Monetary Policy and Distribution: Insights from Argentina[1]

Central Bank of Argentina

I. Introduction

Argentina's economic policy is aimed at restoring macroeconomic stability, by rebuilding sound fiscal and monetary policy frameworks. Price stability remains the focus of the Central Bank. This task requires overcoming the constraints on monetary policy which include shallow financial markets, limits to effectiveness of conventional policy tools, much reduced yet persistent FX controls and still limited hard currency liquidity. In parallel, the Central bank is reengineering domestic regulation that facilitates the transition of the banking system to "crowding in" of private sector credit while preserving financial stability.

In this note, we review the transmission channels for monetary policy in Argentina, highlighting how their impact is evolving as the economy moves from a high to a low inflation regime. The discussion requires an overview of the ongoing stabilization program as a general equilibrium approach emphasizes the complementary role that monetary policy plays alongside simultaneous adjustments through other economic policy levers. Distributional effects of reducing inflation in a sustainable manner are found to be significant. The main channels through which these distributional improvements take place include income, consumption, credit, and wealth channels. The distributional effects that work through these monetary policy channels are also intertwined with relative price adjustments driven by domestic and international trade and financial deregulation.

II. Fiscal dominance has blunted the transmission mechanism of monetary policy

In emerging markets and developing economies, the traditional channels through which monetary policy operates are distinct and less powerful than in advanced economies. This is often attributed to financial market underdevelopment, low credibility and –in some cases, like Argentina- pervasive currency substitution (BIS, 2008; Frankel, 2010).

Due to chronic fiscal dominance, Argentina financial markets have shallowed—reflecting financial repression and distortive subsidies, adoption of informal and

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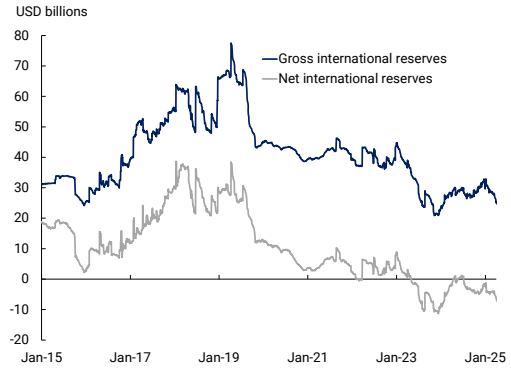
formal parallel markets, and the crowding out of credit for the private sector. A monetary regime with low credibility and an underdeveloped, largely transactional, banking system has reduced the effectiveness of the Central Bank's policy interest rate to influence aggregate demand and prices. Indeed, the interest rate channel, which typically works affecting borrowing, consumption and investment, has a very limited impact on prices.

In fact, the monetary overhang created by fiscal dominance through over-issuance of liabilities and its subsequent sterilization implied that the level of the policy rate adversely affected the size of the quasi-fiscal deficit. Argentina's central bank has faced difficulties in managing inflation through traditional tools like policy rate changes (IMF, 2015). Sterilization became ineffective and eventually counter-productive to anchor inflation expectations. As interest payments by the Central Bank were viewed as an additional source of money creation, money demand plummeted (Werning, 2024).

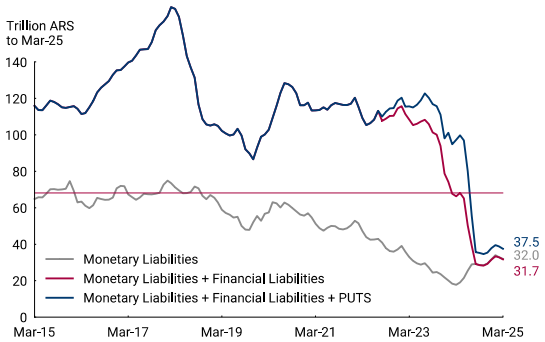
In parallel, fiscal dominance sharply eroded the asset side of the Central Bank's balance sheet as reserves were exchanged for illiquid Treasury IOUs. The financing fiscal deficits with money issuance plus the sale of international reserves to Treasury for the latter's IOUs reached a cumulative 60% of GDP over the past 20 years.

