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Argentina and Overheating: Monetary Policy and Inflation

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Abstract:

Argentina's default in 2001 signaled a commitment to heterodox approaches in macroeconomic policy making. Much debate has centered around the merits of this approach. In the decade post-default Argentina has maintained one of the highest growth rates in the region. And has claimed impressive gains in areas such as unemployment, poverty reduction and social spending. Commodity prices during the mid 2000s, strong demand from China, and insulation from the global financial crises all added to the fortunes of the Argentine economy. But, Argentina is widely considered to be at high risk of overheating. Government and private estimates of inflation diverge greatly. When private estimates of inflation are used the sustainability of the Argentine growth path comes under question. This paper provides an overview of inflation in Argentina and discusses the ways through which inflation may threaten its growth path.

1. Introduction

Over the last decade Argentina, like many Latin American countries has expanded its trade linkages. Its most significant partners are Brazil and China. These more integrated trade relationships with China have allowed many to bounce back quickly from the crisis. Soya products have tripled in price. Roughly 90% of Argentina's soya crop has a final destination of China. And China is committed to a long term investment of 1.5bn toward Argentina's agricultural production. Argentina enjoys not only this trade relationship but, after default in 2001, has been unable to develop strong linkages with international capital markets. These two factors together with a heterodox development model has created a buffer against contagion of the sub-prime fallout.

For the last 7 years economic growth in Argentina averaged 7.60%. In 2009, Argentina experienced a brief, deep slowdown during which growth fell to 6.80%. During this slowdown unemployment registered only 8.60%, still below its seven year average of 10.33%. Gross capital formation declined 10.19%. But after aggressive provision of liquidity by the monetary authorities and a battery of federal programs aimed at stabilizing labor markets, the economy began roaring again in 2010 with economic growth reaching 9.20% on an annual basis. Inflation, also began roaring back reaching an official estimate of 9.10%. The worry now is not whether growth in Argentina will rebound from the effects of the sub-prime crisis but whether they are overheating.

During 2011, Argentina became a target for worries of overheating. Based on inflation, GDP growth, unemployment, real interest rates and changes in current account balances. Since then top IMF leaders have described Argentina as “a frying pan with boiling oil”.¹ Brazil ranked second, experiencing asymmetrical expansion led by household consumption. Brazil's growth has since contracted remarkably.²

This report provides an overview of the signs of overheating in Argentina. And takes a deeper look into the causes of inflation assessing the short term consequences of inflation on growth prospects of the country. The sustainability of the current stance of monetary policy within Argentina concludes the report.

2. The Signs of Overheating

A recent IMF survey of G20 countries has highlighted overheating risks for emerging markets. Among the countries covered, Argentina has been awarded the highest risk.(IMF, 2011) With all key variables operating above trend baselines. Argentina shows a strong positive output gap, historically low unemployment and inflation above trend lines.

Table 1: Output relative to trend, unemployment, inflation.

Argentina	GDP Growth (%)	Unemployment	Inflation (consumer prices)	Inflation (GDP Deflator) ¹
2010	9.20%	8.3%*	10.80%	15.00%
7 year average	7.61%	10.61%	9.12%	12.72%

Source: WDI, except as noted (*)MECON. ¹ Inflation figures have been widely disputed, some private estimates reach as high as 25%.

1 <http://en.mercopress.com/2011/07/08/argentine-economy-a-frying-pan-with-boiling-oil-says-imf-top-official>

2 <http://www.ft.com/intl/cms/s/0/90f9876a-200d-11e1-8462-00144feabdc0.html#axzz1gcqLyldO>

Inflation, (whichever figures you believe) is high. And given the country's figures on unemployment and industrial production, it appears to be operating close to potential. Growth in real wages has been outstripping industrial production since 2006.

The immediate threat inflation poses to Argentina's growth comes through its impact on the trade surplus. High inflation coupled with only moderate devaluation of the exchange rate, 5% against the USD, will result in appreciation of the real exchange rate. The consequent effect will be a narrowing of the current account surplus, and a weakening of the economy's key sources of economic growth. This contraction of the current account has already begun in earnest, falling to 0.84% of GDP, as shown in Table 3. To the extent export driven growth is handicapped by inflation, a growth slowdown is likely.

At current inflation levels further depreciation of the Argentine peso would be required to correct the imbalance in the real exchange rate, enhancing competitiveness and making an external surplus driven growth scenario more optimistic. The overvalued real exchange rate coupled with expectations of depreciation encourage capital flight motivated by haven seeking or speculation. Argentina has sacrificed reserves to intervene in FX markets, and at the same time imposing foreign exchange controls consistent with Mundell's Trilemma.³

If current trends continue, Argentina will have to choose between taming inflation, imposing stricter capital controls or facing a potentially abrupt and disturbing bout of capital flight and forced depreciation.

