The Argentine Economy: Three Problems, One Solution

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In the past three years, Argentina has experienced a remarkable recovery from one of the most severe economic depressions on record. The fast growth path that the country is currently embarked in is jeopardized, however, by three serious problems.

One problem is inflation. Current forecasts place the annual rate of inflation for 2006 around 12 percent. The damaging effects of inflation are aggravated by a misled desinflation policy based on price controls. Price controls are introducing serious distortions in relative prices and shortages of inputs, consumption goods, and services.

The second problem afflicting Argentina at the moment is a significant increase in labor strikes. Because nominal wages are not indexed to consumer price inflation, labor unions resort to striking as a way to preserve the purchasing power of salaries in an environment of rising prices. Labor is the main input in the production of goods and services. Disruption in the supply of this vital factor can kill the current expansionary phase in aggregate activity.

The third problem affecting economic life in Argentina is the 6-month ban on beef exports imposed by the government in March. The objective of this measure was to induce a decline in the domestic price of meat and is part of the ill-conceived desinflation plan in place. The export prohibition is highly distortionary. Argentine meat exporters are forced to interrupt commercial relations with foreign markets that were difficult to establish and will probably be hard to regain. At the same time, artificially low meat prices are likely to induce cattle growers to liquidate significant part of their stocks.

All of the three problems described above have a common cause: the lack of appropriate measures to curb price inflation. A notable characteristic of

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the current inflationary process in Argentina is that it is taking place in the context of a relatively flat nominal exchange rate. In effect, the price of the dollar has been fluctuating in the vicinity of 3 pesos for the past three years. Inflation appears to be entirely driven by sustained increases in the price of nontradable goods (such as services), which, in a context of high aggregate demand, are becoming relatively more expensive than traded goods (such as agricultural goods). In general, there is little short-run monetary or fiscal policy can do to alter movements in relative prices like the price of services relative to the price of food. For movements in relative prices are caused by real factors, such as terms of trade shocks, chenges in international financial conditions, etc., which are out of the control of the policymaker. However, it is in the policymaker's control whether or not required changes in relative prices take place in an unstable inflationary environment or in the context of price stability.

In Argentina today, the right desinflation policy should aim at allowing for the observed movements in relative prices with substantially less inflation in nontradables. This could be accomplished by allowing the peso price of the dollar to adjust downward. In particular, if with a nearly constant nominal exchange rate the expected rate of inflation is about 12 percent per annum, stabilizing the inflation rate of nontradables would require lowering the price of the dollar by about 1 percent per month, or to about 2.6 pesos by March of 2007.

The proposed policy would go a long way toward solving the three problems mentioned above.First, inflation would cease to be an issue. Second, in a context of price stability nominal wages need not adjust so often, and as a result unions have less incentives to go on strike. Third, because beef is a tradable good, its price is directly linked to the exchange rate. A reduction in the peso price of the dollar, therefore, would immediately be reflected in a decline in the nominal price of meat.

Implementing the desinflation policy suggested in this article requires a radical policy change on the part of the government. Price controls, whose effectiveness as a cure for inflation doesn't withstand any serious analysis, ought to be abandoned completely and immediately. All of the attention should be focused on the central bank, which is failing to achieve its central goal, namely, price stability. Moreover, Mr. Kirchner must stop blaming supermarkets, cattle growers, and other suppliers of goods and services for the rise in inflation, and redirect his energy to monitoring the actions of the president of the central bank.