Argentina in Crisis

Argentina's decision to float the peso represents a radical change in course in the country's exchange-rate policy. Pegging the peso to the US dollar via a currency board had led the country into deep crisis. While the dramatic inflation that characterised the early 1990s was brought to a halt, Argentine economic policy had no room for manoeuvre to prevent the related deflationary trend. The strong appreciation of the US dollar in the mid-1990s led to entrenched deflation, and Argentina – with its foreign debt rising steadily – found itself in the depression which has lasted until now. The more prudent approach would have been to try from the outset to peg the peso to Argentina's most important trading partners. But even after the failure of its exchange-rate policy, this route is still open to Argentina.

Argentina is currently bogged down in economic and political chaos. While many observers believe the fault lies with deficits in the political and economic policy institutions, in actual fact the main cause was an entirely misguided economic policy strategy aimed at battling hyperinflation and creating conditions for lasting growth.

Argentina's economic situation was worrying at the beginning of the 1990s. While GDP growth was very strong at over 10%, inflation rocketed out of control, increasing to rates of almost 800%. Policy makers were faced with the urgent question of how to bridle inflation quickly without also halting the country's dynamic growth, for at 9.2% in 1990, the unemployment rate was still high.

Options in the battle against inflation

The problem was a challenge for monetary policy, in particular, which had to demonstrate to the markets its determination to effectively combat the runaway inflation. In situations of this kind, the central bank basically has two options: it can adopt a strategy of de-inflation geared towards the domestic economy, or it can anchor the domestic currency to a foreign economy.

If the strategy chosen targets the domestic economy – the strategy adopted by the US central bank in the early 1980s to combat much lower inflation rates – the signal sent out must convince the domestic markets, in particular. In the ideal case all market participants would immediately adjust their inflation expectations and reduce their price and wage demands accordingly.

The reality is usually different. Downward adjustment of price and wage increases is associated with costs, including information costs, and is a gradual procedure. In addition, in a decentrally organised market economy, simply signalling that monetary policy is oriented towards stability is not enough. It takes some time until the information has been distributed and general expectations have adapted to a low inflation target. The credibility of such a signal is extremely important, for the markets will only adjust their expectations if they believe that the central bank will push through its intended aims – even at the cost of a recession.

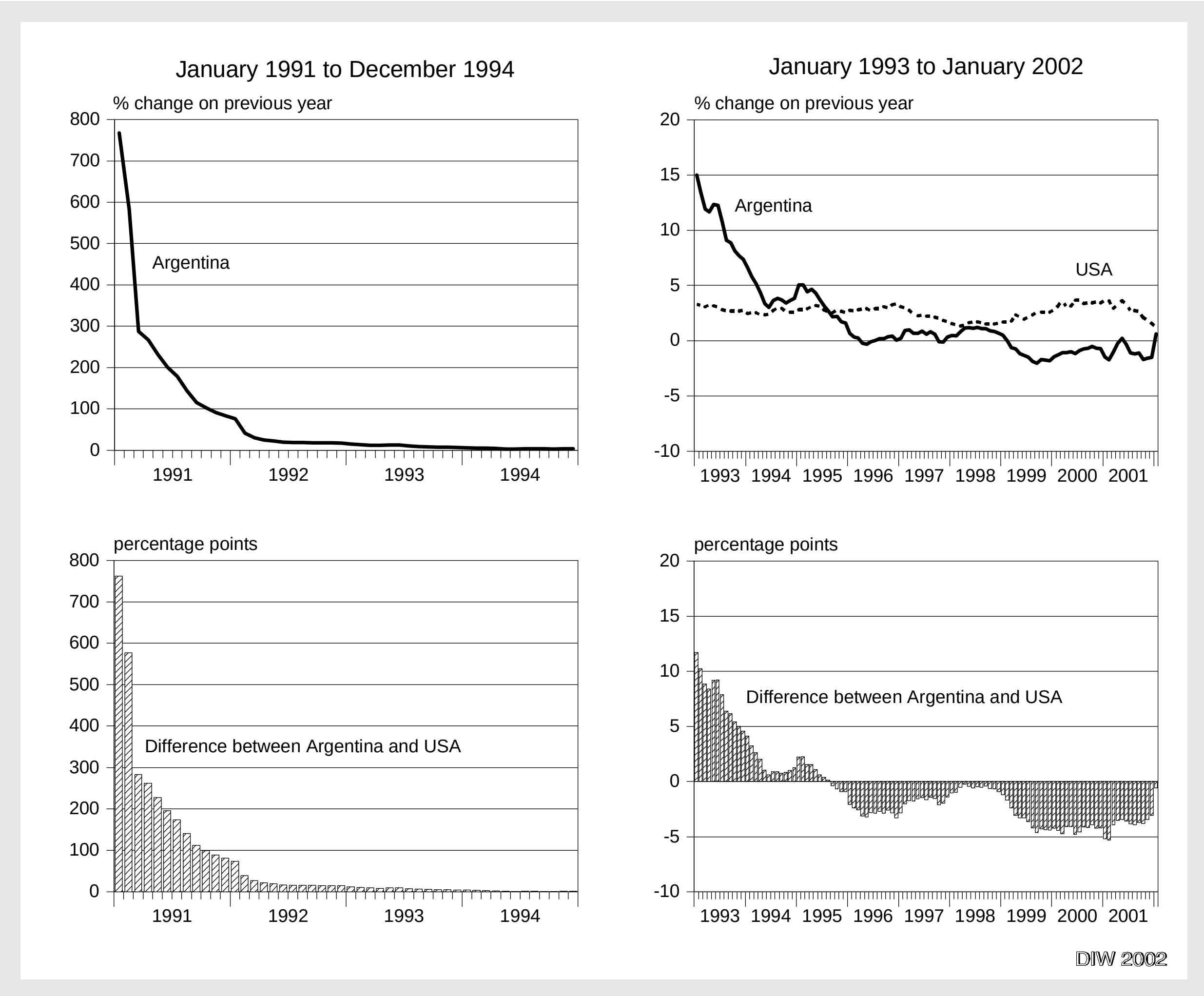
This is what happened in the USA, where the possibility of a severe 'stabilisation recession' was consciously accepted at the time. A softer approach – not possible at institutional level in the USA, however, because of its decentralised system of wage determination – would be a national stability pact in which wage increases that foster stability are agreed with the trade unions, which would serve as a domestic anchor for a more stable price climate. But this approach requires both centralised wage determination and the willingness of the workers to temporarily accept significant losses in real wages.

