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Fiscal Consolidation and Disinflationary Frictions in Argentina

RESEARCH

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ABSTRACT

Argentina has struggled with persistently high inflation for the past two decades, surpassing 200% in 2023. While there is a broad consensus on the need for fiscal consolidation to curb inflation in the country, the path to disinflation is fraught with challenges. The objective of this paper is to provide an analysis of the frictions that arise in the process of reducing inflation through fiscal consolidation in Argentina. To accomplish this, we embed Argentina's unique institutional features—particularly those related to fiscal spending and inflation dynamics—into an otherwise standard macroeconomic framework, drawing on the logic of Sargent and Wallace (1981), which links fiscal deficits to inflation. We then use the model to analyze the potential short- and long-term inflationary consequences of different strategies for closing fiscal imbalances.

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Inflation in Argentina surged to 211% in 2023, a phenomenon that is not new in the country. Since 1970, inflation has exceeded 20% in 40 years (Figure 1), including three hyperinflations in 1975/76, 1984, and 1989/90. During this period, the country replaced its currency several times, removing 13 zeros from its currency along the way.

Argentina's economic struggles extend beyond inflation. The nation has endured multiple financial crises, including balance of payments crises (1975, 2001, and 2018), sovereign defaults (1982, 1989, 2001, 2014, and 2020), and banking crises (1980, 1995, and 2001).

As a result, Argentina has experienced weak economic growth. The economy has been in recession for almost half of the past 50 years (21 years), with an average growth rate of just 2.1%—considerably lower than the world average (3.6%) and the regional average (3.2%). Among Latin American countries, only Venezuela has exhibited worse growth performance over the same period. In the last decade alone, the economy was in recession for six years, and inflation surpassed 20% every single year (Figure 2).

Normal years have been the exception rather than the norm. Argentina has maintained inflation below 5%—a norm for most countries in the world—while achieving positive economic growth in only five years out of the past fifty. Over the past two decades, this occurred only once.

Economic phenomena are often influenced by multiple factors, and each economic crisis that Argentina has faced can be analyzed based on its specific context. However, there is a critical and predominant driver of the inflation and the recurrent crises of the Argentine economy, which is the persistent fiscal imbalances. Since 1970, Argentina's Central Government had overall fiscal deficits in 42 years and primary fiscal deficits in 32 years (Figure 3).

We maintain that high inflation, sovereign defaults, and balance of payment crises are different symptoms of the underlying fiscal problem that is compounded by the absence of stable and consistent domestic financing. When fiscal deficits are recurrently financed by the Central Bank, it creates fiscal dominance (or expected fiscal dominance),¹ which results in high inflation. Instead, when fiscal deficits are financed through borrowing from the markets at a rate that significantly increases the ratio of public debt to GDP, a sovereign default tends to occur once the financing dries up. Since Argentina's domestic financial markets are relatively shallow, most of the borrowing is usually done from abroad. This means that defaults are often triggered by a sudden stop in capital flows, which can be caused by increased default risk or some external factor, leading to a simultaneous balance of payment crisis.

Therefore, the prescription to stop the vicious cycle is clear: implement a robust and sustainable fiscal consolidation. However, given the links between the fiscal deficit and inflation in Argentina, following this simple recipe encounters significant challenges. Two key sources of friction are: (i) a large share of expenditures being indexed—directly or indirectly—to past inflation, and (ii) high government spending on public service subsidies.

To illustrate the relevance of these two frictions, consider Argentina's government spending in 2023. In that year, indexed expenditures—including pensions and most social transfers—reached 7.6% of GDP, accounting for 39% of Central Government primary spending. This structure implies that a sudden decline in inflation could deteriorate the fiscal balance: while revenues adjust with a lag, indexed expenditures would increase immediately in real terms. At the same time, reducing public service subsidies—equivalent to 2.1% of GDP and about 11% of primary spending—could generate short-term inflationary pressures. These would arise both directly, through increases in regulated prices, and indirectly, via pass-through effects on core inflation, as was the case during the 2016–2019 period.

This paper aims to develop a framework to assess the short- and long-term inflationary effects of different fiscal and monetary adjustment strategies in the context of these idiosyncratic features.

1 Fiscal dominance is a regime in which the fiscal authority sets its expenditures and taxes, and the monetary policy adjusts to deliver the level of seigniorage required to balance the government's intertemporal budget (Leeper 1991).

To achieve this, we extend the framework of Chen et al. (2023), which builds on Sargent and Wallace (1981)'s seminal paper on the links between fiscal deficits and inflation, to reflect the specific institutional characteristics of fiscal spending and inflation in Argentina. We conclude that a time-consistent economic program must include buffers to manage the frictions between disinflation and fiscal consolidation.

The paper is organized as follows. Section 2 briefly reviews the literature; Section 3 presents a simplified model highlighting key fiscal-monetary linkages in Argentina. Section 4 details the frictions that a fiscal consolidation and disinflation program may encounter in Argentina. Finally, Section 5 offers concluding remarks.

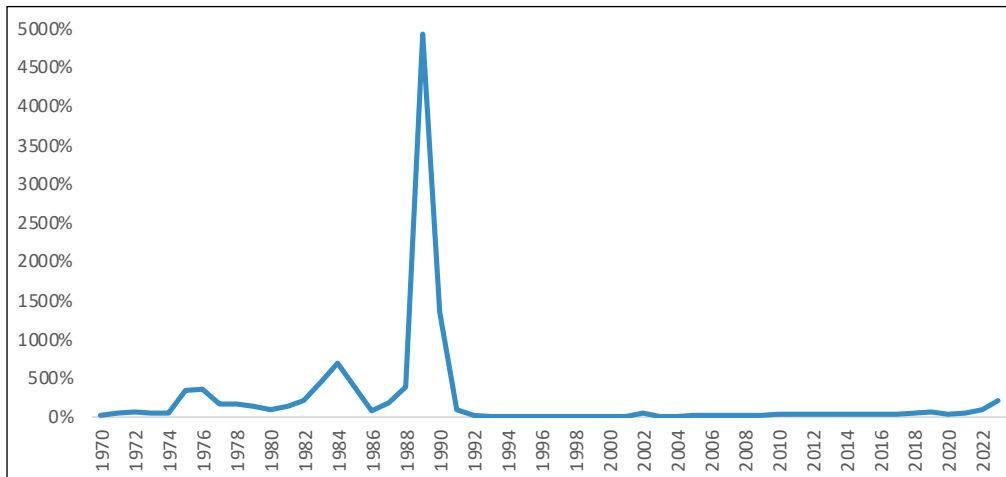


Figure 1 Inflation (1970–2023, EOP).

Source: INDEC, provincial statistics institutes, and private sources.

