Argentina – Facing the moderate inflation challenge

• While the Central Bank of Argentina has made progress in fighting inflation since 2016, consumer prices continue expanding at a rate far above the target, in spite of higher (and rising) real interest rates.

• The international experience shows that countries that have ended moderate inflation (defined as inflation that persists for at least three years in the 15%-30% range) used a mix of policies, and there is no evident growth cost during the disinflation process. The nominal exchange rate has almost always been used as anchor.

• However, as exchange-rate-based stabilization programs often lead to real exchange-rate appreciation, the conditions for adopting an exchange-rate anchor in Argentina are not there: the wide current-account deficit indicates that there is not much room for real exchange-rate gains. In addition, net reserves seem too low to defend a peg, should that become necessary.

• In the absence of help from the exchange rate, Argentina could usefully add faster fiscal-policy tightening to its anti-inflationary toolkit. Income policies, such as those guiding wage agreements, could also help, but are no substitute for credible macro policies. In addition authorities should use potential exogenous shocks as an opportunity to bring inflation down faster, as many countries that ended moderate inflation have done.

How did we get here?

Inflation in Argentina fluctuated between 15% and 38% in the period from 2007-2015, with an average of 25%. Inflation would have been even higher if it were not for the frozen regulated prices and other price controls implemented during the second term of Cristina Kirchner. Persistently lax fiscal and monetary policies were the factors responsible for the high inflation. In fact, general government expenditures as a proportion of GDP increased from 22.7% in 2003 to 41.7% in 2015, with a turnaround of the fiscal balance, from a 1.2% of GDP surplus to a 5.9% deficit. Real interest rates were negative throughout this period. In fact, the Badlar rate (a 1-month wholesale deposit rate paid by private banks) averaged -4.6% in real terms between 2003 to 2015.
A new and reformist administration took office in December 2015 and made “single-digit” inflation one of its goals. Exchange-rate controls were quickly removed and the central bank adopted an inflation-targeting framework with a floating exchange-rate, a policy regime that has been tried and tested in the region. A reference monetary-policy rate was chosen (initially the yield of the short-term sterilization bill, the 30-day Lebac and then the 7-day repo rate). The inflation target was set at 12%-17% for 2017, 10% +/- 2% for 2018, and 5% +/- 1.5% in 2019. With the liberalization of exchange-rate and unfreezing of utility prices, inflation spiked, peaking at 47.2% (YoY) in July 2016. Monetary policy has been tightened substantially, and the ex-ante real policy rate currently stands at 13.6% (using annualized core inflation expectations for the next three months). However, as the government also sought to reduce the tax burden on the economy (in particular on exporters), fiscal policy has not been tightened: the primary and nominal fiscal deficits remained broadly unchanged between 2015 and 2016 (in spite of heavy reductions in the subsidy bill), while in 2017 a one-off boost to revenues from the tax-amnesty bill is contributing to narrow the fiscal deficit.

To be sure, Argentina has made progress in fighting inflation since the new administration stepped in. Headline inflation in Greater Buenos Aires area is currently at 22.9% year over year, while the three-month annualized core inflation – a measure that excludes prices that exhibit seasonality and regulated items – is at 19%. So inflation is currently below the average level it was during Cristina Kirchner’s second term (29.2%) in spite of rapid price liberalization. Inflation expectations and the exchange rate helped in this process. The real bilateral exchange rate is significantly stronger than it was right after the new government let the peso float, and 12-month-forward inflation expectations have consistently run below current inflation since the central bank started to publish surveys with market analysts in mid-2016.

Still, these inflation levels remain far above the ambitious targets set by the central bank. A tight monetary policy has not been able, or has not been able yet, to bring inflation below 20%. At the same time, in spite of high real interest rates, economic and credit growth have been strong, as confidence improves with the power consolidation of a market-friendly administration.

Moreover, Argentina’s inflation stands out in a world of subdued price pressures, even in Latin America, a region long plagued by inflationary problems and monetary instability. Current price pressures in Argentina are a stark outlier and erode its global competitiveness.
Anti-inflation tools

According to Dornbusch and Fischer’s (1993) classic analysis, moderate inflation is characterized as an inflationary process that persists for at least three years in the 15%-30% annualized range. As Burton and Fischer (1998) put it, “moderate inflation can be beaten, but there is no single magic formula.” Countries that have ended moderate inflation used a mix of fiscal, monetary, exchange-rate and income policies, and many opportunistically used exogenous shocks to reduce inflation.