Table 2: Expansion of credit, current account, Change in reserves, money supply

Argentina	Domestic credit to private sector (% GDP)	Current account (% GDP) ²	Change in reserves ³	Change in Money supply ¹
2010	15.00%	0.84	7.90%	33.11%
7 year average	13.40%	2.92	20.95%	21.00%

Source WDI

3. Factors Contributing to Inflation

Demand led pressure on inflation should be visible from unprecedented expansion of national expenditure in a climate where capacity has been reached and productivity growth is low. When viewing national expenditure the most notable trends are a dramatic spike in household consumption as a percentage of GDP up 8.50% to 69.20% of GDP. There has been a dramatic retrenchment of government spending, declining 4.75% to 3.2% of GDP. While gross capital formation is increasing the effect on GDP seems swamped by consumption spending. And indeed the growth of gross capital formation reflects a restoration to levels seen prior to the 2009 collapse. Yet post recession recovery is not the story behind household consumption the expansion of which places it above its long run trend. Household consumption was 69.2% of GDP in 2010 up from a seven year average of 61.3%. In part, it appears that the government is falling back as consumption fuels national expenditure. What is happening is a re-balancing of the components of national expenditure. Overall, total national expenditure has remained very stable, around 94% of GDP.

³ <http://blogs.ft.com/beyond-brics/2011/11/01/argentina-fx-controls-fuels-peso-fears/#axzz1hrJdTBSH> and <http://blogs.ft.com/beyond-brics/2011/10/28/argentina-let-the-great-dollar-hunt-begin/#axzz1hrJdTBSH>

For some the most salient culprit for inflationary pressure is the 33.11% growth in monetary aggregates combined with stubborn industrial production, and historically typical unemployment levels. These factors suggest that inflationary pressures may be demand led. One explanation for such aggressive growth in monetary aggregates might be that the Argentine authorities over-corrected for the effects of the global economic slump in 2007-8, underestimating the stabilizing impact of increased trade relations with Brazil and China. But money growth numbers for 2008 and 2009 are far lower than the 33% figure in 2010. If there was a monetary over-correction, it happened late in the game. At present, the BCRA shows no sign of curtailing the roughly 30% growth in M2⁴ In fact this growth is consistent with their targets. The official target for private M2 is 29.2% by December 2011.(BCRA, 2011) Under the current analysis, this seems exorbitant.

Governor Martin Redrado of the BCRA has argued that Argentina is not an inflation targeting country but rather, targets growth in monetary aggregates. He asserts that the growth of M2 is strict and kept below the growth of nominal GDP and that it is kept in check by a deep sterilization policy. This was true until 2009 when broad money growth began exceeding that of nominal GDP. In 2010 growth of money aggregates exceeded that of nominal GDP by 7.2%. In part, this reflects that the strong growth post crisis, has brought the economy beyond capacity.

Breaking down the growth in M2, September 2011 shows a 52% increase in loans to the private sector. This design is intended to impact growth of investment in the productive sector, rather than to fuel household consumption. However, personal loans and credit card loans rose by 35.5% and 37.2% respectively.⁵ (BCRA, Sept. 2011) The BCRA argues that this growth in consumer lending is justified by growing real wages. However, when private inflation figures are used, this official growth in real wages is obviously over estimated. Therefore, the consumption boom is being supported not by rising real wages but rather by consumer credit expansion. If growth does slow significantly, stagnation will be prolonged by consumer debt hangover and negative balance sheet effects on lenders.

This expansion of consumption, fueled by consumer credit in an environment of inflation and the overvalued real exchange rate will further encourage imports, placing additional pressure on the current account surplus and real growth.