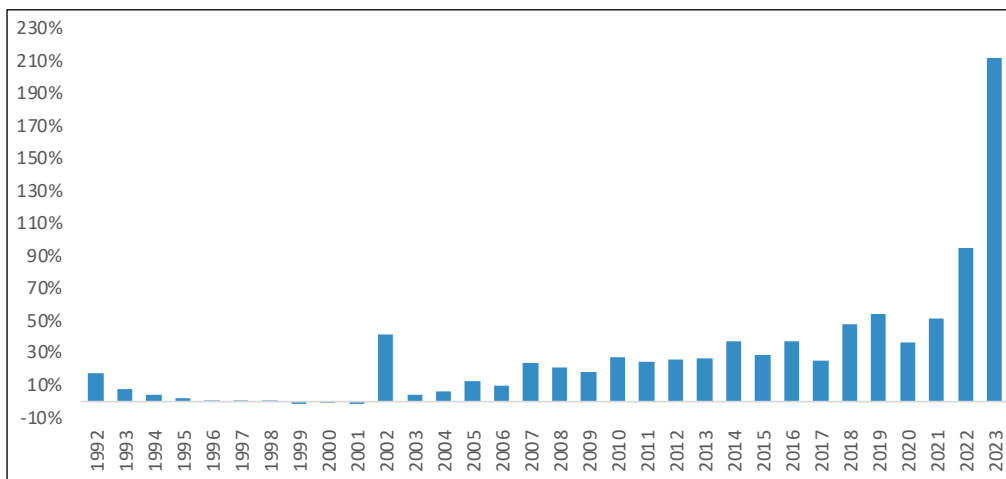


Figure 2 Inflation (1992–2023, EOP).

Source: INDEC, provincial statistics institutes, and private sources.

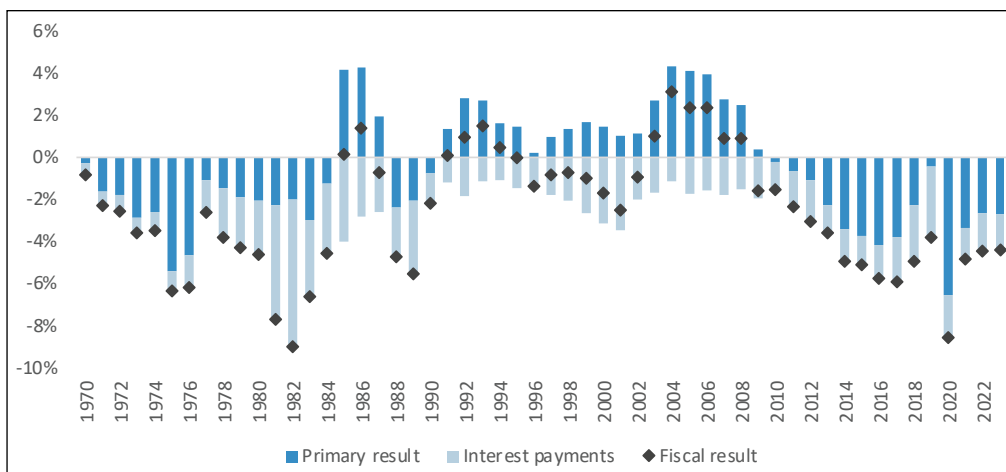


Figure 3 Central Government Fiscal Balance (1970–2023, % GDP).

Source: Ministry of the Treasury (1993–2023) and Fundación Norte y Sur (1970–1992).

This paper builds on several strands of literature that examine fiscal consolidation and inflation, structural models with fiscal blocks, and historical economic features of Argentina.

The relationship between fiscal consolidation and inflation has been widely studied. Guajardo, Leigh, and Pescatori (2010) explore how fiscal adjustment influences inflation, concluding that successful disinflations often involve expenditure-based adjustments. Cogan et al. (2013) and Chen et al. (2023) emphasize the role of fiscal rules in preventing inflationary pressures during fiscal adjustments. Molnar (2013) and Eichengreen and Esteves (2022) highlight the risks of incomplete fiscal consolidations, showing that inflationary pressures persist when adjustments lack credibility. Alesina et al. (2017) provide empirical evidence that expenditure cuts are more effective than tax increases in achieving sustainable fiscal consolidation. Our work complements these papers by introducing Argentina's specific frictions explicitly.

Several studies integrate fiscal policy into structural macroeconomic models in a similar fashion to our approach. Stähler and Thomas (2012) introduce a dynamic stochastic general equilibrium (DSGE) model that incorporates fiscal constraints, showing that fiscal policy plays a critical role in economic stabilization. Philippopoulos, Varthalitis, and Vassilatos (2017) extend DSGE models to include fiscal multipliers, demonstrating how fiscal discipline affects economic growth. Our work is most closely to Chen et al. (2023), who developed a simplified structural model that accounts for fiscal spending explicitly.

This paper also builds on recent research analyzing Argentina's fiscal and economic challenges. Kaminsky, Mati, and Nada (2009) analyze Argentina's fiscal crises, identifying recurring patterns of deficit-driven inflation. Our work complements Buera and Nicolini (2019), who examined the fiscal roots of Argentina's inflation between 1970 and 2017. However, our approach differs by focusing on the present-day situation and the inflationary impact of fiscal consolidation. Our paper also relates to that of Gerchunoff and Rapetti (2016). While their paper basically argues that the underlying problem of the Argentine economy is that the real exchange rate that makes the economy competitive is politically unsustainable, our focus is, as explained, on the fiscal front. However, one can map fiscal expenditures to different equilibrium real exchange rate levels. As a result, our paper can be seen as providing fiscal fundamentals to an analysis focused on the real exchange rate.

3. A SIMPLE MODEL OF FISCAL AND MONETARY LINKAGES IN ARGENTINA

In this section, we develop a framework to illustrate the core linkages between inflation and fiscal deficits in Argentina. Two key mechanisms are at the center of this relationship:

- 1. Indexation and Inflation Persistence:** In high-inflation environments, a substantial share of public expenditures—particularly pensions and social transfers—is indexed to past inflation. This backward-looking indexation introduces fiscal rigidities, as a sharp disinflation can increase real expenditures in the short term, thereby deteriorating the fiscal balance.
- 2. Subsidy Adjustments and Inflation:** Cutting subsidies on regulated prices, such as those for energy and public transportation, can improve fiscal outcomes. However, these adjustments tend to generate upward pressure on inflation in the short run, particularly through direct and indirect effects on consumer prices.

These intertwined dynamics help explain why traditional disinflation and fiscal consolidation strategies often face significant challenges in the Argentine context.