Fiscal and monetary policies affect inflation not only because of their impact on aggregate demand. Both fiscal and monetary policies also have an effect on domestic prices by influencing exchange-rate and inflation expectations, although in the case of fiscal policy, the impact could be non-linear (that is, only when the fiscal balance or public debt reaches worrying levels, fiscal policy has the capacity to alter the exchange-rate path and inflation expectations).

Exchange-rate anchors have also been used as tools to reduce inflation from high or moderate levels in many cases. One issue with this approach is that the exchange-rate anchors are often not fully credible at first, meaning that the central banks adopting them face higher inflation (at least in the initial stages of stabilization) than would be justified by inflation abroad and the productivity growth differential. This “residual inflation” leads to real exchange-rate appreciation and a widening of the current-account deficit. This is why exchange-rate pegs typically work if set when the real exchange rate is undervalued; in these cases, real appreciation does not lead to a balance-of-payment problem.

Policy makers can also use exogenous shocks as an opportunity to anchor inflation at lower levels. This is the so-called “opportunistic approach” to disinflation. A boom of capital inflows, unforeseen recessions, positive supply or terms-of-trade shocks, and reforms (such as trade liberalization) are all examples of events that policy makers can use to permanently reduce inflation. Of course, this strategy deprives the authorities of much control over the timing of the disinflation process.

Income policies, such as wage agreements and temporary price freezes, are quite unlikely to work on their own, but experience shows that they can be part of a stabilization strategy. A problem with price freezes is that they may foster the view that disinflation is temporary, lasting only while the sector freezes are in place. Moreover, reliance of the previous administration on price controls might exacerbate this credibility shortfall.

How moderate inflation ended in other countries

Burton and Fischer (1998) explore five examples of countries that ended moderate inflation between the late ‘80s and early ’90s (Chile, Egypt, Iceland, Kenya and Paraguay). Except for Kenya, the countries in this study resorted to exchange-rate anchors (although in the Chilean case the effectiveness of the anchor is unclear, as it aimed at the real exchange rate, not the nominal rate). In many cases monetary policy had a supporting role, often subordinated to exchange-rate management. In Kenya, there was no exchange-rate peg, but the currency seems to have helped in the disinflation process anyway, as monetary-policy tightening contributed to attract inflows and the real exchange rate strengthened. In Egypt and Kenya, the fall of inflation was accompanied by significant fiscal tightening, while in Paraguay and Chile a prudent fiscal policy (general government surpluses) was already in place before the disinflation process started. In Iceland, Chile and Paraguay, exogenous factors played an important role in the disinflation process. A slump in the Icelandic fishing industry drastically reduced growth, helping to cool inflationary pressures. In Paraguay, a strong harvest brought food inflation down sharply. In Chile, productivity-enhancing reforms and an improvement in terms of trade helped. The end of moderate inflation in Iceland also got a hand from income policies (wage agreements).

Importantly, these five countries’ experiences indicate that there is no obvious ex-post growth cost from disinflation, as in many countries growth remained robust throughout the period when inflation was falling to below-moderate levels.
Since then, other examples of countries that managed to end moderate inflation have emerged.

**Colombia, for instance, ended moderate inflation in two stages.** In the first stage, disinflation seems to have resulted from a capital-inflow boom (partly related to financial liberalization, exploration of new oil fields and privatizations). Inflation fell from 32.4% to 19.5% between 1990 and 1995, as the real effective exchange rate appreciated by around 25% and the current account swung from a 4% surplus to a 4% deficit. During this period, growth remained solid. In the second stage, when capital flows reversed in the late '90s, Colombia experienced a financial crisis, and GDP dropped by 4.2% in 1999. Inflation converged to single digits (from 16.7% in 1998 to 9.2% in 1999) and has not climbed above 10% since then. Our interpretation is that the disinflation process in Colombia followed the opportunistic approach: in the first stage, the opportunity came from a boom in capital inflows, which were at least partly exogenous to macro policies. In the second stage, a non-policy induced recession provided the opportunity to reduce inflation. During the disinflation period, fiscal policy was not a relevant factor for disinflation. The central bank had set inflation targets since the beginning of the 90’s. The exchange rate was managed, but the regime went through many changes until a free floating currency was finally adopted at the end of the ‘90s. Interestingly, the economic slowdown in Colombia following the global financial crisis in 2008 gave the country another opportunity to consolidate inflation at a level closer to the 3% long-term target set in 2001: inflation from 2009 to 2016 averaged 3.7%, compared with 6.2% between 2001 and 2008.

