# Consequences of Inflation on Development of Argentina

## Introduction

Argentina is the second largest economy of South America famous for its mineral and agricultural resources. The population of Argentina is highly educated and the nation is world famous for its achievements in the field of soccer (Coraggio & Arroyo, 2009). However, there has always been instability persisting in the political and economic facet of the nation. The nation has been facing problem with the inflation rate, growth of financial sector and trading sector of the economy. The macroeconomic problems of the economy that has been existing for the last few decades could not be solved till date by the any of the measures undertaken by the government. There are many underlying factors which are held responsible for the present situation of the economy. The strategies that had been implement by the government and the currency board of Argentina have proved to be quite ineffective in nature. The fiscal and monetary policies which were designed to improve the economic situation of the nation were not framed effectively and thereby, proved to be faulty. The wrong policies further worsened the situation instead of improving it.

Argentina is one of the developing economies of South America and there are many macroeconomic problems which exist in the country. Inflation is taken up here as the topic of further research in this paper. Inflation is one of the most consistent problem of the nation, which has been continuously hampering the daily life of commoners as well as the economic position of the nation since quite a long time. This paper aims at providing a detailed research on the country specific information, major macroeconomic issues that are troubling the nation, inflation and its causes, analysis of the economic indicator of inflation, consequences of inflation and measures that have been undertaken by the government.

## Country Background of Argentina

Argentina has rich natural resources, skilled and literate human capital and an extensive agricultural sector. The agricultural sector of the country is advanced enough to supply its products to other countries. The economic performance of the nation has been remarkably diverse in nature. It has been characterized by high growth in GDP along with high inflation and recession. The main currency of Argentina is argentine Peso and Argentine Austral. The service sector of the country accounts for the highest contribution in GDP, which is near about 60% of the country’s growth, whereas industry in Argentina is not highly developed and amounts to near about 15% of the total GDP (World Bank, 2017). The agriculture sector of the economy is well developed and is considered as one of the top producer of goods and products like beef, honey, soybeans, sunflower seeds, maize and wheat (Coraggio & Arroyo, 2009). The exports of Argentina is somewhat well diversified, but not well developed if compared to other countries of Latin America. Agriculture raw materials accounts for nearly 20% of the exports and if processed foods are included, then it amounts to 50% of the total export (World Bank, 2017). The foreign direct investment of the country is mainly divided among natural resource, manufacturing and service sector. The economy fell into crisis between 2000 and 2003 after which the country took few years to recover from it (Caraballo, Dabús & Usabiaga, 2006). After suffering from twenty-five years of boom and bust stagnation, the economy size has doubled between 2002 and 2013.

## Macro-economic Issues of Argentina

The major macro-economic issues of Argentina mostly revolves around the devaluation of the nation’s currency that is PESO, which further leads to inflation. The economic environment of Argentina at present is going through difficulties. The nation is facing troubles from all the sides of the economy, which are fall in industrial output, degrading purchasing power parity, small share of exports in GDP etc., the government of Argentina is facing serious challenges to boost the growth and reduce unemployment of the economy (Coraggio & Arroyo, 2009). The last decade of the nation was characterized by economic mismanagement, corruption, inflation and under employment. The inflation rate of the country was close enough to reach the inflation rate of Venezuela, where the economy is presently ready to invite new investors for investment but the serious political risks are attached with it. According to prominent economists, the nation is currently under stagflation with an annual inflation rate of more than 40%, which is continuously eroding the purchasing power of the commoners (World Bank, 2017). The consumption levels of the whole country has perceived significant drop after the devaluation of the currency. After the last president Marci has come over to power, the country has been experiencing a rise in poverty level as well. The nation was never too advanced in the financial sector or in the trading sector. The trading sector accounts for 30 percent of the GDP and the financial sector of the economy amounts to 3 percent of the whole annual GDP (Ahumada, Alvaredo & Canavese, 2007). The current president is trying to create a business environment in the country, which can help to bring in foreign direct investment and solve the problem of low levels of dollar reserve of the economy. The country is in great need of earning foreign capital for improving its fiscal situation.

The low share of export in the Argentina economy is considered as one of the main reason for the inflation. Generally, the external sector has the potential to provide buffer when there is crisis in domestic demand. In the last two decades, it has been seen that there has been a sharp drop in the economy’s output due to inflation, where the country’s private spending and investment went down. Due to less export and capital deficiency it became hard for the economy to pay for its imports.

The nation has a long history of high inflation, fiscal deficits, volatile and low growth. The prime reason behind the instability of the economic environment of Argentina is due to the inefficiency of the currency board that has failed to provide monetary stability after long years of instability.

The ‘not so well developed ‘trading sector of the economy is one of the reason behind the economic problems. The total value of export and import which if taken together equals to 29% of the country’s GDP. The tariff applied to this sector is near about 7%, but there are several non-tariff barriers, which often intervene into the trading of the economy (Caraballo, Dabús & Usabiaga, 2006).