3.1 LAW OF MOTION FOR GOVERNMENT EXPENDITURES

Government expenditures can be decomposed into three main components: Consumer price index (CPI)-indexed expenditures (g_t^i), **subsidies on regulated prices**—mainly utilities—(g_t^s), and **other expenditures** (g_t^o). Total expenditures are therefore represented as:

$$g_t = g_t^I + g_t^S + g_t^O \quad (1)$$

The first component includes pension payments and other social transfers that are legally adjusted using formulas based on past inflation. In the case of Argentina, indexed expenditures (primarily pensions and social transfers) account for approximately 60% of total primary spending. The second component captures subsidies to the prices of energy and public transportation. The third component includes all remaining expenditures, such as capital spending. The dynamics of these components are governed by the following equations:

$$g_t^I = \frac{(1 + \pi_{t-1})}{(1 + \pi_t)} g_{t-1}^I + \epsilon_t^{gI} \quad (2)$$

$$g_t^S = \frac{(1 + \pi_t)}{(1 + \pi_t^R)} g_{t-1}^S + \epsilon_t^{gS} \quad (3)$$

$$g_t^O = \rho_g g_{t-1}^O + \epsilon_t^{gO} \quad (4)$$

where π_t is the headline CPI inflation rate, π_t^R is the inflation rate of regulated prices, and $\{\epsilon_t^{gI}, \epsilon_t^{gS}, \epsilon_t^{gO}\}$ are stochastic shocks to each expenditure component.

According to Equation (2), indexed expenditures decrease in real terms when inflation accelerates ($\pi_t > \pi_{t-1}$), as current expenditures grow more slowly than the past inflation index. Conversely, a sharp disinflation increases these expenditures in real terms, potentially undermining fiscal consolidation efforts. This dynamic, in turn, reinforces inflation persistence through indexation clauses.

Equation (3) implies that for expenditures in subsidies (g_t^S) to remain stable in real terms, regulated price inflation (π_t^R) must match headline inflation (π_t). This creates a policy trade-off: postponing adjustments in regulated prices (i.e., maintaining subsidies) helps dampen short-term inflation but increases fiscal costs. On the other hand, reducing subsidies can drive up inflation, complicating monetary policy efforts to anchor expectations.

Finally, **other expenditures** (g_t^O), as shown in Equation (4), follow a standard AR(1) process. This component represented 43% of total expenditures in 2010, falling to 33% by 2019.

3.2 STYLIZED MODEL

We now present a simplified reduced-form model, closely aligned with the framework proposed by Chen et al. (2023), and conceptually similar to the models developed by Clarida, Gali, and Gertler (1999). The model captures the interplay between regulated and core prices, monetary policy, and fiscal dynamics, as relevant to the Argentine context.

Equation (5) defines the structure of the CPI, P_t , as a weighted average of regulated prices, p_t^R , and core prices, p_t^C , where α denotes the share of regulated prices in the CPI. In Argentina, this share is approximately 0.21.

$$P_t = \alpha P_t^R + (1 - \alpha) P_t^C \quad (5)$$

The evolution of regulated price inflation, π_t^R , is governed by an autoregressive process with partial convergence toward relative price parity. Equation (6) reflects the government's role in setting regulated prices, where λ represents the speed of adjustment, and ϵ_t^R is a regulatory price shock. Finally, η measures the direct path-through of lower subsidies over regulated prices.

$$\pi_t^R = \rho_R \pi_{t-1}^R + \lambda \left(\frac{P_{t-1}^R}{P_{t-1}^C} - 1 \right) + \epsilon_t^R + \eta \epsilon_t^{gS} \quad (6)$$

This structure implies that when regulated prices are kept artificially low, the gap between regulated and core prices widens—eventually triggering inflationary corrections unless subsidies persist.

Core inflation (π_t^C) follows a hybrid Phillips curve, incorporating forward-looking expectations, backward-looking dynamics via regulated prices, and demand pressures captured by the output gap (x_t). Supply shocks are represented by $\epsilon_{\pi,t}$:

$$\pi_t^C = \beta_1 \mathbb{E}(\pi_{t+1}) + \beta_2 \pi_{t-1}^R + \beta_3 x_t + \epsilon_{\pi,t} \quad (7)$$

This formulation emphasizes the short-run trade-offs faced by monetary authorities, especially when regulated price inflation is volatile or subject to political discretion.

The canonical Investment-Saving (IS) curve (Equation 8) follows Eggertsson and Woodford (2003), but incorporates the steady-state share of government spending (g_y), affecting the transmission of the real interest rate to aggregate demand:

$$x_t = x_{t-1} + \sigma(1 - g_y)(i_t - \mathbb{E}(\pi_{t+1}) - r_t^{POT}) \quad (8)$$

Here, i_t is the nominal interest rate, $\mathbb{E}(\pi_{t+1})$ the expected inflation rate, and r_t^{POT} the natural real interest rate.

The remainder of the model, drawing from Erceg and Lindé (2014), links output and potential output to government expenditures, and defines the Taylor-type interest rate rule:

$$y_t = x_t + y_t^{POT} \quad (9)$$

$$y_t^{POT} = \frac{g_y}{\phi_{mc} \sigma} g_t \quad (10)$$

$$r_t^{POT} = \frac{1}{\sigma} [\Delta \mathbb{E}(y_{t+1}^{POT}) - g_y \Delta \mathbb{E}(g_{t+1})] \quad (11)$$

$$i_t = (1 - \gamma_i)(\gamma_\pi \pi_t + \gamma_x x_t) + \gamma_i i_{t-1} + \epsilon_{i,t} \quad (12)$$

This monetary rule features interest rate smoothing (γ_i) and standard reaction coefficients to inflation and the output gap.

The model is calibrated using a combination of standard values from the literature and empirical estimates derived from Argentine data for the period 2012–2022 (see Table 1). Parameters such as α , λ , ρ_R , and β_2 are estimated to reflect institutional features of the Argentine economy, particularly the prevalence of backward-looking indexation and large regulated sectors.

PARAMETER	DESCRIPTION	VALUE	CALIBRATION SOURCE
α	Share of regulated price in the CPI.	0.21	INDEC's 2016 Methodology.
λ	Speed of adjustment of regulated prices towards core prices.	0.12	Based on Argentine data, 2012–2022.
ρ_R	AR(1) coefficient for regulated prices inflation.	0.955	Based on Argentine data, 2016–2022.
η	Path-through of subsidies to regulated prices	0.135	Based on Argentine data, 2016–2022.
β_1	Discount factor	0.995	Chen et al. (2023)
β_2	Path-through from regulated price to core inflation.	0.35	Based on Argentine data, 2016–2022.
β_3	Sticky price parameters	0.075	Based on Argentine data, 2016–2022.
σ	Intertemporal Elas. of Subst.	1	Chen et al. (2023)
g_y	Government spending share in SS.	0.3	Based on Argentine data, 2016–2022.
ϕ_{mc}	Consistent with a Frisch Elasticity of 2.5 (standard)	5	Chen et al. (2023)
γ_i	Smoothing coeff. in policy rule	0.9	Chen et al. (2023)
γ_π	Resp. coeff. to π in policy rule	1.5	Chen et al. (2023)
γ_x	Resp. coeff. to x in policy rule	0.125	Chen et al. (2023)

Table 1 Calibrated Parameters for the Simplified Model.

3.3 RESULTS

We use the model to conduct two distinct policy simulations. The first examines a fiscal consolidation implemented through a reduction in government consumption, in particular government expenditure in subsidies to utility prices. The second evaluates a conventional monetary tightening achieved via an increase in the policy interest rate.

