1. Monetary Policy: Assessment and Outlook

Since October 2018 the Central Bank of Argentina (BCRA) has been implementing a monetary regime based on a stringent control of the monetary base and the definition of an exchange reference zone (previously called non-intervention zone). During the second quarter of the year, the BCRA has complied, month after month, with its zero growth target of the monetary base, which remained at $1,343.2 billion.

The regime based on monetary aggregates helped reduce the nominal volatility in place up to the third quarter of 2018, while the inflation rate started to decelerate from the monthly peak of 6.5% recorded in September 2018. However, during the first quarter of the year, the concentration of increases in regulated utility prices and the delayed impact of 2018 exchange rate depreciation, added to a new episode of foreign exchange volatility, contributed to a new acceleration of the inflation pace.

Against this backdrop, the BCRA's Monetary Policy Committee (COPOM) adopted a series of additional measures during March and April 2019 aimed at reinforcing the monetary-exchange regime: 1) it reduced the monetary base target by $43 billion, eliminated the seasonal adjustment of the target to be performed in June, and extended the monetary base zero growth commitment, initially effective until June 2019, to the end of the year; 2) it established a minimum value for the reference interest rate; 3) it set at zero the increase of the bounds of the exchange reference zone, leaving the upper bound constant at $51.448/US$1 and the lower bound at $39.755/US$1 until the end of 2019, and decided to refrain from purchasing foreign currency if the exchange rate stood below the reference zone; and 4) it authorized the sale of foreign currency in the exchange market vis-à-vis episodes of excessive volatility, even if the exchange rate stands within the reference zone.

Within a context of better international conditions, the measures adopted by the BCRA and the implementation of a contractionary monetary policy helped stabilize the foreign exchange market and inflation expectations, thus allowing for inflation to resume its declining path as from April. In turn, these measures, added to a series of initiatives launched by the Executive Branch to underpin household spending, helped the economic activity to continue with the recovery process started in December 2018.

As a result of a scenario of lesser nominal volatility and the decline of inflation expectations, the nominal interest rates of Liquidity Bills (LELIQs) tended to go down since early May to the minimum level of 62.5%, which had been established from April to late June. In order to ensure the contractionary bias of its monetary policy and showing some caution in the face of potential episodes of uncertainty, the COPOM reduced the floor of the reference interest rate to 58% during July. This reduction entails an admission that the inflation rate and inflation expectations have gone down in recent months but, at the same time, it also admits that the economy is still undergoing a period of uncertainty. In this way, the BCRA ensures that the real interest rate remains at high positive levels.

Likewise, in order to promote competition among financial institutions and improve the transmission channel of the reference rate to the interest rates paid to savers, the BCRA has allowed bank clients to make time deposits online at any financial institution without the need of being client or complying with any other formalities. As a result of this measure, there was an increase in the interest rates on retail time deposits, which came closer to the rates paid on transactions for higher amounts.

Compliance with the target is especially stringent in June and July, due to the seasonal behavior of the monetary base demand, which increases upon the payment of the semi-annual complementary wage and the higher expenses related to the winter vacations. In order to improve the management of liquidity conditions during this period, the BCRA decided to establish a bimonthly reserve requirement position for July and August, and also for December and January, when the same seasonal behavior is observed.

In addition, to contribute to strengthening the transmission channel of the LELIQs interest rates, the BCRA decided to reduce by 3 percentage points (p.p.) the regulatory minimum cash requirement on time deposits as from July. This entails a reduction of the monetary base demand due to minimum reserve requirements of around $45 billion, which offsets the seasonal increase of the demand for cash held by the public. After the end of this seasonal behavior and for the purpose of keeping the contractionary bias of the monetary policy, the monetary base target will be reduced as from August to reach $1,298.2 billion in October, thus totally offsetting the effect of the reduction in minimum reserve requirements.

The Central Bank of Argentina considers that macroeconomic conditions have been set for a sustainable disinflation process, since the economy has regained its basic macroeconomic balances. The fiscal balance is already at the doorstep and no monetary financing has been required from the Treasury. Today, the exchange rate is competitive, standing at a level 50% higher than the value recorded before the unification of the foreign exchange market in December 2015, and this has allowed for correcting the external sector imbalance. In addition, the distortions resulting from lags in energy prices have been virtually eliminated. In turn, the BCRA has a strengthened balance sheet, with a sustainable level of remunerated liabilities and an adequate stock of international reserves, added to higher degrees of freedom to intervene in the exchange market.

However, disinflation processes tend to be gradual and non-linear, since the monetary policy has a response lag and inflation has an inertial component, which is even more marked after more than a decade of high inflation. Thus, the contractionary bias of the monetary regime will be kept throughout 2019 and the reference interest rate is expected to decline gradually and only to the extent that the inflation rate goes down. Nevertheless, this medium-term trend might also be temporarily disturbed if any of the risks to which the economy is exposed effectively materialized, such as a new episode of volatility in global financial conditions or the usual uncertainty inherent in electoral processes. In the current regime, the endogenous interest rate allows for a quick response in the face of any sudden disturbance.

For the reasons mentioned above, the BCRA must persevere in its policy based on the stringent control of the amount of money and achieve, as a result, a long-lasting reduction of inflation, providing an environment of stability conducive to economic growth.