The Covid-19 crisis response, monetary and fiscal policy interactions: the case of Argentina[1]

Central Bank of Argentina

Abstract

The Covid-19 crisis brought fiscal and monetary policy interactions back to the fore. In Argentina extraordinary fiscal and monetary policy interventions, in both quantity and quality, have played a major role in containing the impact of the pandemic. The policy response was heavily conditioned by the situation prior to the shock, which reinforced the key role of the central bank, in particular, to finance an adequate fiscal policy response to cushion household and business income. The challenge now is to normalise fiscal and monetary policy in a gradual and sustainable way, moving towards a balanced fiscal position, price stability and inclusive growth. One crucial element is to develop domestic capital markets to finance both public and private sector investment needs. The crisis may also have more general lessons for EME monetary authorities. To cope with more frequent episodes of high volatility, they will need to develop new tools , including an enhanced monetary policy toolkit. However, domestic policies are not enough on their own and international cooperation will be essential to ensure adequate liquidity at a global level.

JEL classification: E52, E58, E62, E63.

Keywords: Argentina, Covid-19, crisis response, fiscal policy, monetary policy.

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Introduction

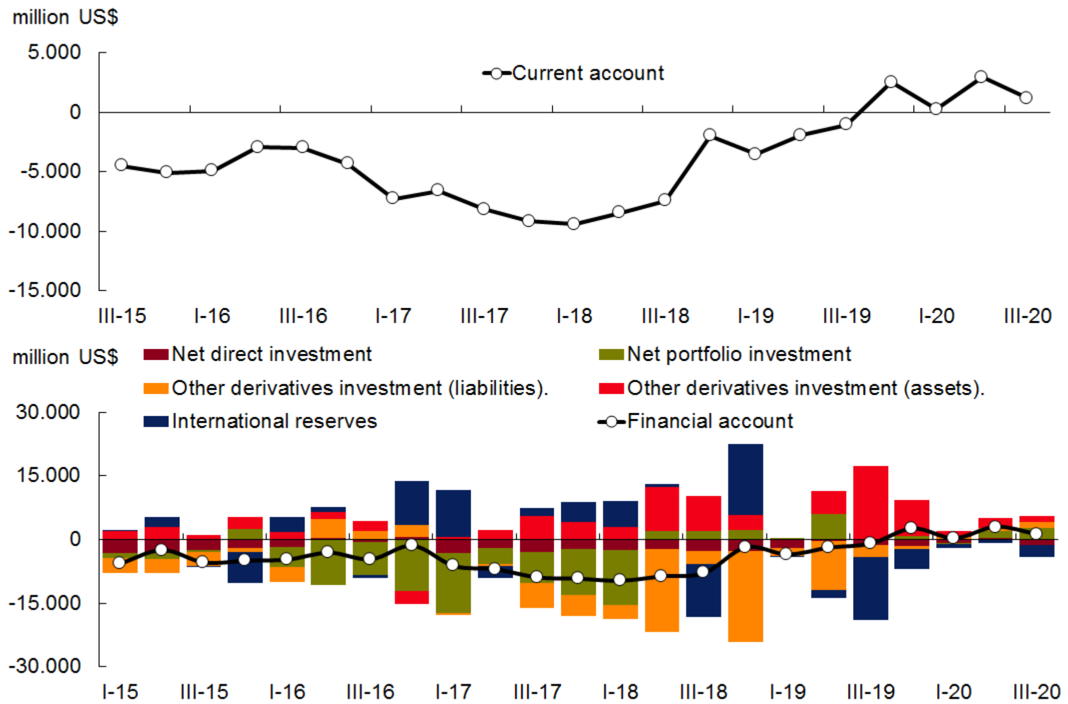
The Covid-19 crisis brought fiscal and monetary policy interactions back to the fore. As part of the response, both advanced and emerging market economies (EMEs) embarked on programmes that involved both fiscal and monetary authorities. This note reviews how Argentine economic policy responded to the crisis, considering the challenging pre-pandemic conditions; what the response implied in terms of fiscal expansion and monetary financing; how the central bank managed side effects and potential trade-offs; and the challenges ahead.

