

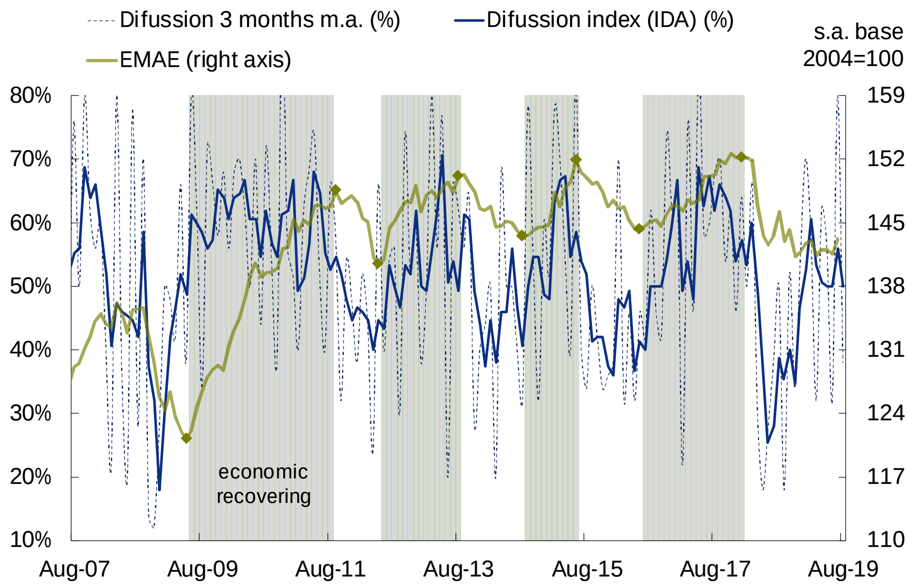


Source: BCRA from INDEC data

The financial instability after the PASO elections prevented the consolidation of the signs anticipating a potential exit from the recession started in December 2017. In August, the Diffusion Index of the monthly growth of a wide group of indicators related to the economic activity[14] interrupted the growing trend observed since November 2018 (see Figure 3.2).

13 The National Government announced plans for different purposes such as purchase of housing units (PROCREAR), automobiles (Junio0KM), home appliances (Ahora 12) and personal spending (ANSES). See Box in IPOM – July 2019.
14 Percentage of series with monthly growth, seasonally adjusted, on a total of 51 monthly frequency series available as of today, on a 3-month moving average.

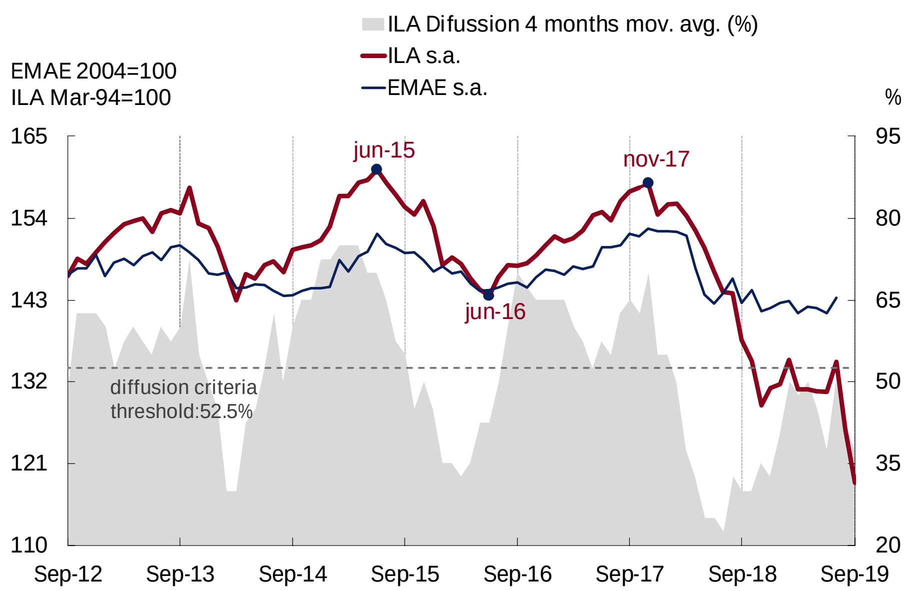
Figure 3.2 | Growth diffusion index and economic activity



Source: BCRA from INDEC, sectorial associations, UTDT, Fiel and OJF data.

In the same line, the BCRA's Leading Indicator of the Economic Activity (ILA-BCRA) which, as of July 2019, exhibited signs that the activity was close to start an expansionary phase, went down sharply in August and September. Besides, due to the effect of backward corrections, the current series of the ILA-BCRA moved away from the fulfillment of the diffusion and depth criteria that had been observed in the series published in the previous IPOM (see Figure 3.3).

Figure 3.3 | Leading indicator of economic activity (LIA)



Source: BCRA from INDEC, AFIP, Sectoral associations, Bloomberg and UTDT data.

The GDP growth forecasts prepared by REM's analysts deteriorated in the last two quarters of the year, reflecting the change in the macroeconomic context. For the third quarter, the median went from a 0.5% growth s.a. in the survey of July to a 0.7% drop s.a. in September. For the fourth quarter, the forecast was revised downwards from +0.5% to -1.1%, respectively. In the same line, the BCRA's GDP Contemporaneous Forecasting (PCP-BCRA) corresponding to the third quarter was adjusted downwards from 0.8% s.a. in the first issue to -0.3% s.a. in the fifth issue.

In a context of increased uncertainty, in August, the National Government announced new income-related measures aimed at mitigating the negative effects of the inflation acceleration on domestic demand (see the following Box).

Box: Measures to Underpin Income

As from the acceleration of inflation in August, after the exchange rate shock following the Primary Elections (PASO), the Executive Branch adopted a series of measures to shore up income in real terms of the ensemble of workers (formal and informal workers, employees under contract of employment, self-employed workers and unemployed):

- **Workers under contract of employment with a gross salary up to $60,000:** Exemption from the payment of 11% of the gross wage as **employee contribution** up to a limit of $2,000 per month during two months (September and October)[15]. Number of beneficiaries: 6.5 million workers.

- **Workers under contract of employment with a gross salary above $60,000**: Increase by 20% of the Minimum Non-Taxable Amount and a special deduction as from which the **Income Tax** is paid[16]. This measure implies an improvement of the net wage of around $2,000 per month (depending on the income and type of family group) and of around $12,000 (for a family with two children and a gross salary of $80,000) for the taxes already withheld during the year. Number of beneficiaries: 2 million workers.

- **Workers of the National Public Administration, Armed Forces and Federal Security Forces:** Grant of a one-time **remunerative fixed amount** (excluded from time of service calculations) of $5,000, payable on the first working day of September[17]. Number of beneficiaries: 400,000 workers. In the same line, several provincial administrations granted bonuses to their state employees.

- **Workers under contract of employment (wage-earners) of the private sector**: Grant of a one-time **non-remunerative fixed amount** of $5,000 (early payment for future wage revisions or increases already foreseen for 2019) payable in October or in the terms, installments and conditions defined under the Collective Bargaining Agreements, depending on the means available to each sector[18]. Number of beneficiaries: 6 million workers.

15 Executive Order 561/2019.
16 Executive Order 561/2019.
17 Executive Order 589/2019.
18 Executive Order 665/2019.

- **Workers providing housekeeping services:** Grant of an extraordinary non-remunerative amount of $3,000 ($1,500/$1,000) in two installments of $1,500 ($750/$500) in October and December to personnel working over 16 hours per week (between 12 and 16 hours / less than 12 hours)[19]. Number of beneficiaries: 500,000 workers.

- **Informal workers and unemployed:** Through the **Universal Child Allowance for Social Protection (AUH)** and the **Universal Pregnancy Allowance for Social Protection (AUE)**, they will receive 2 extra payments of $1,000 per child, one installment in September and the other one in October[20]. This measure supplements the 46% increase granted in March 2019 as early payment of future annual increases derived from the application of the Social Security Mobility Act in 2019. Number of beneficiaries: 2.2 million holders of the Universal Allowance for Social Protection.

- **Self-employed workers (members of the simplified tax regime - *monotributo*):** Removal of the tax component of their **installment** in September[21]. On average, this measure is equivalent to $1,000 per person and up to $4,000 in the highest categories of the simplified tax regime. In turn, the National Government authorized the extension of the permanent plans for credit terms that enable the regularization of tax obligations, resources of social security and/or customs payments[22]. Number of beneficiaries: 3.1 million workers.

- **Self-employed workers:** 50% reduction of early payments related to the **Income** tax for the months of October and December[23]. Number of Beneficiaries: 400,000 workers.

- **Minimum, Vital and Adjustable Salary (SMVM):** 25% increase (in three tranches) of the SMVM as from September, and of the unemployment benefit as well[24]. This increase impacts on the minimum retirement benefit guaranteed to full retirees proving 30 years of effective contribution, with three extra payments as a supplement of $54 in August and $901 in October and November so as to ensure the adjustable 82% of the SMVN. Likewise, this salary impacts on wages not covered by collective bargaining agreements and on the informal economy wages[25]. Number of beneficiaries: 2 million workers.

- **Value Added Tax (VAT):** Removal of VAT for end consumers until December for a set of products included in the food basket[26].

- **UVA-Mortgage Loans:** Freezing of the installment from August to December for around 80% of UVA-mortgage debtors[27]. Between September and December, the beneficiaries will pay an amount equal to the installment of August, without the inflation adjustment estimated by the system. Number of beneficiaries: 93,000.

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19 Resolution 4/2019 of the National Labor Board for Housekeeping Services of the Ministry of Production and Labor.
20 Executive Order 594/2019.
21 Provided they have paid the tax installments of the periods January to August. Executive Order 561/2019.
22 General Resolution AFIP 4548/2019.
23 Executive Order 561/2019.
24 Resolution 6/2019 National Council of Employment, Productivity and Minimum, Vital and Adjustable Salary.
25 According to the Social Emergency Act, the Supplementary Social Salary received by workers of cooperatives accounts for 50% of the SMVM. It also serves as reference for the teachers' minimum wage, which must exceed the SMVM by 20%.
26 Executive Order 567/2019.
27 This benefits two types of families: 33,000 families under the Pro.Cre.Ar.Plan and 60,000 families that used the loan to buy a housing unit for a value below 140,000 UVAs at the time of the transaction.

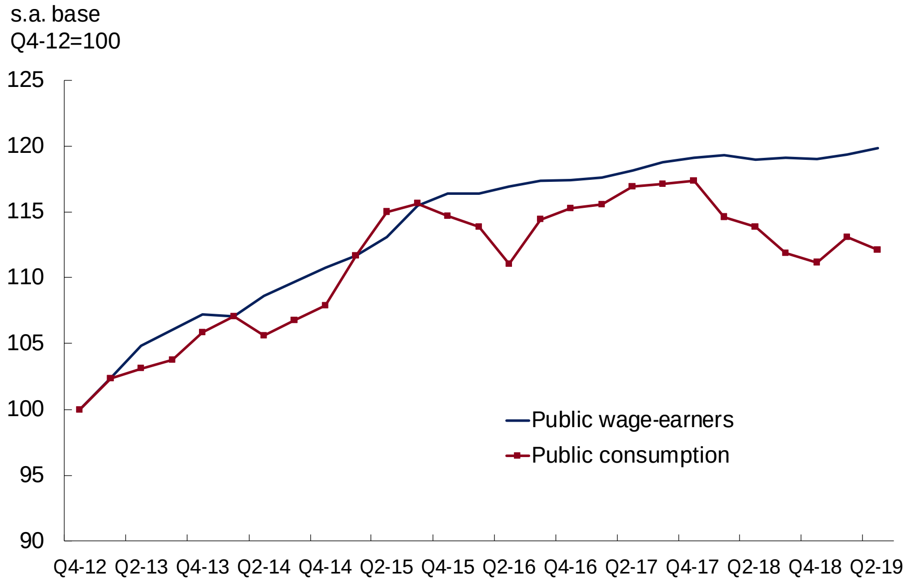
3.1.1 Domestic demand showed a slight improvement in the second quarter but it would deteriorate as from August

In the second quarter of 2019, domestic demand posted a slight improvement against the previous quarter (+0.1% s.a.) after falling for four consecutive quarters. Private consumption remained unchanged against the previous quarter, after dropping for four consecutive quarters. The reduction of inflation and exchange volatility, added to the stimulus measures implemented by the Executive Branch (see IPOM, July 2019), underpinned household spending[28].

The Gross Fixed Capital Formation (GFCF)[29] (investment) went up 1.5% quarter-on-quarter s.a. for the first time since the fourth quarter of 2017. This recovery resulted from the improvements in Construction and Investment in Machinery and Equipment, while the Transportation Equipment component continued to drop.

During the second quarter, public consumption shrank (-0.8% s.a.), thus resuming the downward trend observed since late 2017. In real terms, spending in goods and services by the General Government would have explained the evolution of the last two years since public wage-earning jobs have increased slightly during such period (see Figure 3.4).

Figure 3.4 | Public consumption (in real terms) and public-wage earners



Source: BCRA from INDEC and MPyT

28 The plans had different purposes such as purchase of housing units (PROCREAR), automobiles (Junio0KM), home appliances (Ahora 12) and personal spending (ANSES).
29 GFCF: It includes the purchase of assets (material and non-material) used for productive processes. It is divided into Durable Production Equipment and Construction. It is called “gross” because it does not consider the depreciation of assets.

Net exports contributed positively with 0.5 percentage points (p.p.) to the quarter-on-quarter change of GDP, s.a., in the second quarter as a result of the reduction of imports (-2.7% s.a.) and a slight contraction of exports (-0.6% s.a.).

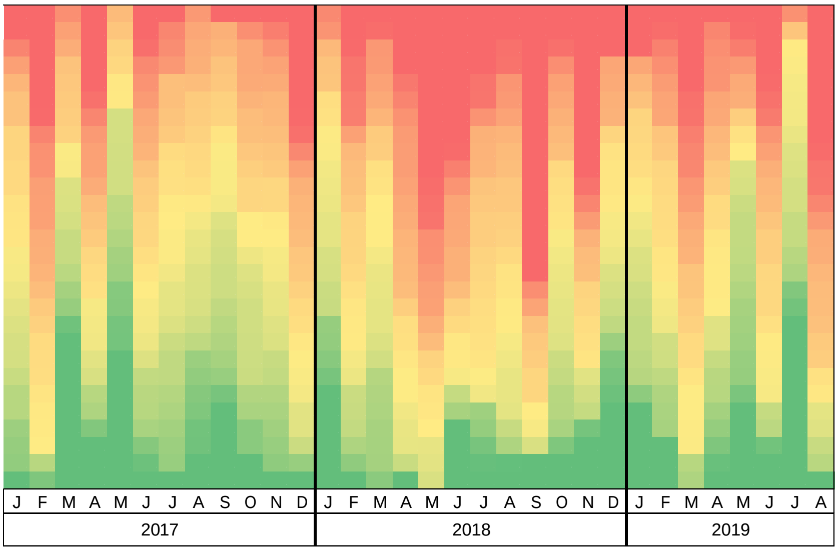
In year-on-year terms, all the components of demand shrank, except for exports, which went up 15% y.o.y. Domestic demand contracted 8.9% y.o.y. (private consumption and investment stood at -7.7% y.o.y. and -18% y.o.y., respectively). In turn, imports recorded the sharpest drops (-22.7% y.o.y; see Table 3.1).

Table 3.1 | GDP growth and contributions of its components

	q.o.q. % chg. s.a.				*y.o.y % chg.*			
	Q3-18	*Q4-18*	*Q1-19*	*Q2-19*	*Q3-18*	*Q4-18*	*Q1-19*	*Q2-19*
GDP constant prices	-0.1	-1.3	0.0	-0.3	-3.7	-6.1	-5.8	0.6
Domestic expenditure	-4.5	-3.5	-0.9	0.1	-6.5	-12.0	-11.5	-8.9
Private consumption	-4.0	-2.2	-1.4	0.0	-5.4	-9.4	-9.9	-7.7
Public Consumption	-1.7	-0.6	1.7	-0.8	-4.2	-5.3	-0.5	-1.7
*Gross fixed investment**	-8.5	-10.0	-0.8	1.5	-11.7	-24.4	-24.5	-18.0
*Net exports***	3.3	5.3	0.8	0.5				
Exports	3.2	11.4	0.9	-0.6	-6.2	7.8	1.4	15.0
Imports	-8.8	-10.9	-2.3	-2.7	-10.2	-24.6	-25.1	-22.7
Statistical discrepancy and change in inventories	1.6	-2.9	0.1	-1.0				

The different indicators related to consumption recorded a sharp deterioration in August (see Figure 3.5). There were sizable drops in: motorbikes and cars licensing (-13% s.a. and -10% s.a., respectively), volume of sales in retail stores reported by the Argentine Medium-Sized Business Confederation (CAME; -10.2% s.a.) and volume of imported consumer goods (-5.3% month-on-month s.a.)[30].

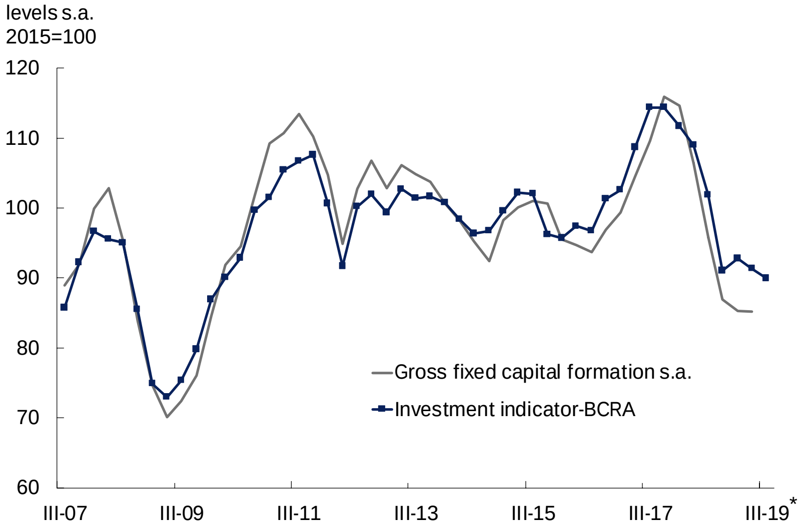
Figure 3.5 | *Heatmap*. Private consumption indicators



30 To assess the intensity of activity growth, the seasonally-adjusted monthly changes of 51 indicators corresponding to September were calculated (see IPOM, April 2019). The average observed since 2004 was subtracted from each change and the result was divided by its historical volatility. Standardized or normalized changes are ordered from the lowest to the highest change in the heatmap Figure, where the intensity of the green (red) color defines a more marked rise (drop).

As regards investment, the BCRA's Indicator of Gross Domestic Fixed Investment (IBIF-BCRA) went down 1.6% s.a. during the July/August bimonthly period against the second quarter of 2019 (see Figure 3.6). Such drop mainly resulted from a reduction of spending on durable production equipment of both domestic (-2.8% s.a.; data from FIEL) and imported origin (-3.5% s.a.; data from INDEC), which was not offset by the slight increase in construction (1.3% q.o.q., s.a., INDEC'S Synthetic Construction Activity Indicator (ISAC)).

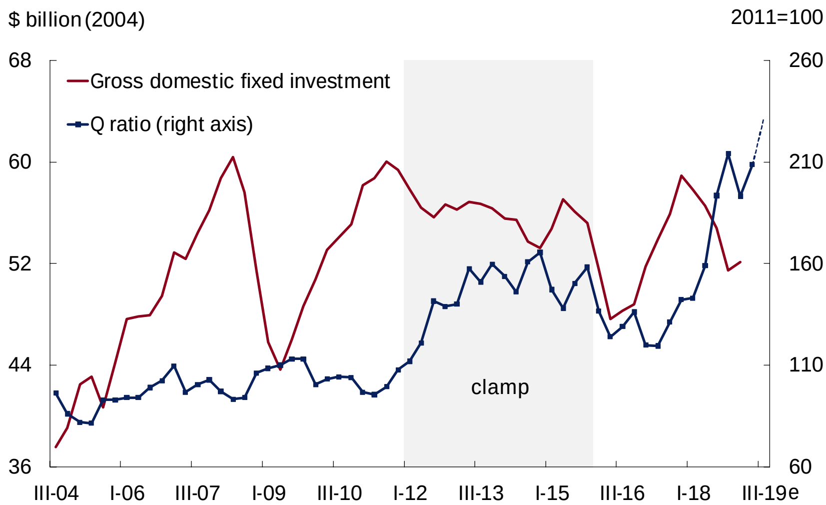
Figure 3.6 | Gross fixed capital formation - Investment



*Data up to August 2019. Source: INDEC and FIEL

For the rest of the year, the construction activity would remain unchanged within a context of favorable relative prices. The ratio of relative prices relevant for construction –known as Q Ratio– relates the market price of real estate (which is generally dollarized) with the cost of construction, which especially depends on wages and materials. Such price ratio has kept a growing trend since late 2017 and is expected to reach a historical maximum record in the third quarter of 2019 (see Figure 3.7).

Figure 3.7 | Evolution of investment and Q ratio

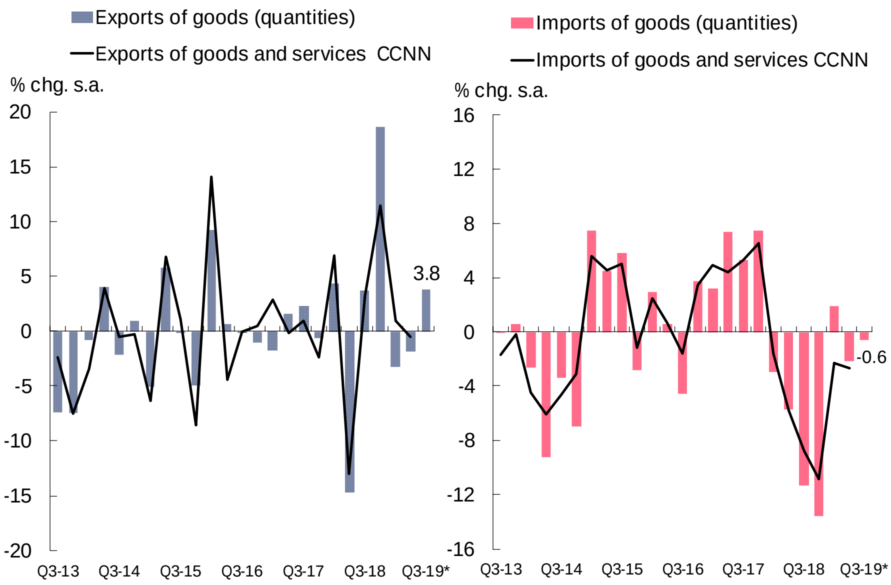


e: Estimated. Note: Q ratio is the ratio between assets price and the reposition cost.
Source: BCRA from INDEC, UADE, Dirección de Estadísticas de CABA and Merval data.

3.1.2 In the third quarter, exports of goods resumed their growth path

In the second quarter of 2019, exports of goods and services in real terms exhibited a slight drop (0.6% q.o.q. s.a.) but, nevertheless, they stood well above the level observed in the same period of 2018 when the agricultural sector suffered the impact of the drought (+15% y.o.y.). In turn, imports contracted again (-2.7% q.o.q. s.a. and 22.7% y.o.y.) despite the slight recovery of domestic demand (see Figure 3.8).