[Disinflation process in Colombia](#)

**Israel also successfully ended moderate inflation during the '90s.** In the early '90s, the central bank adopted a “forward-looking” crawling peg, based on the projected inflation differential. Only gradually, the band fluctuation limits were widened and the interest-rate policy started to focus on the inflation targets, instead of supporting the exchange-rate regime. Inflation also benefited from an exogenous shock: an immigration boom following the end of the Soviet Union, which created slack in the labor market and put downward pressure on wages. In fact, during the '90s, Israel’s population increased by 27% (compared with 18% the previous decade), so the opportunistic approach was a key part of the disinflationary strategy in Israel. Inflation had fallen to levels slightly above 10% (above the 7%-10% inflation target) already in 1992, but it was only in 1997 that inflation reached single digits.
How to end moderate inflation in Argentina

Beating moderate inflation is unlikely to be easy - the gap between current inflation and the 2018 target is some ten percentage points. Policy makers need to be willing to tighten macro policies to the point of significantly slowing aggregate demand, even if at the cost of risking a recession, to achieve the targets set by the central bank, even more so if inflationary expectations remain high. Maintaining real interest rates at positive (and high) levels can certainly help to lower inflation expectations, but it is not working as fast as the Argentine authorities would like, and would have activity costs if the authorities’ selection of the policy mix overburdens monetary policy. Easing monetary policy prematurely, however, would be detrimental to the credibility of the disinflation effort. So, while the room for further tightening may be limited (absent willingness to face a slowdown), there is scant room for early monetary accommodation either.

One way to bring inflation expectations down faster is borrowing credibility from another central bank, through exchange rate pegs, as suggested by some prominent Argentine economists. As mentioned above, countries that ended moderate inflation often adopted exchange-rate anchors in their stabilization programs. The problem with such a strategy in the case of Argentina is that the valuation of the exchange rate already seems stretched (we forecast a current-account deficit of 4.3% of GDP this year) and international reserves are too low to defend a peg (approximately 5% of GDP netting short-term foreign-currency liabilities of the central bank, or 9% in gross terms). So, most likely a peg would not be completely credible: after the exchange-rate anchor is adopted, inflation would be higher than would be justified by inflation abroad and the productivity growth differential, at least for some time, strengthening even more the real exchange rate and worsening the balance of payments even further. Besides the capacity to implement a credible peg, it is widely recognized that Argentina’s experience with a fixed exchange-rate regime during the ’90s ended badly, turning policy makers, and the society, averse to exchange-rate based stabilization.
So, without the conditions necessary to adopt an exchange-rate anchor, policy makers could usefully add fiscal-policy tightening to bring inflation down more rapidly. In fact, fiscal consolidation is a key feature in many examples of countries that reduced inflation to single digits. Aggressive fiscal tightening would help not by (or at least not only by) slowing demand – fiscal consolidation reduces the probability that the government will rely on monetary financing in the future, therefore contributing to lower inflation expectations. Since Argentina’s new administration started, policy makers have emphasized that they would target a gradual reduction of the fiscal deficit. With ample funding availability and poor growth, gradualism was the strategy to maintain political support and ensure governability. In particular, the government targets a primary deficit of 4.2%, 3.2% and 2.2% of GDP for 2017, 2018 and 2019, respectively. Currently, the primary deficit stands at around 4.9% of GDP once the one-off revenues related to the tax amnesty are excluded.

A gradual approach to fiscal deficit reduction can be good for protecting short-term growth, but at the cost of credibility. That is, with slower fiscal retrenchment, society tends to doubt that future governments will deliver medium- and long-term fiscal targets. So, inflation expectations fall only gradually, as the targets are effectively delivered. Also, a key source for fiscal adjustment in Argentina is the still-sizeable subsidy bill (estimated at 2.5% of GDP this year, while the government plans to bring it to 1% in 2019); cutting subsidies creates one-off upward pressure on consumer prices that could make managing inflation expectations difficult.
Finally, the government’s recently presented tax-reform proposal will involve fiscal costs (estimated at 1.5% of GDP in five years), even though it will have a positive impact on the investment climate. Thus, the tax proposal may play against reducing the fiscal deficit.