The economic impact of the Covid-19 pandemic

The Argentine economy was in a critical situation before the pandemic, with two years of recession – partially linked to the 2018 balance of payment crisis (see Graph 1) – an annual inflation over 50%, the unemployment rate at 10%, a poverty rate of 35.5%, and unsustainable public debt (see Graph 2). On top of the challenge of normalising the economic and social situation, the Covid-19 crisis made the task much more difficult.

Argentina pre-pandemic conditions – balance of payments

Graph 1

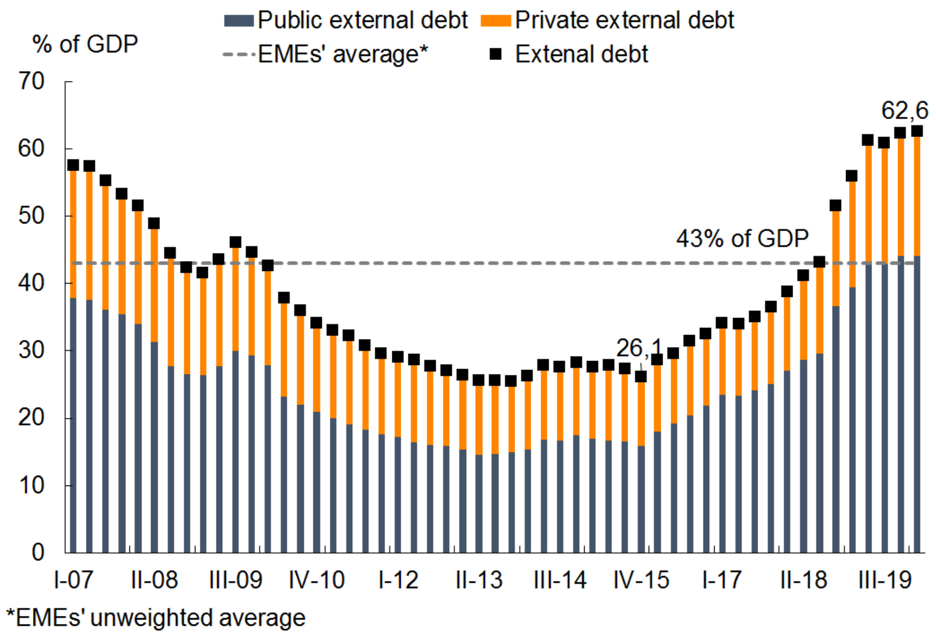


Source: INDEC.

In order to prepare the domestic health system for the pandemic, the Argentine government imposed a tight lockdown from 20 March 2020. Due to the combination of supply and demand shocks, economic activity bottomed out in April 2020, when output dropped 17% year on year. From May onwards, as restrictions were gradually lifted, all low and high-frequency indicators began reflecting a steady recovery (Graph 3). This has tended to concentrate in sectors such as industry, construction and commerce. Other activities, mainly services such as hotels, entertainment, tourism and transport, have seen a more persistent negative impact. By December 2020, the economic activity index (a monthly proxy of GDP) stood at 2.9% below pre-crisis levels, and activities representing 70% of the index had already reached pre-pandemic output. GDP fell 9.9% in 2020 and is expected to return to pre-pandemic output levels between late 2021 and 2022.

Argentina pre-pandemic conditions – external debt

Graph 2

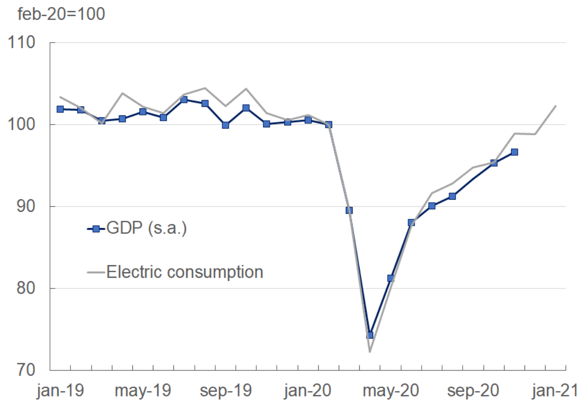


Source: Central Bank of Argentina.