By late 2023 BCRA held too few liquid assets (net international reserves of about minus USD 11 billion) and too many liabilities (interest-bearing liabilities equivalent to about USD 59 billion) (Graphs 1 and 2). This resulting imbalance of the central bank balance sheet became unmanageable, triggering a pervasive relationship between devaluation risk and inflation expectations which intensified despite financial repression. The Argentine economy was extremely vulnerable, with no access to international financial markets, on the brink of a sovereign default and undergoing 3-digit annual (and accelerating) inflation.

Graph 1: BCRA's net international reserves



Graph 2: BCRA's liabilities



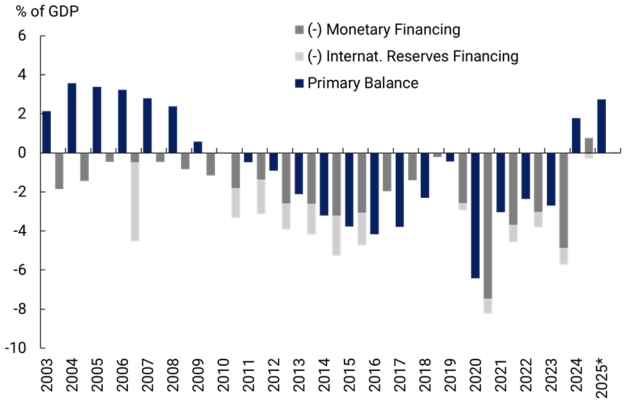
Source: based on data from BCRA.

III. The current stabilization program reestablishes monetary policy control

Since December 2023, a new administration has taken very significant steps to overturn this situation, implementing an economic program focusing on structural changes to first stabilize prices and then reverse economic stagnation (BCRA, 2023 and 2024). The stabilization plan required that monetary policy act rapidly in combination with fiscal and exchange rate policy to eliminate excess money.

The first pillar needed to regain macroeconomic stability was a reversal of fiscal policy. An unprecedented fiscal adjustment was carried out, reducing a headline deficit of 2.7% of GDP in 2023 to a headline surplus of 2.0% in 2024 (Graph 3). These "shock" measures immediately eliminated fiscal financing by way of money issuance. To protect vulnerable households, changes to income policy were made by fiscal authorities. The income policy was prioritized to reverse the prolonged erosion of real social spending, focusing on the Universal Child Allowance and the minimum pension.

Graph 3: Argentina: public sector balance and total BCRA financing of Treasury (Monetary and international reserves)

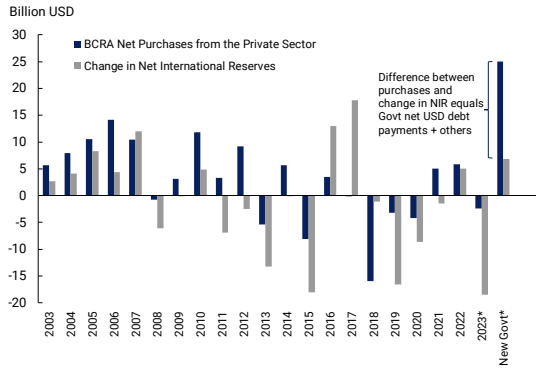


* Seasonally Adjusted Non-Financial National Public Sector primary balance up to Jan-25. Monetary and International Reserves financing up to Feb-25.

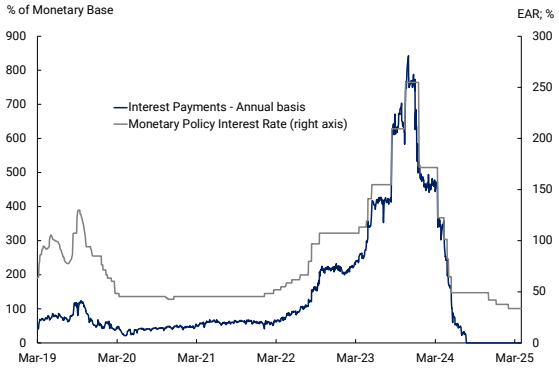
Source: based on data from BCRA and the Ministry of Economy.