Considering the political capital the government gained as a result of mid-term elections and the solid activity growth figures, the government could accelerate the pace of fiscal adjustment so as to help contain inflation expectations and support the central bank in its fight against inflation. In this context, there are some welcome initiatives. The government recently agreed with all but one provincial governments to support a fiscal responsibility bill in congress that would cap primary expenditures growth (of provinces and federal government) to zero in real terms. If approved, revenue surprises would boost the primary fiscal result (at least when the expenditure cap is binding) so authorities can potentially deliver fiscal adjustment faster than they are currently targeting. The governors of provinces also agreed to support modifications in the way pensions are readjusted, which could also contribute to reduce fiscal expenditures as a share of GDP.

Income policies can help, if inflation expectations are well behaved. Wage agreements in Argentina are arguable a key immediate driver of inflation. Although wage agreements are usually based on past inflation, there is no formal indexation mechanism in Argentina. In this context, the government will try to coordinate the upcoming wage negotiations in a way that agreements are based on expected inflation in 2018 rather than on past inflation. Although the strong economy, and some labor union reluctance, would make such an agreement difficult, readjustment triggers can be offered (like in 2017): so if actual inflation surprises to the upside, wages would be readjusted.

Finally, there is the opportunistic approach. For example, once the government is done with subsidy reductions, inflation for regulated items would fall substantially (in 2017 it should contribute three percentage points to headline inflation), providing an opportunity to anchor inflation at lower levels. Negative shocks on activity can also be an opportunity. Reforms (such as the labor reform the government is trying to approve) and trade liberalization can also provide one-off downward pressure on prices and productivity boosts that could help reduce inflation permanently, while increasing growth at the same time.

In all, international experience shows that it is possible to end moderate inflation relatively fast with no significant ex-post cost in terms of growth. While in these cases, stabilization packages usually involve the adoption of an exchange-rate anchor, in Argentina it doesn’t look like the conditions for a peg are there - the temptation to rely on an exchange rate peg would actually be risky, from a macroeconomic balance viewpoint, given the starting point of an already wide current account deficit. In this context, a mix of other strategies could be used. Besides the
already tight monetary policy (and we see no scope for easing in the near term), it is especially important to pursue a credible and faster fiscal consolidation in order to lower inflation expectations. A tight fiscal policy would also contribute to reducing the burden on monetary policy and consequently allow for a lower current-account deficit, which is already hovering near uncomfortable levels. Income policies could support the disinflation process, but evidently would only work, if they work at all, if a credible macro-policy mix is in place. During the disinflation process, authorities should use opportunities created by exogenous factors (such as unforeseen recessions or positive productivity and terms-of-trade shocks) to anchor inflation at lower levels.

João Pedro Resende
Juan Carlos Barboza

REFERENCES:


Macro Research – Itaú
Mario Mesquita – Chief Economist

Tel: +5511 3708-2696
Click here to visit our digital research library.

App Itau Economic Analysis
Our Research on your mobile.
Download it on the App store or Google Play.
Relevant Information

1. This report has been prepared and issued by the Macro Research Department of Banco Itaú Unibanco S.A. ("Itaú Unibanco"). This report is not a product of the Equity Research Department of Itaú Unibanco or Itaú Corretora de Valores S.A. and should not be construed as a research report ("relatório de análise") for the purposes of the article 1 of the CVM Instruction NR. 483, dated July 06, 2010.

2. This report aims at providing macroeconomics information, and does not constitute, and should not be construed as an offer to buy or sell, or a solicitation of an offer to buy or sell any financial instrument, or to participate in any particular trading strategy in any jurisdiction. The information herein is believed to be reliable as of the date on which this report was issued and has been obtained from public sources believed to be reliable. Itaú Unibanco Group does not make any express or implied representation or warranty as to the completeness, reliability or accuracy of such information, nor does this report intend to be a complete statement or summary of the markets or developments referred to herein. Opinions, estimates, and projections expressed herein constitute the current judgment of the analyst responsible for the substance of this report as of the date on which it was issued and are, therefore, subject to change without notice. Itaú Unibanco Group has no obligation to update, modify or amend this report and inform the reader accordingly.

3. The analyst responsible for the production of this report, whose name is highlighted in bold, hereby certifies that the views expressed herein accurately and exclusively reflect his or her personal views and opinions and were prepared independently and autonomously, including from Itaú Unibanco, Itaú Corretora de Valores S.A. and other group companies.