To ensure comparability, the magnitude of both shocks is calibrated to produce a similar initial contraction in output. This allows us to isolate the differing transmission mechanisms and macroeconomic effects associated with each policy.

The outcomes—depicted in Figures 4 and 5—illustrate the dynamic responses of output, inflation, and the composition of government expenditures under each scenario.

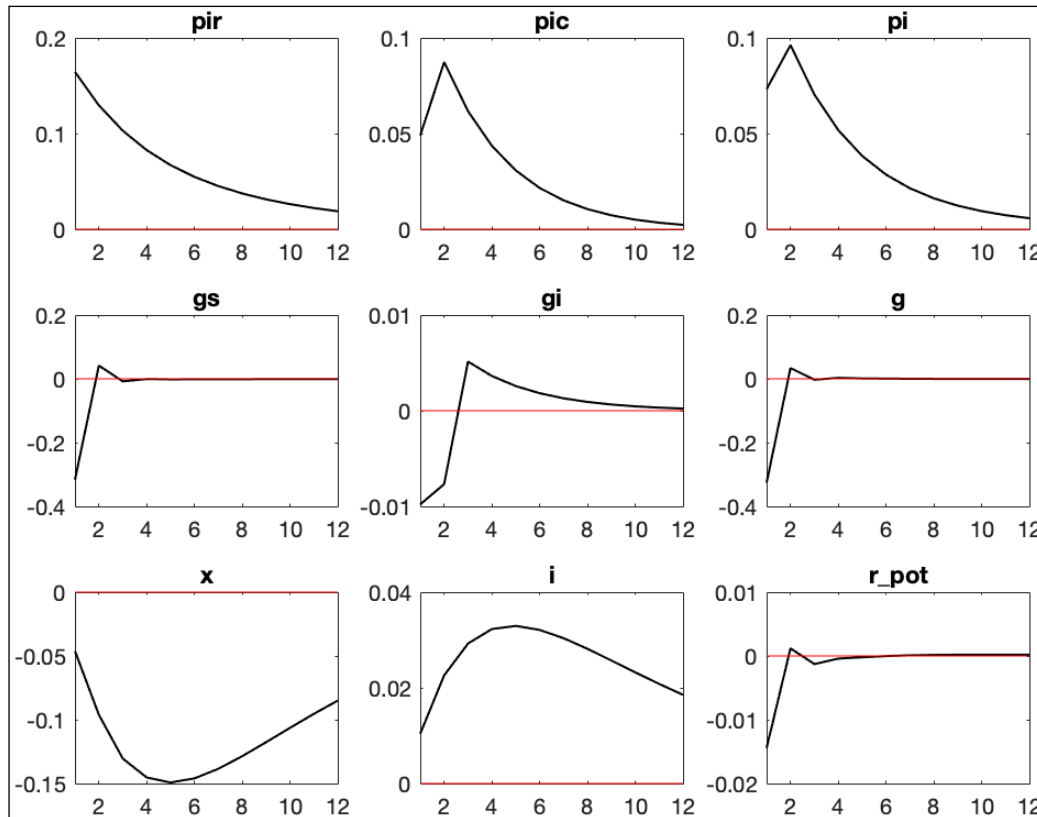


Figure 4 Shock to the government expenditures g_t^s .
Source: Authors' calculations.

Figure 4 illustrates the response to a fiscal consolidation shock, modeled as a reduction in government spending on subsidies (g_t^s). The cut in subsidies leads to an immediate increase in regulated prices, which triggers a rise in regulated price inflation. This adjustment passes through to core inflation by increasing utility costs and unanchoring inflation expectations.

Initially, the inflation surprise causes a temporary decline in real indexed expenditures due to lagged indexation mechanisms. However, over the medium term, as inflation expectations adjust and nominal transfers catch up, indexed expenditures begin to rise again in real terms.

Overall, the simulation shows that a fiscal consolidation shock through subsidy reduction leads to an increase in both short-term and long-term inflation. This highlights the inflationary friction embedded in Argentina's fiscal structure when attempting to reduce expenditures without complementary policy coordination.

Figure 5 presents the model's response to a conventional monetary policy shock, implemented through an increase in the nominal interest rate (i_t). The tightening leads to an immediate contraction in aggregate demand, as reflected by a sharp drop in the output gap (x_t), consistent with the IS curve dynamics and intertemporal consumption smoothing.

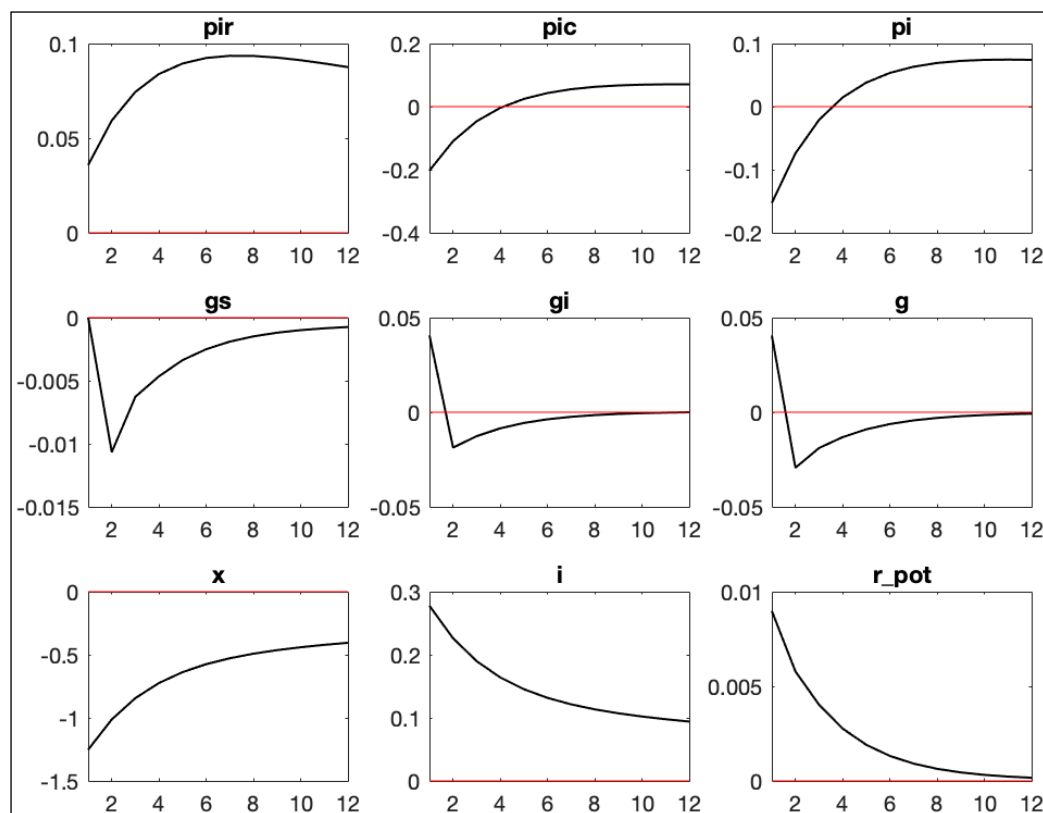


Figure 5 Shock to the monetary policy i_t .
 Source: Authors' calculations.

