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4. Difficult process of disinflation in a context of rising tariffs and a high level of inertia

Despite the highly contractive tendency of monetary policy in 2H17, neither inflation nor expectations converged towards targets and this led to a “recalibration”.

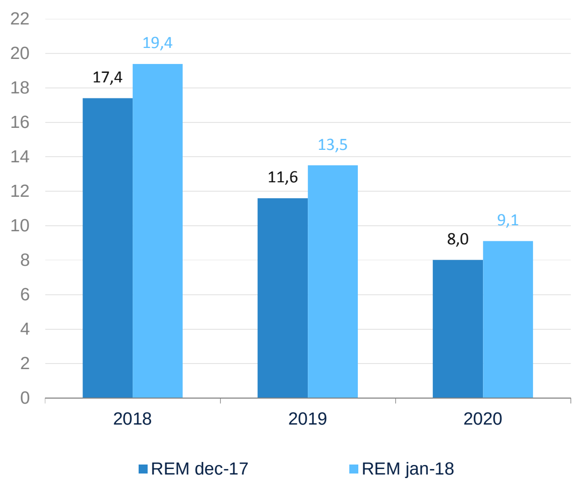
Inflation for 2017 closed at 24.8% YoY, well above our initial predicted levels (we were expecting 19.5% in December 2016) and market expectations (REM-BCRA Dec-16: 19.6%) due to a bigger-than-expected impact from correction for delayed price controls and greater inflation inertia than that initially expected. The fall of core inflation to a monthly average of 1.4% in 4Q17, the smallest moving average since 2012, was not enough for the forecasts in the central bank’s Market Expectations Survey (REM) to converge on lower levels by the end of the year, with the increases forecast for December having taken place for electricity, gas, fuel, pre-paid medicine rates and others besides. The deregulation of fuel prices – now fluctuating with the international crude oil price and the exchange rate – together with the accelerated scheduling for rises in electricity and natural gas rates, resulted in regulated prices rising 38.7% YoY in 2017 with an impact of 7 percentage points on inflation for the year, comfortably surpassing the rise in core inflation of 21.1% YoY.

The extremely contractive trend in monetary policy as reflected in the 250bp hike in the MPR in the last quarter of 2017 was also unsuccessful in making analysts’ expectations converge, as by the end of 2017 these had risen again to 17.4% for December 2018, in contrast to the central bank’s target of 10% +/-2%. Finally, at the end of December the government announced a “recalibration” of inflation targets.

In a joint press conference by the Chief of the Cabinet of Ministers, the Minister of the Treasury, the Minister of Finance and the chairman of the central bank, Minister Dujovne announced that it had been decided to change the inflation targets originally announced in January 2016 on the basis of information now available and taking into account the current fiscal and financial agenda. The goal of reaching inflation of 5% YoY was thus postponed by one year, and precise targets have been adopted instead of ranges. The specific inflation target for 2018 is now 15% (previously 10% +/-2%), that for 2019 10% (formerly 5% +/- 1.5%), and that for 2020 is 5%. The presentation made it clear that the inflation target is decided by the Executive and that the central bank’s autonomy is on an operational basis of how to achieve such targets, which clears up the criticism that centred on the central bank’s targets being overly rigid and “lacking in coordination” with the rest of the economic programme.

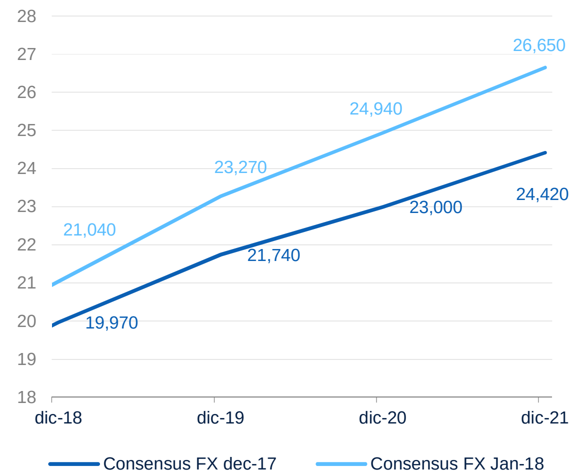
It is still too early to gauge the impact of this change on the central bank’s credibility, but the immediate effect was a rise in the inflation expectations of REM analysts to a median level of 19.4% (Figure 4.1). The prospect of a loosening of monetary policy after the change in targets, which the central bank validated with two successive cuts of 75bp in January 2018, also sparked a rapid exchange rate depreciation, which was as much as 10% in one month, and lifted expectations of peso depreciation (Figure 4.2).