Inflation has been falling from very high levels, reaching 36.1% year on year in December 2020, significantly below the 53.8% year on year recorded in December 2019. Gradual deceleration of the inflation rate was due to several factors: the managed floating exchange rate regime implemented by the central bank, which was instrumental in curbing exchange rate instability and thereby contributed to anchoring inflation expectations; retail price dynamics, affected by social distancing measures; limited wage rises; and the temporary freezing of utility prices and price controls over a basket of first-need products. At the beginning of 2021, consumer inflation increased due to the recovery of profit margins with the reopening of the economy, certain supply constraints and higher commodity prices. Since several of these factors are transitory in nature, inflation is expected to begin a process of gradual and sustained deceleration during the rest of the year.

Argentina: economic activity

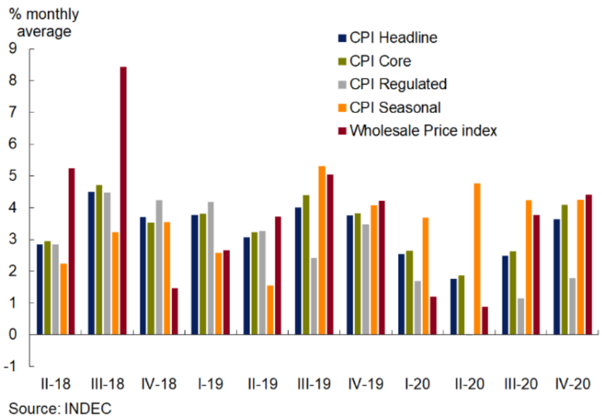
Graph 3a



Source: INDEC.

Argentina: inflation

Graph 3b



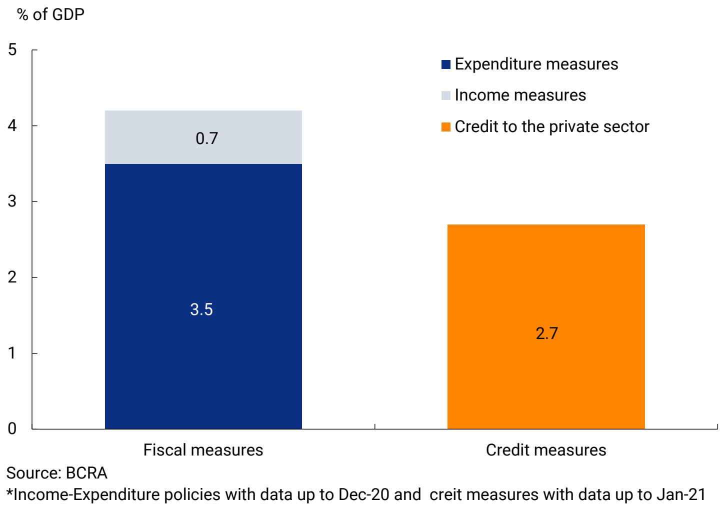
Source: INDEC.

Policy response

Extraordinary fiscal and monetary policy interventions, in both quantity and quality, have played a major role in containing the impact of the pandemic. In Argentina, the policy response to Covid-19 was heavily conditioned by the situation prior to the shock, as described above. The conventional trade-offs that monetary policy faces were made worse by these initial conditions, limiting monetary policy headroom.

The fiscal policy measures to deal with the pandemic have amounted to additional government spending of around 5% of GDP. In a short time, new direct transfers to households and companies were designed and implemented to sustain basic consumption and income (Graph 4). This sent the primary fiscal deficit soaring to almost 6% of GDP (Graph 5).

