Monetary Policy: Assessment and Outlook

The world has striven to weather the impact of COVID-19 in the last few months, and Argentina has not been an exception. Shortly after the first case of COVID-19 was identified in Argentina, the National Government implemented containment measures and decreed a social, preventive, and mandatory lockdown on 19 March. As a result, workers other than those considered essential could not attend work, causing economic activities to come to a halt. In the absence of effective antiviral treatment or a vaccine against COVID-19, the early adoption of mitigation measures has so far prevented the health system from imminent collapse, and significantly limited death tolls in Argentina.

The pandemic hit the country during a period of economic and social emergency triggered by the adverse effects of the 2018-2019 balance of payments and debt crises, with a recession of more than two years —the longest since the 1998-2002 crisis— and record inflation since the early 1990s. The toughest moment of the lockdown agreed with the public debt restructuring offer under foreign law. The negotiation with bondholders was expected to happen in times of high financial volatility in the domestic market.

The magnitude of the domestic and international shocks of the pandemic is still uncertain. However, early activity indicators and available projections reveal that the pandemic outbreak is only comparable to the Great Depression of the 1930s. The depth of the recession will depend on several factors, such as the lifespan and effectiveness of health mitigation policies; the precautionary behavior of households and businesses affecting private-sector consumption and investment; and the effectiveness of fiscal and monetary policies deployed during the emergency. In turn, the timing between domestic and global economic cycles has a bearing on Argentina's situation. Against the backdrop of high uncertainty, the most optimistic preliminary projections of a fall in global activity by 2020 are around 3%, which double the figures recorded during the 2008-2009 global financial crisis. The GDP contraction in Argentina is expected to be even more significant.

In March and April, high-frequency indicators began to show the extent of the economic crisis Argentina is facing due to the pandemic. Total retail sales fell by a half. The unprecedented nominal wage reductions agreed by companies and trade unions in exchange for preserving jobs in non-essential sectors hindered the incipient recovery in real wages promoted by the Government since last December, and flag a low level of consumption. Likewise, the performance of supply, affected by the non-residential energy consumption, slid down up to 25% in essential activities, and between 75% and 90% in those directly affected by restrictions on labor mobility. Industrial production and construction shrank by 17% and 32%, respectively, between February and March.

The epidemiological nature of the shock and the health approach to the crisis allow to foresee three phases within this economic cycle marked by strong offer restrictions in the first stage, and progressive relaxation later to finally reach a return to a "new routine". This dynamic will also be reflected on a bias in economic policies. In the first phase, social lockdown measures hampered "non-essential" productive activities; and the GDP contracted, despite some easing was observed at geographical and activity levels. At this stage, the economic policy was focused on supporting the most vulnerable sectors and preserving the productive and financial fabric. In the second phase, starting by the time this report is released, people's mobility is further eased under strict health regulations, and most activities in most productive sectors are progressively restored with security protocols. The measures aimed at stimulating demand will gradually become more meaningful. In the third phase, while going through the recovery of the economic activity and having no restriction on supply after health conditions come to normal, the level of activity is expected to be close to that recorded before the pandemic.

Within the first phase, the National Government strived for avoiding the deterioration of household income, assisting businesses to preserve employment, and ensuring the normal operation of essential services, and strengthening public health expenditure. These policies led the GDP to accrue 2 points. The fiscal cost of the crisis is estimated to be around 4% of the GDP—based on both higher expenditures and lower tax revenues derived from tax relief and falling activity.

The BCRA has played an essential role in cushioning the impact of the crisis, by striving for (1) adapting the operation of the financial system to the social, preventive, and compulsory lockdown; (2) easing the financial situation of businesses and households; (3) protecting households' savings in pesos; and (4) channeling credit to the productive sector.

The BCRA safeguarded natural and legal persons' savings in pesos by setting a minimum interest rate of 70% of the LELIQ rate for time deposits. The annual nominal interest rate currently stands at 26.6% (30.1% EAR). This instrument, together with the early-payment UVA time deposits, ensure that small savers get a positive interest rate in real terms.

To boost productive credit, the BCRA implemented credit lines at a subsidized interest rate, moving on the direction of a managed expansion of liquidity through LELIQs and repos to streamline their trading. These measures led to a historical record of credit granted to the financial system, judging by the amount and speed at which they entered the market. Credit was further channeled to unbanked MSMEs by means of a special line, PYME PLUS, which requires a guarantee from the Argentine Guarantee Fund (Fondo de Garantías Argentino, FoGAr). Upon the release of this report, the loans granted and to be granted to MSMEs, the main driving force behind employment in Argentina, and to health service providers amounted to $223.28 billion. Disbursements amounted to $183.87 billion, and reached 113,618 companies. Furthermore, 15 days after being introduced, financial assistance for self-employed workers under the simplified tax scheme and the self-employed through a 0% credit line totaled $19,89 billion and reached 151,443 individuals.

Finally, the BCRA made available the necessary resources to finance the fiscal measures implemented by the Government, without having to access international credit during the external debt restructuring process. Existing capital controls enabled to smooth foreign exchange volatility, thus avoiding further inflationary pressures and contributing towards the preservation of the financial stability. In this context, international reserves remained stable.

The managed floating exchange rate system promoted by the BCRA, along with a deferral of new utility rates gave way to a decrease in inflation. During the first quarter of 2020, monthly inflation averaged 2.5%, down 1.3 p.p. against September-December 2019. Within this framework, the price of some high-consumption goods highly increased on a proportionate basis due to the end of the VAT exemption period. The Ministry of Productive Development provided for Maximum Prices for the basic food basket and basic products in order to ensure supply and restrain price abuse during the health emergency. It further agreed prices of medicines with leading players from the sector. In addition to these policies, the Preserved Prices program was launched, contributing to lower inflation in April, and, to remain, as expected, at limited levels over the coming months.

Monetary policy management during the emergency will require a major expansion of liquidity. Once the pandemic is over, the growing demand for money brought about by the economic recovery will help to absorb a significant share of the resources directed towards the market. Truly, the monetization of the Argentine economy was at the beginning of the pandemic at historically low levels. However, the BCRA has a wide range of tools to sterilize any excess liquidity that may arise in the aftermath of the crisis. The arrangement signed with the National Ministry of Economy to develop a powerful debt market in domestic currency will enable to channel excess liquidity to the latent financing needs in our economy.