Figure 4.1 Inflation expectations in the REM-BCRA (YoY var. in domestic CPI expected in December each year)



Source: BCRA and BBVA Research

Figure 4.2 Exchange rate expectations (expected ARS/USD rate for December each year)



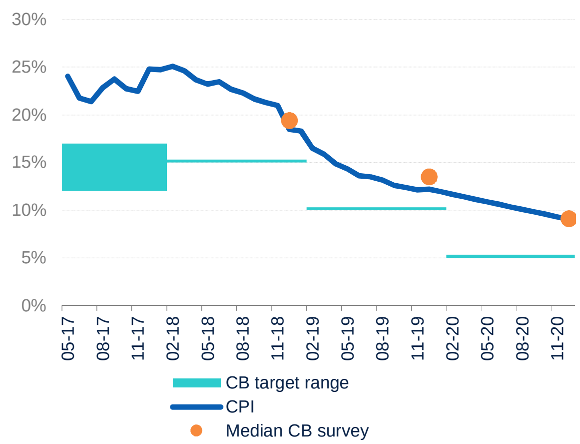
Source: Latinfocus and BBVA Research

The de-anchoring of expectations is prompting an upward revision of our inflation estimates

In 2018, the schedule for reducing energy and transport subsidies (concentrated in the first half) will have the effect of a rise in regulated prices in 2018 of 21.9% YoY, which is less than the increase in 2017, also with a smaller impact of 4 p.p. (Figure 4.4). The inflow of capital to finance the fiscal deficit and the gentle recovery of long term foreign investment will contribute to containing the peso's rate of depreciation over the rest of the year, although the *pass-through* effect of January's sudden rise in the exchange rate remains to be assessed. While in previous episodes once the "clamp" of currency controls had been removed, the "pass-through" to depreciation prices was low, such an effect could now increase given that no sudden reverse in the exchange rate is observable and the depreciation takes effect against more relaxed monetary policy. Although the recovery of agricultural commodity prices and the oil price could work against price containments, this is unlikely to have a big impact over the rest of the year as we think that the oil price will back-track relative to current levels, thereby avoiding any sharp adjustment in fuel prices, which have been deregulated and now move in line with the international price. Nonetheless, what should decide the contest are likely to be the wage agreements that will be bargained in 1Q18 and to what extent these come close to the central bank's target of 15% or market expectations. The few special bargaining committee negotiations agreed for 2018 show strong discrepancies and the government is now encouraging wage rise agreements of around 15% with a "wage review" clause in the final quarter in case inflation should surpass the rises provided for.

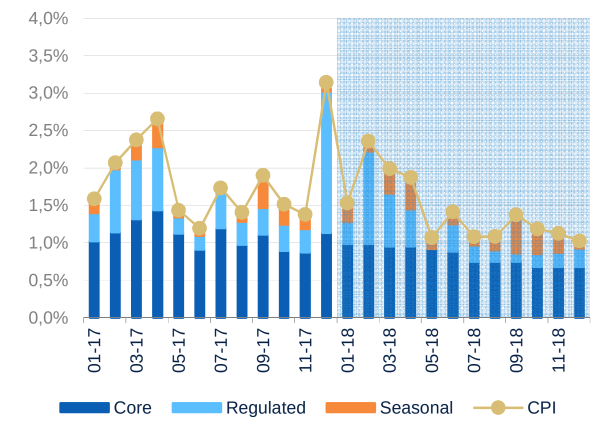
The waning credibility of the central bank makes it harder for wage agreements and expectations of 15% to meet each other, leading to inflation estimates rising to 19.4%, above the level of 17.4% before the change. Bearing in mind the rise in expectations, the higher level of depreciation and the signs of a more *dovish* central bank, we are changing our CPI rise forecast to 18.5% for 2018 and 12.2%% for 2019 (Figure 4.3). Whatever the case, both we and the market foresee a path of disinflation that will end in single-digit inflation in 2020, though not at the pace required by the recently re-defined inflation targets.

Figure 4.3 Inflation expectations, forecasts and BCRA targets



Source: BBVA Research based on INDEC and BRCA data

Figure 4.4 Inflation. Increase in regulated prices by month, Domestic CPI in 2017 and 2018



Source: BBVA Research based on INDEC data

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This report has been produced by the Argentina Unit

Head Economist Argentina
Gloria Sorensen
gsorensen@bbva.com

Marcos Dal Bianco
marcos.dalbianco@bbva.com

Juan Manuel Manias
juan.manias@bbva.com

María Celeste González
celeste.gonzalez@bbva.com

Andrea Savignone
asavignone@bbva.com

Adriana Haring
aharing@bbva.com

Jorge Lamela
jorge.lamela@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Economic Situations
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Long term Global Modelling and Analysis
J. Julián Cubero
juan.cubero@bbva.com

Innovation and Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems And Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

International Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China and Big Data
Álvaro Ortiz
Alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

China
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Perú
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research - BBVA Banco Francés: Reconquista 199, 1st floor. C1003ABC - Buenos Aires (Argentina).
Tel.: (+54) 11 4346 4000 / Fax: (+54) 11 4346 4416 - bbvaresearch@bbva.com www.bbvaresearch.com