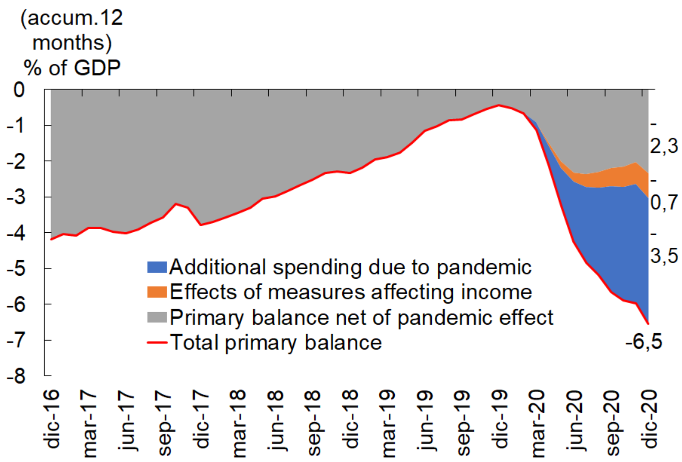
Argentina: fiscal and credit measures in response to Covid-19 Graph 4



Source: Central Bank of Argentina.

In turn, the central bank played a key role in the policy response, focusing its efforts on adapting the functioning of the financial system to the lockdown put in place in March; alleviating the financial situation of firms and households; protecting the households savings of the latter in domestic currency, ensuring positive real interest rates; boosting credit to the productive sector; and providing funds to the Treasury to finance countercyclical policies, given its restricted access to international and domestic credit markets.

Argentina: primary fiscal balance Graph 5



Source: Central Bank of Argentina from Ministerio de Economia and INDEC.

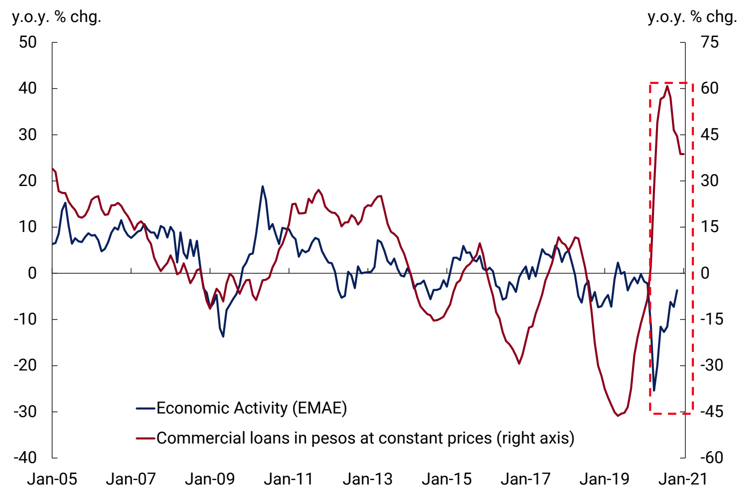
The central bank's measures to alleviate the financial situation of households and companies included the following: credit card balances were refinanced, and unpaid installments were transferred at the end of the credit life, without additional costs beyond the contractual interest rate; mortgage instalments were no longer adjusted for inflation; Temporarily bank debtors were not reclassified on the basis of their creditworthiness. Other measures included the suspension of bank account closures and the extension of cheque maturities.

The Central Bank of Argentine used mainly its existing toolkit to provide liquidity and channel credit to SMEs. This included reducing liquidity requirements to finance new bank credit lines (government guarantees were also reinforced).

The following new credit lines were launched: loans to SMEs for working capital financing (including wages), with a 24% interest rate; extension of this facility to SMEs that did not have access to bank loans, and to companies (independently of their size) to finance the ourchase of capital goods produced by local SMEs; a special credit line at a 0% interest rate for independent workers in the lowest tax brackets; and a special credit line with an interest rate between 0% and 15% for SMEs receiving the pay cheque protection program.

As a result, credit behaved countercyclically precisely when it was most needed – something unrecorded in over a decade (Graph 6). Credit to MSMEs in Argentine pesos grew by almost 71% in real terms, and loan interest rates fell 10.5 percentage points. For the financial system as a whole, loans to the private sector increased 12.4% in real terms during the same period. Total disbursements made under the central bank's credit initiatives amount to nearly 2.7% of GDP.

Argentina: commercial loans and business cycle dynamics — Graph 6



Monetary-fiscal policy interaction

Fiscal space was severely restricted during the response to the pandemic. Access to the international debt markets was basically closed, and a debt restructuring process until its conclusion in September 2020. In addition, the functioning of the domestic debt market was impaired pending a reconstruction process.