Figure 3.8 | Foreign trade of goods and services

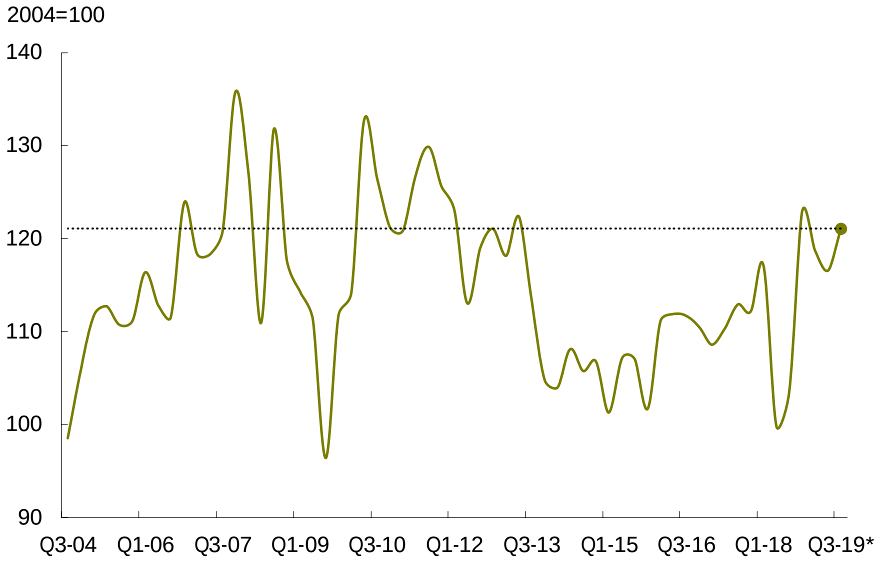


Fuente: BCRA from ICA and National accounts (CCNN) - INDEC data. *Data up to August

During the July-August 2019 bimonthly period, the exported volumes of goods went up 3.8% s.a. against the previous quarter. This evolution mainly resulted from the shipment of fuels[31] (28% s.a.), meat (11% s.a.) and soy beans (6% s.a.). As a result, the exported volumes continued to exhibit the upward trend observed as from the minimum values reached in 2015 and stood at levels similar to those of late 2012 (see Figure 3.9).

31 This group includes oil by-products such as petrol, gasoline and gasoil.

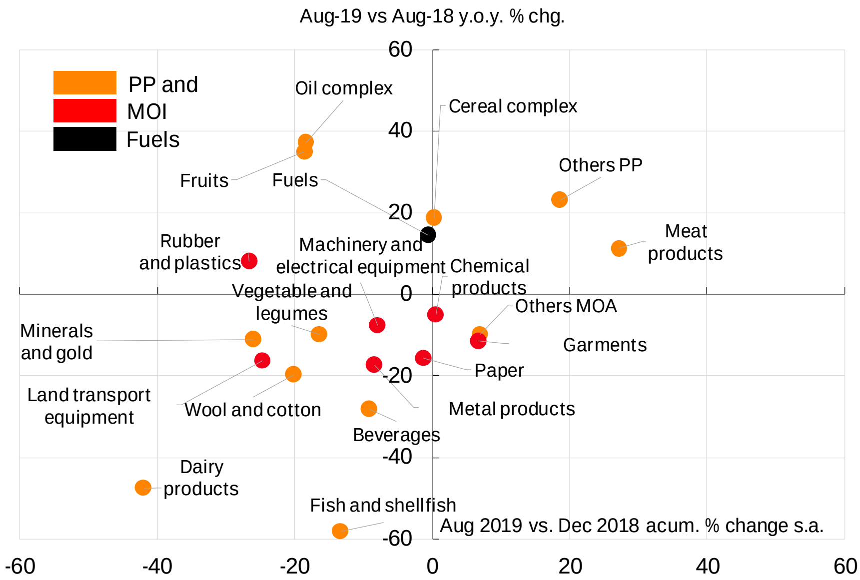
Figure 3.9. | Exports. Quantities



Source: INDEC *Data up to Aug-19

From the exchange hike of August 2018 to August 2019, the exported volumes of the different goods-producing sectors exhibited a heterogeneous evolution. The exports of meat –posting a sustained growth boosted by a larger penetration in the Chinese and European markets–, and of Other primary products, such as honey and tobacco, posted the best performance. A second group includes the sectors whose exported volumes stood above the levels observed a year before, but which have decelerated in recent months. This group includes Fruit, Fuels, Rubber and Plastics, and Grain and Oilseed sectors. Another group consists of sectors that exhibited a recent recovery, such as Textile, Other Agriculture and Livestock Manufactures (MOA; such as coffee and yerba mate), but the levels reached still stand below those of 2018. The remaining export sectors have reduced their shipments abroad over the last year and have kept this unfavorable trend (see Figure 3.10). This last group includes most Manufactures of Industrial Origin (MOI), the evolution of which was in part explained by the weak demand from Brazil (see Chapter 2. International Context).

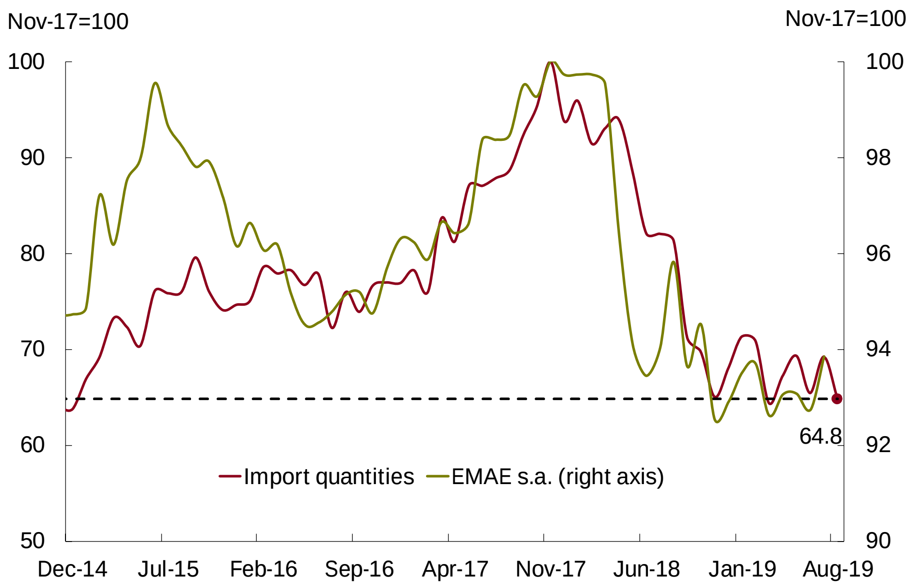
Figure 3.10 | Export quantities by sector



Fuente: INDEC

The imported volumes of goods shrank significantly in August (-6.4% m.o.m. s.a.) and returned to the minimum levels of late 2018. From the peak of November 2017, imports accumulated a 35% drop s.a. as a result of the weakness of the economic activity and the rise of the real exchange rate (see Figure 3.11).

Figure 3.11 | Imports. Quantities



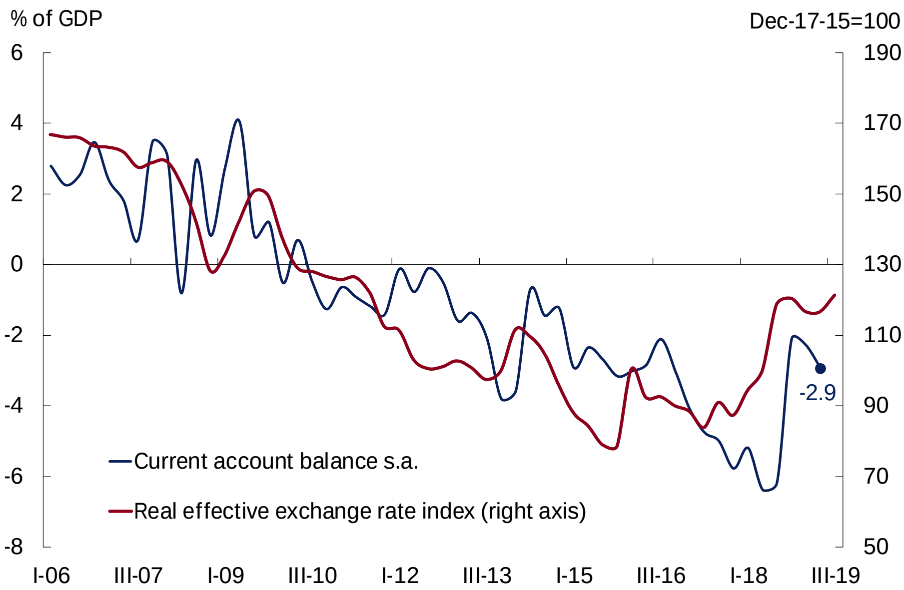
Source: BCRA from INDEC data

The evolution of exported and imported volumes widened the trade surplus of goods. In August, exported amounts (s.a.) were US$5.28 billion, while imported amounts stood at US$4.08 billion. As a result, the s.a.

trade balance (US$1.2 billion) was the highest since November 2012. According to data as of the second quarter, the trade balance of goods and services went from a deficit of US$4.32 billion in 2018 to a surplus of US$2.66 billion in 2019.

In the second quarter of 2019, the correction of the current account deficit came to a temporary halt, a process that accompanied the rise of the real exchange rate. The increase of the net interest payment of the General Government to non-residents more than offset the improvement of the trade surplus, thus deteriorating the current account deficit by 0.6 p.p. of GDP against the first quarter. Anyway, the current account deficit contracted 3.4 p.p. against the maximum value reached a year ago (see Figure 3.12).

Figure 3.12 | Current account (annualized values s.a.) and REER



Source: INDEC and BCRA

For the rest of the year, exports are expected to continue growing, mainly underpinned by the agricultural sector and fuels. The remaining sectors may benefit from the recent rise of the real exchange rate. In turn, imports would remain at low levels within a context of a weak economic activity.

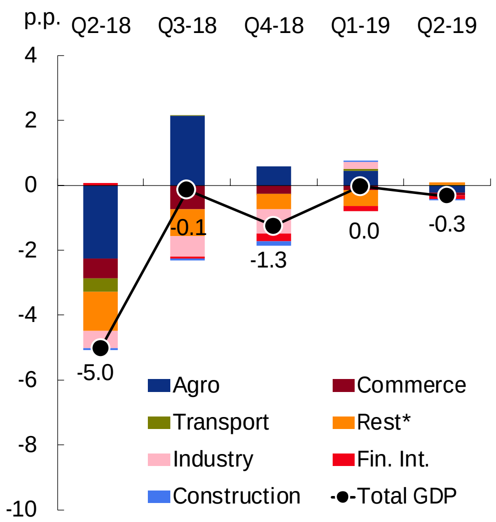
3.1.3 The incipient recovery being recorded by some sectors was interrupted in August

During the second quarter, the GDP went up 0.6% y.o.y. and this rise mainly resulted from the recovery of the agricultural sector. The output of this sector accumulated a sound growth in the second quarter of 2019 (46% y.o.y.) as from the drought of 2018 which especially affected soybean and corn harvests.

The economic activity contracted slightly (-0.3% s.a.) in the second quarter against the first quarter of 2019. The main sectors behind this drop were Agriculture, Financial Intermediation and Commerce. Meanwhile, the output of the other sectors remained relatively stable (see Figure 3.13).

Figure 3.13 | Sectoral economic activity in Q2-2019

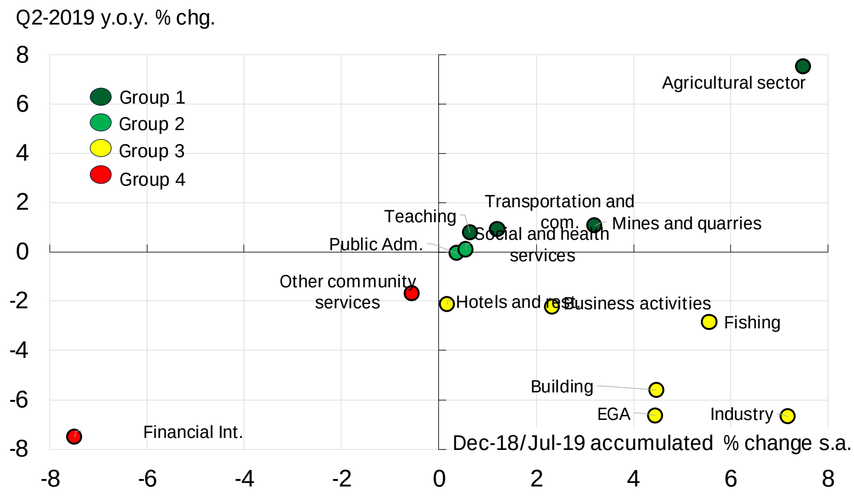
	Q2-19	
	% chg. s.a	contribution (p.p.)
GDP at market prices	-0.3	-0.3
Agricultural sector	-2.9	-0.2
Industry	0.0	0.0
Transport	0.2	0.0
Construction	-0.5	0.0
Commerce	-0.6	-0.1
Financial intermediation	-3.3	-0.1
Rest	0.2	0.1



* Contribution of each component to GDP quarterly s.a. growth. It is calculated by multiplying the q.o.q. % change of each component by its % share (of GDP) of the previous quarter.

From December 2018 to July 2019, 13 out of the 15 sectors that make up the EMAE had reached a floor and evidenced a slight recovery after accumulating a 7.1% s.a. drop since the beginning of the recession process in November 2017. Using a similar classification to that proposed in the most recent IPOM reports, the sectors making up EMAE can be divided into four groups according to their recent evolution (see Figure 3.14).

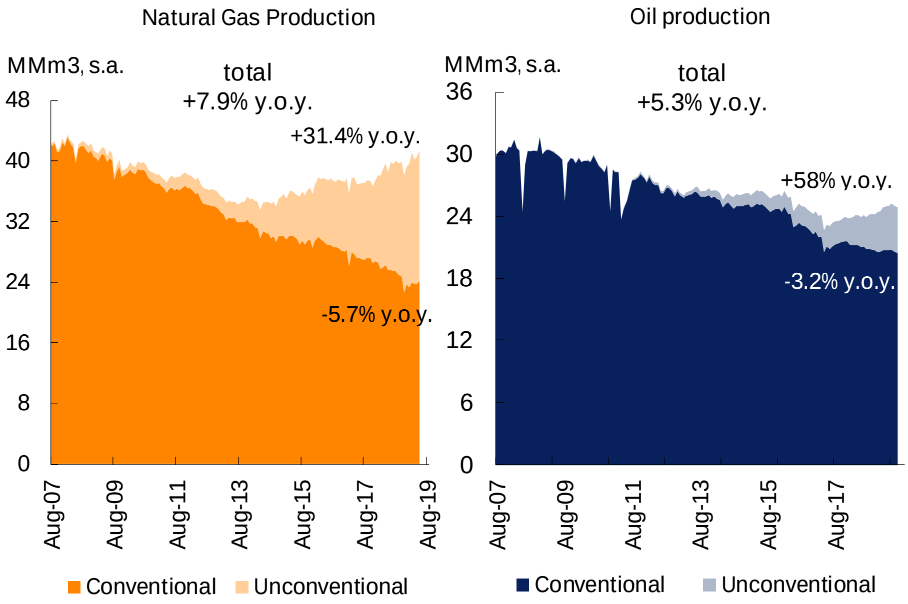
Figure 3.14 | Performance of sectoral economic activity



Note: Own seasonal adjustment. Source: BCRA from INDEC data.

Group 1 —Agriculture, Transport, Mining and Quarrying, Education– includes the activities that have been improving since 2018 and that, in the second quarter of 2019, reached levels above those of the same period of 2018. The most relevant sector of this Group is Agriculture (+46% y.o.y.), which rebounded after the sharp drop of 2018 due to the drought that affected the harvest of the main crops. Apart from the recovery of traditional crops, the sector managed to increase the exports of fruit, tobacco and honey.[32] The growth of agriculture and tourism has boosted Transport which, during the second quarter (+0.9% y.o.y.), exceeded the level reached in the same period of 2018. Another activity that grew in year-on-year terms is Mining and Quarrying (+1.1% y.o.y. in the second quarter of 2019). This sector was led by the unconventional production of oil (+58% y.o.y. in August) and gas (+31.4% y.o.y. in August), from the Vaca Muerta field, which allowed for offsetting the drop of conventional wells production (see Figure 3.15). Finally, Education has kept a positive long-term trend, recording a year-on-year growth in the second quarter (+0.8% y.o.y.)[33].

Figure 3.15 | Energetic sector is pulled by unconventional hydrocarbons production



Group 2 —Public Administration and Social and Health Services— includes sectors that have recovered since December 2018, reaching in the second quarter of 2019 levels similar to those of the same period of 2018. These service sectors follow a less procyclical performance and are more related to the natural population growth[34].

Group 3 includes seven sectors that had reached their floor and started to recover slightly since December 2018 but which, given the depth of the previous drop, did not manage to grow year-on-year in the second

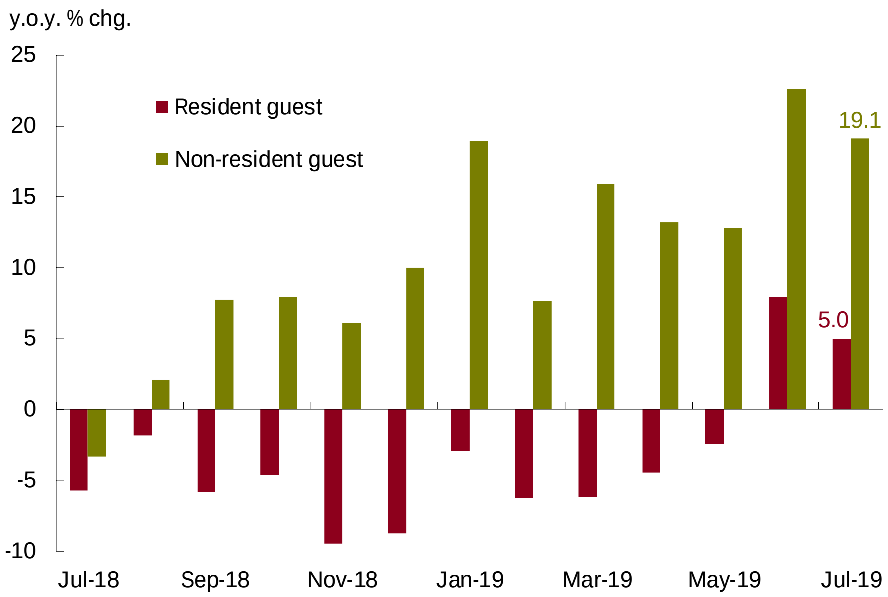
32 According to the latest available data as of August 2019, exports of fruit, tobacco and honey went up 35% y.o.y., 34% y.o.y. and 5% y.o.y., respectively.

33 The methodology for the estimate of some services such as Education, Public Administration and Social and Health Services is related to the staffing involved in these tasks. In the case of Education, the series shows a positive long-term trend as from the base year (2004), which accompanies the natural population growth and the increase of coverage of this service.

34 The Public Administration series went up steadily from 2004 to mid-2016, when a stability phase started. Social and Health Services also exhibited a growing path from the base year to late 2017 and, from that moment onwards, it has remained virtually stable. The change of trend is related to the fiscal consolidation process in progress.

quarter of 2019. This group –Industry, Construction, Commerce Electricity, Gas and Water, Real Estate and Business Activities, Fishing, Hotels and Restaurants– accounts for over 50% of GDP and was affected the most given the weakness of the domestic demand as from the beginning of the recession phase. In the case of Industry, some sectors benefited from the rise of exports. Between December 2018 and August 2019, there was an increase in the external sales of meat (27% s.a.), grain milling products (6% s.a.), oilseed fats and oils (20% s.a.) and food industry waste (4% s.a.)[35]. The Hotels and Restaurants sector recorded a recovery but stood below the level seen in the same period of 2018 (-2.1% y.o.y.). This performance mainly resulted from a contraction of restaurant activity (-3.7% y.o.y.), which was not offset by the growth of the hospitality sector (+6%, y.o.y.). There was a rise of inbound tourism (residents and non-residents), which was boosted by the improvements in the domestic flights connections and the increase in the real exchange rate. Within this context, the number of resident and non-resident guests in Argentine hotels went up 5% y.o.y. and 19% y.o.y., respectively, in July 2019 (see Figure 3.16).

Figure 3.16 | Tourism



Source: INDEC

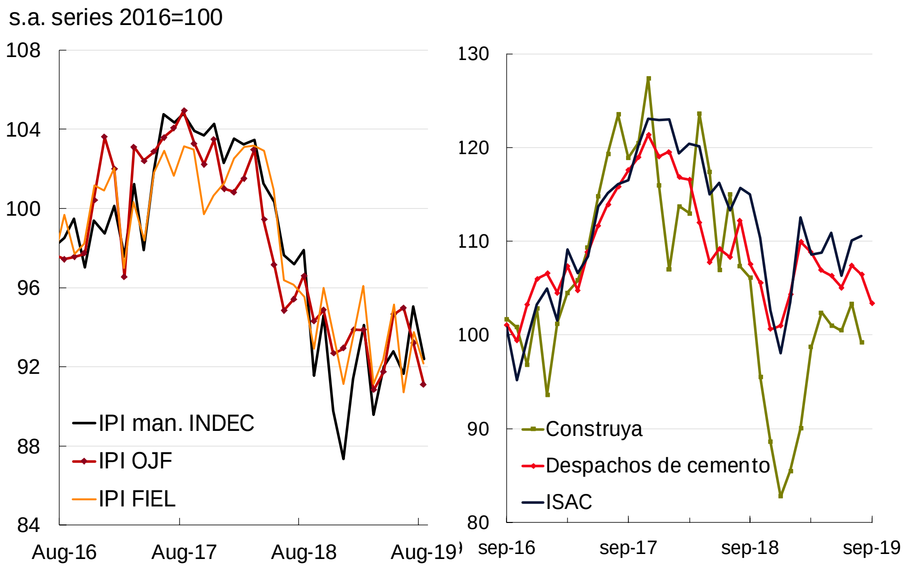
Finally, Group 4 includes two EMAE activities that as of July 2019 had failed to reverse their downward trend. Financial Intermediation (-13.5% y.o.y. in the second quarter of 2019) continued to be affected by the economic recession and the tightening of financial conditions, which increased the cost of bank loans and reduced their demand. So far in 2019, the drop of this sector, started in 2018, has deepened and accumulates an 8.6% s.a. contraction between December 2018 and July 2019. The second sector that did not show signs of finding a floor is Other Community Services (-1.7% y.o.y. in the second quarter of 2019). Cultural and Sport

35 The exports of these products also went up in year-on-year terms: meat (11% y.o.y.), grain milling products (11% y.o.y.), oilseed fats and oils (10% y.o.y.) and food industry waste (32% y.o.y.).

Services (-4% y.o.y. in the second quarter of 2019) account for 54% of that sector and explained the drop of this sector as a whole.