The contraction in demand gradually reduces core inflation (π_t^c), while regulated price inflation (π_t^r) remains relatively sticky in the short term due to its exogenous and slower adjustment mechanism. As a result, headline inflation (π_t) declines more gradually, reflecting the lagged disinflationary impact of tighter monetary conditions.

The shock also leads to a moderate reduction in indexed expenditures (g_t^i), as lower inflation eventually feeds into the indexation formula with a lag. Subsidy expenditures (g_t^s) remain largely unaffected in the near term, given that regulated prices are not immediately adjusted. The overall decline in government expenditures (g_t) is driven mostly by the contraction in indexed transfers.

Meanwhile, the natural real interest rate (r_t^{POT}) declines over time due to lower potential output growth, while the policy rate initially spikes and then converges downward as inflation stabilizes.

In summary, a monetary tightening shock effectively reduces inflation, primarily through its impact on aggregate demand and core prices. However, the disinflation process is gradual and may be offset in part by persistent regulated price dynamics. The result is a **short-term drop in output and inflation**, with **minimal fiscal pressure** compared to a fiscal shock.

Overall, the model successfully replicates key stylized features of Argentina's macroeconomic dynamics. It highlights the contrasting effects of fiscal and monetary policy on inflation and output. On the one hand, monetary policy proves to be an effective tool for short-run inflation control, reducing both core and headline inflation through demand compression, with limited fiscal side effects. On the other hand, fiscal consolidation through subsidy cuts generates short- and long-term inflationary pressures, primarily via regulated price adjustments and feedback effects from indexed expenditures.

The simulations underscore two critical frictions: inflation inertia and backward-looking indexation mechanisms, which create self-reinforcing loops between inflation and fiscal performance. Without a credible and coordinated monetary-fiscal policy, fiscal adjustment alone may destabilize inflation expectations. Therefore, efforts to reduce subsidies or compress other expenditures—if not synchronized with monetary tightening and institutional reforms—may fail to achieve lasting disinflation and could even prove counterproductive.

4. FISCAL CONSOLIDATION AND DISINFLATIONARY FRICTIONS IN ARGENTINA

Over the past 20 years, Argentina's fiscal challenges have intensified due to an expanding public sector. The primary expenditures of the Central Government more than doubled, increasing from 12.2% of GDP in 2002 to 24% of GDP in 2015 under the presidencies of Néstor Kirchner and Cristina Fernández de Kirchner (Figure 6). General Government expenditures (including those of subnational governments) followed a similar trajectory, rising from 22.6% in 2002 to 41% in 2015.

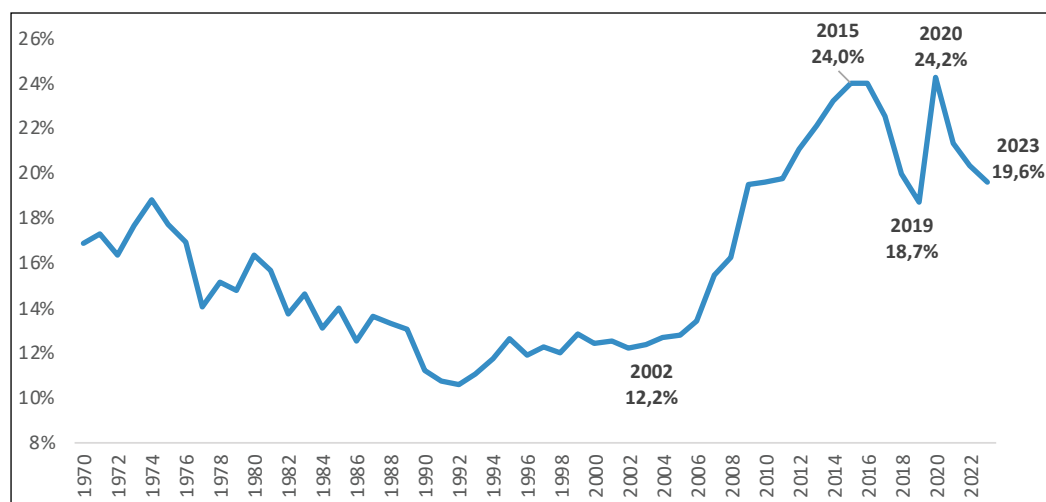


Figure 6 Primary Expenditures of the Central Government² (1970–2023, % GDP).

Source: Ministry of the Treasury.

The government came closest to fiscal balance in 2019, when the primary fiscal deficit was reduced to 0.4% of GDP. However, the COVID-19 pandemic and the strict lockdowns imposed led to a severe drop in government revenues, while households and businesses required financial support. As a result, the primary fiscal deficit ballooned to -6.6% of GDP in 2020—the largest since 1976. The deficit was financed by the Central Bank, while real interest rates remained negative. This fiscal-monetary mix persisted through 2023, driving inflation to 211%.

Implementing a fiscal consolidation program to correct this dynamic is crucial, but at the same time, it is a challenging endeavor that poses numerous obstacles. The inherent political costs associated with such initiatives often create a temptation to defer necessary fiscal adjustments and instead rely on economic growth to naturally enhance tax revenues and reduce the ratio of expenditures to GDP. Nevertheless, given the extent of the fiscal imbalances in Argentina, it becomes increasingly arduous to envision a scenario where sustained economic growth will effortlessly materialize. While external factors like favorable and enduring high commodity prices might bring some fortuitous fortune, it would be unwise to solely depend on such serendipity. A comprehensive and proactive approach, encompassing deliberate policy measures and structural reforms, is imperative to achieve lasting fiscal stability, low inflation, and sustained economic growth.

Fiscal programs typically aim to achieve their objectives through a combination of increased taxation and reduced government expenditures. However, in the case of Argentina, considering the current tax burden, there appears to be limited room for a program heavily reliant on tax hikes. Argentina already has comparatively high tax levels within the region. As a result, the alternative approach lies in implementing expenditure cuts.

The two components that generate tensions between fiscal adjustment and its inflationary impact together account for more than half of national public expenditures (Figure 7). The largest of these is indexed spending, composed entirely of transfers to households, including pensions and other social benefits. In 2023, 39% of the Central Government's primary spending—equivalent to 7.6%

² Central Government expenditures represent only approximately half of total public spending, as subnational governments account for a comparable share.

of GDP—was allocated to indexed pensions and social programs. This marked a decline from 9.9% of GDP in 2019, largely due to the lag embedded in the indexation formula, which caused these expenditures to adjust more slowly than prices during a period of sharply accelerating inflation. Meanwhile, economic subsidies to households, particularly for public utility tariffs, represented nearly 13% of primary expenditures (2.6% of GDP).