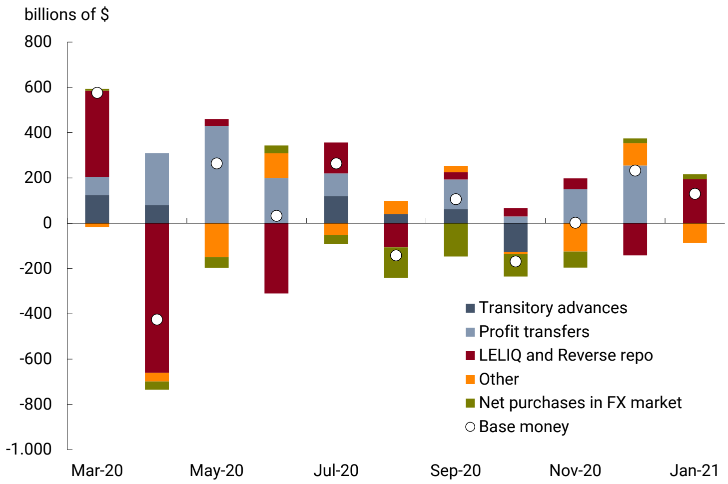
Limited fiscal headroom meant that the central bank had to increase financing to the Treasury to support household incomes and prevent a dramatic shutdown of firms. It did so through direct lending and profit transfers to the national government, as permitted by its charter. Unlike other central banks in the emerging world, the Central Bank of Argentina used mainly its existing toolkit in response to the pandemic, rather than broadening it to implement a wider scope of open market operations or asset purchase programmes.

Direct lending is carried out through advances to the national government repayable within a year. [2] They can reach up to 12% of base money and 10% of fiscal revenues on a cash basis (in the last 12 months). Central bank profits (as defined by its profit and loss statement) can be transferred to the government once reserves are approved by the central bank board.

This extraordinary financing reached 7.6% of GDP in 2020 but it has been transitory and expected to decline by more than half in 2021. The central bank toolkit has also been used to manage liquidity in order to preserve monetary equilibrium. Advances to the government and payout profits increased base money between March and July 2020 and the central bank sold its own securities to mop up excess liquidity (Graph 7).

Argentina: base money growth drivers

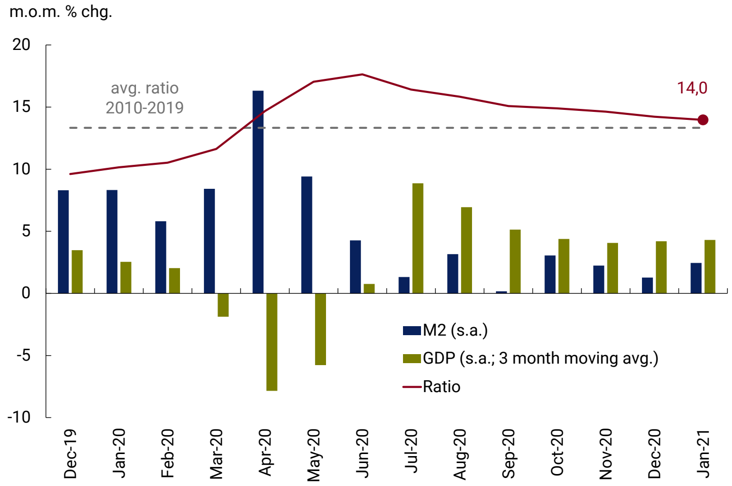
Graph 7



Growing money demand (at record lows before the pandemic) has helped absorb a significant portion of liquidity. Broad money as a proportion of GDP rose to a record 17.6% in June 2020. The increase in money demand was related to the greater uncertainty, the extended bank holidays at the beginning of the pandemic forced by the lockdown, and government transfers to low-income sectors. Since July 2020, M2/GDP has entered on a gradual decline, in parallel with the economic recovery (Graph 8). M2 finished last year at 13.7% of GDP, just 0.3 percentage points above its 2010–19 average, while base money stood at 7.2% of GDP by the end of 2020, 1.2 percentage points below its 2010–19 average.

