Box 1
INFLATION DEVELOPMENTS IN ARGENTINA

The fiscal origin of the inflation problem

In recent years inflation has been much higher in Argentina than in other Latin American countries. Average annual inflation was 72% between 2020 and 2023, rising to triple-digit inflation from February 2023. One of the main causes of this was the persistent budget deficits (see Chart 1) and its monetary financing. The central bank partially financed the deficits by issuing currency (see Chart 2) as they could not be covered with debt issuance, especially after Argentina abandoned the International Monetary Fund (IMF) programme in 2020.[1] Money supply, in a setting of economic slowdown, far exceeded demand in the private sector, leading to soaring inflation in recent years (see Charts 3 and 4).

The new Argentine Government's stabilisation programme

Argentina's current President was sworn in on 10 December 2023. A few days later, the new Government announced a fiscal consolidation programme that aimed to eliminate the fiscal deficit – estimated at 5% of GDP for 2024 – in the space of just one year, to put an end to the main cause of monetary issuance. At the same time, the official exchange rate was devalued sharply from 366 to 800 pesos to the dollar, bringing it closer to the parallel exchange rate. The Government also announced an automatic devaluation rate (crawling peg) of 2% per month, which has remained to date.

Argentina's key financial variables have improved since the new President took office, although some volatility remains which is linked to the passage through Congress of the new legislation proposed by the Government. Thus, the sovereign debt spread has narrowed (see Chart 5), the stock market indices have risen (also in US dollars) (see Chart 6) and the gap between the parallel and the official exchange rates has narrowed (see Chart 7). The central bank also stopped losing its international reserves and has begun to rebuild them (see Chart 8).

The Government has run a budget surplus since January, earlier than envisaged by private analysts, without even having implemented all the measures of the fiscal adjustment programme, as these had not yet been approved by Congress. The surplus was mainly achieved through spending cuts: all public works financed by the central government have been halted, discretionary transfers to provinces have been reduced and public sector wages and pensions have grown slower than inflation. Also, international trade taxes and the tax on foreign currency purchases paid with bank cards were raised. These measures were chosen because they do not require congressional approval. The Government has undertaken to reverse them when tax revenues from these two measures can be replaced by a fiscal package that was approved by Congress in late June. This package includes personal income tax and wealth tax changes and a fiscal moratorium.

The stabilisation programme also envisages a reduction in energy and transportation subsidies. This requires updating regulated prices, which have not increased at the same pace as those of other goods since 2020, leading to a growing distortion between the relative prices of regulated and non-regulated goods (see Chart 9). The updates are being made gradually, with the relative price of regulated goods having recovered slightly between February and April.

The strong fiscal consolidation has penalised economic activity, which fell further in the early months of the year. In Q1 GDP fell by 2.6% quarter-on-quarter (see Chart 4) and by 5.1% year-on-year. The IMF expects GDP to fall by 3.5% in 2024 as a whole.[2]

Inflation following the announcement of the stabilisation plan

Monthly inflation doubled in December 2023, reaching a monthly rate of 25.5% (211% year-on-year), compared with 12.8% (160% year-on-year) in November. This surge in inflation is, above all, explained by the price hikes recorded in the early weeks of the month in anticipation of the depreciation of the official exchange rate.[3] From February, the updating of public sector services and other regulated prices has had a highly significant direct

1 Banco de España. (2024). "Box 1. Recent economic policy measures in Argentina". In Banco de España. *Report on the Latin American economy – Second half of 2023*. Also IMF. (2024). "Eighth Review of the Extended Arrangement Under the Extended Fund Facility".

2 IMF (2024). "Eighth Review under the Extended Arrangement under the Extended Fund Facility".

3 In early December expectations were for the official exchange rate to be devalued more in 2024 Q1 than it ultimately was. According to the Consensus Economics December report, which was conducted two days before the adjustment programme was announced, the economic analysts expected the official exchange rate to stand at 935.40 pesos per dollar by end-March 2024. However, the actual official exchange rate was 857.42 pesos to the dollar at end-March.

Box 1
INFLATION DEVELOPMENTS IN ARGENTINA (cont'd)

inflationary impact. Despite accounting for 21% of the domestic consumption basket, the change in regulated prices explains around one-third of total inflation in 2024 to date.