## Inflation and Its Cause

Rise in the price of the goods and services of the economy is termed as inflation. It is majorly associated with devaluation of currency. Decrease in the quantity of goods and services that is usually bought by a particular amount of money is termed as inflation. One of the direct cause of the rise in inflation is the expansionary policies, which are undertaken by the government to stimulate growth of the economy. Among the South American nations, Venezuela was at the top position in the list of countries with high inflation whereas Argentina was at the sixth position between the countries Malawi and Yemen. This was in the period before 90’s, but after that, Argentina suddenly came at the top of the list with an inflation rate of 20,000 percent (Ahumada, Alvaredo & Canavese, 2007). Inflation in an economy can at times be helpful but it is mostly harmful when its ‘high’ or ‘hyper’. The present government nor their predecessor cannot be held responsible for the ‘hyper’ inflation. The state intervention in most of the cases have proved to be wrong, and the nation now relies mostly on the market forces. The engagement of state into every matter has become redundant. Another reason behind the hyperinflation is the corruption among that prevails in the population of the country and also the faulty strategies and policies that were taken up by the state.

There are several other factors that can be held responsible for the current devastating state. Argentina in its initial phase was a very rich and fertile country with an abundance of resources and was the prime exporter of grain, wool, meat and leather unlike the present situation. The nation has always been lagging behind in the industrial sector even after having a proper infrastructure. It failed to diversify itself because of its industrial sector. There was also class division among the population of Argentina, which gave rise to a dominant class of Landlords and an oppressed Class of workers. At that time the population of Argentina even lagged behind many other nations in terms of education and health. This further slowed down its growth (Caraballo, Dabús & Usabiaga, 2006). The nation was dependent on the United Kingdom for its investment but after Second World War, the situation changed entirely and Argentina became a closed economy (Caraballo, Dabús & Usabiaga, 2006).

The government of the nation was unable to issue debt and faced a static constraint on its budget deficit. The nation was allowed to borrow both from international and domestic sources. The currency board imposed direct constraints on the fiscal policies of the nation after the creditors got to know about the government’s unwillingness to provide new financing. The above-mentioned reasons when considered together can be utilized for providing justification for the current macroeconomic scenario of Argentina. These reasons prove why the correct economic policies of growth have resulted in the rising and up surging inflation of the nation.

Some major steps were undertaken for disinflation in the early years of 1990, which decreased the inflation rate to a certain extent but this was not a long term arrangement for solving the issue of inflation (Coraggio & Arroyo, 2009). The currency board tried to keep a pegged regime in Argentina, but keeping in mind the economy, export percentage, labor market rigidities, the size of the economy and other factors the maintenance of this exchange rate for controlling inflation is not that compelling (Caraballo, Dabús & Usabiaga, 2006).

Another major wrong decision taken up by the authorities was to make the PESO as good as the US dollar. This resulted in the ‘dollarization’, which refers to lack of confidence in the domestic currency and monetary instability (Ahumada, Alvaredo & Canavese, 2007). This added to the devaluation of PESO and increased the inflation.

During 90’s, inflation in Argentina got reduced and contradictorily at that time, the PESO of Argentina was pegged to that of US dollar, both the currencies were exchanged for transactions at that time. The scenario changed drastically after the collapse of PESO’s dollar peg and when the dollar contracts were converted to PESO contracts at an exchange rate which did not even follow the market trends (Ahumada, Alvaredo & Canavese, 2007). This caused the inflation rate to soar again. In spite of knowing that most of the decisions undertaken by the Currency Board were faulty, abandoning of the board did not seem feasible, as that would have never been costless (Guerrero, 2006). This would have included both economic and political costs, which would not have been possible to bare at that moment.

## Consumer price index

Consumer price index or CPI is perhaps the most appropriate indicator of the inflation or deflation of an economy. The consumer price index when compared between different years shows the difference that has taken place in the purchasing power of the individuals due to the devaluation of currency (Caraballo, Dabús & Usabiaga, 2006).

**Figure 1: Annual Consumer Prices**



(Source: World Bank, 2017)

The following graph depicts that the inflation rate in Argentina has always been consistently high between 2000-2013.. The rate of inflation has been moderate from 2004 onwards but around 2006 it took a leap. The main rise in inflation can be noticed from the year 2001 to 2003. Here the inflation reached a great height due to the execution of some faulty policies.

## Consequences

Inflation in Argentina is not something which can arouse anybody’s surprise, it is not a rare phenomenon rather this price hike is something which is a part of their day to day life. Rather, inflation at the present decade is still in a manageable state. During the fifteen years from 1975 to 1990, the inflation of the country reached at a rate of 300 % on an average, at this time, the price level of different commodities were expected to double in every second month (Manzetti & Wilson, 2006). In 1989, the rate of inflation reached its peak of more than 1000%, after which the government was determined to bring under control. After which it was brought under control, but it again took a leap on 2003 then came to normalcy and again rose to 40% annually in 2016 (Ahumada, Alvaredo & Canavese, 2007). The consequences to this consistently high rate of inflation has brought some permanent structural changes in the administration of the state. The market interest rates even rise to compensate for the high inflations rates, even the government is now compelled to pay a 25% interest rate in short run to borrow in the domestic currency (Calomiris, 2007).

