Monetary Policy: Assessment and Outlook

Under the new monetary policy regime effective since October 1, 2018, the Central Bank of Argentina (BCRA) has committed not to increase the monetary base until June 2019, except for the months of December 2018 and June 2019 when there is an increase in the demand for money. The new regime, adopted at a time of high nominal instability, entails a concrete and powerful commitment that may be immediately noticeable and verifiable by the public in general.

The BCRA implements the new regime by means of daily auctions of Liquidity Bills (LELIQs) with banking institutions. The BCRA's monetary base target has been overcomplied every month since the implementation of the new regime. Such overcompliance amounted to $19 billion in October, $15 billion in November, and $14 billion in December.

LELIQs average annual interest rate stood at 73.5% in early October; then it started to go down and stood at 56.9% on January 22, 2019, latest available data. The highest drop was recorded in November, due to the reduction of nominal volatility, inflation expectations and headline inflation in September and October. The pace of decline of the interest rate was slower as from December, because of the recovery of cash held by the public in that month, which grew markedly and even stood above the usual seasonal factor of such period, in contrast with the trend in place since early 2018. In turn, time deposits grew markedly during the quarter, positively impacted by both the reference interest rate level and the incentive of its pass-through to borrowing interest rates boosted by the minimum cash regulation effective since October 1, 2018.

Monthly inflation rates went down from 6.5% in September and 5.4% in October to 3.2% in November and 2.6% in December. The contractionary bias of the monetary policy, strengthened by the new regime in place, has allowed for resuming the nominal control of the economy. Anyway, inflation rates are still high. It is well-known that the monetary policy has a response lag. As a result, market analysts estimate that the monthly inflation rate will continue to be high in the next few months, while the adjustment to regulated prices announced for the near future entails an additional limiting factor to reduce inflation.

Under the current monetary policy scheme, the monetary base target is supplemented by the definition of intervention and non-intervention zones for the exchange rate. The non-intervention zone was set on October 1, 2018 for an exchange rate of $34 per dollar in the lower bound and $44 per dollar in the upper bound. These bounds were adjusted daily at a monthly rate of 3% in the last quarter of 2018, and are adjusted at a monthly rate of 2% in the first quarter of 2019. Beyond the upper bound of the non-intervention zone, the BCRA may sell foreign currency for a daily amount of up to US$150 million, 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. 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.

The exchange rate has remained within the non-intervention zone during the last quarter of 2018, coming closer to the lower bound. In January 2019, due to the combined effects of the monetary policy in place and a more favorable international context for emerging markets, the exchange rate stood below the non-intervention zone and the BCRA started to purchase foreign currencies for a total of US$290 million until the date of publication of this report. As the BCRA had announced at the beginning of the month, it only made daily purchases up to US$50 million because it considers this is the adequate limit for the monetary evolution expected for the month. The monetary expansion associated with purchases entails a partial increase of the monetary base target in January ($5.36 billion), since it is effective only for a few days of the month as from which such purchases are made. This increased target will be effective in full during February ($10.82 billion).

During the last quarter of 2018, with a more competitive exchange rate and a contraction in the economic activity level, there was a significant adjustment of Argentina's current account deficit. The BCRA estimates that the annualized deficit of the quarter (seasonally-adjusted) would stand at levels close to 1.2% of GDP, from levels over 6%. This correction of the external imbalance is a critical component as from which our economy may start to grow on more sustainable foundations.

The BCRA's remunerated liabilities, made up mainly by LELIQs as from the unwinding of LEBACs, remained stable in nominal terms during the quarter. The interest paid on such liabilities was offset by the stock reduction made in December to cater for the seasonal increase of the monetary base considered in the monetary scheme. In terms of GDP or international reserves, the remunerated liabilities of the BCRA dropped significantly.

The Central Bank of Argentina considers that the monetary plan effective since October 1, 2018 has been an essential tool to start reducing the nominal volatility in place in previous months. The monthly inflation rate has gone down if compared to the levels recorded in September and October, but it is still high. The BCRA will continue working with prudence and perseverance to help this evolution to consolidate.