The incipient recovery of the economic activity was interrupted in August due to a change in the macroeconomic context and to the deterioration of expectations. According to the first available data after the primary elections, the main economic activity sectors have shrunk. In August, the INDEC's Manufacturing Industrial Production Index (Manufacturing IPI) went down 2.8% s.a. against July. Cement shipments –main input used in the construction business– contracted 2.9% m.o.m s.a. in September (see Figure 3.17). The deflated stock of loans to the private sector went down 3% s.a. in September, anticipating a new drop in the Financial Intermediation Sector's output. On the whole, title deeds of real estate in the Province of Buenos Aires and the Autonomous City of Buenos Aires contracted 0.6% s.a. during August, thus indicating an output contraction in the Real Estate, Business and Rent Activities.

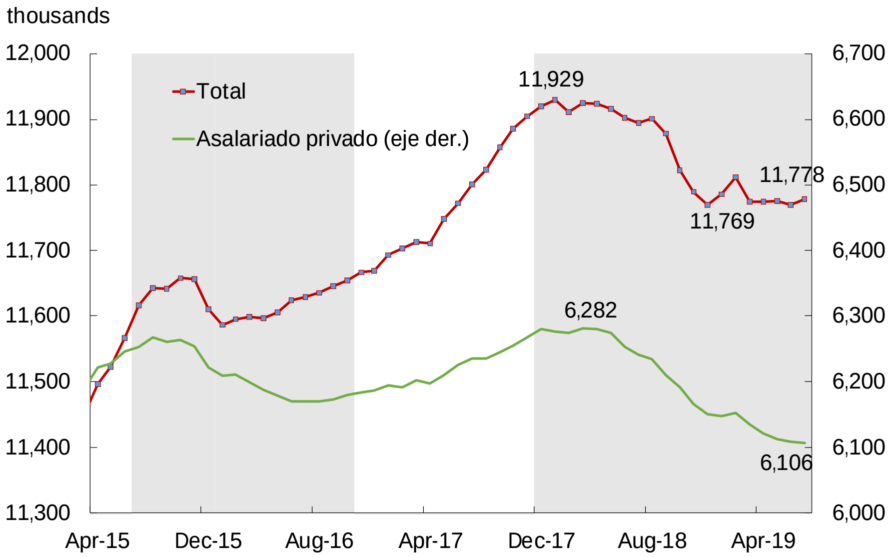
Figure 3.17 | Industry and construction



3.1.4 Formal employment stabilized in the second quarter of 2019

In the second quarter of 2019, total formal employment remained stable against the previous quarter, and went up slightly in July. In the first seven months of the year, formal employment was underpinned by the rise of self-employment (1.3% s.a.), housekeeping services (1.2% s.a.) and public employment (0.7% s.a.), while private wage-earning jobs continued to drop (-0.7% s.a.; see Figure 3.18).

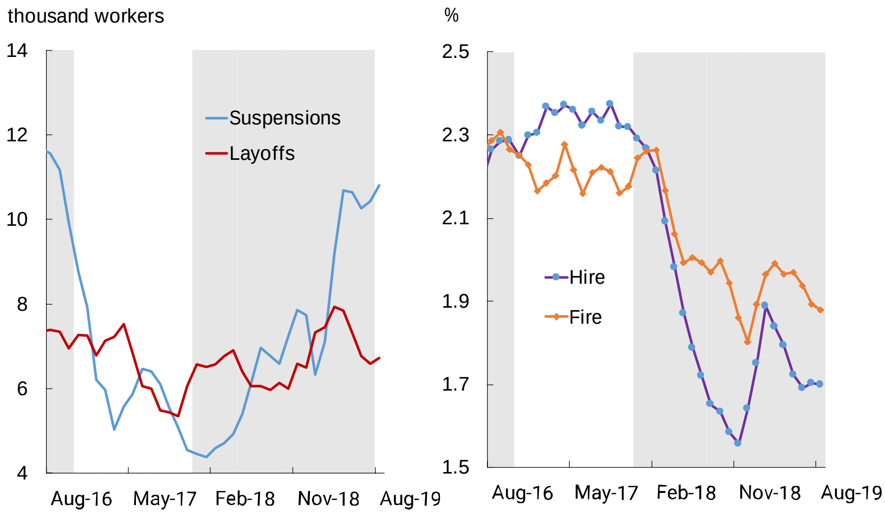
Figure 3.18 | Formal employment (excl. social simple tax)



Source: BCRA from MPyT data.

The downward trend of wage-earning jobs in the private sector remained unchanged during 16 months and it has become the longest contractionary phase of recent recessions. Considering the fragility of domestic demand, companies continued to opt for reducing labor costs through different strategies so as to moderate staffing reduction. In the same line, the Government established an earlier schedule for the foreseen increases of the “minimum non-taxable amount” in employers’ contribution for some regional activities[36], thus reducing the incentives to cutback the number of job positions.

Figure 0.19 | Suspensions, layoffs and incorporations* (3 months mov. avg.)

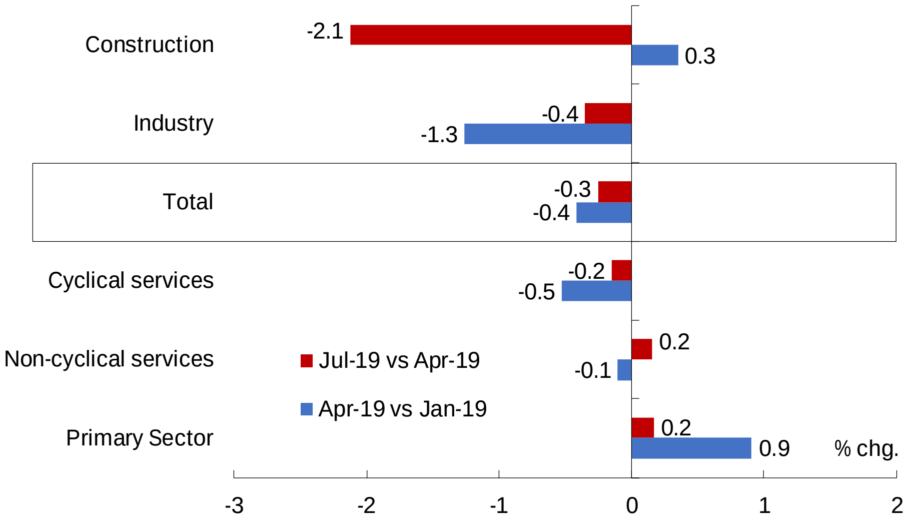


* In the category of dismissal without cause it is included the trial period and the end of building projects in the case of the construction sector.
Source: BCRA from Labor Indicators Survey (Ministry of production and employment) data.

36 Executive Order 128/2019. This measure impacts positively on 25,000 companies and 230,000 workers.

As from April, the drop pace of the private sector's wage-earning jobs decelerated. According to the Labor Indicator Survey (EIL), prepared by the Ministry of Production and Labor, and the Permanent Household Survey (EPH), released by INDEC, there was a preeminence of adjustments via suspensions –that stood at high levels–, new hires –low substitution due to termination of employment– and labor intensity –reduction of hours worked (see Figure 3.19). At sectoral level, the good performance of non-cyclical services and the drop in the contraction of job positions in the industry and cyclical services contributed to this deceleration. In contrast, the construction sector reduced its staffing after three months of expansion (see Figure 3.20).

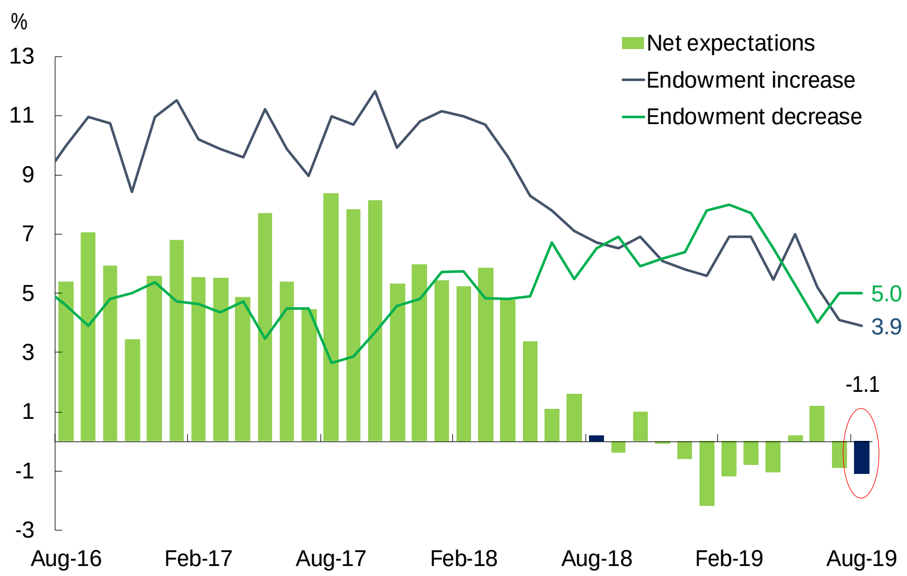
Figure 0.20 | Formal employment



Note: Cyclical services: Commerce and reparations, Hotels and restaurants, Trasportation, allocation and communications, Financial intermediation, Real estate, renting and business activities.
Source: BCRA from MPyT data.

According to EIL (Ministry of Production and Labor), the expectations of net job creation in the private sector deteriorated after the primary elections held in August. For the moving September-November quarter, 3.9% of the companies surveyed forecast an increase of staffing, while 5% of such companies anticipate a reduction, thus resulting in a negative balance of 1.1 p.p. In turn, 91.1% of companies expect no staffing-related changes for the next three months (see Figure 3.21).

Figure 0.21 | Employment expectations



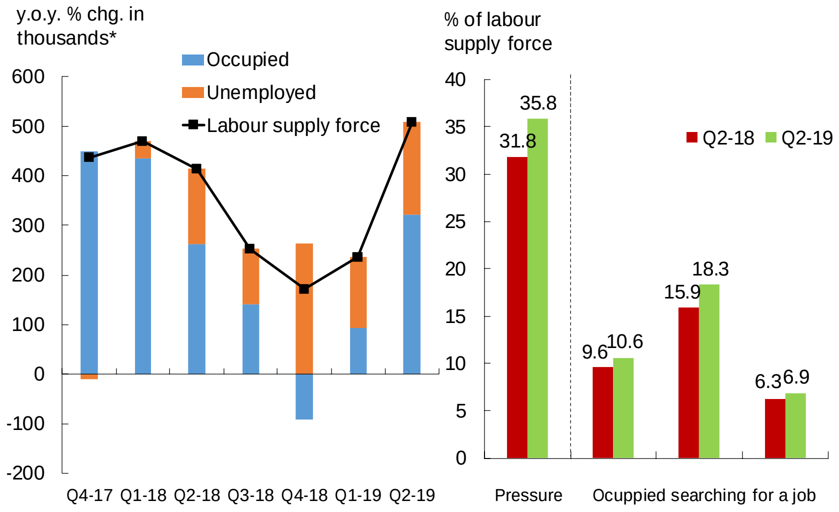
Source: BCRA from EIL (MPyT) data

According to EPH, the total employment rate went up 0.7 p.p. year-on-year in the second quarter of 2019, but it was not sufficient to cater for the rise of labor supply. The activity rate increased significantly by 1.3 p.p. y.o.y., from 46.4% to 47.7%, thus resulting in an unemployment rate of 10.6% (+1 p.p. y.o.y; see Figure 3.22).

New job positions were characterized by a relative higher growth of underemployed workers (1.1 p.p. y.o.y.) and self-employed workers (0.4 p.p. y.o.y.). This change of composition in favor of jobs with a lower remuneration intensified the pressure on the labor market, which went from 29.9% to 33.9% (+4 p.p.). The increase of unemployment was accompanied by an increase of employed job seekers who are actively seeking another job or more working hours to supplement their workday. Consequently, employed job seekers accounted for 60% of the increase of labor pressure.

For the second half of the year, the reopening of collective bargaining agreements and the measures implemented by the Government to underpin households' real income are expected to mitigate the pressures on the labor market (see Box: Measures to Underpin Income).

Figure 0.22 | Labour force and labour market pressure



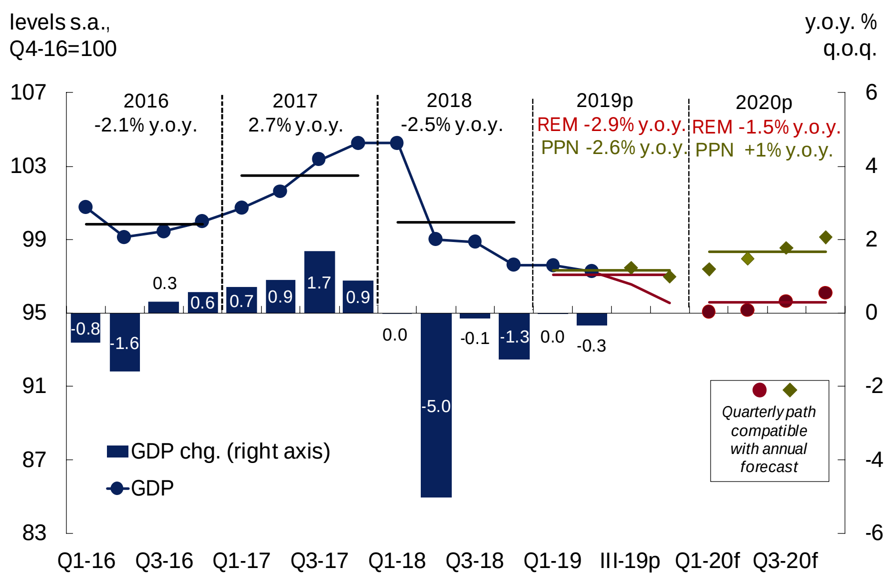
* Calibrated data by a sample enlargement of INDEC's household survey.
Source: BCRA from INDEC data

3.2 Outlook

In line with the increased uncertainty after the primary elections held in August and the fluctuation of the exchange rate, REM's analysts revised downwards their growth forecasts. REM anticipates a 2.9% GDP drop for 2019. In turn, for 2020, it estimates that the economic activity will start to recover, but at a slower pace than anticipated in the previous IPOM.

For 2019, the National Budget Bill (PPN 2020) estimates a GDP drop of 2.6%, in line with REM forecasts. In turn, for 2020, the PPN anticipates a more vigorous recovery of economy (if compared to REM figures), which would result in an average annual growth of 1% (see Figure 3.23).

Figure 3.23 | GDP scenarios



Source: BCRA from WEO-IMF and 2020 National Budget Bill (PPN) data. f: Forecast

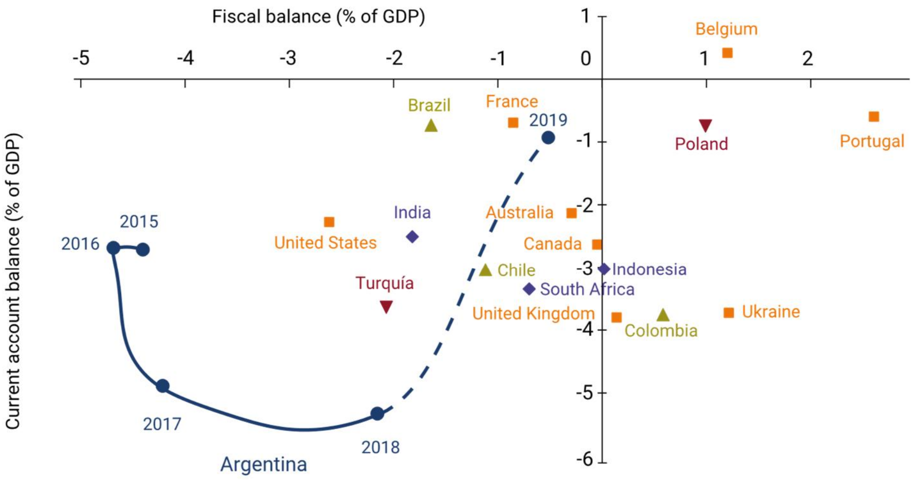
The expansion anticipated in PPN 2020 would be led by the rise of exports (7%) and the improvement of private consumption (1.4%).

For 2020, exports would be driven by the expected growth of our trading partners and by a higher real exchange rate, which would especially favor manufactures and tradable services such as Tourism and Knowledge-Based Services (KBS). Moreover, the external sales of some key sectors would continue exhibiting a positive momentum based on the good perspectives for the 2019/20 agricultural cycle and the recent openness to new markets for manufactures of agriculture and livestock origin (MOA), such as beef meat.

In particular, an acceleration of manufactures of industrial origin (MOI) is expected, mainly related to the consolidation of some investments, the improvement of the real exchange rate and the acceleration of Brazil's growth. The energy sector will continue exhibiting a good performance due to the development of Vaca Muerta, within a highly challenging context. The estimated increase of oil and gas production in the next few years would allow for reducing the energy deficit.

Within the framework of the expected reduction of the fiscal and external imbalances for this year (see Figure 3.24), the Argentine economy faces important challenges and might be affected by different risks. In this sense, the stress episodes related to the deterioration of global trade conditions (see Chapter 2. International Context) and the typical uncertainty inherent in electoral processes may particularly affect the Argentine economy.

Figure 3.24 | Fiscal and current account balances



Source: BCRA from WEO - IMF and 2020 National Budget Bill (PPN-20)

4. Prices

After the results of the primary elections held on August 11, there was a sharp decline of Argentine asset prices and an increase of the exchange rate, thus interrupting the inflation moderation process started in April. Vis-à-vis a context of high uncertainty, the peso depreciation translated into an acceleration of the inflation and an increase in inflation expectations for the upcoming months.

As a result, during the third quarter of the year, the inflation pace accelerated to an average monthly change rate of 4.0%, up 0.9 percentage points (p.p.) against the figures of the second quarter. At category level, core inflation led the change of trend, followed by the prices of seasonal goods and services. Meanwhile, regulated utilities exhibited a relatively limited change in their prices.

The National Government launched a series of measures tending to limit price hikes. As a result, the value-added tax (VAT) was eliminated for a group of products that are part of Household Food Basket (exclusively for the sale of these products to end consumers). This measure will contribute to mitigating the effects of inflation on households, particularly low-income families (for whom the incidence of spending on food is higher). Besides, by mid-2019, the National Government announced that it planned no further increases to public utilities rates until the end of the year.

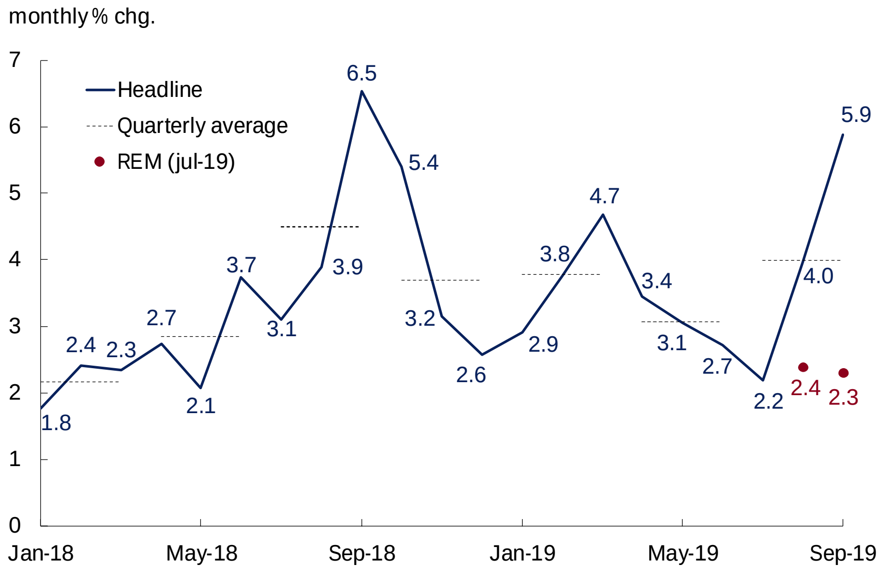
With the purpose of preserving monetary and financial stability, the Central Bank of Argentina (BCRA) has adopted several measures and has kept the contractionary bias of its monetary policy (see Chapter 5. Monetary Policy). The objective of these measures is that inflation may go up only temporarily and they also seek to reduce exchange volatility within a context of high uncertainty inherent in the current electoral process.

In the short-term, the inflation pace would exhibit a downward trend, even though at relatively high rates due to the delayed impact of the nominal exchange rate increase pass-through to prices. In fact, for the rest of 2019, the Market Expectations Survey (REM) anticipates a deceleration of the inflation monthly rate to 3.6% in December 2019 (54.9% year-on-year (y.o.y.) for December 2019).

4.1 In August 2019, the inflation pace accelerated due to the peso depreciation after the primary elections (PASO)

During the third quarter, the retail inflation pace sped up, thus reversing the trend observed in the previous quarter. The average monthly change of the National Consumer Price Index (CPI) was 4.0%, up 0.9 percentage points (p.p.) against the previous quarter (see Figure 4.1). Inflation acceleration was led by the Core and Seasonal categories while the Regulated prices component exhibited some moderation against the previous quarter.

Figure 4.1 | National CPI. Headline

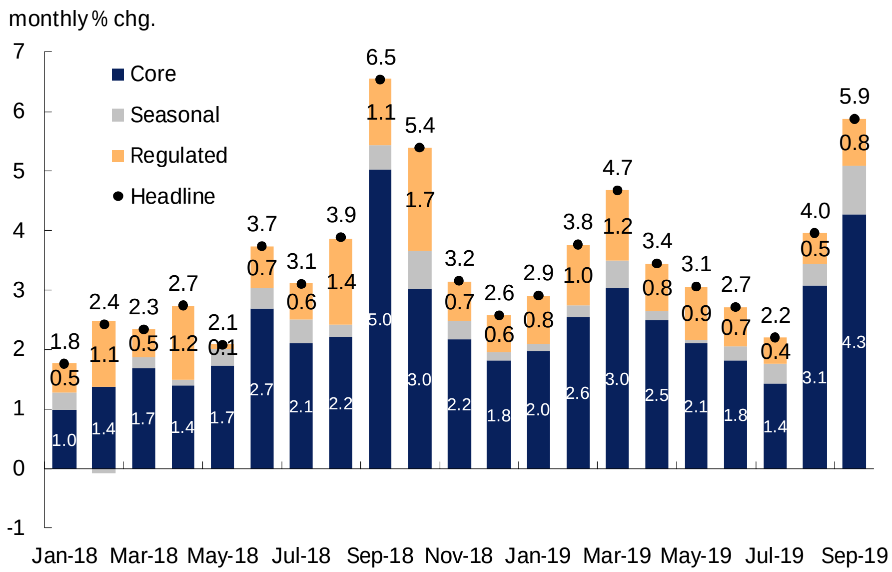


Source: BCRA from INDEC and REM data

The exchange rate jump after the primary elections (PASO) has driven inflation up since August, thus reversing the downward trend observed since April. Inflation rose up to 5.9% in September, i.e. 3.7 p.p. above the inflation rate for July. This acceleration of inflation was not anticipated by REM's market analysts, who, by the end of July, had anticipated a 2.4% and 2.3% increase for August and September, respectively.

During the third quarter, the evolution of Headline Inflation largely mirrored the evolution of Core Inflation, which accounts for approximately 70% of the CPI basket. The average monthly price increase of this category was 4.4%, up 1.2 p.p. against the value recorded on average during the second quarter of the year (see Figure 4.2).