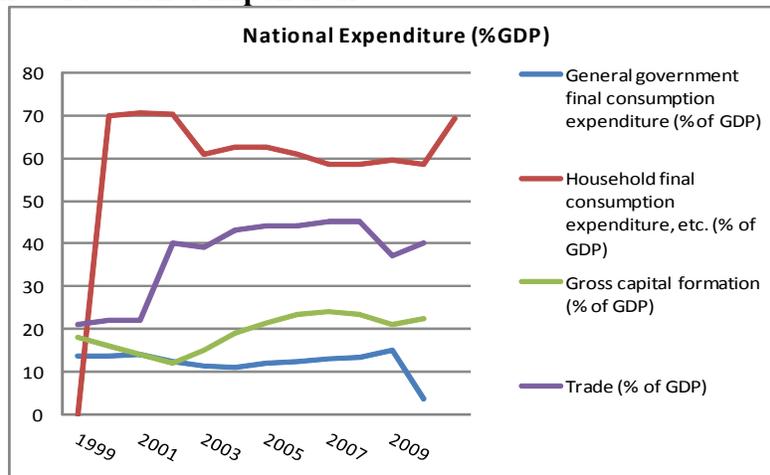
Trends in real wages, industrial output and productivity may be used lend support to the idea that it is a credit fueled consumption boom at the heart of inflation. However, They also open the door to an additional/alternative explanation, cost push inflation in the context of the wage bargain. Productivity growth is above trend at 4.29%, but real wage growth at an official 10.8% is outpacing both productivity and industrial production.(Table 2) Argentine private firms have shown absolutely abysmal performance in equity markets.(Table 4) The MERVAL equity index has fallen 31.9% to date over 2011. This equity trend is should be viewed in context of the global financial crisis.

It appears tough to justify the real wage growth the productivity performance alone. Thus, the increasing wage share of output may be coming at the expense of the profit rate. In this case firms would be expected to defend the profit rate through passing costs onto consumers. To the extent that these price increases are validated through credit fueled consumption, the BCRA facilitates the negative effect on real wages and thus the protection of the profit rate. The effect on real wages is masked by official underestimation of actual inflation.

4 <http://www.bcra.gov.ar/pdfs/polmon/BMB0911.pdf>

5 <http://www.bcra.gov.ar/pdfs/polmon/bul0911.pdf>

Figure 1: Components of National Expenditure.



Source: WDI

Table 3: Wages, industrial production, labor productivity.

	Real Wages (Index change annual)	Industrial production (Index change annual)	Labor productivity (GDP per work hour) ¹
2010	10.80%	9.75%	4.39%
Average (7 year)	10.42%	8.25%	2.25%

Source: IADB. ¹ Source KILM database, ILO. Calculated from index annual change.

Table 4: Corporate profit rate, market capitalization and S&P equity index.

	2005	2006	2007	2008	2009	2010	7 year average
Market capitalization (listed companies) annual change	32.40%	29.69%	8.72%	-39.66%	-6.46%	30.61%	0.00%
S&P Global Equity Index (annual change)	45.39	57.65	0.67	-56.16	97.84	55.32	32.00%

Source: WDI & GDF Online.

In this vein, note that all data on real wages and inflation has come through official channels. Private sources estimate that inflation is running upwards of 20%. If the official data on real wages indicates 10% growth, and official estimates of inflation are around 10% then nominal wage growth must be around 20%. When combined with private figures for inflation-real wages are not increasing nearly so dramatically, and may be falling. Under this lens the redistributive effects of pro-labor, anti-poverty policies are being devoured by inflation.⁶ Considering private estimates of inflation, the recent increase in the minimum wage, by 25%, does not seem any more radical than a COLA.

⁶ <http://www.ft.com/intl/cms/s/0/809d7abe-b174-11e0-9444-00144feab49a.html#axzz1hrSf0Shu>

Keeping in mind that private estimates of inflation greatly mitigate the official growth in real wages, the stake the government has taken in supporting wages and employment deserves attention. Fiscal policy seems to have been the key tool that the government used to defend against threats to its political platform during the brief recession. President Cristina Kirchner has made it plain that the government would focus on stabilization of growth and employment rather than stability of financial markets. Argentine unemployment has been lower than its 7 year average of 10.36% since 2007. During the growth slowdown of 2009, unemployment only reached 8.6% while economic growth collapsed to 0.85%. Real wages have continued a steady increase since the default, rising by 12.47% during the 2009 growth slowdown. Even as growth in industrial production fell to 0.06%.⁷

President C. Kirchner acted aggressively to support aggregate demand, and promote reduction in the post tax Gini coefficient. Reforms have included nationalization the pension system, a recent increase of 25% in the minimum wage, the re-birth of trade unions and large scale public works programs. In addition to these labor market policies the economy utilizes a host of subsidies in various industries.

Linked to government spending, seniorage revenue may be another impetus for masked inflation as it will ease the government real debt burdens. In this vein, Argentina may be running the printing press to pay for its wide array of subsidies. And as of recent months Argentina has begun to claw back revenues through a targeted sequencing plan designed to reduce these subsidies.⁸ However, as of yet a 7.4% reduction of the 10bn in subsidies is all that has come to fruition. Without these subsidies energy costs for consumers can be expected to rise, in many cases by 100%, further fueling inflation.