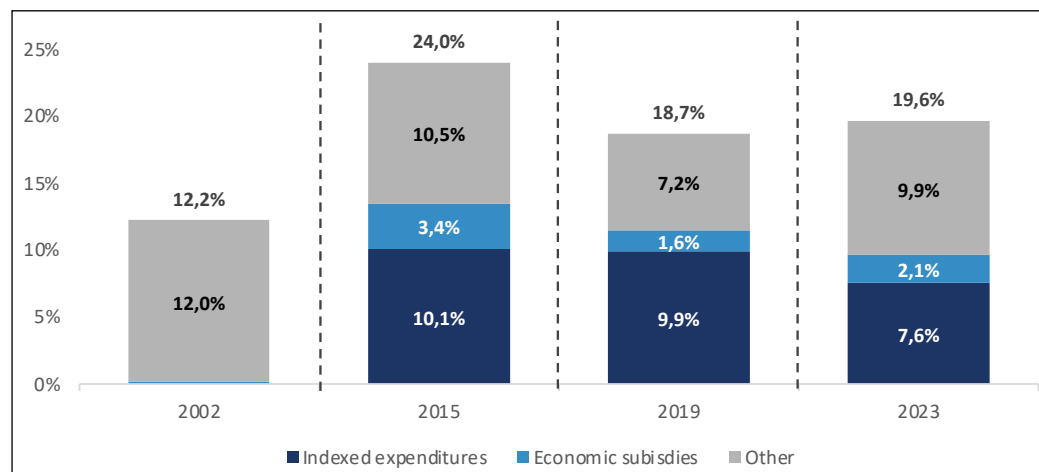


Figure 7 Primary expenditures of the Central Government.

Source: Own estimates based on Ministry of the Treasury.

Given these statistics, it becomes evident that any fiscal program aiming to address the fiscal challenges in Argentina must confront the complexities associated with these substantial expenditure components. Efforts to rationalize and optimize public spending in these areas can contribute significantly to achieving fiscal consolidation goals while ensuring the efficient allocation of resources.

The political sustainability of budget cuts becomes a crucial concern in Argentina, where a significant portion of the public sector is primarily dedicated to providing income to households or subsidizing their energy expenses. This dynamic presents challenges when attempting to implement fiscal measures that entail reducing expenditures. For instance, during Macri’s administration from 2015 to 2019, energy prices were increased by over 1,000% in real terms, public sector wages experienced a nearly 25% decline in real terms, and a law altering the pension adjustment formula was passed through Congress. These actions led to street protests and numerous legal disputes. The fiscal adjustment pursued by Macri’s administration was one of the contributing factors behind his defeat in the 2019 elections.

In the subsequent subsection, we delve into an analysis of the connections between inflation and the two primary components of expenditures, namely indexed expenditures and subsidies for public utilities. Specifically, we examine two key aspects: (i) the influence of inflation on these components, and (ii) the potential effects on inflation resulting from their reduction.

A. INDEXED EXPENDITURES

As previously mentioned, indexed expenditures represent a substantial share of primary spending, accounting for 39% in 2023. These expenditures are composed entirely of transfers to households, with pensions constituting the largest component. Given their magnitude, any meaningful fiscal consolidation effort must address this segment of public spending. However, implementing pension reform—which is central to the sustainability of indexed expenditures—has proven politically difficult, and the fiscal savings it generates typically materialize only in the long term. In the face of Argentina’s pressing need to restore fiscal balance, more immediate measures are required to contain the growth of indexed expenditures.

A key issue with indexed expenditures is their rigid link to past inflation, which limits fiscal policy flexibility. Under sharp disinflation, these expenditures rise in real terms, as shown in the aforementioned model. If real revenues do not increase in tandem, the result is a worsening of the

fiscal balance in real terms. This dynamic implies that sudden disinflation not only threatens fiscal sustainability but can also undermine the credibility of the disinflation process itself.

The indexation formula approved by Congress in 2020³ adjusts benefits based on a combination of wage growth and public revenues, with various lags. While it does not directly track inflation, it incorporates nominal variables that are strongly correlated with it, alongside economic activity through revenue performance. The formula is largely backward-looking, relying on data from up to 26 months prior to the adjustment. As a result, in a scenario of rapid disinflation, this mechanism severely limits the capacity to achieve meaningful fiscal consolidation.

To illustrate this point more clearly, consider the following hypothetical scenario: suppose a stabilization program succeeds in reducing inflation to an annual 50% in 2024 and to 2% in the medium term, while medium-term economic growth reaches 4%. In this context, indexed expenditures would rise by almost 2% of GDP relative to their 2019 level and by 3.9% of GDP compared to 2022, as depicted in Figure 8.

A more gradual scenario—the “base case”—would also present significant challenges. Suppose that economic activity returns to its 2019 level, medium-term growth averages 2.5%, and inflation declines to approximately 130% by 2024 and 35% by 2027. In this case, indexed expenditures would increase by 3.2% of GDP between 2023 and 2027, reflecting the combined effects of disinflation and economic recovery (Figure 8).

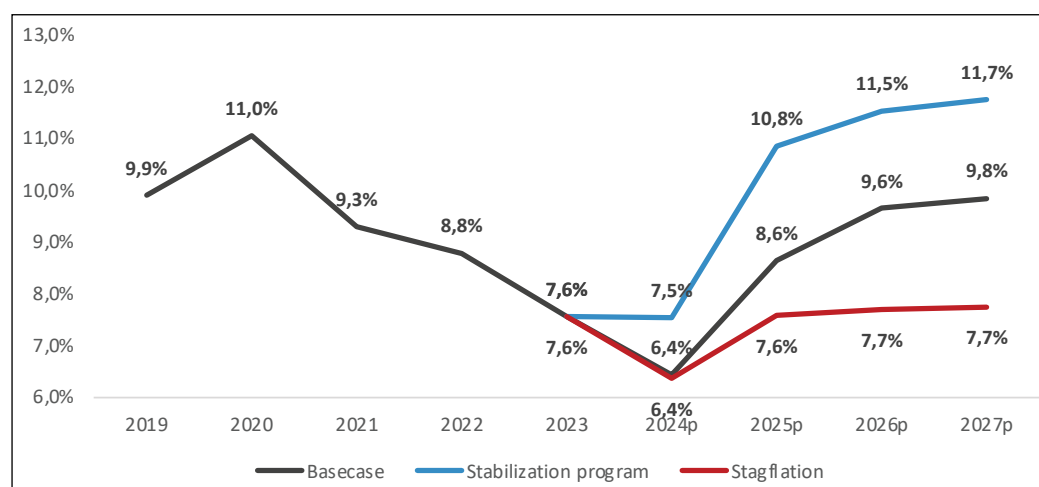


Figure 8 Indexed expenditures under different macroeconomic scenarios (% GDP).

Source: Own estimates based on Ministry of the Treasury.

The only scenario in which indexed expenditures remain manageable is one of stagflation (Figure 8). In this scenario, we assume medium-term economic growth of 1.2% and annual inflation of 100%.