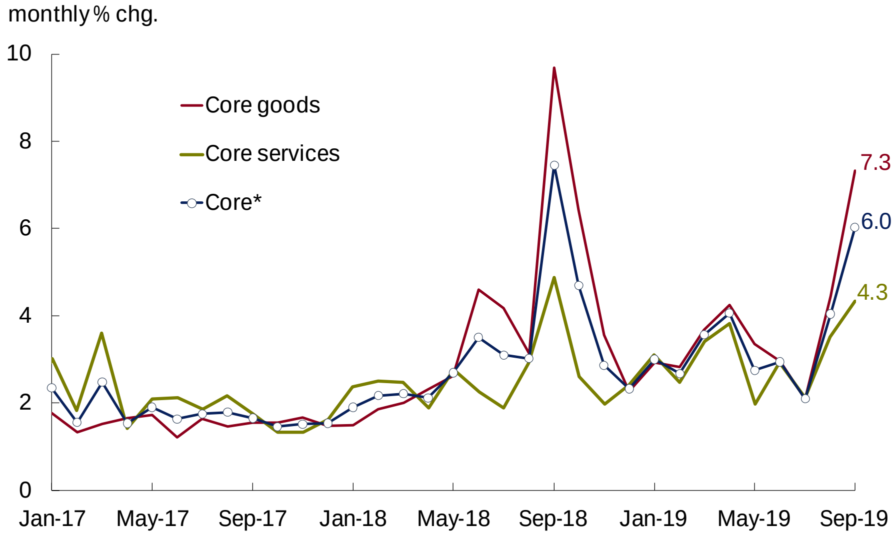
Figure 4.2 | CPI. Contribution by categories



Source: BCRA from INDEC data

The acceleration of the Core Inflation was mainly related to the evolution of goods prices which, given their intrinsic tradable nature, are more sensitive to the evolution of the nominal exchange rate. In contrast, private services, which are intrinsically non-tradable and whose evolution is more associated with salary evolution, exhibited more limited rises during the period[37] (see Figure 4.3).

Figure 4.3 | BA CPI. Core inflation by goods and services



**Core: The groups formal education and health insurance were excluded from the CPI Rest of the the City of Buenos Aires to proxy the CPI Core using the INDEC classification. Source: BCRA from Statistical office of the City of Buenos Aires data

On this occasion, the exchange rate pass-through to food and beverages prices was more limited than in the similar episode of peso depreciation that took place in August/September 2018. Processed food and beverages (excluding fruit, vegetables and meat) averaged a monthly price rise of 4.6% during the August-September 2019 period. During the two months following the peso depreciation of late August 2018, the average monthly increase was 7.5%, up 2.9 p.p. against the increase observed in the current episode. This evolution mainly resulted from the temporary exemption[38] of the VAT paid by end consumers for a group of products of the basic food basket. This measure aimed at mitigating the socioeconomic impact of the peso depreciation on households, particularly low-income families (for whom the incidence of spending on food is higher).

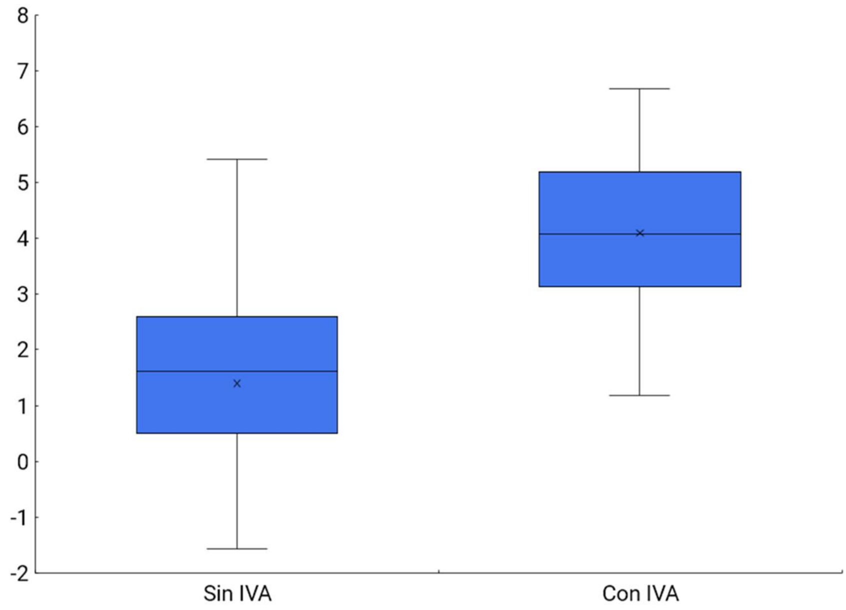
Within the Food and Beverages Category, the price change of the products included in the measure[39] was 1.4% in August, while for the remaining processed food (excluding Fruit, Vegetables and Meat) was 4.1%[40] (see Figure 4.4).

37 Analysis based on the CPI of the City of Buenos Aires since this report includes broken down information of indexes and their weights.
38 This measure will be effective only up to December 2019.
39 The VAT-exempted products for end consumers are: bread, milk, sunflower/ blended oil, dry pasta, rice, wheat flour, *polenta*, batter, breadcrumb, *yerba mate*, *mate cocido* and tea, canned fruits, vegetables and legumes, as well as yoghurt and sugar.
40 Based on average food prices published by the General Board of Statistics of the Autonomous City of Buenos Aires.

The prices of seasonal goods and services also accelerated during the third quarter, with hikes above those of the Core component. In fact, the average monthly change was 5.3% (up 3.8 p.p. against the second quarter). As anticipated, the rises of regulated utilities prices concentrated markedly during the first part of the year. In

Figure 4.4 | BA CPI. Distribution of the increases of the Food prices with VAT and without VAT

monthly % chg.



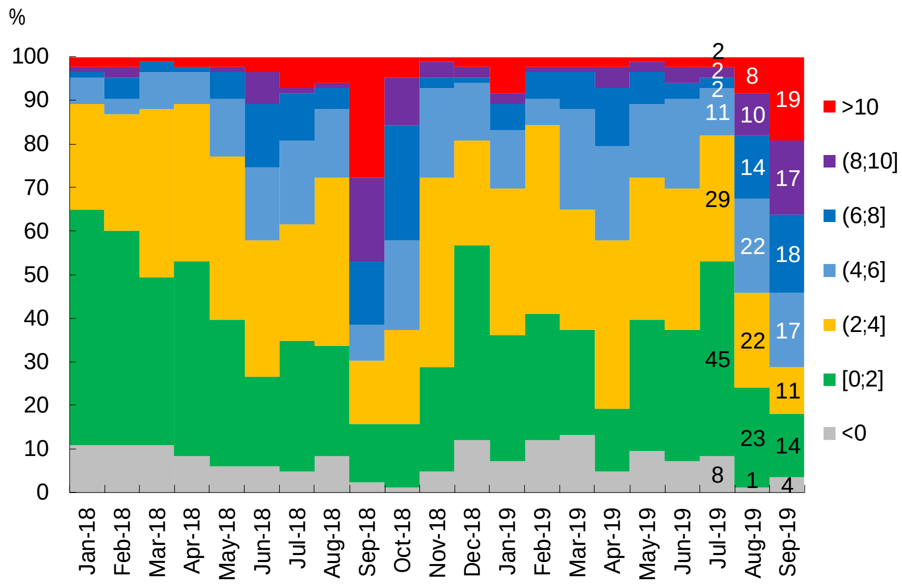
Source: BCRA from Statistical Office of the City of Buenos Aires data

the third quarter of 2019, the average monthly change rate of regulated prices at national level shrank to 2.4%, down 1.3 p.p. against the first half of the year. The evolution of these prices was mainly related to the National Government decision not to implement new increases in public utilities rates, beyond the rises that had been previously announced for electricity, gas and transportation. This measure only included the rates within the sphere of influence of the National Executive Branch. Nevertheless, as from the announcement of these measures, the acceleration of inflation and the higher depreciation of the Argentine peso entailed a drop in the relative prices of these public utilities.

The prices of the remaining regulated goods and services (excluding public utilities) continued adjusting during the third quarter but followed a heterogeneous evolution. The installments of private health insurance services increased above core inflation, reaching a rise of 18% in the period. Besides, new increases for the next two months (4% in both October and November) were already announced. Conversely, fuels and educational services exhibited limited rises. Fuel prices for vehicles went up only 2% monthly in the quarter. The new regulations introduced by the Government for the sector decoupled the price of the domestic market from the international price and from the fluctuations of the exchange rate. Lastly, the installments of educational services recorded limited changes in August and September in terms of the national average, similar to the figures recorded in 2018.

The CPI of the City of Buenos Aires exhibited an evolution relatively similar to that of INDEC's CPI in the aggregate of the year, even though with some differences in monthly changes. In general, these differences were mainly related to the composition of the basket. This allows for using the better disaggregation level of data collected by the City of Buenos Aires to analyze the diffusion and size of price increases. As from August, under the COICOP classificartion[41], there was an increase in the proportion of classes with monthly changes above 4% (see Figure 4.5).

Figure 4.5 | BA CPI. Distribution of monthly variations

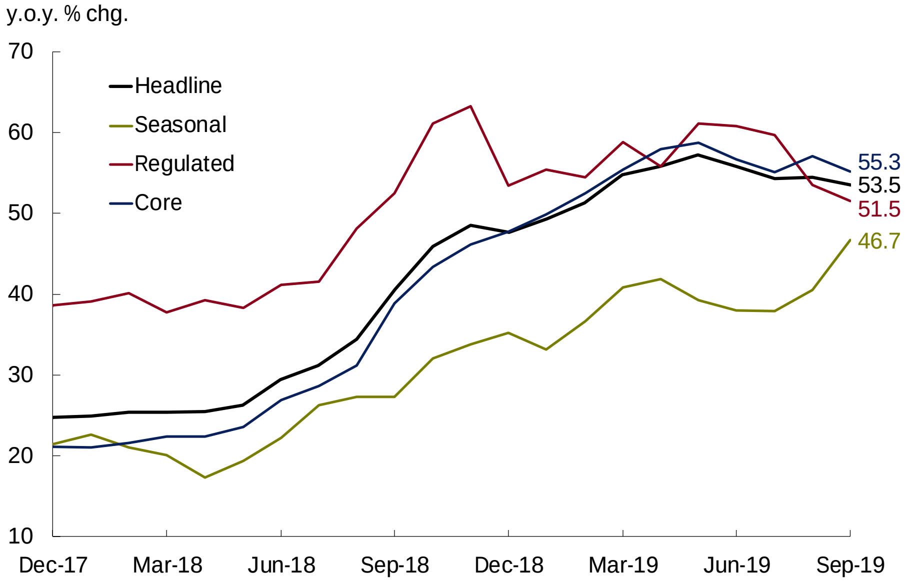


Source: BCRA from Statistical Office of the City of Buenos Aires data.

As a result of the dynamics described above, the National CPI recorded a 53.5% y.o.y. rise in September, standing above 50% for the eighth consecutive month. The year-on-year evolution of the core component recorded an increase of 55.3% y.o.y. in the same period (-3.5 p.p. against the maximum value of May). Meanwhile, the year-on-year growth pace of regulated goods and services prices moderated to 51.5%, which entails a reduction of 9.6 p.p. against the value reached last May. In this case, public utilities prices did not increase during the period, unlike what happened in the same period of 2018, giving rise to this deceleration in the year-on-year evolution (see Figure 4.6).

41 Disaggregation at the maximum level available. The information is only available for the CPI of the City of Buenos Aires and the disaggregation level used corresponds to class (Level 3). The classification of spending used by the City of Buenos Aires is the Classification of Individual Consumption by Purpose (COICOP) and, on the basis of this criterion, goods and services that make up the CPI were grouped in 12 Divisions, 37 Groups, 83 Classes, 145 Subclasses, 285 sets of products and 628 products.

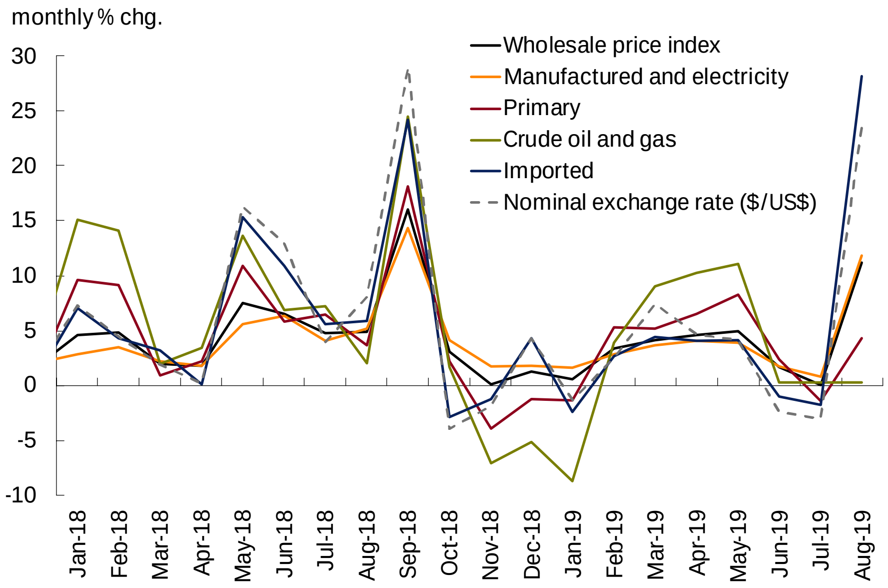
Figure 4.6 | National CPI. Interannual variations of prices



Source: BCRA from INDEC data

The peso depreciation after the primary elections (PASO) has impacted more markedly on wholesale prices than on retail prices due to the higher tradable nature of the former. As a result, they went up 12% in August. Wholesale price indices exhibited opposite evolutions in each month of the July-August period: in July, wholesale prices continued decelerating and averaged a change of only 0.1%, but, in August, they recorded an average rise of 11.9%. This significant increase of prices mainly resulted from the high contemporaneous correlation between wholesale prices and the nominal exchange rate (see Figure 4.7).

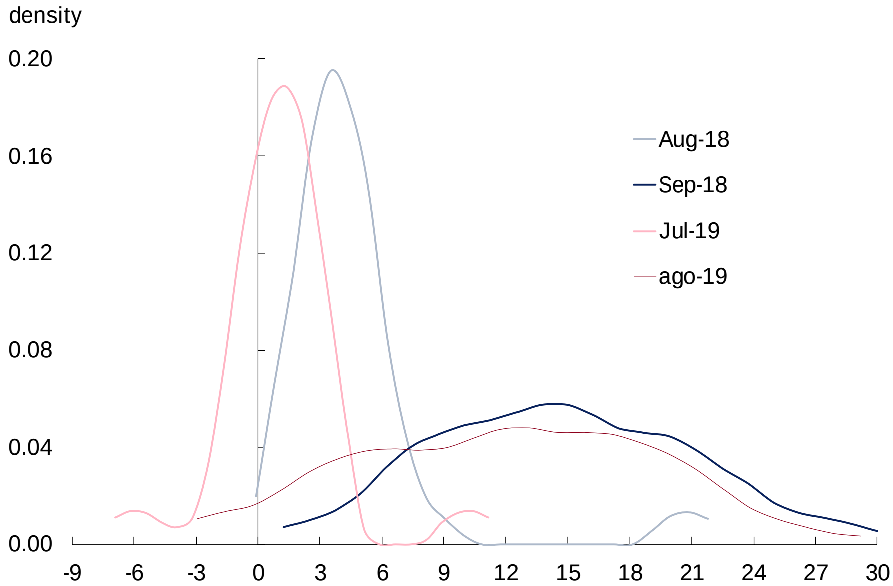
Figure 4.7 | Wholesale prices (IPIM). Monthly variations by divisions



Source: BCRA from INDEC and Comm. "A" 3500

In August, price rises were widely diffused. According to the Domestic Wholesale Price Index (IPIM), the price change distribution at division level mainly concentrated in August 2019 in values around 12%, with an increase in the dispersion of the distribution, after the improvements observed in these indicators in previous months. In July, the change distribution had concentrated in values close to 1% (see Figure 4.8).

Figure 4.8 | IPIM. Distribution of the variations by division

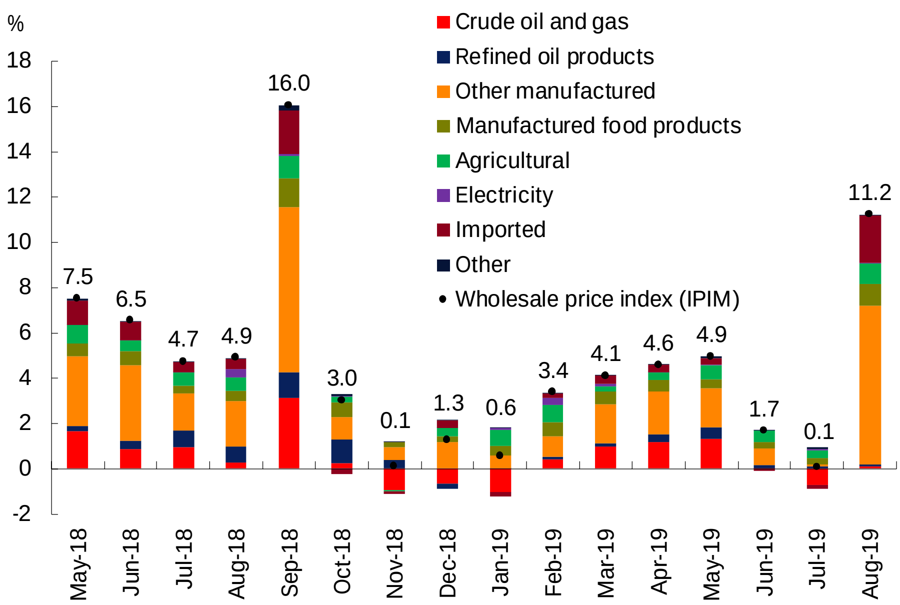


Fuente: BCRA from INDEC data

In August, the acceleration of the IPIM mainly resulted from the price evolution of manufactured and imported products (see Figure 4.9). The increases that impacted the most on the price hike of manufactured products were: Substances and Chemicals, Vehicles, and Food and Beverages. The prices of imported products exhibited the highest increases, since they were directly impacted by the evolution of the exchange rate. In addition to this, there were also rises in agricultural products in pesos (grains and oilseeds), remarkably affected by the depreciation of the domestic currency. In contrast, the Crude Oil and Gas component went up only 0.9% as a result of Executive Order 566/19[42] that decoupled oil price in the domestic market from the international price and the exchange rate fluctuations.

42 The rule set the price of the oil barrel at US$59.0 for 90 days and an exchange rate of $45.19/US$1.

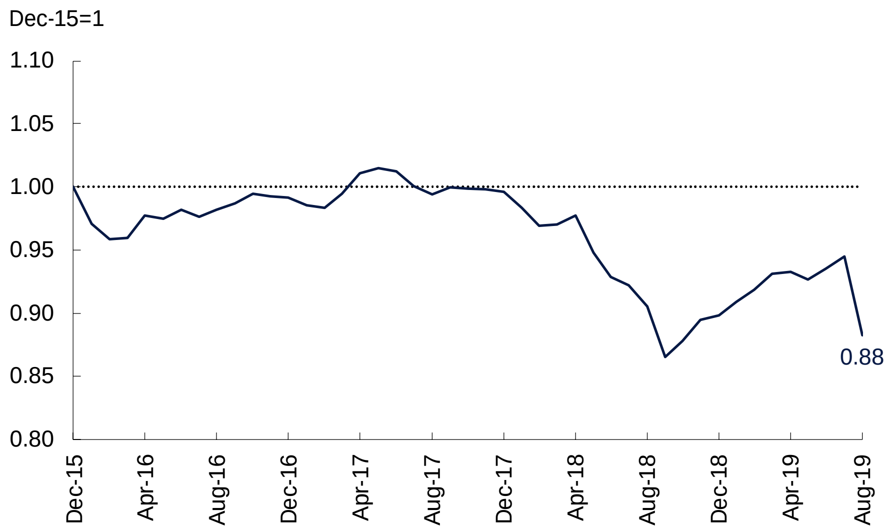
Figure 4.9 | Wholesale price Index (IPIM). Contributions by divisions



Source: BCRA from INDEC data

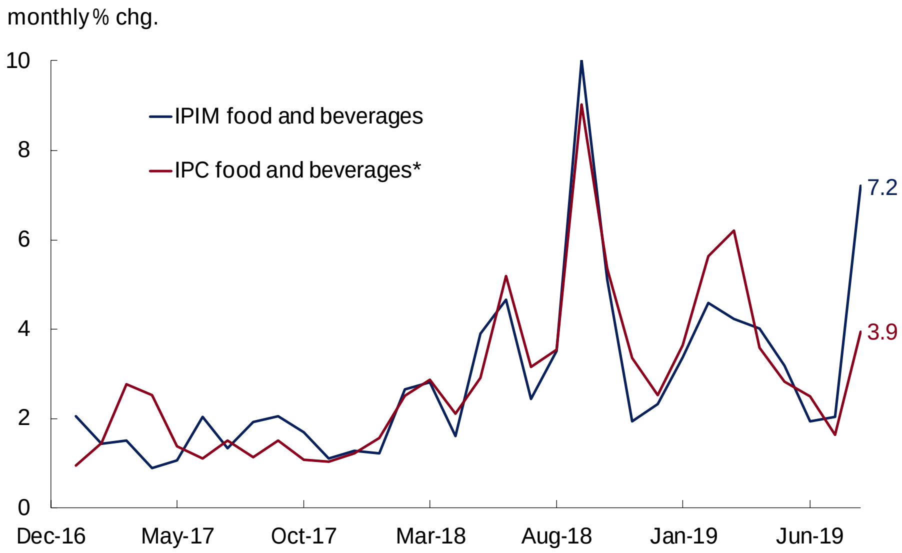
The price rise of Manufactured Products (12.1%) observed in August stood well above that of CPI Goods, excluding fruit and vegetables (4.7%), thus suggesting a deterioration of retail trade margins after the exchange rate hike. In this case, there was a significant difference in the price rise of processed Food and Beverages at wholesale and retail levels (7.2% vs. 3.9%, corresponding to the CPI Food and Beverages, excluding fruit and vegetables). This difference may be partly related to VAT exemption on some basic food products intended for end consumers (see Figures 4.10 and 4.11).