In any event, since January the month-on-month inflation rates have been on a pronounced downward path, declining from 20.6% in January to 4.2% in May. However, the year-on-year inflation rate has continued to rise (from 254% in January to a 289% high in April). This gradual and continuous reduction in inflation mainly reflects the effects and expectations of lower monetary issuance as the fiscal deficit has been eliminated. According to a

Chart 1
Budget balance (a)

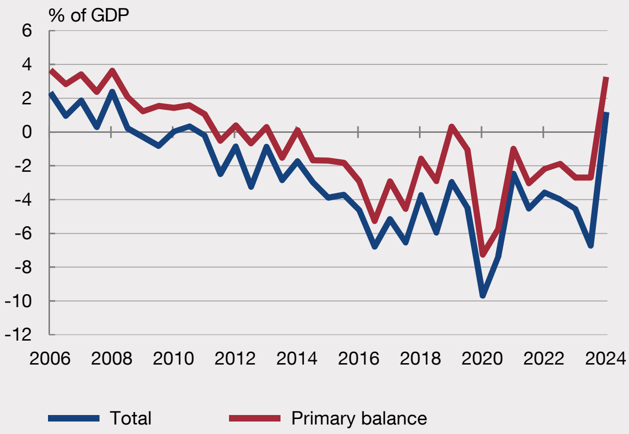


Chart 2
Transfers from the central bank to the Treasury (b)

Chart 3
Inflation (c)

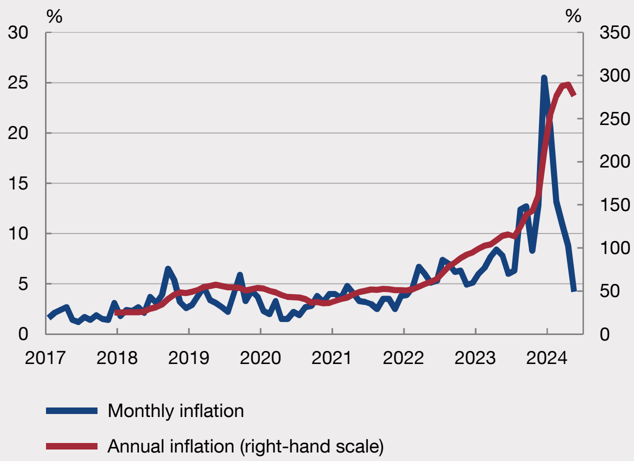
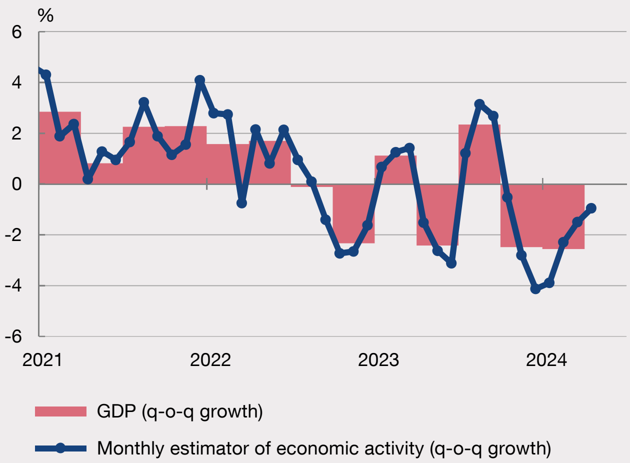


Chart 4
Economic activity (d)



SOURCES: National statistics, Banco Central de la República Argentina, IMF, LatinFocus and Banco de España..

a Monthly data are aggregated into half-yearly data. The latest observation of the budget balance is May 2024. The latest observation of nominal GDP is 2024 Q1. For 2024 H1 the calculation is performed by extrapolating the budget balance for the first five months of the year. Nominal GDP in Q2 is estimated by drawing on LatinFocus's June 2024 GDP and inflation forecasts for that quarter.
b Latest observation: June 2024.
c Latest observation: May 2024.
d The monthly estimator of economic activity (EMAE by its Spanish initials) is a monthly measure of economic activity that weights the economic sectors by their respective shares of GDP. Both this indicator and GDP are calculated by Argentina's National Institute of Statistics and Censuses (INDEC, by its Spanish acronym). The latest observation of the EMAE is April 2024. The latest observation of GDP is 2024 Q1.

Box 1
INFLATION DEVELOPMENTS IN ARGENTINA (cont'd)

memorandum sent to the IMF,[4] the Argentine Government projects year-on-year inflation of 140% for December 2024 and of 45% for December 2025. These figures are in line with those expected by the economic analysts, according to the Banco Central de la República Argentina (BCRA) May survey (146% at December 2024 and 50% at December 2025).

Future risks to inflation

The stabilisation of inflation in Argentina will depend on the future course of public finances and exchange rates, and the regulated price adjustments that are still pending. All of these areas pose risks.