One theoretical alternative to addressing the challenges of backward-looking indexation is to link adjustments to current inflation or to more recent data, such as inflation from the preceding one or two months. The advantage of this approach is that it preserves the real value of pensions over time, even in the face of sharp inflation fluctuations. Consequently, during periods of positive economic growth, indexed expenditures would decline as a share of GDP.

While implementing a mechanism strictly tied to current inflation may not be feasible due to the lack of real-time inflation indices, a practical alternative could involve adjusting pensions by a predetermined estimate of inflation and reconciling the difference at the end of the period. Such a mechanism would help mitigate the fiscal risks associated with disinflation under backward-looking formulas, while maintaining the purchasing power of pensions.

Careful consideration of implementation details is essential. Any new indexation scheme should strike a balance between preserving purchasing power, ensuring predictability, and enabling fiscal sustainability in the context of stabilization.

³ At the time of this paper’s publication, the indexation formula had been modified.

B. SUBSIDIES TO THE PRICE OF PUBLIC UTILITIES

Economic subsidies to the price of public services represent one of the largest, unfair and most inefficient components of public spending in Argentina. Besides improving the fiscal balance, implementing reductions in government subsidies for public services allows prices to reflect relative scarcities accurately. Artificially low energy prices, for instance, lead to excessive consumption and low thermal efficiency. Furthermore, while many subsidies aim to improve income distribution, energy subsidies exhibit a pro-rich bias, with a significant portion of expenditures benefiting the highest income deciles.

Another key rationale for reducing public expenditures on economic subsidies is their disproportionate size. Between 2002 and 2023, subsidies increased more than elevenfold, outpacing the growth of any other component of public spending (Figure 9). Although significant progress was made in reducing subsidies between 2015 and 2019, this trend was partially reversed beginning in 2020. However, starting in 2022, the burden of subsidies began to decline again.

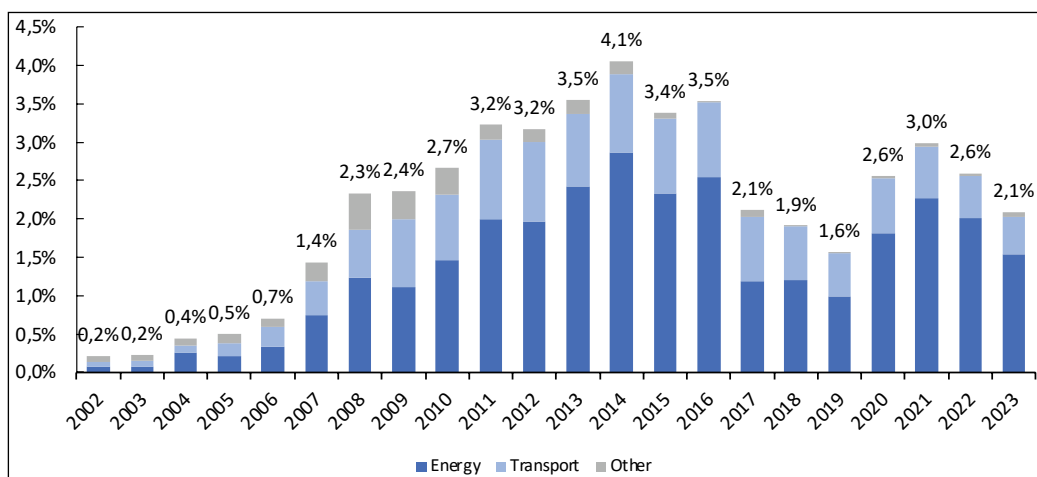


Figure 9 Economic subsidies (% GDP).

Note: Economic subsidies current are considered expenditures of the National Public Administration in the functions of Energy, Transport, Agriculture, and Industry. Source: Own estimates based on Ministry of the Treasury and INDEC.

Reducing subsidies is not only fiscally necessary but also economically desirable. It contributes to correcting resource misallocations, improving income distribution, and reversing the unsustainable growth in subsidy spending. These efforts are essential for advancing fiscal consolidation and promoting long-term economic growth.

Nonetheless, subsidy reductions entail short-term inflationary costs. Regulated prices—such as those for natural gas, electricity, and public transport—represent nearly 10% of the CPI. As a result, subsidy cuts would lead to price increases in these sectors, putting upward pressure on inflation in the short run.

Over the past two decades, Argentina has gone through a full cycle: from a prolonged period of frozen public service prices (2002–2015) to a phase of sharp adjustments aimed at reducing subsidies (2016–2019). Since 2020, however, there has been a renewed tendency to freeze public sector tariffs. While this approach is often framed as anti-inflationary, it has had substantial fiscal consequences, as shown in Figure 9.

Between 2002 and 2014, economic subsidies increased by nearly 4 percentage points of GDP, rising from 0.2% to 4.1%. In 2015, they declined to 3.4% of GDP, partly due to the non-recognition of certain debts (equivalent to 0.8 percentage points of GDP), the real appreciation of the exchange rate—which reduced energy generation costs—and the recovery of GDP following the 2014 recession. That year, subsidies accounted for 14% of the Central Government’s primary expenditures.

From 2015 to 2019, subsidies were further reduced to 1.6% of GDP and 8.4% of primary spending. This was achieved despite the depreciation of the real exchange rate and the recession caused by the 2018 balance of payments crisis.

In 2020, subsidies increased by almost 1 percentage point of GDP. This was not only a consequence of the COVID-19 crisis and its effect on GDP, but also of the continued freeze on energy and transport tariffs, which had been in place since the second quarter of 2019—despite cumulative inflation of nearly 90% between then and December 2020. Subsidies continued to grow in 2021, reaching 3% of GDP, before declining to 2.6% in 2022. This reduction was driven by the implementation of a new tariff segmentation scheme and by the sharp real appreciation of the exchange rate, which lowered the peso cost of imported energy.

In 2023, subsidies continued to decline, falling to 2.1% of GDP. This further reduction was primarily explained by three factors: the persistent real appreciation of the exchange rate, which continued to reduce the cost of imported energy; a sharp drop in international energy prices; and an increase in domestic energy production, which lowered reliance on imports.

The short-term mitigation of inflation pursued by the increase in subsidies between 2002 and 2015 came at the price of rising distortions. In that period, electricity and gas prices for a representative household in Buenos Aires City dropped 89% and 88% in real terms, respectively (Figure 10). In the same period, average bus and train prices of Buenos Aires City dropped 64% and 69% in real terms, respectively. This measure does not capture the complete magnitude of the distortion, as general CPI is not necessarily a precise indicator of the trajectory of equilibrium prices. However, given the size of the changes, it is a rough indicator of the relative price misalignment.