Figure 4.10 | Ratio between CPI goods and IPIM manufactured



Note: goods excluding fruits and vegetables. National CPI as of Jan-17 linked with the Greater Buenos Aires CPI as from may-16 and linked backwards with the CPI of the City of Buenos Aires. IPIM manufactured: source INDEC beginning in Dec, 15.
Source: BCRA from INDEC and Statistical Office of the City of Buenos Aires data

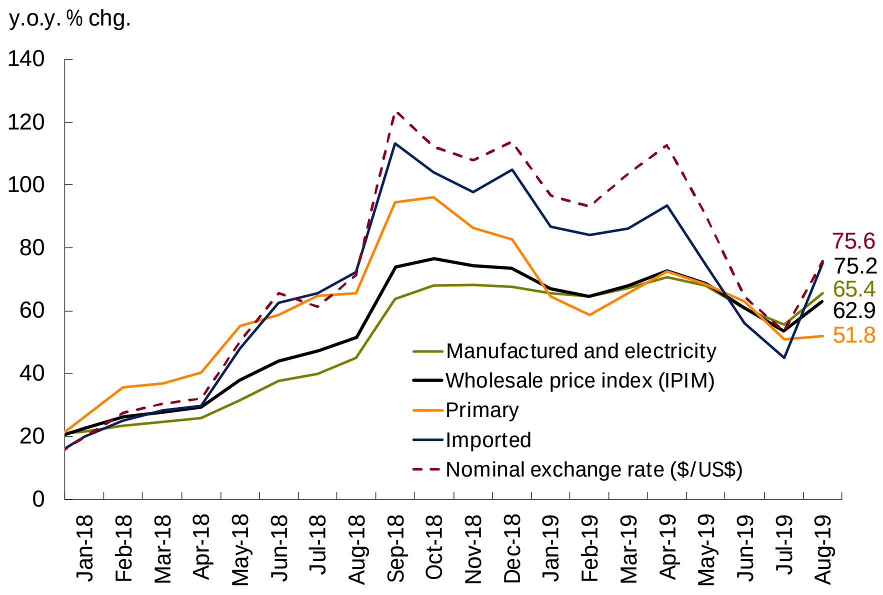
Figure 4.11 | CPI and IPIM. Food and beverages



*Food and beverages to be consumded at home excluding fruits and vegetables.
Source: BCRA from INDEC data

The monthly acceleration of wholesale prices in August drove year-on-year change rates up, which rose to values close to 63% in the eighth month of 2019 (see Figure 4.12).

Figure 4.12 | Wholesale prices (IPIM). Interannual trajectory

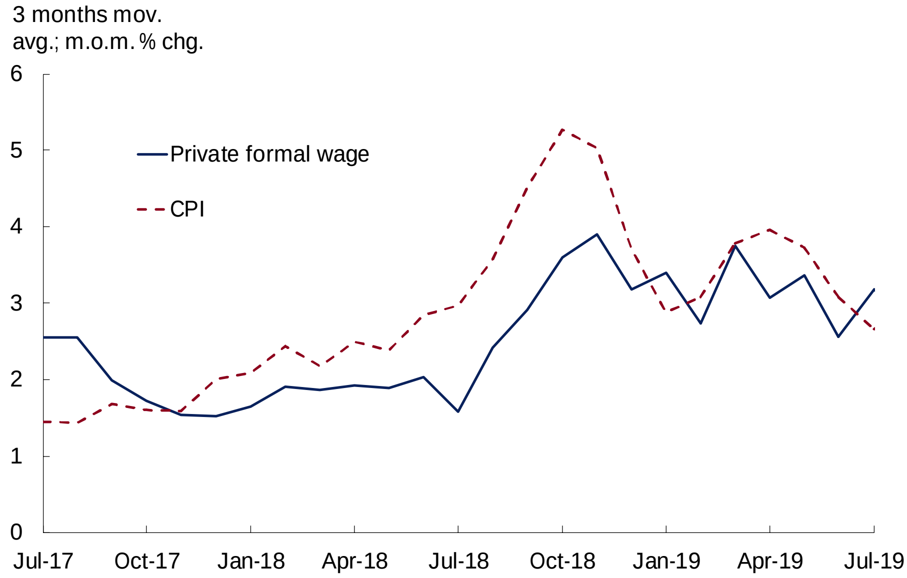


Source: BCRA from INDEC and Comm. "A 3500" data

4.2 The distribution of wage increases over time was more homogeneous than in previous years

According to the Ministry of Production and Labor (MPyT), the nominal wages of the formal private sector continued accelerating in year-on-year terms during the third quarter of 2019. In real terms, remunerations would continue narrowing the drop, both in year-on-year terms and against the second quarter of 2019 (see Figure 4.13).

Figure 4.13 | Nominal wages and retail prices



Source: BCRA from INDEC and Ministry of Production and Labor data

For the third quarter of 2019, the negotiations to review the formal wages entailed an earlier schedule for the increase of remunerations against what happened in 2018. The mandatory salary recomposition (Executive Order 665/2019) involves the payment of non-remunerative amounts of $5,000 to be paid in October, which may be an early payment subject to future wage negotiations, depending on the sector considered. This salary recomposition strategy entails an earlier schedule for bargaining negotiations and contractual revisions, which, in most cases, had been agreed upon for the last quarter of the year. As a result, the 2019 reopening of negotiations would be different from that of 2018, when the decision was to discuss compensations in the last quarter of the year and the first quarter of 2019. Due to this earlier schedule, and added to the distribution over time of wage tranches impacting between July and September, at aggregate level, real salaries would narrow the drop not only against previous quarters but also against the same quarter of 2018.

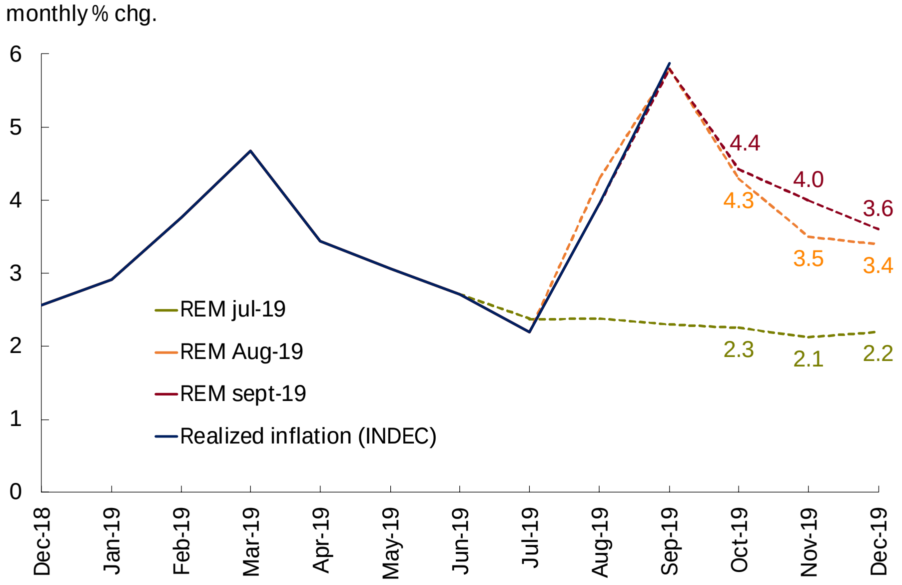
4.3 Outlook: Within a context of higher uncertainty due to the electoral process, REM's analysts revised their inflation expectations for 2019 and 2020 upwards

After the results of the primary elections held on August 11, there was a sharp decline of Argentine asset prices and an increase of the exchange rate, thus interrupting the inflation moderation process started in April. Within a context of high uncertainty, the sizable depreciation of the domestic currency in August led to the acceleration of inflation in August and September and to the rise of inflation expectations for the rest of the year.

For the purpose of mitigating the effects of financial volatility on the real economy and preventing a potential disanchorage of inflation expectations, the Central Bank of Argentina implemented, on September 1 and effective until December 31, a series of measures oriented to regulate inflows and outflows in the foreign exchange market and to reduce the net demand for dollars[43]. These measures, which contribute to the stabilization of the exchange rate, reinforce the contractionary bias of the monetary policy, seeking that inflation increase may be only temporary and it may go down gradually as from October.

The market analysts participating in the REM revised their inflation forecasts upwards for the next few months. The inflation expected for the last quarter has nearly doubled (from 2.2% on average per month to 4% between REM surveys; see Figure 4.14). This increase is due to the fact that pressures on prices would continue beyond the inflationary peak of September. The sharp depreciation of the Argentine peso will continue passing-through to retail prices, particularly in the case of tradable goods. Conversely, the decision by the National Government of not applying new increases to public utility rates will contribute to mitigating the pressure on inflation in the following months.

Figure 4.14 | Monthly inflation expectations

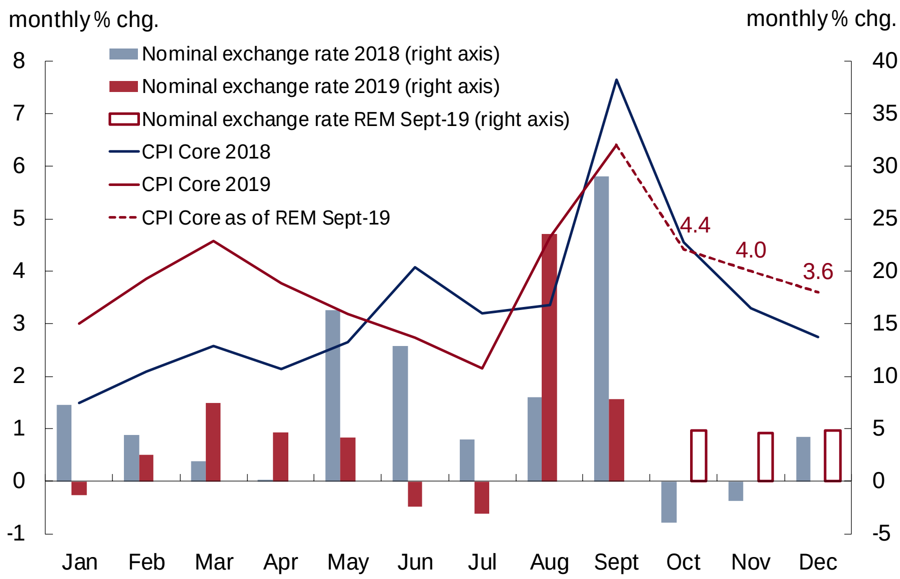


Source: BCRA from INDEC and REM data

For the Core component, analysts anticipate a price hike of 4.1% for the last quarter of 2019 (up 1.9 p.p. against July forecast). Even though, in terms of size, the depreciation of the domestic currency that took place in August was similar to that of late August 2018, for this year analysts foresee that the exchange rate shock will be more persistent and will contribute to a more gradual decrease of core inflation against the episode of 2018 (see Figure 4.15).

43 See Communication “A”6770 and its amendments https://www.bcra.gob.ar/Pdfs/comytexord/A6770.pdf

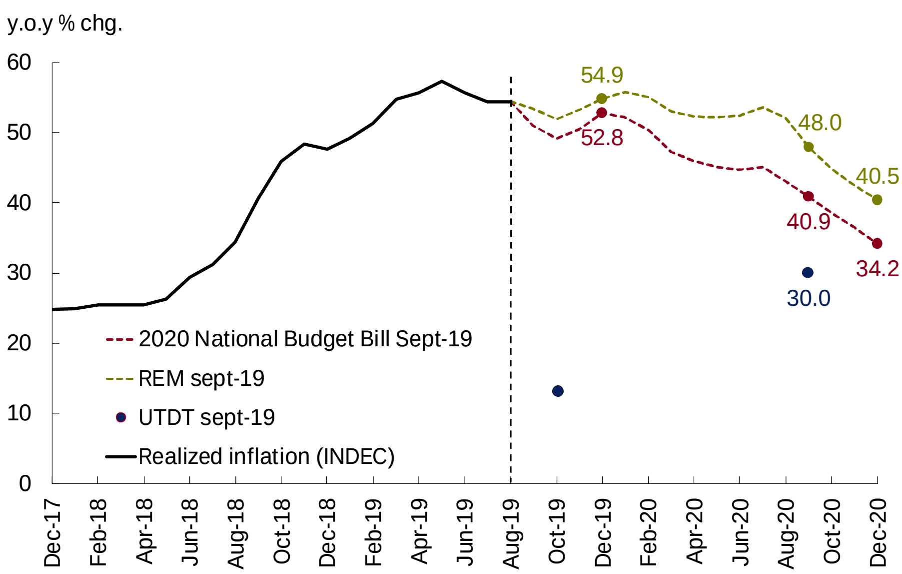
Figure 4.15 | Core inflation expectations comparison 2018 vs 2019



Source: BCRA from INDEC and REM data

Several forecasts anticipate a rise of inflation expectations for the different time horizons under analysis. As of December 2019, apart from the forecasts of REM's analysts, the National Budget Bill (PPN) considers a price hike of 52.8%. In turn, for December 2020, both REM and PPN predict a moderation of the year-on-year inflation against 2019, which would nevertheless stand at high levels of 40.5% (+12.5 p.p. against July expectations) and 34.2%, respectively. Unlike REM and PPN forecasts, the median of the Inflation Expectations surveyed by Universidad Torcuato Di Tella (UTDT) (which measures the expected inflation as perceived by households for the next 12 months) remained at 30% y.o.y. in September, for the sixth consecutive month (see Figure 4.16).

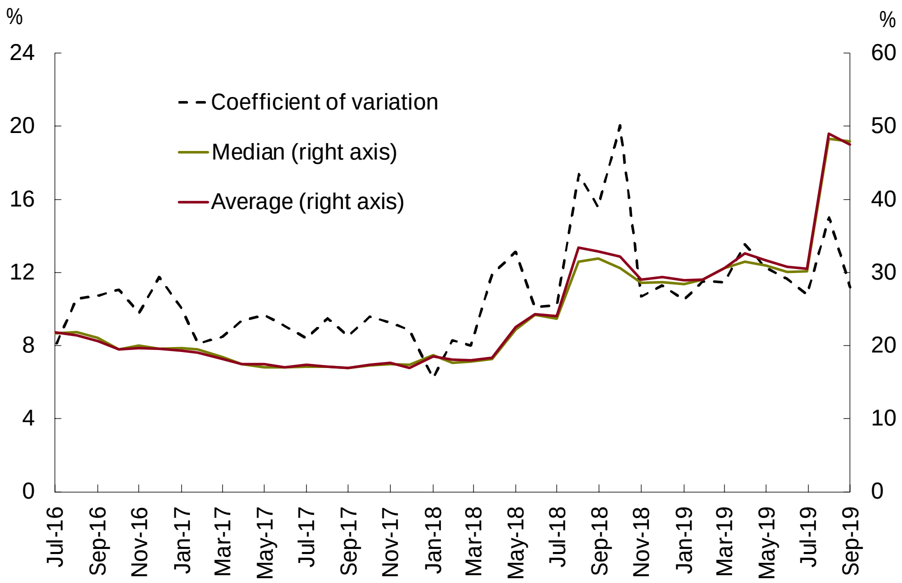
Figure 4.16 | Annual inflation expectations



*Note: 2020 Budget Bill as for Sep-19. Source: BCRA from INDEC, REM-BCRA, National Budget Agency (Ministry of Finance) and University Torcuato Di Tella (UTDT) data.

The high nominal volatility of August led to a wider dispersion of inflation forecasts, even though if adjusted by the expected average inflation of the answers, it turned out to be lower than the maximum value reached in October 2018. Most market analysts agree that next year inflation will be higher than the inflation anticipated in July. According to the REM for September, the coefficient of variation[44] went down against August, standing once again at the values posted before the elections (see Figure 4.17).

Figure 4.17 | CPI Headline next 12 months. Coefficent of variation, median and average



Souce: BCRA from REM data

44 The coefficient of variation is a dispersion statistical measure related to a set of data. It is the ratio between the standard deviation of a set of data and the absolute value of its mean.

5. Monetary Policy

After the primary elections held on August 11, a new episode of financial instability broke out. Investors reduced their exposure to domestic financial assets, and this resulted in a sharp drop of prices of publicly traded companies and corporate and sovereign bonds, and in a rise of the country risk premium, the exchange rate and the reference interest rate.

The higher level of uncertainty led to an abrupt reduction of bank deposits in dollars which resulted in a drop of the Central Bank's international reserves. Added to this, there were exchange interventions by the monetary authority to mitigate exchange volatility and to prevent a higher exchange rate pass-through to prices, and the closing of capital markets for the public sector entailing a greater use of international reserves to cover debt maturities.

Against this backdrop, authorities adopted several measures aimed at reducing the loss of international reserves and focusing the possible use of such funds on the goals of nominal stability and financial stability. Upon the lack of demand for sovereign bonds, the Ministry of Economy announced an extension of the maturities (reprofiling) of the Treasury's short-term debt for the purpose of lessening the schedule of maturities for the next months. In turn, the Central Bank implemented a series of measures to regulate inflows and outflows in the foreign exchange market and to reduce the net demand for dollars. The foreign exchange regulations set forth do not affect foreign trade, travels and payment of debts in foreign currency, or the freedom to withdraw pesos and dollars from bank accounts. The measures are intended to limit the formation of foreign assets, especially in the case of legal persons, and also to establish the obligation of clearing into the country the collections from exports of goods and services.

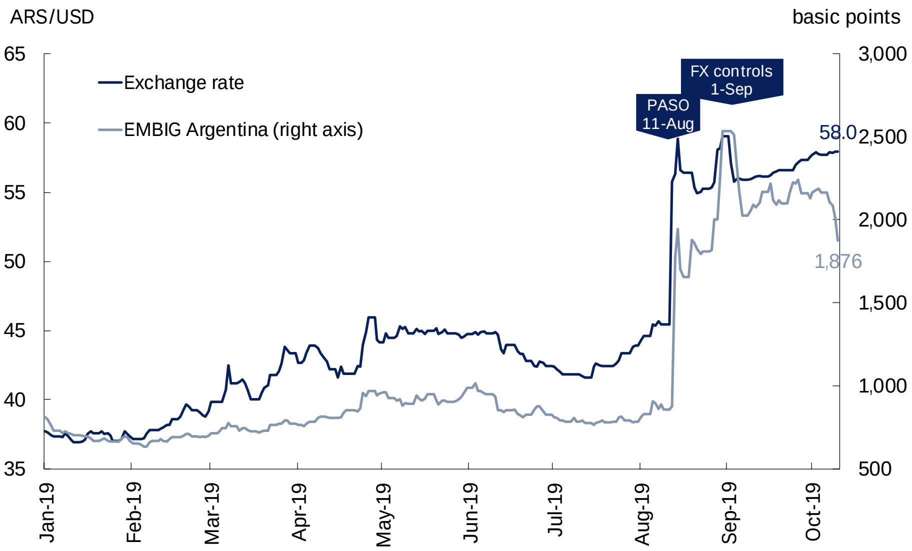
The measures implemented served to stabilize the exchange rate. As the financial volatility started to slow down, the drop of bank deposits in dollars tended to go down as well. The high levels of liquidity and solvency, added to the low exposure to public sector risk and to foreign exchange risk by financial institutions, contributed to stabilization, unlike other past episodes when instability intensified within the financial system. Thus, the main factors behind the drop of international reserves started to fade away.

The Central Bank will continue to prioritize the monetary and financial stability during the electoral period, by keeping the medium-term goal of a low and steady inflation rate. The increase of the exchange rate put a halt to the disinflation process that had been observed until mid-August. The monetary authority will keep its contractionary monetary policy based on compliance with monetary targets and consolidation of positive and high real interest rates, in order to resume the disinflation process.

5.1 Increased financial uncertainty following the primary elections

After the Open, Simultaneous and Mandatory Primary Elections (*Primarias Abiertas, Simultáneas y Obligatorias* - PASO) held on August 11, the risk perception by market participants went up significantly. Consequently, there was a sharp drop of prices of domestic financial assets and a depreciation of the peso. Thus, the country risk premium doubled from August 9 to August 13, to then stabilize at around 2000 basis points (bp) by the end of such month. On August 12, the stock market recorded one of the most significant drops ever (-37.9% in pesos and -49.5% in dollars) and both short-term and long-term Treasury bonds in dollars went down 28% and 25% on average, respectively.[45] In turn, the exchange rate rose 22.8% on the first business day after the elections, and went up again by the end of August to $59.1/US$1 (+30.1% against August 9; see Figure 5.1). In addition, the interest rate of Liquidity Bills (LELIQs) increased from an annual rate of 63.7% on August 9 to an annual rate of 85.3% on September 2 (see Figure 5.2).

Figure 5.1 | Exchange rate and country risk



Source: BCRA from Bloomberg

As a result of the increased financial uncertainty, the National Treasury started to face difficulties to renew the maturities of its short-term debt in the market. Whereas until August 9, the average renewal was for 88% of maturities of bills in pesos and dollars (Lecap, Letes, Lecer and Lelinks), after the primary elections, the renewal percentage fell to levels below 10% (the last auction held on August 28 was declared void).[46]

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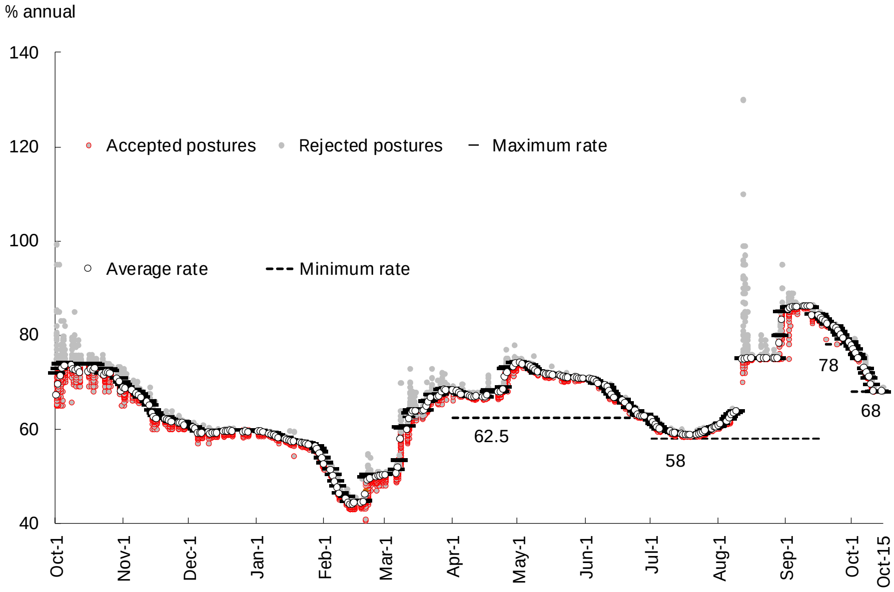
45 Country risk premium measured according to Argentina's EMBIG calculated by J.P. Morgan, MERVAL Index, and indexes of short- and long-term bonds issued in dollars of the Argentine Institute of Capital Markets (IAMC), respectively.
46 For further detail, see the information on auctions of bills and bonds published by the Ministry of Economy: https://www.argentina.gob.ar/hacienda/licitaciones.

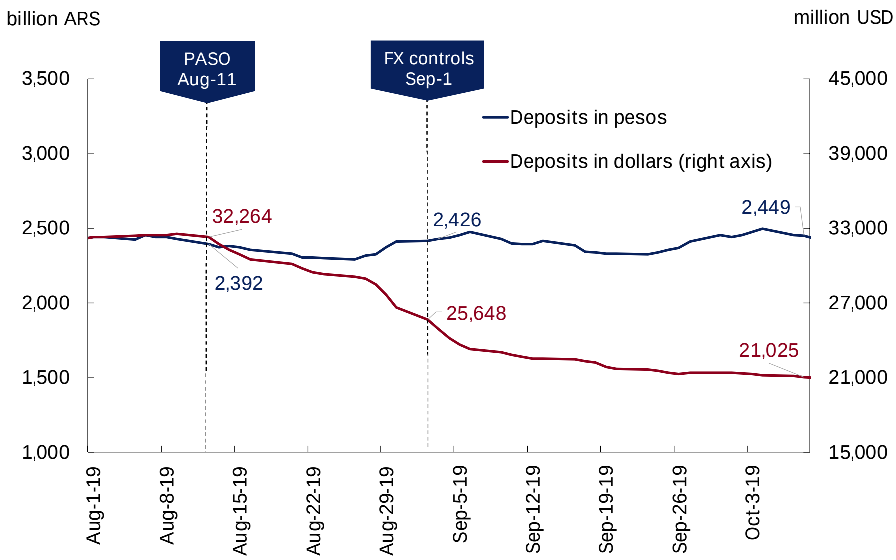
Figure 5.2 | Reference interest rate (LELIQ)



Source: BCRA

The financial uncertainty also resulted in a drop of bank deposits in foreign currency. From August 9 to the end of such month, deposits in foreign currency from the private sector shrank 18%, around US$5.87 billion. This evolution started to exert pressure on international reserves by means of the use of the minimum reserves requirements that financial institutions have deposited with the Central Bank to cover their clients' withdrawals of funds. In turn, deposits in pesos from the private sector posted a better performance, and they remained practically stable as from the financial shock (see Figure 5.3).