Long-term investments are generally avoided by both businesses and households. Rather short- term loans or variable- interest- rate loans are substituting these long term ones as any leap in inflation would cause a rise in their interest payment (Neiburg, 2006).The domestic mortgage market has been completely destroyed by the general tendency of the variability of the nation’s inflation rate. Households have also become reluctant to use mortgages to buy home (Ahumada, Alvaredo & Canavese, 2007). Not only households but also the businesses are not interested in borrowing, as the rise in inflation makes the interest rates go high and unstable. This situation can often lead to bankruptcy of healthy companies.

The insurance companies of Argentina are not in a functional state, as the insurance holder is uncertain about the value of PESO, concerning the future claim. This problem can be defended by adjusting the payments to the contemporary rate of inflation, different agreements, insurance contracts and mortgages could be indexed to the price level (Thornton, 2008). However, this is a very difficult task as the inflation rate alters very rapidly and it is hard to identify the contemporary rate.

The demand have been depressed which may lead to bankruptcy of healthy companies whereas, the real GDP has declined because of high interest rates and tight money schedule. Even when there is decline in the inflation rate and the public is not able to perceive it then the state has to pay a price for adjusting to this situation. It has to pay a short-term price for a long-term gain.

The credit market of the economy is severely affected by inflation. Due to high inflation, the market interest rates always have a tendency to rise to compensate the effects of inflation. The government in this situation are also bound to pay high interest rate to borrow in PESO. Lenders in such circumstances are unwilling to borrow loans or credits at a fixed rate as the change in inflation rate would anytime destroy the real value of their bonds and loans (Grugel & Riggirozzi, 2007).

The outflow of funds from Argentina has made the investment of the nation very low. The capital formation in the country has slowed down and it only accounts for 17% GDP, which is very low compared to other countries of South America (Ahumada, Alvaredo & Canavese, 2007).

## Measures Undertaken by government of Argentina

The government of Argentina after the Second World War mostly followed the protectionary policies and government intervention in every economic situations was a general scenario (Grugel & Riggirozzi, 2007). However, presently, the government has reduced its level of intervention in monetary policies so that it can help in reducing inflation.

The currency board, which proved itself unworthy of bringing stability to the nation, opted for a risky regime. After facing years of high inflation and turmoil, it sacrificed the use of exchange rate as an adjustment tool to and put a lot of constraints on the authorities to bring changes and make any alternations in the monetary policy. All the above stated reasons again resulted in the inconsistencies between fiscal and monetary policies and gave rise to cyclical monetary conditions (Basco, D'Amato & Garegnani, 2009).

The previous Argentine government even tried deceiving the public by publishing false estimates of inflation. The government even fired the statistician who tried to publish the actual anticipated rate of inflation (Grugel & Riggirozzi, 2007). The government was keen on establishing very low figures of inflation as the expected rate. The government appointed political allies who were ready to produce artificially low numbers, which would misguide the public.

The government allowed the residents of the country to convert the PESO into dollars, so that it can be transferred out of the country. People who were wealthy got a chance to move their money for investment in the United States (Basco, D'Amato & Garegnani, 2009). As a result, Argentinian investment in the US increased. The current government of Argentina is trying its best to combat the situation and they are determined to decrease rate of inflation and bring stability in prices but it is sure to incur a lot of political cost.

The government sets controls on the amount of dollar that could be bought by the ordinary people of Argentina, this measure was undertaken so that the foreign reserve of the government could be secured. However, the decision backfired and resulted in the creation of a parallel foreign- exchange market.

The tariffs on agricultural products such as corn, beef, wheat and soya were reduced. This relaxation of currency controls is supposed to result in increase of exports. The finance team of the government is trying to replenish the dollar reserve prior to the devaluation of the currency. A number of regulatory measures have been undertaken by the state for the regulation of business environment, however the inflation is sometimes triggering because of the low base effects.

## Conclusion

The conclusions that can be easily drawn from the experience of Argentina is that stability of price should not be considered as a long term solution for the economy. The inflation rate can shoot up anytime causing an upheaval in the economy. Secondly, it has been seen that the consistency of high rate of inflation can stay in the memory of public for long. This cannot be easily driven out of their minds even if the actual rate of inflation lowers than the anticipated one. Hence, they make their investments and other financial decisions based on their anticipations. In order to avoid these adverse effects the state and market should work towards achieving price stability. They should implement correct monetary policy to bring the situation under control. The correct type of interest rate regime should be made functional keeping in mind the economic conditions of the nation.

The currency board was critical at the initial stage while taming the hyperinflation. It became increasingly difficult for the board to escape this situation without creating any crisis. Formal dollarization was never helpful and the forced redenomination of assets and liabilities also provides support to this claim. The country is in need of an appropriate policy or a perfect exchange rate regime that can fit the country’s internal political and economic structure. The government of Argentina has brought many significant policy changes in the field of economics reforms. The major ones among them are reduction of inflation, reform of the national statistic system and modernization of the import regime. The substantial policy reforms and structural adjustments have sent a strong signal to everyone that the new government is on the verge of restoring Argentina back to the place of economic freedom.

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