At any rate, implementing a de-inflation strategy in the domestic economy is an extremely difficult undertaking. This applies all the more when, as in Argentina, the central bank has suffered a substantial loss in credibility due to accepting high inflation rates for years, not least because it sanctioned the monetarisation of the country's public deficits.

In such circumstances it makes sense to seek the anchor for a more stable price trend not at home, but in foreign institutions which are more credible from the outset. In a sense, the idea is to 'import' price stability. This second route to de-inflation implies a more or less rigid exchange-rate peg, which narrows the scope of national monetary policy and thus also prevents it from further tolerating inflation.

In the quest for a particularly high degree of credibility, Argentina opted for a currency board. Next to monetary unification, this is the most rigid type of exchange-rate peg because the central bank commits itself to strictly observing a fixed exchange rate to an anchor currency, in Argentina's case the US dollar, while its currency is still freely convertible. The expansion of domestic money supply is thus determined exclusively by the inflow and outflow of dollar reserves. In the case of an inflow, demand for money results in an increase in money supply and a decrease in the market interest rate. Conversely, in the event of an outflow from the anchor currency reserves, interest rates increase because there is a corresponding reduction in the money supply. The result is a downward pressure on prices, and ultimately deflation. In this model the central bank turns into a simple 'bureau de change' because it can only supply its

Figure 1
Inflation Rates



Sources: Secretariat of Economic Policy; OECD; DIW Berlin calculations.

own money in exchange for incoming 'hard' currency. It naturally hopes that the 'hardness' of the anchor currency will be transferred to the local currency.

Financing government deficits by printing more currency – which many observers believe to have been the primary cause of the preceding hyperinflation – is no longer possible under such a system because the state also has to provide foreign exchange if it wants to persuade the central bank to print pesos. This rigid form of self-regulation seemed to many to be a way to finally leave the mistakes of the past behind.

The strategy Argentina adopted against inflation was long held up as a model for other countries. After all, it was based on the 'two-corner solution' recommended by the IMF,[1] according to which exchange rates should either float freely or be pegged to an anchor currency.