Figure 5.3 | Deposits of the private sector



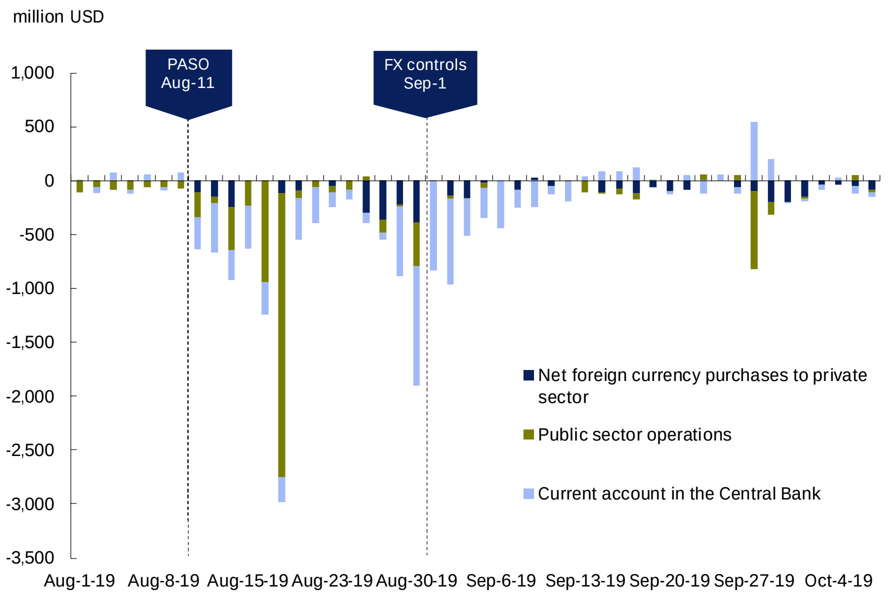
Source: BCRA

5.2 Measures to contain financial volatility: rescheduling of debt maturities and restrictions on the foreign exchange market

The Central Bank intervened in the foreign exchange market to reduce volatility and to prevent a higher pass-through to prices of the exchange rate increase. To such effect, the monetary authority made a non- sterilized intervention by selling foreign currency for the first time since the implementation of the monetary base target regime in October 2018 (see Figure 5.4).

On the other hand, the closing of the capital markets for the public sector created an additional factor for contraction of international reserves. Until such time, the maturities of debt in dollars were offset by the inflow of foreign currency from the issues of debt. Payments for maturities of debt in foreign currency of the National Treasury added up to the drop of deposits in dollars and the exchange interventions by the Central Bank. Thus, from August 9 to August 30, international reserves fell US$12.21 billion (-18%) driven by US$2.04 billion from exchange interventions, US$4.86 billion related to the outflow of bank deposits in dollars and US$5.26 billion from public sector transactions, mainly due to maturities of debt (see Figure 5.4).[47]

Figure 5.4 | International reserves and variation factors



Source: BCRA

In a context in which the real exchange rate had reached a historically high level, standing 90% above the level prior to the foreign exchange unification in December 2015 and at the highest level in the past ten years (see Figure 5.5), the authorities adopted several measures seeking to mitigate the loss of international reserves and to focus their possible use on the goals of nominal stability and financial stability.

47 Among the transactions conducted by the National Treasury especially relevant was the cancellation of a repo transaction with foreign banks for around US$ 2.6 billion on August 20. This amount in dollars was acquired from the Central Bank with pesos from a transfer of profits of the monetary authority for $127 billion.

Figure 5.5 | Real effective exchange rate

Source: BCRA

On the one hand, the Ministry of Economy announced an extension of maturities (reprofiling) of short-term debt of the National Treasury in order to mitigate the burden of payment in the next months, and the intention of amending the schedule of maturities for the rest of the debt, seeking to mitigate the burden of payments for the 2020-2023 period (see Box: Extension of Maturities (Reprofiling) of the National Treasury's Debt).[48]

Box: Extension of Maturities (Reprofiling) of the National Treasury's Debt

The following measures were announced on August 28, seeking to amend the schedule of maturities of the National Treasury's debt:

- *Short-term debt (Lecap, Letes, Lecer and Lelinks):* Extension of the maturities of debt held by legal persons (including banks, insurance companies and mutual funds), by paying 15% upon maturity, 25% after a period of three months and 60% after a period of six months.[49] Whereas for natural persons, it was established they would collect all their claims as provided for in the original securities. At the time of the announcement, natural persons comprised 90% of holders of short-term debt.

- *Bonds under domestic laws:* A bill was submitted to Congress seeking a voluntary extension of terms, mainly through the introduction of collective action clauses as those included in securities under foreign laws. These clauses enable a security holder to propose modifications of the terms and conditions of issued securities which, if accepted by a special majority, shall be applicable to all security holders.[50]

48 The announcement was made on August 28. For further detail, see https://www.argentina.gob.ar/sites/default/files/programa_financiero.pdf.
49 For further detail, see Executive Order No. 596/2019 issued by the National Executive Branch.
50 The bill was submitted to Congress on September 19. For further detail, see https://www.argentina.gob.ar/noticias/proyecto-de-ley-para-la-modificacion-de-los-terminos-y-condiciones-de-titulos-de-deuda.

- *Bonds under foreign laws:* The monetary authority announced the intention of starting a negotiation process, under the collective action clauses, in order to extend maturities, not interrupting the regular payment of debt.

- *Debt with the International Monetary Fund:* A new negotiation will be sought for, which shall conclude during the next presidential term of office, to extend the maturities (reprofiling) of debt with the IMF.

On a supplementary basis, the Central Bank implemented a series of measured aimed at regulating the foreign exchange market inflows and outflows.[51] In general terms, regulations do not affect foreign trade transactions, travels, payment of debt in foreign currency, or the freedom to withdraw pesos and dollars from bank accounts. They are mostly intended to limit the formation of foreign assets, mainly in the case of legal persons, and to establish the obligation of clearing into the country the collection of exports of goods and services (see Box: Foreign Exchange Regulations by the Central Bank of Argentina).

Box: Foreign Exchange Regulations by the Central Bank of Argentina

The main foreign exchange measures implemented by the Central Bank as from September 1 (effective until December 31, 2019) were as follows:

- It was established that exporters of goods and services must settle their income of foreign currency in the domestic market. In the case of exports of goods made after September 2, several terms were established as from the bill of lading (15, 30, 60, 180 and 365 days, depending on the good) for settlement of foreign currency. Irrespective of the above, foreign currency must be settled within 5 business days after collection or disbursement, in case of financing from abroad. Exports of goods prior to September 2 still not collected are also subject to a maximum term for settlement of 5 business days calculated as from the date of collection (including advances and prefinancing). As regards exports of services, collections must be settled in the foreign exchange market within a term not exceeding 5 business days as from the date of collection abroad or in Argentina, or the crediting of such amounts in accounts held abroad.

- No restrictions were established for the purchase of foreign currency allocated to payment of imports, except for those with related companies.

- Legal persons residing in Argentina may purchase foreign currency without restrictions for payment of debt at maturity, but they need the Central Bank's prior authorization to purchase foreign currency for the formation of external assets, the early cancellation of debts, the transfer abroad of earnings and dividends, derivative transactions and transfers abroad.

- The Central Bank established the obligation of clearing into the country and settling in the domestic foreign exchange market any new financial debts abroad and the obligation to prove compliance with this

51 The announcement was made on September 1. For further detail, see http://www.bcra.gob.ar/Noticias/01-09-19-medidas-para-proteger-estabilidad-cambiaria-y-ahorristas.asp, Communication "A" 6770, as supplemented, and Emergency Executive Order No. 609/19.

requirement to gain access to the foreign exchange market for the purpose of debt service (principal and interest).

- The access to the exchange market was restricted for payment of new debts and other obligations in foreign currency among residents (except for financing granted by domestic financial institutions).

- As regards natural persons, they are authorized to purchase up to US$10,000 per month, for formation of external assets, family assistance and derivative transactions; the Central Bank's authorization is required to purchase amounts exceeding such cap. This measure affects only 2% of people purchasing dollars, around 26,000 persons. In addition, when the amounts traded for these items may exceed US$1,000 per month in the ensemble of authorized institutions, the transaction must be performed by means of a debit in accounts of domestic financial institutions.

- The natural persons' transfers of foreign currency from their domestic accounts in foreign currency to their own accounts abroad may be made without restrictions.

- Non-residents must request the Central Bank's prior authorization to access the exchange market for any amounts above US$1,000 per month in the ensemble of authorized institutions (except for international organizations and diplomatic missions).

- In the case of a purchase of a single, family home to be occupied permanently, natural persons may access the exchange market to purchase foreign currency to the extent such funds come from a bank mortgage loan, for an amount up to US$100,000, and the total of funds allocated to such purpose (in domestic and foreign currency) are deposited or transferred simultaneously to an account in a financial institution in the name of the property's seller.

- In order to discourage transactions in financial markets known as "*MEP dollar*" (buying and selling of bonds in different currencies) and "*contado con liquidación*" (at an exchange rate implied in blue chip swap), it was established that the purchase of foreign currency by natural persons within US$10,000 per month may not be allocated to the purchase of securities in the secondary market for up to a term of 5 business days. This was supplemented with regulations issued by the National Securities Commission, pursuant to which the purchases of tradable securities in dollars (D instrument) may only be settled within a term of 48 hours and the tradable securities credited must remain in the purchaser's portfolio for a period of at least five business days calculated as from the date when the transaction was settled, prior to their sale or transfer to other depositary institutions. This minimum holding term shall not apply when the sale of tradable securities is made in foreign currency against the same jurisdiction of settlement as that of the purchase of such currency.[52]

Finally, the Central Bank amended its intervention strategy in the exchange market to achieve greater efficiency in the target of mitigating exchange volatility. Until early September, the monetary authority could intervene by means of daily auctions up to US$250 million if the exchange rate stood above the upper bound

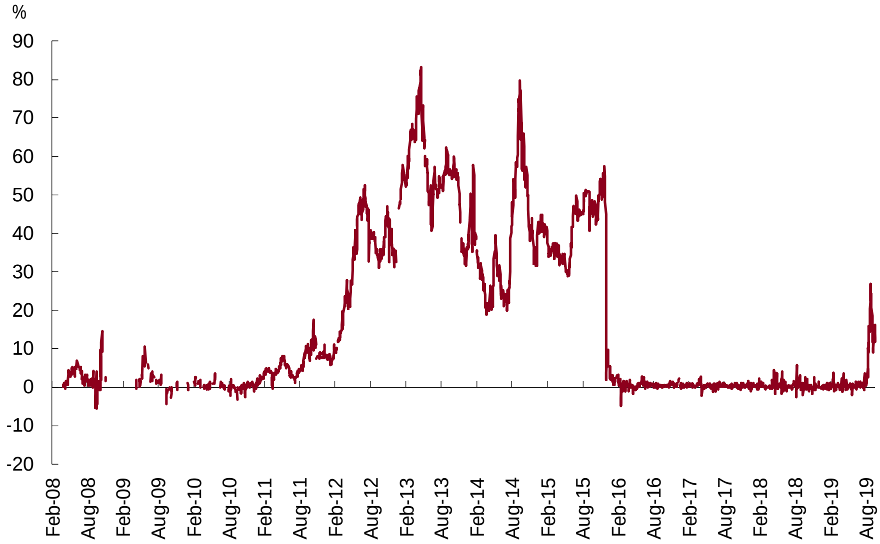
52 For further detail, see General Resolutions No. 808/2019 and No. 810/2019 of the National Securities Commission, and Communications "A" 6770, 6780 and 6799.

of the Exchange Reference Zone (ZRC), even though it could also make additional sales to counteract episodes of excessive volatility.[53] From then onwards, with the exchange rate above the ZRC, the Central Bank set aside the daily auctions and started to make direct sales for amounts and at frequencies subject to market conditions.

5.3 Financial calm was recovered with the measures implemented

As from the effectiveness of the new measures, the exchange rate stabilized; such rate went from the maximum peak of $59.1/US$1 recorded on August 30, down to $57.8/US$1 on October 8 (see Figure 5.1). At the same time, as a counterpart of exchange regulations, there was a gap between the official exchange rate and the exchange rate of capital market transactions. With a real exchange rate at high values in historical terms, contributing to the closing of external accounts, these gaps stood at limited values and at much lower levels than the gaps recorded in the previous exchange control period from 2011 to 2015 (see Figures 5.5 and 5.6).

Figure 5.6 | Exchange rate gap



Source: BCRA from market data

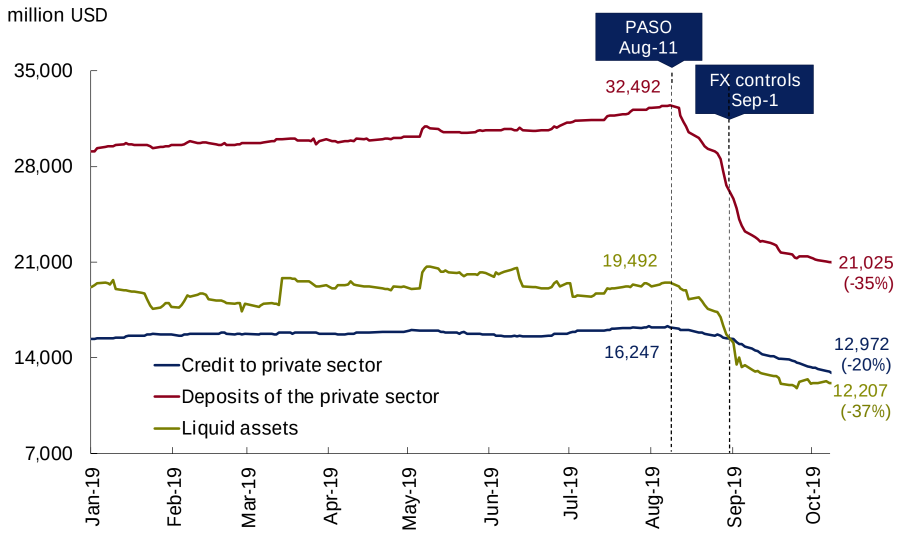
As financial volatility receded, the pace of the drop of deposits in dollars and the size of exchange market interventions by the Central Bank slowed down. This added to fewer payments in foreign currency of the public sector due to the rescheduling of short-term debt maturities. These developments helped reduce the contraction pace of international reserves observed after August 12 (see Figure 5.4). As from the Friday prior to the primary elections, international reserves fell US$ 18.35 billion, and were standing at US$ 47.96 billion as of October 8.

The financial system faced the outflow of deposits in dollars of the private sector, which accumulated around US$11 billion from August 12 to October 8 (-35%), using the liquidity available in foreign currency, both in cash

53 The upper bound of the ZRC had been fixed at $51.448 up to the end of 2019.

and in deposits with the Central Bank. Liquidity was standing at high levels, around 55% of total deposits, due to the macroprudential regulatory framework that limits possible uses to which financial institutions may apply the funding in foreign currency (see Exhibit 4 / The Relevance of Consensus on Macroprudential Policies). In turn, the Central Bank coordinated with financial institutions a series of measures to assure the availability of their deposits to the public, as well as extended hours for customer service and the improvement of logistics for distribution of physical banknotes. An additional source financial institutions resorted to for the purpose of covering the withdrawal of deposits was the reduction of loans in foreign currency, which exhibited a drop of around US$3.3 billion within the same period (-20%), mainly due to discounted documents, which account for 80% of the total financing in dollars to the private sector (see Figure 5.7).

Figure 5.7 | Loans, deposits and liquidity in foreign currency of the private sector



Source: BCRA

On the other hand, the 7-day LELIQ interest rate rose in the days following the primary elections, thus mirroring the change observed in market conditions. After a maximum level of around 86% annually from September 9 to September 12, the stabilization of the exchange market resulted in a gradual reduction of the reference interest rate of around 18 p.p., to an annual rate of 68% by mid-October (see Figure 5.2).

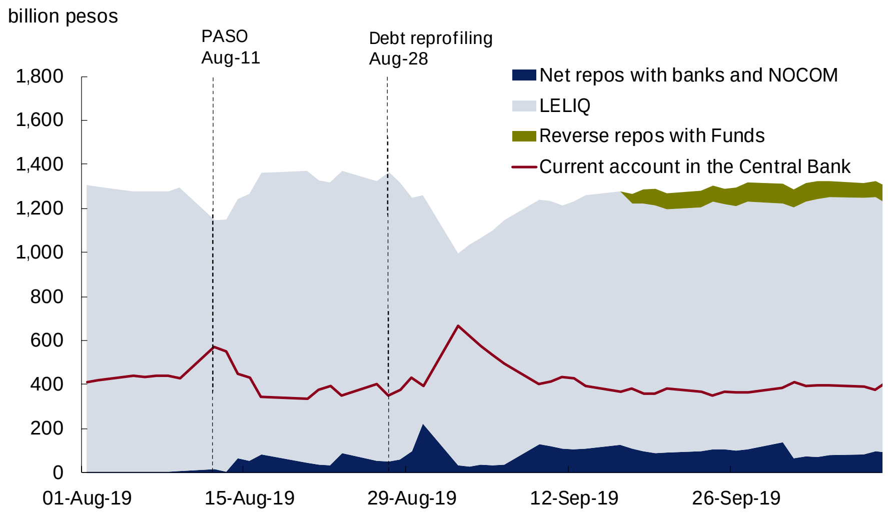
Financial institutions behaved cautiously when managing their liquidity holdings after the primary elections and following the announcement of the extension of maturities (reprofiling) of the sovereign debt (August 28). This was observed in a first episode on August 12, when banks increased their holdings in pesos in the current account with the Central Bank and, as a counterpart, they unwound part of their 7-day stock of LELIQs. This temporary event made it difficult to comply with the monetary base target of the July-August bi-monthly period (see Section 5.4.).

Later, between August 28 and September 2, financial institutions increased their deposits in current account and the stock of overnight reverse repos, reducing again, on a temporary basis, their holdings of LELIQs. Even though the institutions quickly regularized the balance of their accounts with the Central Bank in the following days, the stock of repos still stands a higher levels than in the past, which shows the persistence of the institutions' cautious behavior (see Figure 5.8).

In addition, on September 16, the Central Bank decided to increase the interest rate paid on overnight reverse repos for Mutual Funds (FCI) for the purpose of improving the transmission mechanism of the reference interest rate to the rates of the financial system. This measure was especially aimed at the rates of remunerated sight deposits, in which Mutual Funds kept a portion of their portfolio in pesos, which led to an increase in the stock of such repos (see Exhibit 3 / BCRA's Response to the Impact of Financial Volatility on Mutual Funds).

As a consequence of such developments, the stock of remunerated liabilities stood at $1,324 billion as of October 8, a level similar to that recorded before the primary elections (+2.4%).

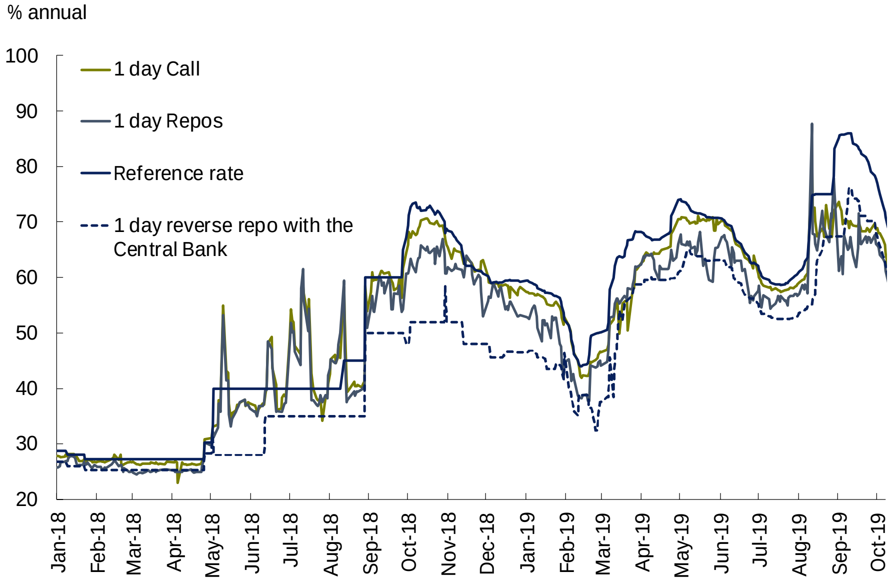
Figure 5.8 | Non-monetary liabilities of the Central Bank (LELIQ, NOCOM and net repos) and current account in the Central Bank



Source: BCRA

There was a pass-through of the reference interest rate increase to the main money market interest rates. Jointly with the first increase of the LELIQ interest rate after the primary elections, the overnight call rate and the overnight third-party repo rate went up 21 p.p. and 31 p.p., and then stabilized at levels of around 68% and 70% annually, respectively. However, the increase of the LELIQ rate by late August and early September widened the spread with the call and third-party repo rates. After an increase of approximately 5 p.p. in the last days of August, call and third-party repo rates exhibited a downward trend and, as of October 11, they stood at annual rates of 60.6% and 58.1%, respectively (see Figure 5.9).