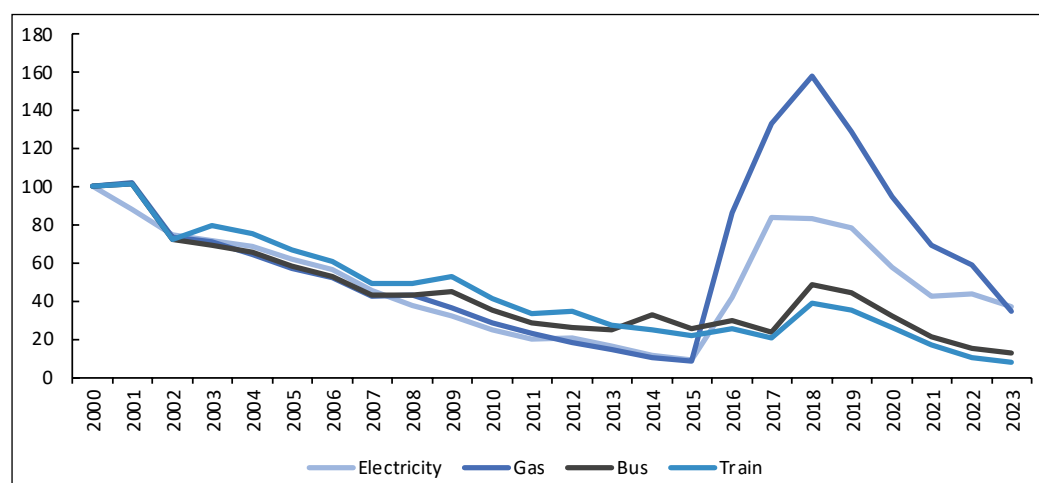


Figure 10 Price of selected services in real terms (CABA, December of each year, 2002 = 100).

Note: Electricity price charged by EDENOR to households with consumption of 400 kWh (does not include taxes). Gas price charged by Metrogas to households with consumption of 1,100 M3/month. Average bus rate for AMBA. Average train rate for AMBA. Source: Own estimates based on ENRE, ENARGAS, DGEyC, INDEC, and private estimates of inflation.

The reduction of subsidies in 2016–2019 entailed an acceleration of inflation that made it more difficult for the Central Bank to keep expectations anchored. Electricity, gas, bus, and train prices in Buenos Aires City increased in real terms by 752%, 1,453%, 73%, and 60%, respectively. The adjustment was incorporated into the CPI directly through its “regulated prices” component.

We estimate that the relative price adjustment of the whole regulated component represented, on an annual basis, 16 percentage points of inflation during 2016–2019, through direct and indirect channels. The average inflation during that period was 39.8%, so increases in regulated prices accounted for about 40% of inflation over the period. The direct effect of regulated prices represented, on an annual basis, 9 percentage points of inflation during 2016–2019 (Figure 11). So, it explained 28% of the inflation during the period (vs. 14% in the previous three years). The indirect impact of the public utilities increases on inflation took place via cost-push and expectations channels, and we estimate this effect in 7 percentage points, on an annual basis, in 2016–2019 (Figure 11).

In 2020, as a result of the aforementioned price freezes, regulated prices rose just 15%, compared with 46% for the rest of the CPI. The direct contribution of regulated prices to inflation was only 3.4 percentage points, accounting for less than 10% of total inflation. In 2021, this dynamic began to shift: regulated prices increased by 38%, while core and seasonal prices rose by 54%. Although the gap narrowed compared to previous years, regulated prices still lagged behind, contributing 7.4 percentage points to total inflation—around 15% of the annual increase. In 2022 and 2023, regulated prices accelerated further, increasing by 86% and 165%, respectively, yet still below the rise in core and seasonal components. Their contribution reached 15 and 28 percentage points,

respectively, between 13% and 16% of the total inflation. While these figures reflect a partial correction of the trend observed in earlier years, regulated prices continued to grow at a slower pace than the rest of the CPI.

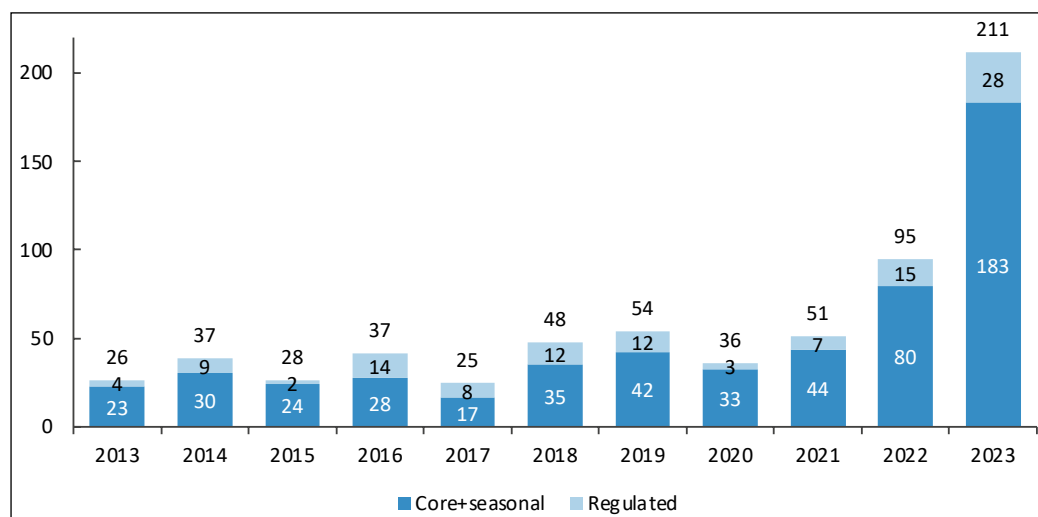


Figure 11 Inflation by component (annual).

Source: Own estimates based on INDEC and DGEyC (CABA).

In this context, economic subsidies are once again emerging as a significant fiscal challenge. Any fiscal consolidation program will inevitably need to address this issue. However, the short-term inflationary impact of subsidy reductions must be carefully considered and coordinated with the inflation objectives—or targets, if established—of monetary policy.

5. CONCLUSION

Argentina has exhibited one of the poorest macroeconomic performances in Latin America over the past 50 years, primarily due to recurrent fiscal deficits. In 42 out of the last 54 years, the Argentine government has experienced fiscal deficits, leading to severe consequences such as persistent high inflation and frequent financial crises. The fiscal problem worsened in the last 20 years when public spending doubled under successive Peronist administrations.

This paper introduces a simple model that examines the key connections between fiscal deficits and inflation, incorporating key institutional features of government spending in Argentina.

The paper emphasizes that resolving the fiscal and inflationary issues in Argentina will not be a straightforward task. Years of high inflation have resulted in widespread lagged indexation within public spending. Consequently, a stabilization program that rapidly reduces inflation without addressing this characteristic of public spending could undermine efforts toward fiscal consolidation. Moreover, cutting certain expenditure items such as subsidies for public utilities could initially have a detrimental impact on inflation. Therefore, a successful fiscal and disinflationary program must consider these interdependencies seriously. Neglecting to do so may risk derailing the entire program.

In summary, the paper highlights the challenges involved in resolving Argentina’s fiscal and inflationary problems, underscoring the importance of carefully addressing the complex linkages between these two factors.


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COMPETING INTERESTS

The authors have no competing interests to declare.

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