# 5. The loosening of monetary policy will slowly feed through to financial system interest rates

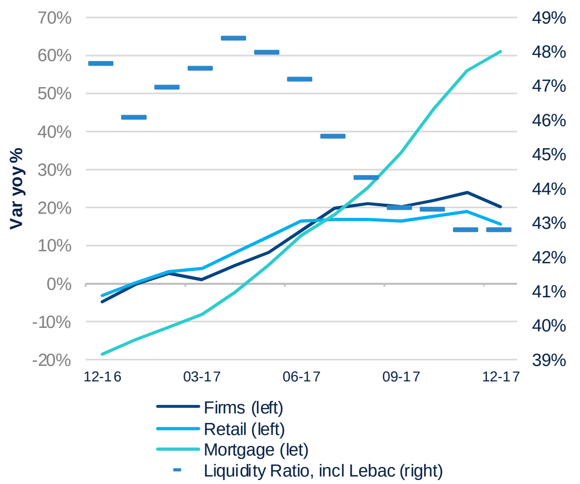
Thanks to powerful sterilisation via Lebacs, monetary base expansion closed 2017 with a change of around 21.8% YoY, below inflation. Private sector credit expanded at a rate of 50.2% YoY as of December 2017, while total deposits (pesos plus dollars) grew at rates considerably under 37.8% YoY, given the strong interest in Lebac investment. Even so, bearing in mind the liquidity that still prevails in the financial system, the feed-though of the central bank's 250bp intervention rate hike in the last quarter of 2017 to short term rates was slow and only showed through in a 200/250bp rise in lending and deposit rates towards early December (Figure 5.1).

The target postponement in the recently announced inflation reduction process allow the central bank chairman some margin to relax monetary policy somewhat, following the sharp rate hikes implemented in the last quarter of 2017 in an attempt to meet the previous targets. In fact, in the Lebac auction the day after the announcement, the cut-off yields were trimmed by 200-300bp depending on the term involved, and this fall was later borne out by a 75bp cut in the MPR in each of the monetary policy decisions in January. The central argument of the chairman of the central bank was that the real interest rates of around 10.8% at which 2017 had ended were excessively high compared to the new target and the progress achieved in reining in inflation, so it was appropriate to reduce the contractive bias to monetary policy on the side of "caution". Nonetheless, the rapid rise in inflation expectations after the change in targets implies that the real expected policy rate came down by 300bp in January 2018.

In this context we estimate that the central bank will continue to lower the policy rate very gradually, especially in the first four months of 2018, given that the inflation figures that will come out (inflation is expected to hold at close to 2% MoM) will not give cause for optimism, while inflation expectations have shifted significantly upwards. Bigger progress in bringing down core inflation in the second half will allow the central bank to increase the pace of bringing down the MPR until it reaches 21% by year end. In any event, if expectations converge towards our estimates for core inflation for early 2019, the real MPR will be 8% at the end of 2018, which is still strongly positive in real terms (Figure 5.2).

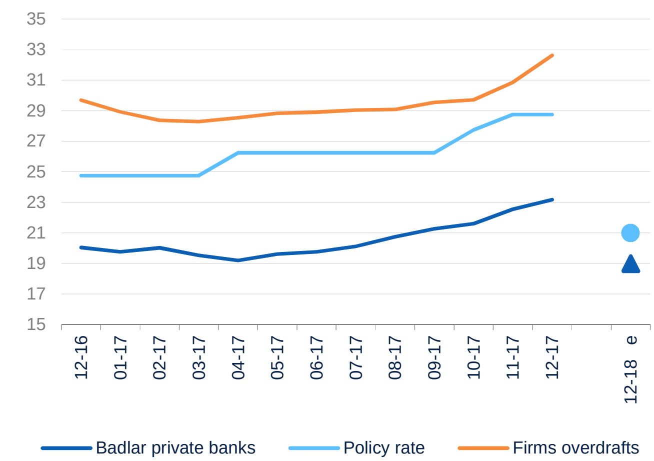
The lowering of the MPR slowly filtered through to short term loan rates and, to a lesser extent, the fixed-term deposit rate in January. As the banks continue to offload their Lebac holdings to allocate credit to the private sector, the process of adjustment of surplus liquidity that began in the second quarter of 2017 will continue to deepen and culminate in the course of 2018. Going forward, deposit rates are likely to fall at a slower pace than loan rates, reflecting less slack in the ratio of credit to deposits and greater leveraging in the system.

**Figure 5.1** Growth of credit in real terms and liquidity ratio of the financial system (%)




Source: BBVA Research based on BCRA data

**Figure 5.2** Monetary Policy Rate and bank lending and deposit rates (%)

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