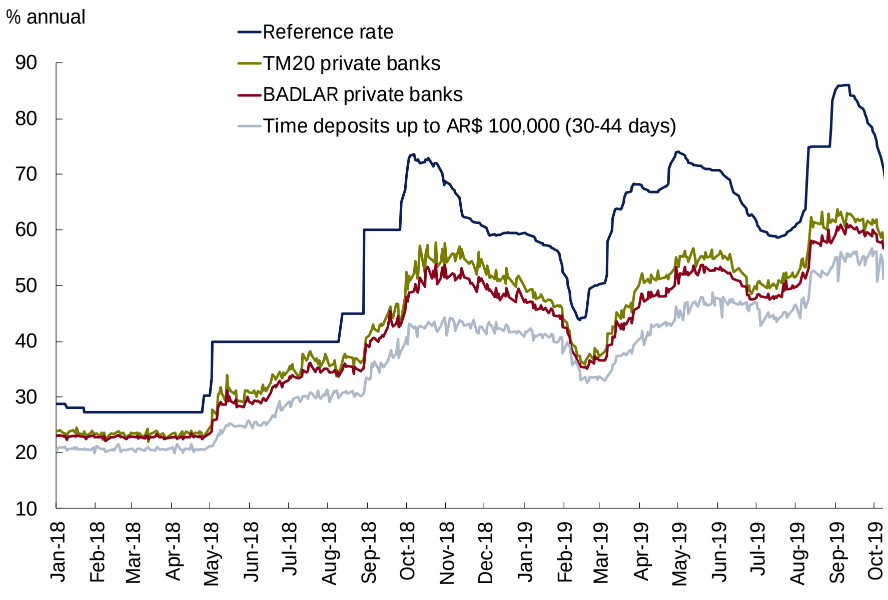
Figure 5.9 | Interest rates



Source: BCRA

The main borrowing interest rates of banks in pesos followed the increase of the reference interest rate as well (see Figure 5.10). The retail interest rate on time deposits and the BADLAR rate (interest rate for 30-day to 35-day time deposits over one million pesos) and the TM20 rate (interest rate for 30-day to 35-day time deposits over twenty million pesos) of private banks increased 5.5 p.p., 6.3 p.p. and 7.6 p.p. from August 9 to August 13, up to annual rates of 51.5%, 57.5% and 60.9%, respectively. Nevertheless, after the second episode of reference interest rate increase, prior to implementation of exchange regulations, borrowing interest rates went up more slowly and to a lesser extent, especially wholesale interest rates. In the following weeks, as financial volatility started to recede, the Private Banks BADLAR and TM20 rates accompanied the reduction of the reference interest rate and reached annual rates of 57% and 58%, respectively, whereas the retail interest rate posted a lesser drop, reaching a value of around 54% annually.

Figure 5.10 | Banking deposits interest rates

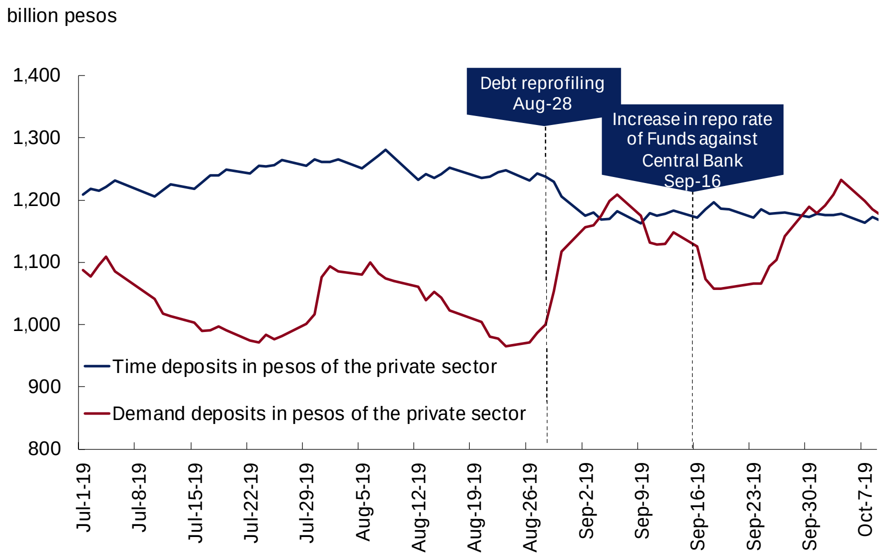


Source: BCRA

The stability of private sector deposits in pesos during the financial turbulence coincided with a shortening of their terms. Whereas time deposits went down, mostly from August 28 to September 2, sight deposits went up, largely driven by the remunerated sight accounts of Mutual Funds, which modified the composition of their portfolios upon the modification of the sovereign debt maturity profile (see Figure 5.11). In the following weeks, the increase of borrowing interest rates and the exchange regulations allowed for stabilization of time deposits, whereas sight deposits fell as a result of withdrawals by Mutual Funds, which allocated their funds to reverse repos with the Central Bank after the increase of the interest rate on such instruments on September 16 (see Exhibit 3 / BCRA's Response to the Impact of Financial Volatility on Mutual Funds).[54] Thus, in September, private sector deposits in pesos grew 1.3% in nominal terms, seasonally-adjusted, slightly below the increase of 2.1% recorded in August (see Figure 5.12), and kept an upward trend in the first days of October. This evolution of deposits in pesos also showed the resilience of the financial system during high volatility episodes (see Exhibit 4 / The Relevance of Consensus on Macroprudential Policies).

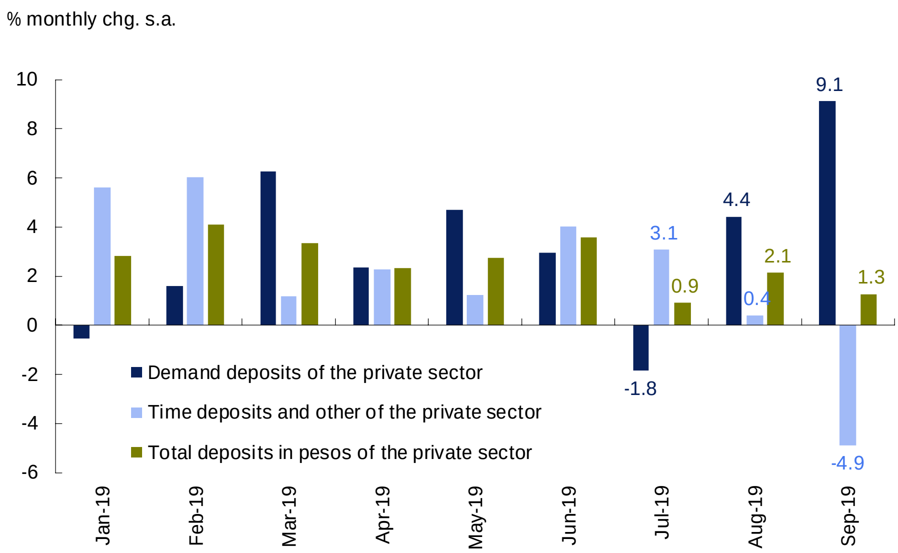
54 See Communication "P" 50953: http://www.bcra.gov.ar/Pdfs/comytexord/P50953.pdf.

Figure 5.11 | Deposits in pesos of the private sector



Source: BCRA

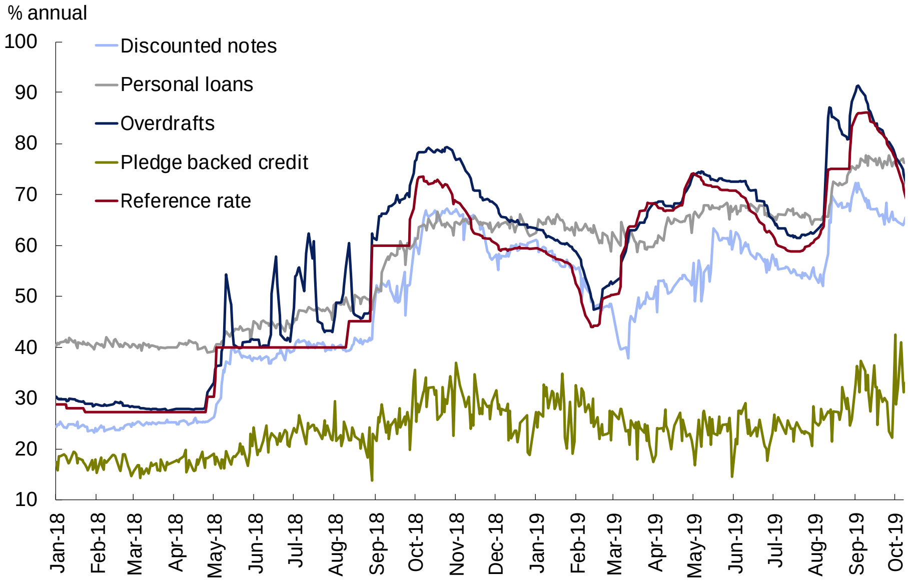
Figure 5.12 | Deposits in pesos of the private sector



Source: BCRA

Banks' lending interest rates accompanied the evolution of the reference interest rate during the quarter. In particular, the rates of current account overdrafts, of personal loans and of discounted documents went up 15 p.p., 9 p.p. and 7 p.p., respectively, upon comparing the monthly average of September against June, even though in September and in the first days of October, they posted a downward trend in line with the reference interest rate, and on October 11 they reached annual rates of 70.4%, 77.2% and 63.5%, respectively (see Figure 5.13).

Figure 5.13 | Banking credit interest rates

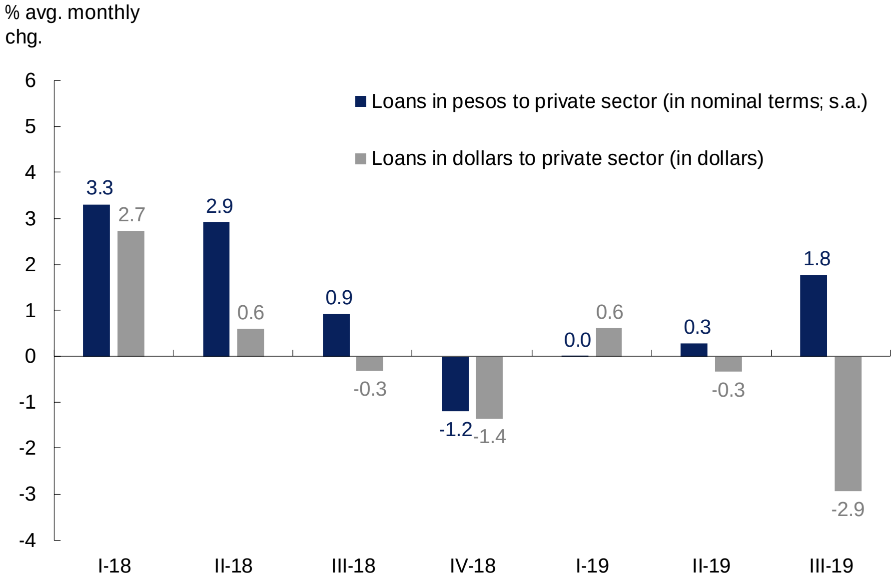


Source: BCRA

After three months of stagnation, loans in pesos to the private sector grew in nominal terms in the third quarter of 2019, at an average monthly pace of 1.8%, seasonally-adjusted (see Figure 5.14). This evolution, mostly observed as from mid-August, was due to the liquidity needs faced by economic agents upon the modification of the public sector's debt maturity profile and the initial impact on Mutual Funds and the replacement of loans in dollars with loans in domestic currency (see Exhibit 3 / BCRA's Response to the Impact of Financial Volatility on Mutual Funds). This replacement was due to lesser financing available for companies in foreign currency as a result of the banks' increased needs of funding to face the withdrawal of deposits in dollars, which led to a 2.9% monthly drop (on average) of loans in this currency during the quarter (see Figures 5.7 and 5.14).

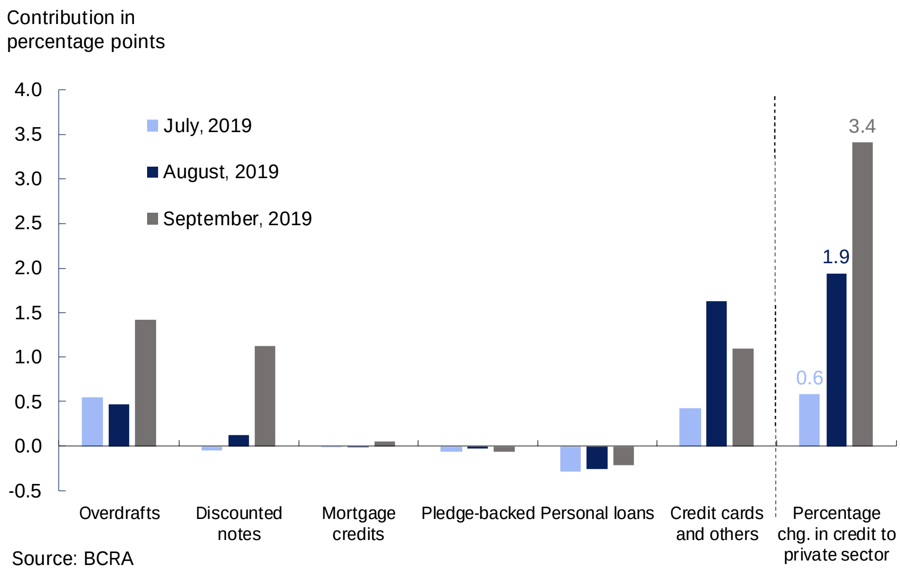
The expansion of loans in pesos was led by short-term credit facilities to companies (overdrafts and documents) and credit cards related to household consumption (see Figure 5.15). Thus, current account overdrafts and discounted documents rose, on average, 7.7% and 2.7% monthly in nominal terms during these three months, whereas credit cards increased 3.7%. On the contrary, during the quarter, personal and pledge-backed loans fell 0.9% monthly in nominal terms, on average, whereas mortgage loans remained stable.

Figure 5.14 | Loans to private sector



Source: BCRA

Figure 5.15 | Contribution to private credit monthly change by credit line



Source: BCRA

5.4 The financial uncertainty episode affected compliance with monetary base targets

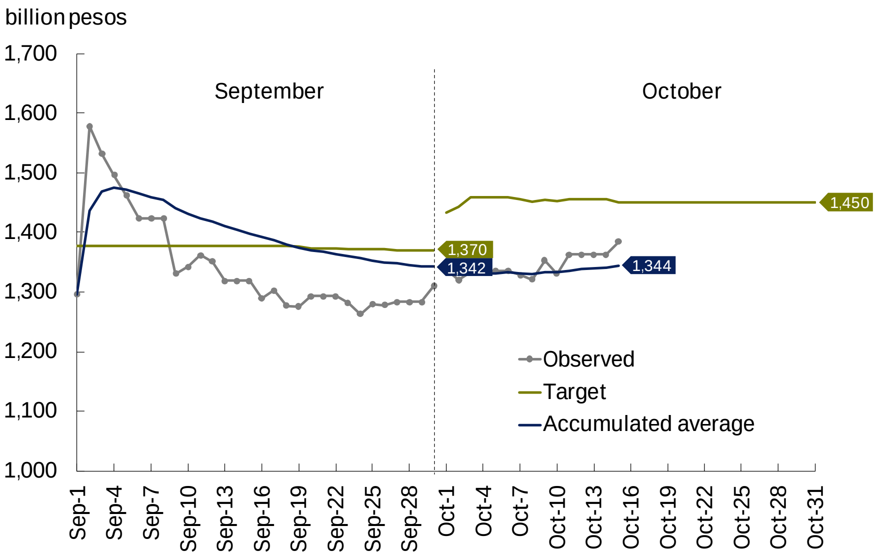
In June, the Central Bank had decided that the minimum cash requirement for July and August of 2019 would be calculated on a bi-monthly basis. The objective of this measure was to ease compliance with minimum cash requirements in a period when the demand for cash is highly seasonal, so as to make it more consistent with compliance of the monetary base (MB) zero growth target.[55] However, by adopting a cautious attitude upon the uncertainty of the pre-election period, during July, banks complied with the minimum cash requirements for an amount higher than that required for the two-month period. Thus, to prevent the regime from becoming excessively contractionary in July and expansionary in August, the Monetary Policy Committee (COPOM) decided to adapt also to a bi-monthly period the assessment of compliance with the monetary base target, which stood at $1,343.2 billion for the July-August period.[56]

The financial volatility after the primary elections impacted on the compliance with the MB target of the July-August period. On the one hand, sales of foreign currency in the exchange market during August, aimed at mitigating the exchange volatility, resulted in a downward adjustment of the target.[57] Sales totaled US$2.04 billion and resulted in an MB target reduction in the July-August period of $15.3 billion, down to $1,328.0 billion. On the other hand, in a context of increased uncertainty, banks showed again a cautious attitude, and this led to compliance with the minimum cash requirements above the amount required under minimum cash regulations. Consequently, the MB bi-monthly average reached $1,347.1 billion, thus standing $19.1 billion (1.4%) above the target adjusted by sales of foreign currency, i.e. this was the first non-compliance with the monetary base target as from implementation of the MB control scheme (see Figure 5.16).

Besides, the events resulting from the financial shock led the COPOM to adjust the parameters of the monetary scheme in September.[58] The exchange rate increase recorded after the primary elections put a halt (in August and September) to the downward trend of inflation observed since mid-April (see Chapter 4. Prices). This temporary increase of inflation entailed a higher-than-expected reduction of the real money supply, whereas the implementation of exchange restrictions allows for anticipating, in the next few months, a higher real demand for money than originally expected. The monetary base targets were adjusted to prevent an excessive monetary contraction. In line with the Central Bank's forecasts of demand for money, a monthly growth of 2.5% was defined for the targets of September and October, based on the bi-monthly target of July-August, which will be adjusted according to net foreign exchange transactions performed by the Central Bank as from September 18. Against this backdrop, the MB average reached $1,342.1 billion in September, down $28.3 billion (2.1%) against the new adjusted monthly target.[59] On the other hand, in the first fortnight of October, the Central Bank continued to comply with the monetary target. The MB average reached $1,344.5 billion, i.e. an overcompliance of $106.4 billion (-7.3%) (see Figure 5.16).[60]

55 See Communication "A" 6719.
56 See Decisions of the Monetary Policy Committee (COPOM) of July 22, 2019 at http://www.bcra.gob.ar/Noticias/Decisiones-del-Comite-dePol%C3%ADtica-Monetaria-220719.asp.
57 Thus, under these circumstances, the monetary scheme becomes more contractionary, and this helps stabilize pressures on the foreign exchange market.
58 See Decisions of the Monetary Policy Committee (COPOM) of September 18, 2019 at https://www.bcra.gob.ar/PoliticaMonetaria/comunicados.asp.
59 September's MB target was $1,370.4 billion, as a result of subtracting the effect of net sales of foreign currency as from September 18 ($6.4 billion) from the original target of $1,376.7 billion.
60 The MB target as of October 15 was $1,450.9 billion. This level derives from applying a change of 2.5% monthly to the original target of September ($1,411.2 billion) and adding the impact of net foreign currency transactions as from September 18 ($39.7 billion). These foreign exchange transactions not only correspond to those with the private sector but also include those arranged with the National Treasury, which imply an adjustment of the target of -$74.6 billion and +$114.3 billion, respectively. On September 27, the National Treasury sold foreign currency to the Central Bank for an amount equivalent to $120 billion. But, since a large portion of these funds remained deposited with the Central Bank, there was no full monetary impact at that time. The Treasury kept on using these funds, so the monetary impact continued during October. The date when the Treasury used such funds is taken into account to adjust the target.

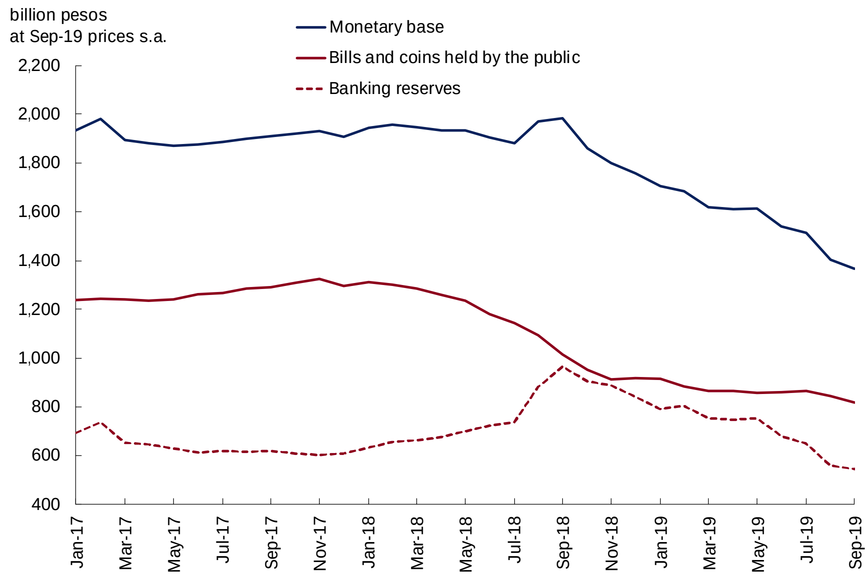
Figure 5.16 | Monetary base objetive



Target adjusted by market interventions of the Central Bank.

Given the evolution of inflation in the third quarter of 2019, the MB kept on exhibiting a downward trend in real terms. The MB fell 11.4% in real terms, seasonally-adjusted, between June and September this year, and accumulated a drop of 31.2% in real terms, seasonally-adjusted, as from the beginning of the monetary scheme in October 2018 (see Figure 5.17). The cash held by the public contracted 4.8% over this quarter (in real terms, seasonally-adjusted) and accelerated its contraction pace against the values recorded in the second quarter, whereas bank reserves showed a greater contraction (-19.8% in the quarter in real terms, seasonally-adjusted).[61]

Figure 5.17 | Monetary base and its components

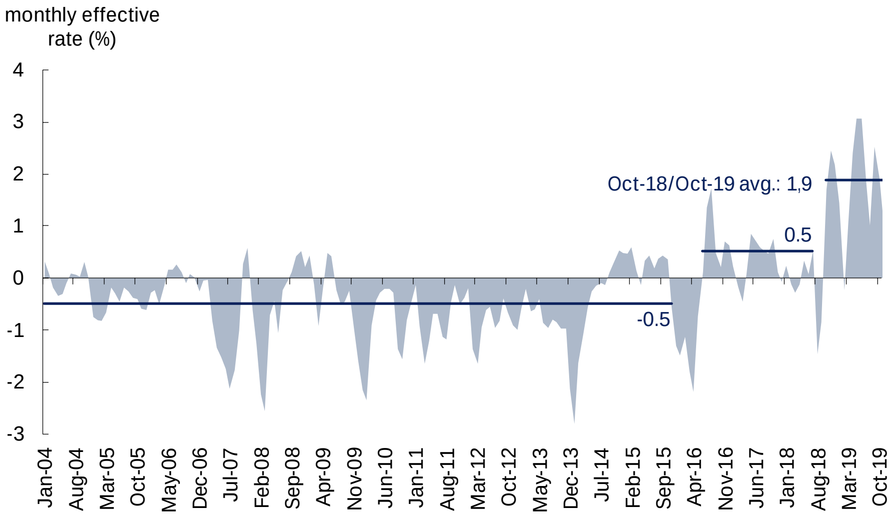


Source: BCRA and INDEC

61 Bank reserves consist of bills and coins held by financial institutions and current account deposits made by financial institutions with the Central Bank due to compliance with regulations on minimum cash requirements.

In order to ensure the contractionary bias of the monetary policy, within a context where the forecasts of the demand for money may lose accuracy, the COPOM also decided to increase the floor of LELIQs interest rates from 58% up to 78%, annually, in September, during the inflationary peak, and to lower the floor in October down to 68% annually, in line with the market forecasts regarding a deceleration of the inflation rate. Upon the inflation rate increase in August and September, the current level of the reference interest rate mirrors a high and positive real interest rate in historical terms, and this helps to keep the contractionary bias of the monetary policy (see Figure 5.18).