4. This report may not be reproduced or redistributed to any other person, in whole or in part, for any purpose, without the prior written consent of Itaú Unibanco. Additional information on the financial instruments discussed in this report is available upon request. Itaú Unibanco and/or any other group companies is not, and will not be liable for any investment decisions (or otherwise) based on the information provided herein.

Additional Note to reports distributed in: (i) U.K. and Europe: The sole purpose of this material is to provide information only, and it does not constitute or should be construed as a proposal or request to enter into any financial instrument or to participate in any specific business strategy. The financial instruments discussed in this material may not be suitable for all investors, and are directed solely at Eligible Counterparties and Professionals as defined by the Financial Conduct Authority. This material does not take into consideration the objectives, financial situation or specific needs of any particular client. Clients must obtain financial, tax, legal, accounting, economic, credit and market advice on an individual basis, based on their personal characteristics and objectives, prior to making any decision based on the information contained herein. By accessing the material, you confirm that you are aware of the laws in your jurisdiction relating to the provision and sale of financial service products. You acknowledge that this material contains proprietary information and you agree to keep this information confidential. Itaú BBA International plc (IBBAlnt) exempts itself from any liability for any losses, whether direct or indirect, which may arise from the use of this material, from its content and is under no obligation to update the information contained in this document. Additionally, you confirm that you understand the risks related to the financial instruments discussed in this material. Due to international regulations not all financial instruments/services may be available to all clients. You should be aware of and observe any such restrictions when considering a potential investment decision. Past performance and forecast are not a reliable indicator of future results. The information contained herein has been obtained from internal and external sources and is believed to be reliable as of the date in which this material was issued, however IBBAlnt does not make any representation or warranty as to the completeness, reliability or accuracy of information obtained by third parties or public sources. Additional information relative to the financial products discussed in this material is available upon request. Itaú BBA International plc registered office is 20th floor, 20 Primrose Street, London, United Kingdom, EC2A 2EW and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority (FRN 575225) – Itaú BBA International plc Libyan Branch is regulated by Banco de Portugal for the conduct of business. Itaú BBA International plc has representative offices in France, Germany, Spain which are authorised to conduct limited activities and the business activities conducted are regulated by Banque de France, Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin), Banco de España respectively. For any queries please contact your relationship manager; (ii) U.S.A: Itaú BBA USA Securities, Inc., a FINRA/SIPC member firm, is distributing this report and accepts responsibility for the content of this report. Any US investor receiving this report and wishing to effect any transaction in any security discussed herein should do so with Itaú BBA USA Securities, Inc. at 767 Fifth Avenue, 50th Floor, New York, NY 10153; (iii) Asia: This report is distributed in Hong Kong and Japan by Itaú Asia Securities Limited, which is licensed in Hong Kong by the Securities and Futures Commission for Type 1 (dealing in securities) regulated activity. Itaú Asia Securities Limited accepts all regulatory responsibility for the content of this report. In Hong Kong, any investors wishing to purchase or otherwise deal in the securities covered in this report should contact Itaú Asia Securities Limited at 29th Floor, Two IFC, 8 Finance Street – Central, Hong Kong; (iv) Middle East: This report is distributed by Itaú Middle East Limited. Itaú Middle East Limited is regulated by the Dubai Financial Services Authority and is located at Suite 305, Level 3, Al Fattan Currency House, Dubai International Financial Centre, PO Box 482034, Dubai, United Arab Emirates. This material is intended only for Professional Clients (as defined by the DFSA Conduct of Business module) no other persons should act upon it; (v) Brazil: Itaú Corretora de Valores S.A., a subsidiary of Itaú Unibanco S.A authorized by the Central Bank of Brazil and approved by the Securities and Exchange Commission of Brazil, is distributing this report. If necessary, contact the Client Service Center: 4004-3131 (capital and metropolitan areas) or 0800-722-3131 (other locations) during business hours, from 9 a.m. to 8 p.m., Brasilia time. If you wish to re-evaluate the suggested solution, after utilizing such channels, please call Itaú’s Corporate Complaints Office: 0800-570-0011 (on business days from 9 a.m. to 6 p.m., Brasilia time) or write to Caixa Postal 67.600, São Paulo-SP, CEP 03162-971. * Cost of a local call.