The second pillar, the FX policy adjustment, included an initial depreciation (USD/AR$ went up by 118% in December) to correct the overvaluation of the peso and a subsequent 2% monthly crawling peg (subsequently reduced to 1% monthly in February 2025), to anchor inflation expectations. Voluntary FX swaps were offered in the form of securities to address a large backlog of FX claims from importing firms whose access to FX had collapsed to only 20% of imports. BCRA defined an incremental access schedule for import payments and offered the private sector the option of purchasing a foreign currency bond (BOPREAL) to settle their trade debts, effectively sterilizing large excess peso holdings. By the end of the first half of 2024, import payments in the official exchange market had returned to around 100% of monthly imports. These combined FX efforts allowed the Central Bank to purchase foreign currency in the FX market (Graph 4) and avoid sovereign debt default.

Graph 4: BCRA's interventions in the FX market



Graph 5: Policy interest rate and interest payments



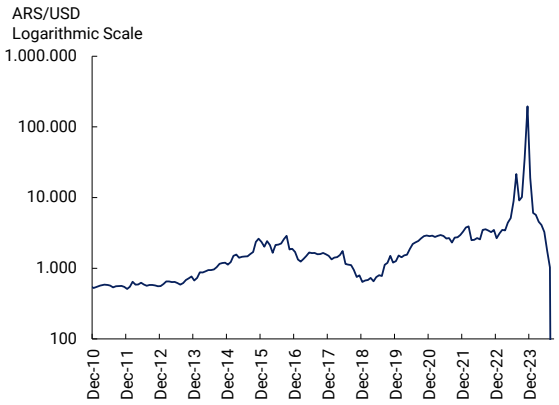
*2023 From Jan 1st to Dec 9th and New Govt from Dec 10th 2023 to Mar 11t h 2025.

Source: BCRA.

The third pillar involved a U-turn in monetary policy, aimed at eliminating endogenous money supply by defusing the "snowball" effect created by rising interest payments on BCRA's interest-bearing liabilities. This was carried out by lowering the policy rate (on reverse repos) from 133% nominal annual rate in December 2023 to 29% in March 2025 (Graph 5). A negative interest rate in real terms shrunk liabilities and reduced expected money growth. Subsequently, BCRA's interest-bearing liabilities were transferred to the Treasury which allowed the warehousing of residual liquidity without creating expectations of peso issuance. Over time, the issuance of *put* options on Treasury securities held by banks against the BCRA was halted and the stock of legacy put options were repurchased, eliminating yet another (contingent) source of money supply.

These crisis management solutions avoided hyperinflation, debt default, freezing of bank deposits and a broad banking crisis. The ratios of the BCRA's interest-bearing liabilities and imports relative to net international reserves decreased fast after reaching alarming highs at the end of the prior year (Graph 6). And the gap between the financial market exchange rate and the official exchange rate narrowed from164% at the end of 2023 to 15% in March 2025 (Graph 7).

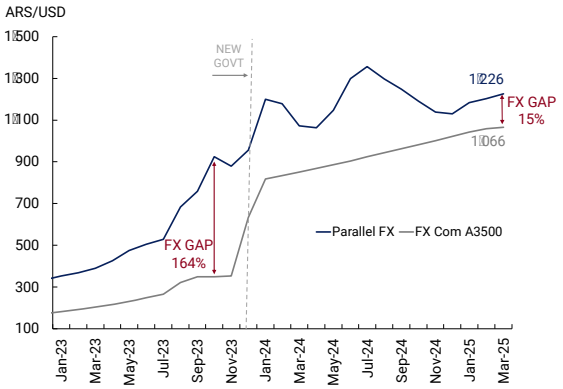
Graph 6: Ratios of remunerated liabilities international reserves



Note: Net international reserves are gross reserves less liabilities with foreign residents.

Source: based on data from BCRA.

Graph 7: FX gap (between paralle and official net to FX rates)



Source: based on data from BCRA.

