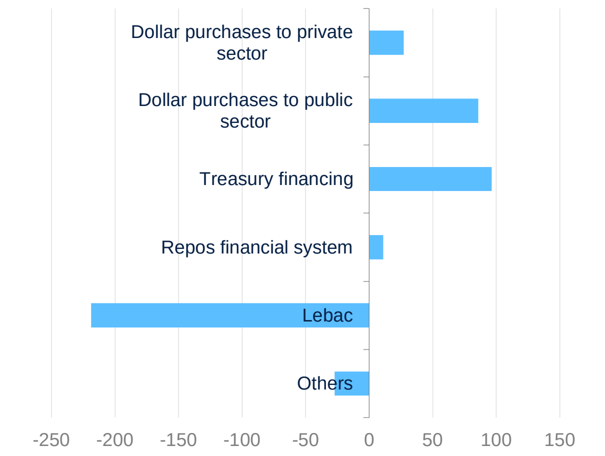
5. The tightness of the monetary policy continues

But we expect pressures on the exchange rate to moderate in the 2nd semester

Due to the strong monetary stringency of the first quarter of last year in which the Central Bank sterilized the "monetary overhang" of the previous administration, if compared in inter-annual terms, the Monetary Base rose by 29% in June, but grew only minimally by 1.3% between June 2017 and December 2016. This is due in part to the reduction of 2 percentage points in bank reserve requirements, which the BCRA implemented from March 2017, and which led to a fall in bank accounts at the Central Bank.

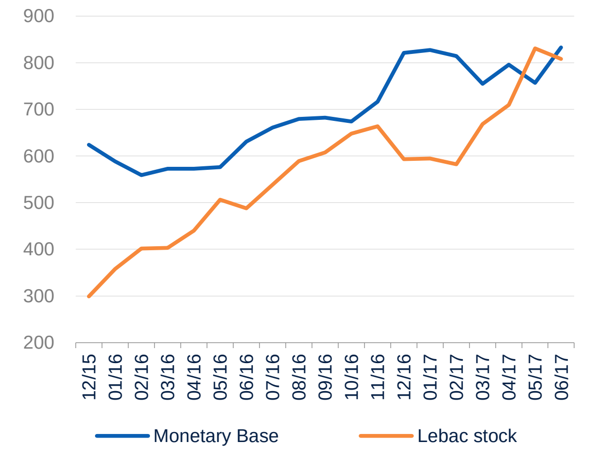
Apart from these statistical effects, monetary policy remained tight given that the creation of pesos from purchases of foreign currency (mainly from the placement of public sector debt) of ARS104.5 billion and from short term loans to the Treasury of ARS 96.5 billion were mostly sterilized by Central bank sales of short term bills, Lebac, (ARS109.5 billion) and reverse Repos (Figure 5.1). In this context, deposits in pesos from the private sector increased by 10.3% between June and December 2016 and loans by 15.7%, while Lebac stock grew by 43.3% in the same period (Figure 5.2). In addition, anticipating a 150 bp increase in Monetary Policy Rate in April, the BCRA had been actively pushing up the Lebac rate in secondary market since March, so as to bring it closer to the monetary policy rate (Figure 5.3).

Figure 5.1 Factors of Expansion and Contraction of the Monetary Base (Jan to June 2017, ARS billion)



Source: BBVA Research based on BCRA data

Figure 5.2 Monetary Base and Lebac stock (ARS billion)



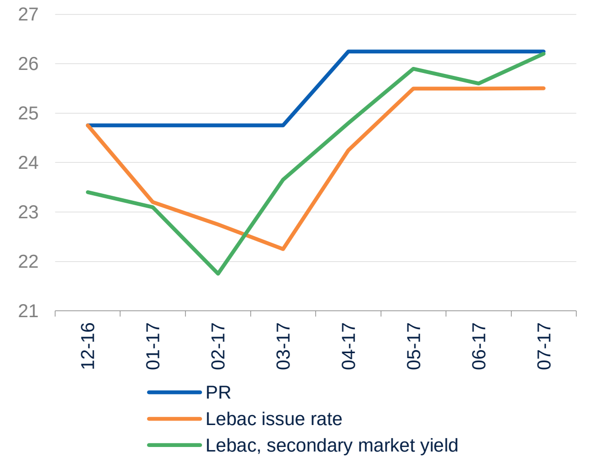
Source: BBVA Research based on BCRA data

The BCRA will be cautious in its reduction of the monetary policy rate after having recognised its haste in lowering it at the beginning of 2017. In line with our declining inflation forecast of the second half of the year, we estimate that it will gradually cut the Monetary Policy rate (MPR) at around 100 bp per month from August to reach 21% by December 2017. This results in a rate which is still high in real terms (about 8%) compared to expected inflation of the next 12 months and is in line with the Central Bank's intention to sustain positive real rates for the duration of the disinflation process.

While this level of interest rates will continue to attract short-term capital inflows, it is expected that in the rest of the year the excess supply of foreign exchange will shrink compared to the first half of the year. Despite the fact that the flow of exports in 2H17 may remain a lilltle above the usual seasonality, due to the delay observed in the settlement of the soybean crop, national public sector debt placements planned for the year are practically already 95% complete. The demand for imports will begin to grow, as the proximity of the elections will encourage hedging by companies and add some volatility. In this context, the exchange rate will depreciate at a higher rate (8.2%) in the second half of the year (even slightly above expected inflation), unlike the first half of 2017 in which the FX only weakened by 1.8% between the average of December 2016 and the average of June 2017.

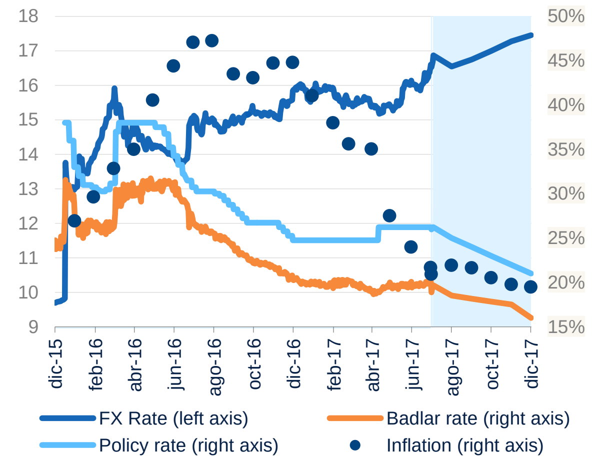
Recent episodes of rapid depreciation in exchange rates (spreading from Brazil because of the political scandal affecting President Temer and market disappointment regarding the non-recategorisation by the MSCI of Argentina as an emerging market) were followed by partial reversals, without altering the medium-term trend, but they contributed to reducing the certainty of outcomes on carry trade strategies in a context where lower interest rates and more FX volatility are expected in the second half of the year. From mid-June, this trend deepened after the announcement of the lists of candidates for the primary elections of August, and the peso depreciated 5% in 2 weeks moving forward the weakening we were expecting in the months leading up to the October elections. For the moment, we maintain our forecast of ARS17.5/USD for December 2017 and ARS18.8/USD for December 2018 although, beyond the fundamentals, in the second half of the year the value of the peso will continue to move at the pace of electoral surveys and political scenarios (Figure 5.4).

Figure 5.3 Monetary Policy Rate and Lebac in %



Source: BBVA Research and BCRA

Figure 5.4 Exchange rate forecasts (ARS/USD) and interest rates (%)



Source: BBVA Research and BCRA

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