In the fiscal realm, the above-mentioned revenue and expenditure measures led to budgetary equilibrium. On

Chart 5
Sovereign spread

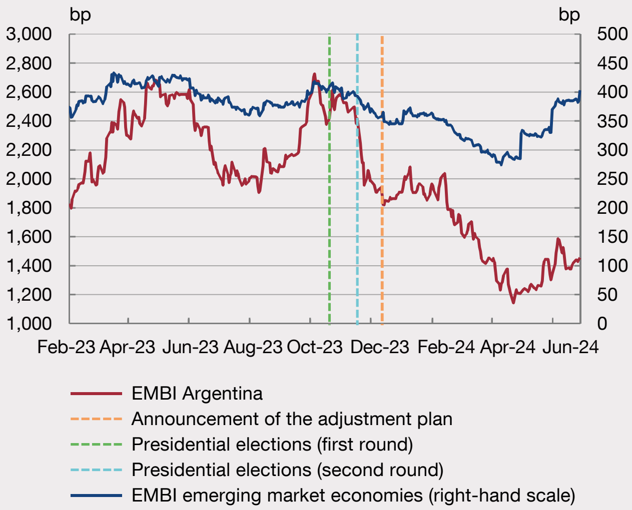


Chart 6
Buenos Aires stock exchange

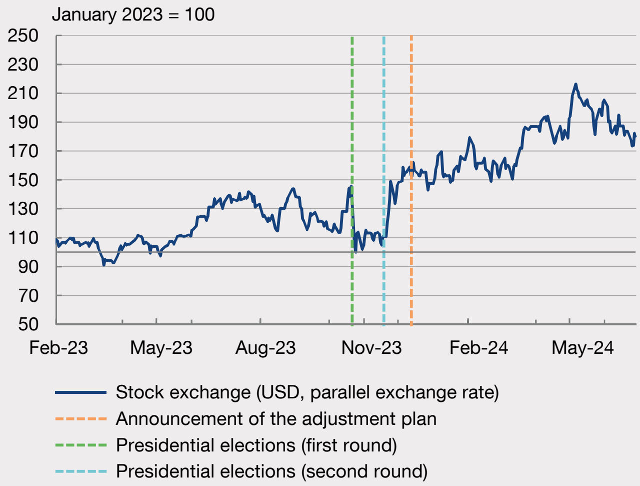


Chart 7
Exchange rate

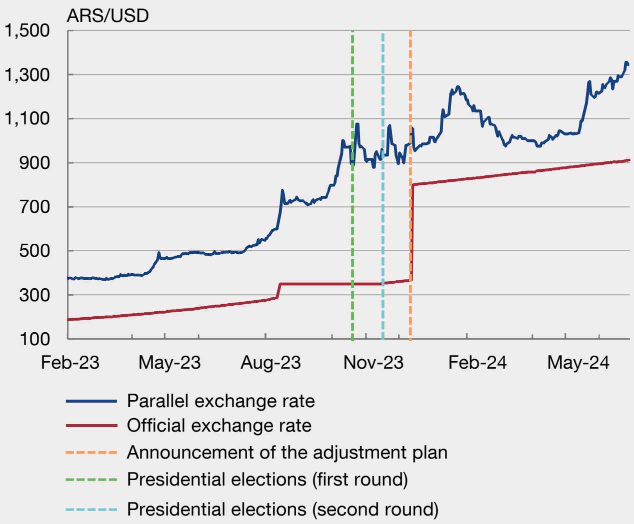
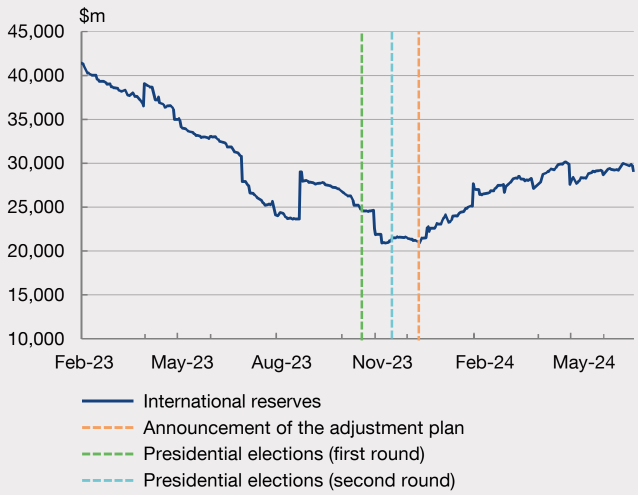


Chart 8
International reserves



SOURCES: Refinitiv, Banco Central de la República Argentina and Banco de España.
NOTE: Latest observation: 28 June 2024.

4 IMF. (2024). "Eighth Review of the Extended Arrangement Under the Extended Fund Facility".

Box 1
INFLATION DEVELOPMENTS IN ARGENTINA (cont'd)

28 June Congress approved a fiscal package sent by the executive branch which broadens the income tax bases, increases the tax rates for certain income brackets and introduces changes to the wealth tax. Reducing or eliminating other distortionary taxes, such as the taxes on international trade and foreign currency transactions, is also being considered.