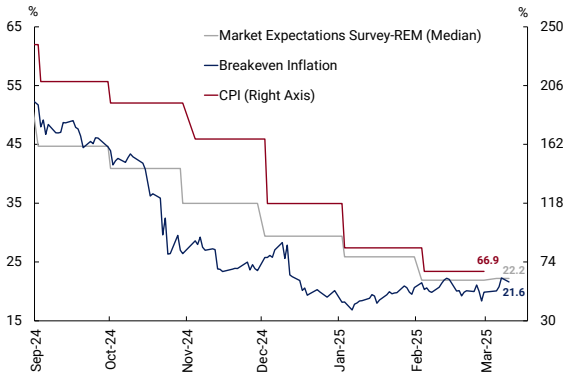
IV. Rapid disinflation sparks remonetization of the economy

As a result, both inflation and inflation expectations (as reflected in surveys and implied in the secondary bond market) have declined sharply. Actual inflation was around half of what market analysts forecasted at the end of the prior year. After reaching 25.5% monthly in December 2023, it fell to 3.7% monthly in March 2025. Meanwhile, annual inflation dropped from 289.4% in April 2024 to 55,9% in March 2025, with the market expecting 24.5% year-over-year over the next 12 months (Graph 8).

Money demand (M3 in local currency held by the private sector), recovered from its lows of early 2024, mainly driven by time deposits. Credit to the private sector growing substantially throughout the year as elimination of the fiscal deficit allowed for a "crowding in" process. Loans in pesos to the private sector grew from almost 4% of GDP at the beginning of 2024 to 7.9% of GDP in March 2025. Loans in foreign currency have grown by almost 300% in the same period (Graphs 9). This has also been enabled by a tax amnesty on external assets (*régimen de regularización de activos*), which led to deposits in USD doubling in volume in a few months.

Reestablishing macroeconomic equilibrium is not only reflected in a rapid disinflation process, a resurgence of bank and non-bank credit markets and a redirection of credit to the private sector. Intimately intertwined with these trends is a strong V-shaped recovery of economic activity. Thus, a key aspect of the stabilization program is that the anti-inflationary policy tightening underway is effectively imparting an expansionary effect on real activity and real money demand. Distributional effects of monetary policy are therefore simultaneously operating through direct (nominal) and (indirect) real channels.

Graph 8: Inflation and inflation expectations



Source: based on data from BCRA and INDEC.

Graph 9: Bank loans to the private sector

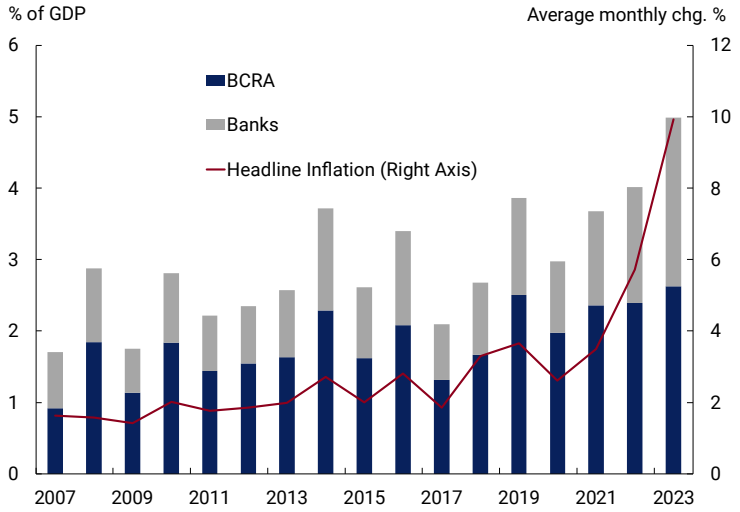
Source: based on data from BCRA.

V. Distributional effects of monetary policy following the stabilization effort

The stabilization program has generated distributive effects that are significant, widespread and beneficial. These effects surfacing through several channels.

Income channel: the reduction of the inflation tax previously captured by the public sector and banks is returning income to households and businesses. Graph 10 shows a recent perspective of the inflation tax collection on the transactional monetary aggregate (M2 private). This constitutes a key distributional aspect of the stabilization program.