[2] If any of these advances remains unpaid after that period, this facility may not be used again until the amounts owed have been repaid. Exceptionally, and if the situation of the national or international economy justifies, temporary advances may be granted of up to 10% of the cash resources that the national government has obtained in the last 12 months. This exceptional facility may be exercised for a maximum period of 18 months. Once this period has elapsed, the central bank will not be able to grant the national government advances in this way. These advances must be reimbursed within 18 months of being granted. If these advances remain unpaid after that period, this facility may not be used again until the amounts owed have been reimbursed (see BCRA charter, section 20)

Argentina: means of payment and GDP Graph 8

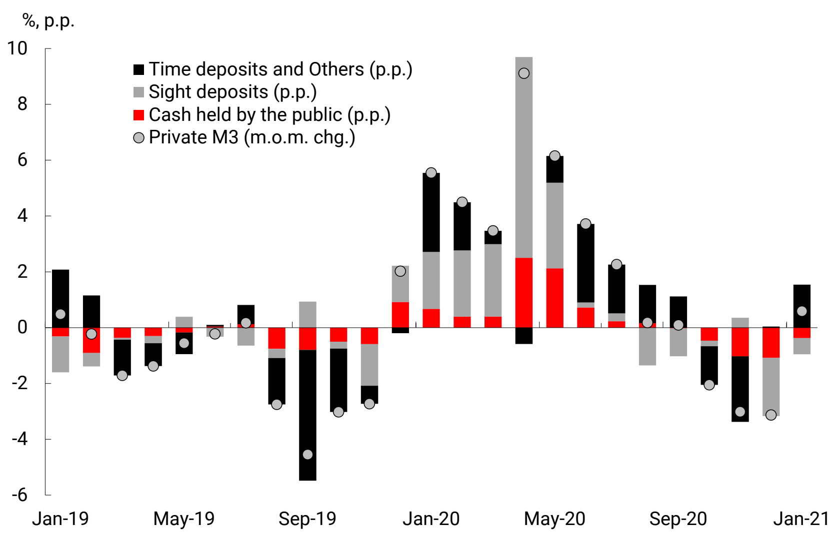


Source: BCRA

In the context of capital outflows from emerging market economies since March 2020, the Argentine economy experienced higher financial and exchange rate volatility. The central bank responded through interventions in the foreign exchange market to reduce volatility, while the foreign exchange regulations (in place since 2019) helped sustain the level of international reserves.

The monetary authority has also encouraged savings in domestic currency by ensuring that deposit interest rates remain positive in real terms. In order to prevent the expansion of liquidity as a result of the emergency policies from inducing lower interest rates on deposits, minimum interest rates were set for private sector time deposits in local currency.

Argentina: private M3 growth drivers, seasonally adjusted Graph 9



Source: BCRA

As a result, while broad money measures have tended to decline as excess liquidity was mopped up, time deposits in local currency increased. In other words, money growth is now associated to savings than with transactions. As the recovery proceeds and money markets stabilise, a growing fraction of M3 real growth is linked to higher time deposits (Graph 9).

The combination of foreign exchange intervention, regulation and deposit interest rate caps was instrumental in supporting liquidity supply to the private sector while providing emergency financing to the Treasury. Without liquidity management, together with capital controls, the short-term monetary policy space would have been substantially more restricted and would have prevented an effective countercyclical policy response (ie lending interest rates would have been higher and less liquidity would have been available). This was part of the short-term response to the emergency situation. Policy normalisation will call for a reversal of these measures over time.

Capital market development, macroeconomic and fiscal sustainability

Going forward, economic policy must focus on the sustainability of economic policies, but without inducing a premature withdrawal of support that could jeopardise the recovery. In terms of monetary and fiscal policy interactions, the key is to substitute monetary financing of the government to debt market financing.

The successful resolution of the government debt restructuring process (foreign and local law, with a 99% acceptance rate) and the fiscal path signalled in this year's national budget are important steps in normalising the government's financial needs. According to the 2021 national budget, the Treasury expects to achieve positive net debt financing, significantly reducing the assistance from the central bank. A new agreement with the International Monetary Fund will also contribute to the process of policy normalisation and will increase monetary space.