4. Monetary Policy Looking Forward

At November, the BCRA estimates a 7.5bn decline in reserves over 2011. There are two main sources of this reserve use. The first, and largest, is debt service paid to international financial organizations via the Argentine Debt Relief Fund. The second is intervention into the foreign exchange market. Inflation running at official rates of 10% and private estimates over twice that, is leading to capital flight as expectations of depreciation build. Aside from this intervention, new capital controls on foreign exchange transactions have been implemented to slow the flight.

The Argentine central bank has set a target of around 30% for the growth of M2. In particular it sees the 30% as not excessive so long as it remains below the growth of nominal GDP, which it has not been the case since 2009. The monetary authorities claim to have monetary aggregates in check through a deep sterilization program. In 2007, when large current account surpluses were the case, the sterilization program took place in the form of purchasing foreign exchange and sterilizing the associated growth in the monetary base via sales of bonds. As inflation has ticked up and current account surplus has declined reserve accumulation is no longer a threat. The BCRA saw a general decline in international reserves through October 2011.(BCRA, 2011) This decline was driven by the BCRA sales of foreign currency used to suppress upward pressure on the exchange rate. This pressure to depreciate is being driven by marked increase in dollar demand-capital flight.⁹ The intervention was not sufficient to keep the currency in check and it depreciated 0.33% over the month. The sale of international reserves had a contractionary effect on the monetary base. To counter this the BCRA undertook securities purchases. These were not sufficient to counterbalance the exchange intervention

7 ILO KILMs Dataset

8 <http://blogs.ft.com/beyond-brics/2011/11/16/argentina-taking-the-axe-to-subsidies/>

9 http://www.ec.gba.gov.ar/areas/English_Version/indicadorers_cambiarior/October%202011.pdf

and the monetary base decreased by 5.9 million (ARG\$). All actions of the central bank show no recognition that monetary growth is a problem.

There are limits to the policy of supporting expansionary monetary policy and a stable exchange rate in an environment of capital flight.¹⁰(Frenkel, 2007) In recognition of this limit, the monetary authorities have placed restrictions on capital outflows. If current trends continue, these restrictions can be expected to become more severe. Contributing to the loss of reserves are debt payments, which contribute significantly. Of course current account surplus are the case currently, though narrowing with the appreciation of the real exchange rate, will mitigate this decline. It is this connection that makes growth of export demand from Brazil and China so critical. Alternatively, much more stringent capital controls could be implemented.

5. Conclusion

Some heterodox scholars have put forward the position that Argentina has made the right choice in refusing to fight inflation at the expense of real economic growth. (Weisbrot, et al. 2011) It is argued that the strong gains Argentina has made in poverty reduction, lowering unemployment and raising social spending are worth the inflation trade-off. The implication of the argument, is that inflation is a necessary consequence of these gains. If this is the case, in light of Argentina's very strong economic growth through 2011, a continuation of redistributive social programs in a climate of low economic growth may only be expected to exacerbate inflation. Neglecting the possible tie between social spending and inflation, to the extent that inflation inhibits growth in the future Argentina's poor can be expected to lose ground that might otherwise be gained through more sustainable growth program.

The main issue Argentina is facing is that of inflation. The associated misalignment of the real exchange rate will narrow the current account surplus that is generating growth. This coupled with low productivity will further dampen growth prospects for Argentina. It is a bad time for this loss of competitiveness. Brazil, a major trade partner has already begun slowing down. There is no reason to expect a immediate collapse of the economy and growth. The ability of Argentina to continue depends largely on whether positive external conditions are strong enough to outpace the competing problems stemming from inflation. This depends critically on the support of demand from China, which has already taken steps to slow its growth path in recognition of overheating. But even with this in place, curbing inflation and reducing the expansion of consumer credit would enhance the growth projections for Argentina. Without feeling compelled to target inflation, perhaps Argentina should target the real exchange rate.(Frenkel & Taylor, 2006) Without handling inflation, sufficient depreciation will be required to maintain current account surplus. But this depreciation will come at the cost of pass through inflation. Taking steps to curb inflation will enhance growth, which will benefit workers, firms and the incumbent political party.

Failing to do so is a risk to economic growth, the gains of those in the lower income percentiles, and the political platform of Argentina's leaders.

¹⁰ <http://www.g24.org/Publications/PolicyBriefs/pbno16.pdf>

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