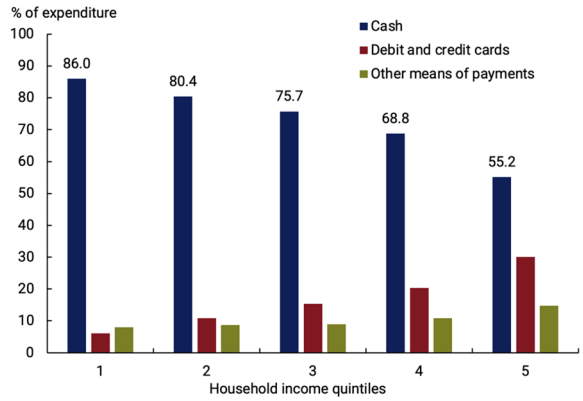
Graph 10: Argentina: inflation tax estimated on M2 (Transactional Private)



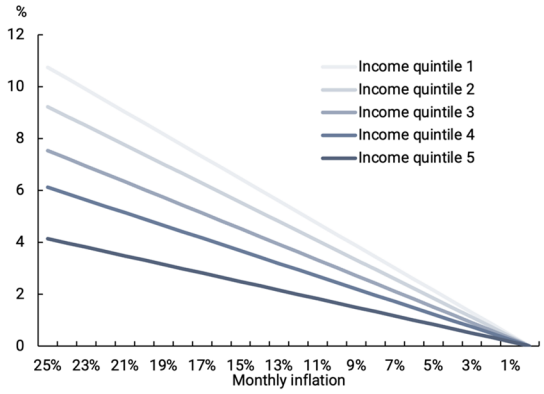
Source: based on data from BCRA and INDEC.

In addition to shifting income streams between certain sectors (public, banks) to others (private), changes in the inflation tax have significant distributional effects within the household sector. Inflation affects the poorest disproportionately, weighing more on households that cannot hedge against it (Easterly and Fischer, 2001). Poorer households tend to hold a larger share of their wealth in cash, which loses value as inflation rises (Graph 11). Our estimates for Argentina indicates that inflation tax incidence on poorer households, as a share of their income, is 2.6 times larger than that of wealthier households (Graph 12).[2] These estimates also suggest that as inflation decreases, poorer households gain between 9 and 10 percentage points of income in terms of lower inflation tax incidence.

Graph 11: Means of payment by income quintiles (% of family expenditure)



Graph 12: Incidence of inflationary tax by quintiles (% of average total family income)



Source: based on data from INDEC (Household Expenditure Survey 2017-18).

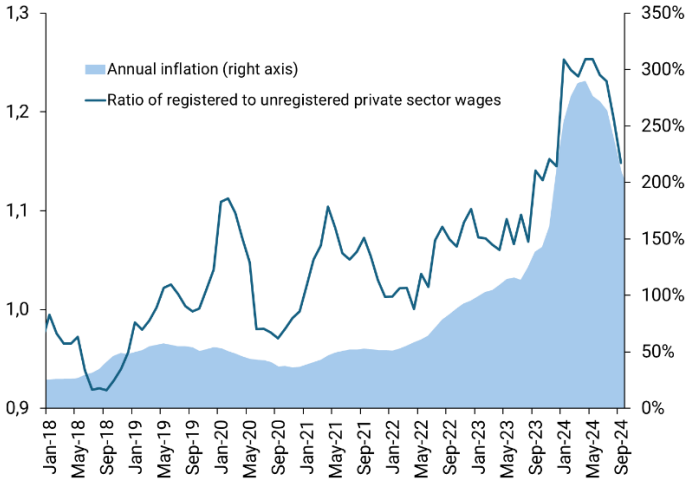
Additionally, poorer households tend to work more in the informal sector, whereas better off households tend to obtain work in the formal sector. Note that the ratio of registered to unregistered private sector wages is positively correlated to inflation (Graph 13). Hence, empirically in Argentina as inflation accelerates formal sector workers tend to obtain wage adjustments linked to labour unions' negotiations while informal sector wage earners adjustments lag and their real wage suffers relatively (a trend that reverses when inflation declines).

Consumption channel: Lower-income households benefited relatively more from the decline in inflation than higher-income households and poverty decreased, also helped by the recovery of economic activity and the increase in social programs. Inflation disproportionately affects households which have a higher share of tradable goods such as food in their consumption basket (Caisl et al., 2023). As the local currency depreciates, poorer households -with higher cash holdings- tend to lose more. Poverty has collapsed from its peak of 57,1% in the first quarter of 2024 to an estimated 33,6% in the first quarter of 2025 (Graph 14). This reflects the fact that food

[2] Household incomes are divided by quintiles using data from the INDEC's Permanent Household Survey of the second semester of 2024. Money holdings as % of income come from the Household Expenditure Survey 2017-18. For the methodology, see BCRA (2016).