As regards the pending adjustments to public services prices, Chart 9 shows the changes in the relative price of regulated goods and the total price index. The relative price of regulated goods has now reached 78% of its value in 2019. The increase in public services prices poses a challenge for the future since, as this item normalises, the regulated price component will drive inflation up. As an example, if this update were to be completed in a single month, with the relationship between regulated and non-regulated prices returning to that in 2019, regulated prices would automatically add around 7 percentage points to month-on-month inflation, without taking into account the effect of this price change on the other macroeconomic variables.

Lastly, there is much uncertainty about the behaviour of the exchange rate, insofar as the Government has not yet announced what the monetary and exchange rate will be like moving forward. By way of illustration, a recent article[5] shows that inflation expectations still remain high as a result of the expected depreciation of the exchange rate, which exceeds the depreciation announced by the government (2% per month against the dollar). The authors use a model under which the inflation rate on internationally traded goods incorporates private analysts' depreciation expectations, while other prices are adjusted according to the inflation recorded in the past. As Chart 10 shows, the inflation path projected by the model[6] captures the dynamics of analysts' inflation expectations and converges towards the long-term inflation expectation, suggesting that such expectations are determined by devaluation expectations.

Chart 9
Relative price of regulated goods

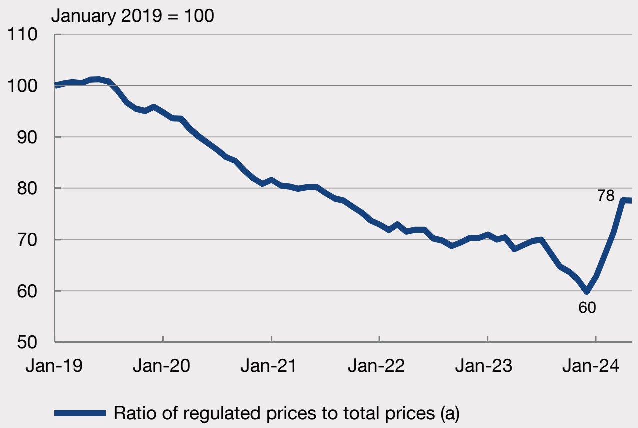
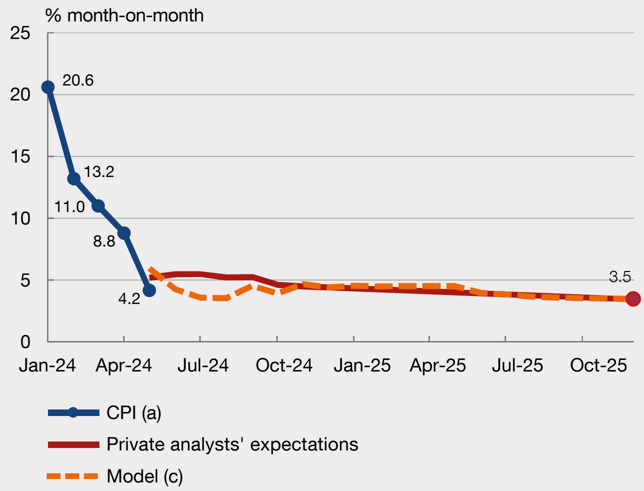


Chart 10
Inflation expectations



SOURCES: INDEC, Banco Central de la República Argentina and Banco de España.

a Latest observation: May 2024.
b The Banco Central de la República Argentina's May Market Expectations Survey (REM, by its Spanish initials). Publication date: 6 June 2024.
c The simulation model is taken from Ernesto Talvi and Sofía Harguindeguy. (2024). "From Milei's zero fiscal deficit towards a stabilisation plan to eradicate inflation: why now?", Elcano Royal Institute, 17 May. This model assumes that monthly inflation is determined by a linear combination of past inflation and expectations of depreciation of the exchange rate against the dollar. The model is updated using expectations data from the May REM.

5 Ernesto Talvi and Sofía Harguindeguy. (2024). "From Milei's zero fiscal deficit towards a stabilisation plan to eradicate inflation: why now?", Real Instituto Elcano, 17 May.

6 The chart replicates Talvi and Harguindeguy's simulation with data on devaluation and inflation expectations for May 2024.

Box 1
INFLATION DEVELOPMENTS IN ARGENTINA (cont'd)

Resolving the uncertainty about the future monetary and exchange regime might help to reduce inflation expectations. The IMF programme contemplates the gradual easing of exchange controls and the currently negative short-term ex ante real interest rate[7] turning positive to support peso demand and disinflation. In the longer term, the government has considered the possibility of implementing a currency competition system, where the local currency co-exists with foreign currencies and economic agents are free to choose the currency they use in contracts and transactions.

7 An ex ante real interest rate is one that discounts the nominal interest rate with expected inflation rather than actual inflation.