

## Monetary Policy: Assessments and Outlook

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

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

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

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

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

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

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

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

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