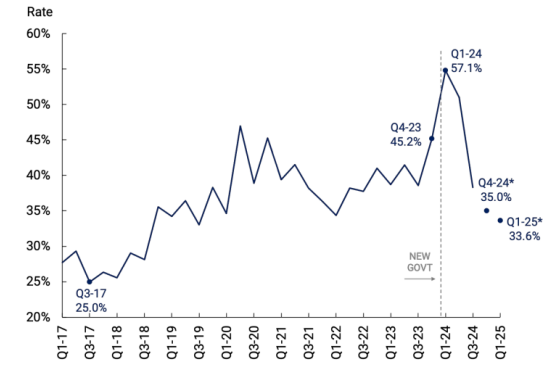
prices carry greater weight in the consumption basket of lower income households than in higher income households (Graph 15).

Graph 13: Ratio of registered to unregistered private sector wage and inflation



Source: based on data from INDEC.

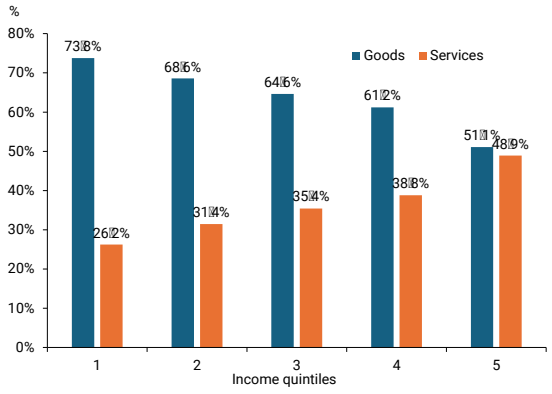
Graph 14: Poverty



*Q4-24 and Q1-25 are projected by G. Rozada (UTDT). Q1-25 is an average of Jan-25/Feb25.

Source: BCRA from INDEC data and G. Rozada (UTDT).

Graph 15: Percentage of household spending allocated to goods and services



Source: based on data from INDEC (Household Expenditure Survey 2017-18).

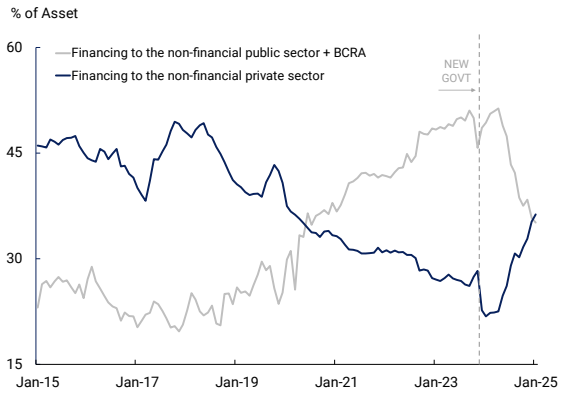
Credit channel: High inflation entails a shortening of planning horizons that weighs on financial markets, where terms are substantially reduced -hence curtailing longer term credit supply (Heymann and Leijonhufvud, 1995). As inflation mounts, financial decisions' horizons are shortened. This in turns weighs on credit supply. In contrast, disinflation facilitated credit price formation, bringing borrowers and banks closer together, while fiscal austerity supported credit expansion to the private sector.

By stabilizing inflation and improving the overall macroeconomic environment, monetary policy can also help "crowd in" private investment. When inflation

expectations are anchored, bank credit tends to increase, leading to greater access to credit for households, especially mortgage loans, and small enterprises (Graph 16).

Wealth channel: Disinflation (through monetary policy) together with USD purchases that ensured debt payments in foreign currency (FX policy) and fiscal austerity (fiscal policy) reduced the risk premia of sovereign and corporate debt, implying an increase in Argentine assets prices (Graph 17).