Figure 5.18 | Real reference interest rate (ex post)*



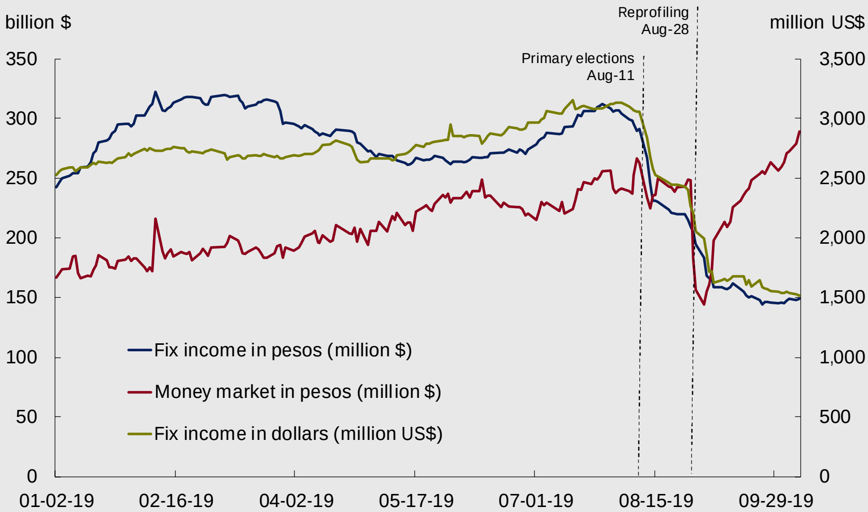
* The nominal interest rate (monthly average) is deflacted with de average between the current and one period ahead inflation (expectations data was used for October, 2019)
Source: BCRA

The Central Bank will continue to prioritize the monetary stability and the financial stability during the electoral period, in a context of a liquid and solvent financial system. In turn, it will keep the medium-term objective of a low and steady inflation rate. To such effect, the monetary authority will keep its contractionary monetary policy based on compliance with monetary targets and the consolidation of positive and high real interest rates, in order to resume the disinflation process.

Exhibit 3 / BCRA's Response to the Impact of Financial Volatility on Mutual Funds

During August, Mutual Funds were affected by two events that gave rise to an increasing volatility in financial markets. In the first place, after the primary elections held on August 11, the sharp drop in the price of public debt instruments brought about a reduction in their valuation (see Section 5.1) and an increase in the redemption of fixed income Mutual Funds, in both pesos and dollars which, as of August 9, had invested 56% and 64% of their portfolio in short-term and medium-term public debt instruments, respectively (see Figures 1 and 2).

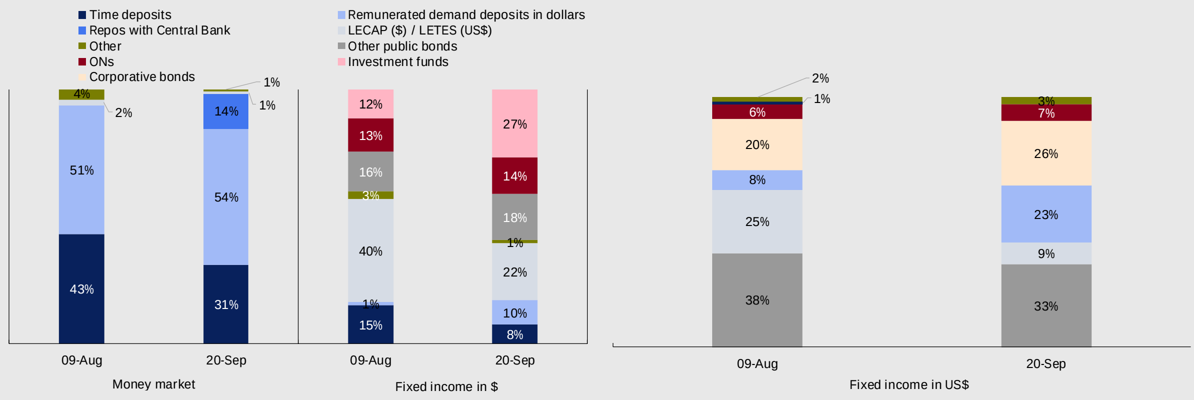
Figure 1 | Equity of investment funds



Source: CAFCI

In the second place, the announcement made on August 28 about a rescheduling of public debt maturities (see Box: Extension of Maturities (Reprofiling) of the National Treasury's Debt) had as a correlation a second episode leading to price deterioration of the fixed income funds, in pesos and dollars, which as of August 9 had kept a 40% and a 29% of their portfolio in LECAPs and LETES, respectively (see Figure 2). This resulted in a new increase in the number of redemptions, which also extended to money market Mutual Funds.

Figure 2 | Equity of investment funds



Vis-à-vis the strong increase of redemptions and a context of insufficient demand for the assets that Mutual Funds could settle in the market, on August 30, the Central Bank of Argentina (BCRA) decided to conduct auctions of repo transactions and purchase of Treasury Bills held in the portfolios of the Mutual Funds[62] in order to pump liquidity to these Funds. Through this mechanism, on October 11, the BCRA purchased bills in pesos and dollars from Mutual Funds for an amount equivalent to around $47 billion.

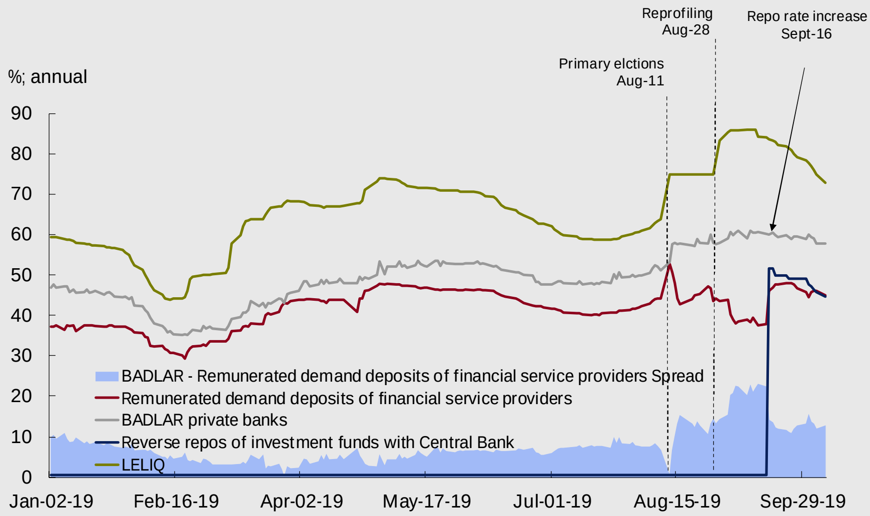
After the initial impact, the net worth of fixed income Mutual Funds in pesos and in dollars exhibited some stability. However, within a context of greater financial uncertainty, investors opted for money market Mutual Funds, which more than recovered their net worth and exceeded the maximum nominal value observed in the first week of August due to higher underwritings by the non-financial private sector and also by the fixed income Mutual Funds in pesos (see Figures 1 and 2).

In turn, Mutual Funds shortened the term of their portfolios. In the first place, and as mentioned in the preceding paragraph, fixed income Mutual Funds in pesos increased the portion of their portfolio invested in Mutual Funds with an immediate redemption and in remunerated sight deposits, to the detriment of short-term and medium-term sovereign bonds and time deposits. Likewise, money market Mutual Funds showed a marked preference for shorter-term assets and increased the proportion of investments in remunerated sight deposits, to the detriment of time deposits. Lastly, fixed income Mutual Funds in foreign currency reduced the proportion of their portfolio invested in LETES and simultaneously increased the proportion invested in sight deposits (see Figure 2).

62 See Communication “A” 6767: http://www.bcra.gov.ar/Pdfs/comytexord/A6767.pdf

The increase in the proportion of remunerated sight deposits held by Mutual Funds in pesos, mainly money market Mutual Funds, resulted in a shortened funding term for financial institutions and, consequently, they reduced the interest rates on these deposits by 10 percentage points (p.p.), unlike the increases observed in the reference rate and in the other borrowing rates of the market. Then, the spread between the Private Banks BADLAR and the rate of remunerated sight accounts widened around 15 p.p. from August 9 to September 16, from 7 up to 22 p.p. (see Figure 3).

Figure 3 | Interest rates received by investment funds and other money market rates

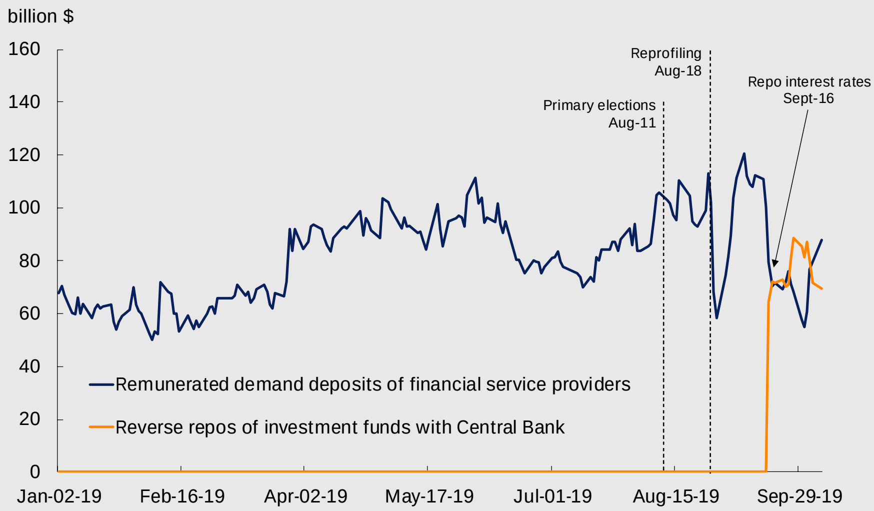


Source: BCRA

In order to encourage competition and improve the transmission channel of the monetary policy to the market interest rates, the Monetary Policy Committee (COPOM) changed, on September 16, the interest rate for the BCRA's overnight reverse repos with the Mutual Funds[63] –which was standing at 0.5% annually–, setting it at a value equivalent to 70% of the reverse repos rate with financial entities (around 45% annually in nominal terms as of October 7). Consequently, there was an initial increase of around 10 p.p. in the rate paid by financial institutions for these deposits (see Figure 3), added to an increase in the stock of Mutual Funds' reverse repos with the BCRA for around $ 70 billion –14% of the net worth of money market Mutual Funds (see Figures 2 and 4).

63 See Communication "P" 50953: http://www.bcra.gov.ar/Pdfs/comytexord/P50953.pdf

Figure 4 | Remunerated demand deposits of financial service providers and reverse repos of investment funds with Central Bank.



Source: BCRA

In short, by means of auctions for the purchase of Bills, the BCRA pumped liquidity to Mutual Funds so that they could face the increase in the number of redemptions by holders of unit shares, while the increase in the rate of the Mutual Funds' reverse repos improved the transmission channel of the interest rate in order to make the remuneration obtained by money market Mutual Funds more appealing. Thus, the measures adopted by the Central Bank of Argentina contributed to stabilizing the Mutual Funds market and preserving financial stability.

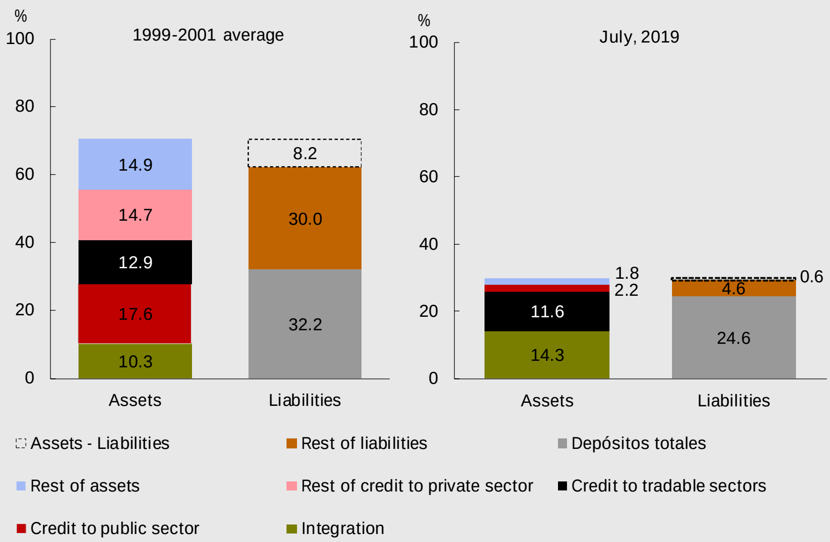
Exhibit 4 / The Relevance of Consensus on Macroprudential Policies

More than 15 years ago, after the crisis brought about by the end of the Convertibility regime, the Central Bank of Argentina implemented some regulations that strongly limit bank exposure to the public sector, and divided the banking system into two segments, dollars and pesos, which, in practice, are almost entirely isolated. The regulation, which over time converged to Basel III international standards, also established that, as a precautionary measure, banks must keep high levels of capital and liquidity.

The episode of higher exchange and financial volatility that took place in mid-August highlighted the relevance of the current macroprudential regulatory framework given the significant degree of resilience evidenced by the financial system. At present, the Argentine financial system has a low level of dollarization and is free from mismatches, i.e. its liabilities in foreign currency (FC) are backed by assets in the same currency (see Figure 1).

As part of the macroprudential regulations, lending to the private sector in foreign currency must be granted to companies having income in foreign currency (mainly to tradable sectors). This regulation mitigates mismatches in the balance sheets of bank debtors, thus preventing a source of vulnerability in the payment capacity when there are sharp fluctuations of the exchange rate. Before the 2001-02 crisis, debtors could take credits in foreign currency even when they did not have income in such currency.[64]

Figure 1 | Foreign currency balance sheet of the financial system
in % of assets

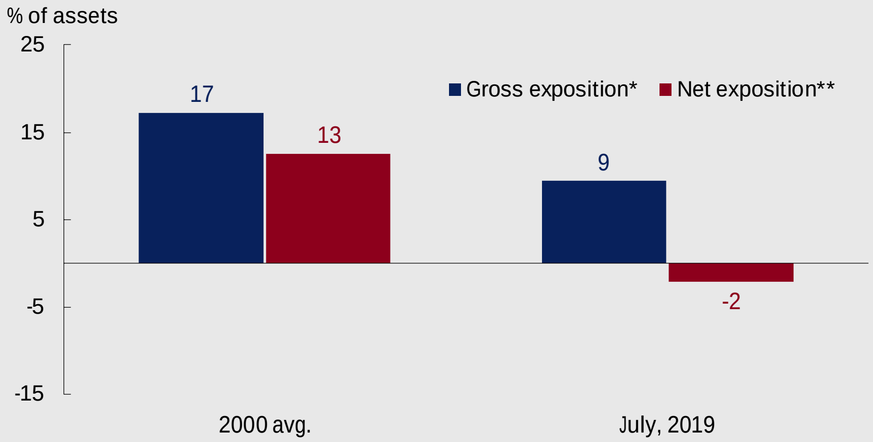


Source: BCRA.

64 See the next Financial Stability Report to be published in November 2019 for a more detailed analysis.

In addition, financial institutions have today a very low degree of exposure to the public sector. Moreover, at the level of the aggregate financial system, the net exposure to the public sector is negative (see Figure 2) when deposits are considered (including all jurisdictions).

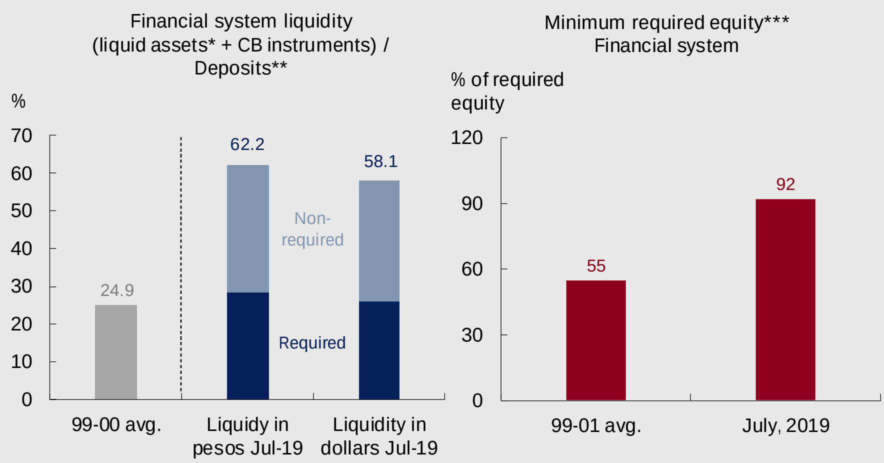
Figure 2 | Public sector exposition



* (Position in public bonds (excluding Central Bank instruments) + Loans to public sector) / Total assets. ** (Position in public bonds (excluding Central Bank instruments) + Loans to public sector - Deposits of the public sector) / Total assets. Public sector includes all government levels.
Source: BCRA.

At present, the financial system exhibits high levels of liquidity and capital, well above the minimum values established for prudential purposes (see Figure 3). As of July 2019, capital compliance almost doubled the minimum requirement, according to the prudential regulation in force. At the same time, the leverage of the ensemble of banks stood at a relatively low and stable level.

Figure 3 | Financial system liquidity and solvency



* Liquid assets include bills and coins and current account in the CB.
** The 99-00 avg. is calculated using deposits in domestic and foreign currency.
*** Minimum required equity = (Equity - Required equity) / Required equity.
Source: BCRA

In short, the financial system is characterized by a sound balance sheet, evidenced by its limited level of dollarization, no significant currency mismatches, low exposure to the public sector and high liquidity levels. As a result, the financial system cannot become a source of instability during episodes of external turbulence or domestic uncertainty, as observed in the past, and final costs are lower for the economy. This is an example that highlights the convenience of reaching consensus on public policies that goes beyond the incumbent governments.

Abbreviations and Acronyms

€: Euro
Acum.: Acumulado
AFCP: Asociación de Fabricantes de Cemento Portland
AFIP: Administración Federal de Ingresos Públicos
AUH: Asignación Universal por Hijo para Protección Social
BADLAR: Buenos Aires *Deposits of Large Amount Rate* (tasa de interés pagada por depósitos a plazo fijo de más de un millón de pesos en el tramo de 30 a 35 días por el promedio de entidades bancarias)
BCB: Banco Central de Brasil
BCBA: Bolsa de Comercio de Buenos Aires
BCE: Banco Central Europeo
BCRA: Banco Central de la República Argentina
BONAR: Bono de la Nación Argentina
CABA: Ciudad Autónoma de Buenos Aires
CEMBI+: *Corporate Emerging Market Bond Index Plus*
CEMBI+AR: *Corporate Emerging Market Bond Index Plus Argentina*
CEPAL: Comisión Económica para América Latina y el Caribe
CER: Coeficiente de Estabilización de Referencia
CIFRA: Centro de Investigación y Formación de la República Argentina – Central de Trabajadores de la Argentina (CTA)
COICOP: *Classification of Individual Consumption According to Purpose*
CNV: Comisión Nacional de Valores
Contrib.: Contribución
CyE: Combustibles y Energía
DJVE: Declaraciones Juradas de Ventas al Exterior
e: Estimado
EDP: Equipo Durable de Producción
EIL: Encuesta de Indicadores Laborales
EMAE: Estimador Mensual de la Actividad Económica
EMBI+: *Emerging Markets Bond Index Plus*
EMBI+AR: *Emerging Markets Bond Index Plus Argentina*
EMBIG: *Emerging Market Bond Index Global*
ENGHo: Encuesta Nacional de Gastos e Ingresos de los Hogares
EPH: Encuesta Permanente de Hogares
excl.: Excluyendo
Fed: Reserva Federal de los Estados Unidos
FIEL: Fundación de Investigaciones Económicas Latinoamericanas
FMI: Fondo Monetario Internacional
FMI WEO: *World Economic Outlook*
FOB: *Free on Board* (operaciones de compraventa que se realiza por barco)
FOMC: Comité Federal de Mercado Abierto
GBA: Gran Buenos Aires
i.a.: Interanual
IAMC: Instituto Argentino de Mercado de Capitales
IBIF: Inversión Bruta Interna Fija
ICC: Índice de Confianza del Consumidor elaborado por la Universidad Torcuato Di Tella
ICC-INDEC: Índice del Costo de la Construcción
IGA-OJF: Índice General de Actividad de Orlando J. Ferreres
ILA: Índice Líder de la Actividad
ILCO: Indicador Líder del Consumo privado del BCRA
INDEC: Instituto Nacional de Estadística y Censos
INML: Índice de Novillos del Mercado de Liniers
IPC: Índice de Precios al Consumidor de cobertura nacional difundido por el INDEC
IPCBA: Índice de Precios al Consumidor de la Ciudad de Buenos Aires
IPC Córdoba: Índice de Precios al Consumidor de la Provincia de Córdoba
IPC GBA: Índice de Precios al Consumidor del Gran Buenos Aires
IPC-NP: Indicador Nacional Ponderado
IPC San Luis: Índice de Precios al Consumidor de la Provincia de San Luis
IPIB: Índice de Precios Internos Básicos
IPIM: Índice de Precios Internos al por Mayor
IPMP: Índice de Precios de las Materias Primas
IPOM: Informe de Política Monetaria
ITCNM: Índice de Tipo de Cambio Nominal Multilateral
ITCRM: Índice de Tipo de Cambio Real Multilateral
IVA: Impuesto al Valor Agregado
kg: Kilogramo
LAC: Latin American Consensus Forecasts
LEBAC: Letras del Banco Central (Argentina)
LELIQ: Letras de Liquidez del Banco Central de la República Argentina
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 $
Mens.: mensual
MERVAL: Mercado de Valores de Buenos Aires

mill.: Millones
Min.: Ministerio
MIP: Matriz insumo-producto
MOA: Manufacturas de Origen Agropecuario
MOI: Manufacturas de Origen Industrial
MRO: *Main refinancing operations*
MSCI: *Morgan Stanley Capital International Index*
MULC: Mercado Único y Libre de Cambios
NEA: Noreste argentino
NG: Nivel general
NOA: Noroeste argentino
OCDE: Organización para la Cooperación y el Desarrollo Económico
OPEP: Países Exportadores de Petróleo
p.b.: Puntos básicos
p.p.: Puntos porcentuales
p: Proyectado
PAMI: Obra Social para Jubilados y Pensionados
PCE: *Personal consumption expenditures*
PCP-BCRA: Predicción contemporánea del PIB del BCRA
PEA: Población Económicamente Activa
PIB: Producto Interno Bruto
PMI: *Purchasing Managers' Index*
PP: Productos primarios
Prom. móv.: Promedio móvil
Prom.: Promedio
R$*: Real*
REM: Relevamiento de Expectativas de Mercado del BCRA
REPO: *Repurchase Agreement* (Operación de Recompra)
ROE: Registros de Operaciones de Exportación
Rueda REPO: Tasa de interés promedio de las operaciones a 1 día hábil entre entidades financieras en el mercado garantizado
S.A: Sociedad Anónima
s.e.: Serie sin estacionalidad
SSPM: Indicador de Consumo Privado elaborado por el Ministerio de Hacienda
t.c.: Serie tendencia-ciclo
TFF: Tasa de fondos federales
tn.: Tonelada
TN: Tesoro Nacional
TNA: Tasa Nominal Anual
Trim.: Trimestral / Trimestre
UCI: Utilización de la capacidad instalada
US$: Dólares Americanos
UTDT: Universidad Torcuato Di Tella
UVA: Unidad de Valor Adquisitivo
Var.: Variación
Vol.: Volumen
YPF SA: Yacimientos Petrolíferos Fiscales Sociedad Anónima

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