Gradual economic recovery from the second half of 2020 onwards made it possible to focus fiscal policy efforts on the most critical sectors, which resulted in a lower level of transfers to the private sector. In addition, after the successful restructuring of debt denominated in foreign currency, the national government continued its efforts to reconstruct the domestic currency debt market. All this will contribute to reduce the central bank's monetary assistance.

In this context, the main challenges for the central bank in the medium term will be related to: (a) the normalisation of the foreign exchange market; (b) consolidating credit growth while strengthening savings in local currency; (c) developing a deep domestic capital market in which firms can finance long-term investment.

If the normalisation of the economy after the pandemic allows a sustained rise of exports, foreign market regulations could be gradually relaxed; but some capital controls that could help reduce volatility will be maintained in the medium term. Indeed, this crisis has again shown the need for EME central banks to draw on an enhanced toolkit.

Aiming for sustainable growth and macroeconomic stability in an emerging country such as Argentina, which is exposed to sudden stops and limited monetary sovereignty, calls for an integrated monetary policy framework that combines monetary policy, foreign exchange intervention, macroprudential and capital flow management measures (CFMs). Studies such as that of Agénor and Pereira da Silva (2018) outline the conditions and shocks faced by EMEs that require changes to the standard policy toolkit. Moving away from the combination of interest rate rules plus purely floating exchange rates is the result of the constraints faced by our economies. This is also in keeping with recent work by the IMF on the "integrated policy framework" that sets out the conditions under which a broader menu of tools may be used, even permanently (Basu et al (2020)). Studies at the local level also point toward the optimality of FX intervention and CFMs in a small, open economy such as Argentina's (Escudé (2015)).

Capital flow management measures can moderate the impact of foreign liquidity shocks on the local financial markets. As they smooth the volatility of portfolio flows, they help preserve the stock of international reserves and hence monetary policy degrees of freedom.

Just as room for policy manoeuvre has been gained due to the adoption of CFMs and foreign exchange intervention, macroprudential regulation is also fundamental. This has meant going beyond capital and liquidity based countercyclical bank regulation. Currency-based measures have also been put in place to deal with currency mismatches. Since 2002, US dollar-denominated deposits can be lent only to companies that generate income in that currency (any excess amount must be kept as a cash reserve). Together with currency-specific liquidity requirements and a limit on the net global position in foreign currency, this has allowed the financial system to respond to higher demand for US dollar deposits during a crisis. It has also prevented foreign exchange volatility from having a negative impact on bank borrowers' solvency.

Finally, developing domestic capital markets will be key to opening up funding sources for the government and private investment. At the same time, domestic financial market development works hand in hand with monetary policy, as it helps the latter influence private sector decisions in a more comprehensive way. This was a key issue in the 2020 meeting of EME deputy governors at the BIS (see BIS (2020)).

Fostering local currency bond markets (LCBM) has proved useful in many EMEs by reducing the risk of currency mismatches. But LCBM development is no silver bullet: while these markets contribute to growth and resilience, they are still subject to financial stability risks. Even when issuing in local currency, conditions can lead to carry trades becoming attractive. Under full capital mobility, or without proper capital flow management measures, short-term capital inflows may be attracted to local currency markets. If flows are reversed, this can be destabilising, as there can be increased demand for foreign currency, a currency depreciation or strong pressure on international reserves. This is why deeper capital markets must be accompanied by a broader policy toolkit.

Concluding remarks

The extraordinary impact of Covid-19 required an extraordinary response. Although it was a global shock, it hit Argentina at a very fragile time, after two years of recession, high inflation and without access to debt markets. These initial conditions reinforced the key role of the central bank, particularly in financing an adequate fiscal policy response to cushion household and business income. The challenge now is to normalise fiscal and monetary policy in a gradual and sustainable way: moving towards fiscal balance, price stability and inclusive growth, while avoiding policy fixes that can work in the short term but lead to costly reversions over time. One crucial element here is to develop domestic capital markets to finance both public and private sector investment needs.

The crisis may also have more general lessons for EME monetary authorities. They will need to develop new tools to cope with a world more frequently subject to episodes of high volatility. However, domestic policies are not enough on their own and international cooperation will be essential to ensure that global liquidity can be adequately provided.

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