5. Monetary policy still tight and based on positive real interest rates

Until inflation expectations converge to the Central Bank target

The Central Bank set its inflation targets within a more ambitious range (17%-12% in 2017 and 12%-8% in 2018) using the CPI INDEC, which at the moment is the official index with the largest geographical coverage, since a national CPI still does not exist. The monetary authority said it will create the necessary conditions for monetary and exchange rate policy to meet those goals as it did during 2016, keeping the monetary policy rate in positive territory in real terms. Strategies to achieve this will be based on a floating exchange rate system, using the interest rate as a monetary policy instrument, breaking the fiscal dominance and transparent communication of monetary policy decisions. However, this year some methodological changes will be making a debut: the monetary policy rate will be the swaps brokers' average rate to be announced every 15 days and there will be only be one Lebac tender per month, for which an attempt will be made to concentrate the maturities that, until now, have been weekly. Monetary policy meetings will also be spaced at fortnightly intervals starting in March, aiming to reach a monthly or smaller periodicity like other Central Banks as the disinflation programme progresses.

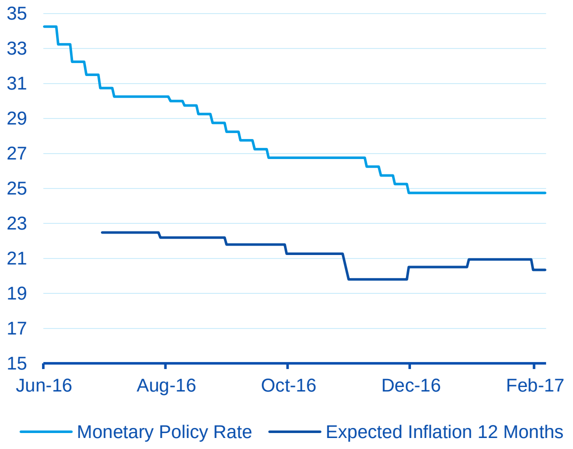
In this new scheme, the BCRA's challenges are not insignificant, since a big reduction needs to be achieved in inflationary inertia in a context of consolidation of public accounts and a very gradual reduction in fiscal dominance. The success of the disinflation programme will depend crucially on its credibility and on the signals it issues on monetary astringency through the single instrument of the monetary policy rate, given its limited impact in a country where the credit to GDP ratio only reaches 13%. We believe that the exchange rate will not be a destabilising factor in either 2017 or 2018, but it cannot be ignored that there is still a long way to go to make consensus inflation expectations converge to official targets, especially in a context where significant changes in relative prices are still required.

In recent months, unclear signals regarding a continued decline in the inflation rate led the Central Bank to keep the monetary policy rate at a level of 24.75% during December last year and January this year, after having trialled scaled decreases from a high of 38% in April 2016 until November. We estimate that the Central Bank will continue to reduce the intervention rate more gradually during the rest of 2017 to reach 19% in December as analysts' consensus inflation expectations remain at 20.8%, even higher than the upper band of the BCRA's target for the next 12 months (Figure 5.1). However, it cannot be ruled out that the Central Bank will decide to raise the rate promptly at some point, if it is observed that inflation's downward resistance is persisting or expectations begin to increase. In line with the BCRA's medium-term commitment to maintaining a nominal policy rate above inflation, for the end of 2018 we expect a policy rate declining to around 11% vis-à-vis the 8.5% rate expected for inflation over the next 12 months, or a real positive rate of around 2.5%.

The only quantitative monetary objective announced for 2017 will be to reduce the Lebac+Swaps / Monetary Base ratio to 81.1% (it finished at 85% at the end of 2016). Although it is a desirable objective, its success could be complicated while the Central Bank continues to buy foreign currency that needs to be sterilised by issuing Lebac to regulate the amount of money. The Lebac stock has experienced exponential growth in the last year (see Figure 5.2), which together with the increase in the interest rate will continue to raise the Central Bank interest rate to figures incompatible with the objective of lowering the inflation rate. The BCRA argues that the risks are lower because Lebac's larger stock will be backed by liquid reserves that can be used if there is any turbulence, while a more professional management of reserves, such as the one it intends to carry out, will increase its yield and reduce the quasi-fiscal deficit.

Figure 5.1

Monetary Policy Rate vs Expected Inflation over 12 months



Source: BBVA Research

Figure 5.2

CB Swaps + Lebac ratio / Monetary Base

Source: BBVA Research

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