5. The Central Bank raises the monetary policy rate

Even after the hike, inflation expectations remain above Central Bank target

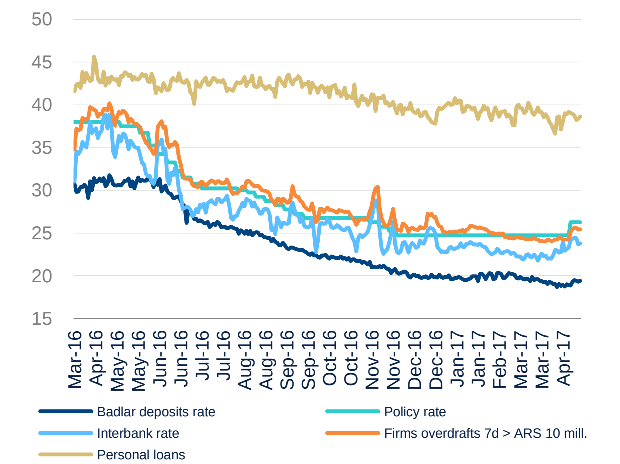
The Central Bank reacted to the latest inflation data by raising the monetary policy rate by 150 bp in April, which took the market by surprise. Monetary policy had already begun to be tightened in March, the money growth rate was reduced and the Central Bank sold short term bills (Lebac)with the aim of increasing the rates on these instruments in the secondary market. The April primary Central Bank Lebac auction (which is now run on a monthly basis) also drove rates up after several months during which gradual drops in interest rates had been accepted by the BCRA in each tender.

The hike in the monetary policy rate began to be reflected in more sensitive rates, such as the interbank rate and overdrafts, which reflect in the short term the financial system's liquidity conditions, while the adjustment to the Badlar deposits rate tended to be slower (see Figure 5.1). The Central Bank's decision caused certain apprehension due to fears that a new rate rise could set back the gradual recovery in economic activity.

During the second half of 2016 the inflation rate's resistance to falling led the Central Bank to maintain the monetary policy rate at a steady 24.75% from December last year until April this year, having piloted scaled drops during the first half of the year from a maximum of 38% in April. We estimate that the monetary policy rate will continue to drop more gradually during the rest of 2017 to reach 21% by the end of 2017 as analysts' consensus on inflation expectations remains above the upper band of the Argentinian Central Bank's target for the next 12 months. The results of the survey on market expectations for April indicate that the market does not expect inflation to meet the target and that the downward path for the monetary policy rates this year and next year will be slower than previously estimated (see Figure 5.2).

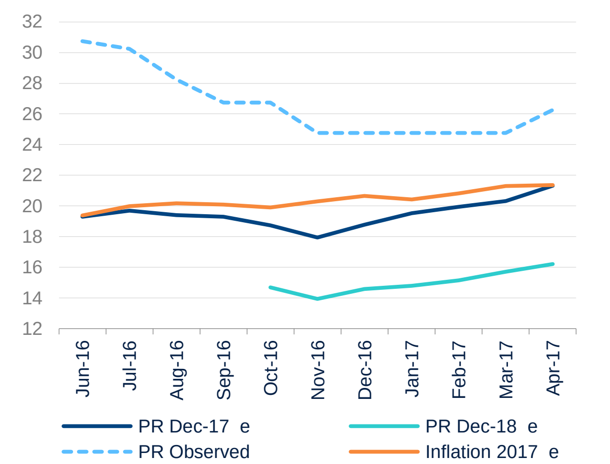
The 2017 target (12%/17%) continues to look difficult to achieve even after the interest rate hike. While the fiscal deficit targets for 2017 announced last year were revised up (the primary deficit projected by the government for 2017 was raised from 3.3% to 4.2% in 2017) the inflation targets remained unchanged, in spite of the fact that there was an opportunity to revise them up when the inflation targeting scheme was formally released in September 2016. Therefore, market expectations for inflation are still relatively high compared to targets, probably due to the impression that there is a lack of consistency between monetary and fiscal policy.

Figure 5.1 Interest rates (%)



Source: BBVA Research and Argentinian Central Bank

Figure 5.2 Monetary policy rate (PR) and inflation expectations (%)

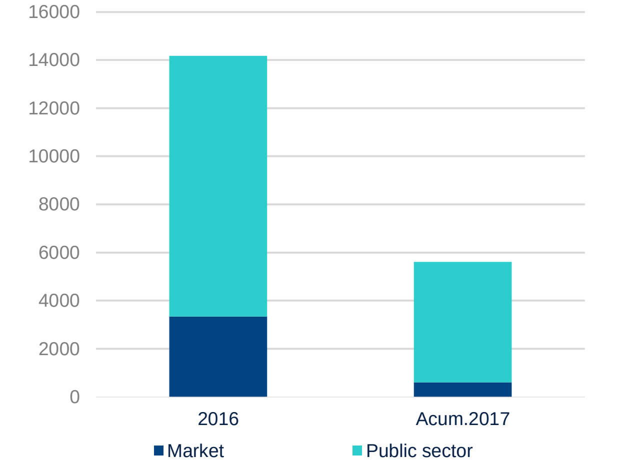


Source: BBVA Research and Argentinian Central Bank

Regarding the exchange rate policy and its impact on monetary policy, although a floating regime was adopted for the exchange rate, the Central Bank has intervened ocasionally in the private exchange market. However, the purchase of hard currency originating in public and private sector debt issues (see Figure 5.3) has led to a significant need for sterilisation which constantly pressures the Central Bank's stock of Bills (Lebac) up.

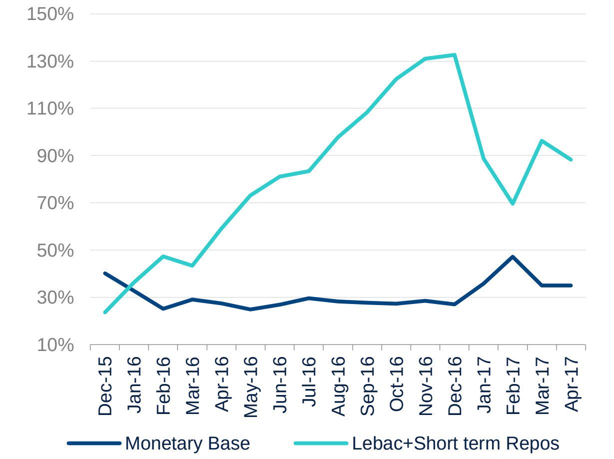
Although the monetary growth rate was finally reduced in April and the monetary base fell 1.5% on a cumulative basis this year, it is still growing at rates of around 35% Y/Y even considering the Central Bank's vigorous sterilization policy (see Figure 5.4). This amount of absorbed liquidity, whether using repos or Lebac's, is also explained by the reduction in reserve requirements mandated by the Central Bank (2 percentage points in March) together with the slow rise in loans to the private sector which compels the financial system to place its excess liquidity in Central Bank instruments. This situation will continue to put the Central Bank under pressure this year, as long as inflation continues to take its time to fall to target levels and slow recovery in economic activity does not trigger stronger growth in loans to the private sector.

Figure 5.3 Central Bank currency purchases (USD millions)



Source: BBVA Research and Argentinian Central Bank

Figure 5.4 Monetary Base and Central Bank Bills (Lebac)+Repos Stock (% change YoY)



Source: BBVA Research and Argentinian Central Bank

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