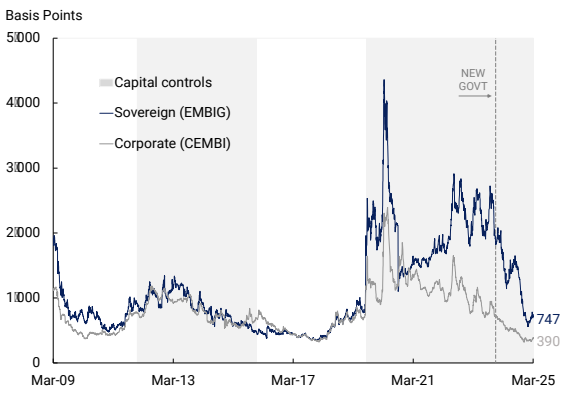
Graph 16: Bank financing to public and private sector (% of assets)



Financing to the non-financial public sector: Position in public securities + Loans to the public sector + LEFI. The public sector includes all jurisdictions.

Source: BCRA.

Graph 17: Risk premium: sovereign and corporates (Basis points)

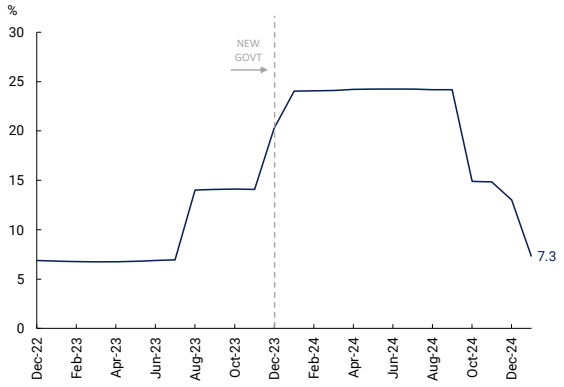


Source: BCRA from Bloomberg data.

VI. Distributional effects are also attributable to mandated relative price adjustments.

Relative price adjustments required under the stabilization program, although not directly attributable to monetary policy, also had significant distributional impacts. The reduction of import barriers (both tariff and non-tariff) is shifting income from importers/producers to consumers (Graph 18). Adjustments in regulated prices (such as public utilities) and those driven by deregulation in other sectors (such as rents) generate transfers that reflected market values (Graph 19). Finally, the narrower dispersion among multiple exchange rates that were reduced, resulted in income transfers from importers to exporters and consumers.

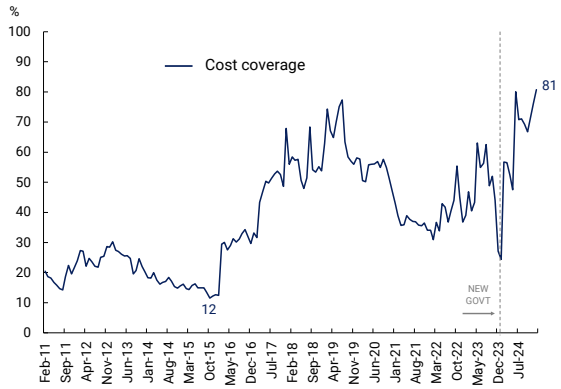
Graph 18: Taxes on imports of goods. Implicit rate



Includes average implicit tariff rate, statistic rate and PAIS tax rate.

Source: based on INDEC and Ministry of Economy data.

Graph 19: Electric utility tariffs. Cost of coverage



Source: BCRA.

VII. Concluding remarks

Argentina's current sound economic program is rapidly restoring macroeconomic stability and promoting a recovery in economic growth. In identifying the distributional effects of monetary policy in Argentina, context matters, and certain caveats are in order: First, monetary policy adjustments are working in combination with major fiscal and FX policy adjustments. Thus, distributional effects should be associated with the overall policy mix.

Second, conventional monetary policy transmission channels have been altered and subdued due to financial market underdevelopment which, in turn, is rooted in persistent macroeconomic imbalances that required deficit monetization and chronic high inflation.

Thus, when referring to monetary policy in Argentina it needs to be noted that the monetary policy toolkit does not conform to the conventional understanding (the FX anchor has played an outsized role) nor have monetary policy actions followed to the standard script (interest rate adjustments were engineered in the opposite direction of inflation risk).

Given that policy efforts have very sharply reduced the inflation tax the distributional effects of monetary policy are significant, widespread and beneficial (progressive). These distributional effects can be distinguished and accounted for through multiple channels of transmission of monetary policy: including income, consumption, credit and wealth channels.

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