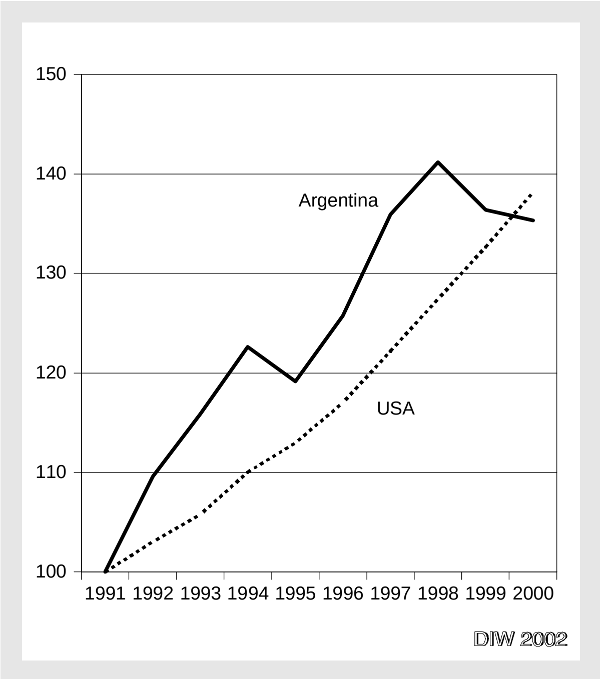
Fixed exchange rates are considered a successful strategy against inflation. Floating exchange rates, by contrast, are beneficial in crisis situations because they can help to absorb external shocks.

Initial success in combating inflation …

The battle against inflation was initially successful (cf. figure 1). Inflation rates plummeted to under 300% in the course of 1991. By 1992 they had fallen below 100%, and by the first half of 1994 there was no longer any difference between Argentina's and the USA's inflation

[1] Cf. Michael Mussa, Paul Masson, Alexander Swoboda et al.: Exchange Rate Regimes in an Increasingly Integrated World Economy. IMF Occasional Paper, no. 193, Washington, D.C., 2000.

Figure 2
Real GDP
1991=100



Sources: National Bureau of National Accounts; OECD; DIW Berlin calculations.

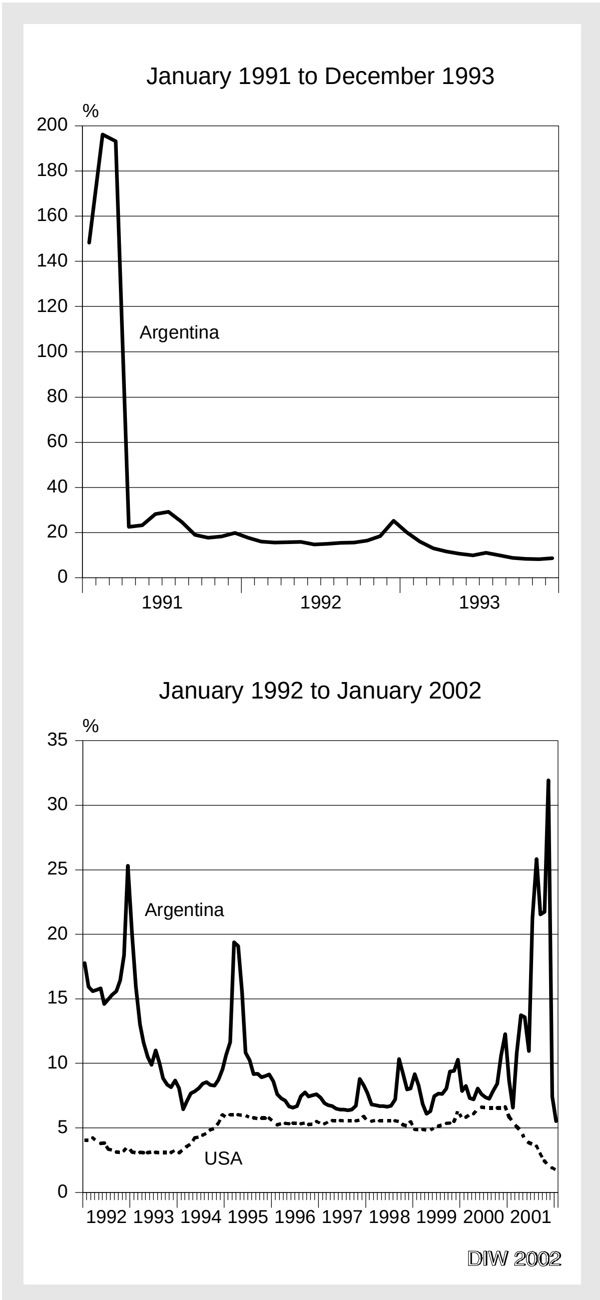
rates. Since then, Argentina's inflation rates have not only been lower than the USA's, but until recently they were actually negative for prolonged periods. Thus, the price trend in Argentina has been manifesting deflationary characteristics for some time now.

Between 1991 and the beginning of 1998, growth was only dampened; apart from a brief recession in 1995 there was no stabilisation recession. Up until 1994, the Argentine economy actually showed stronger growth than the US economy. However, during this period the growth rates decreased by half: from over 10% to over 5% (cf. figure 2). The currency board's deflationary trend was initially softened in this period by a sharp increase in foreign debt. But during 1998 the country slipped ever deeper into a severe economic crisis, which has lasted until today.

… followed by deflation crisis

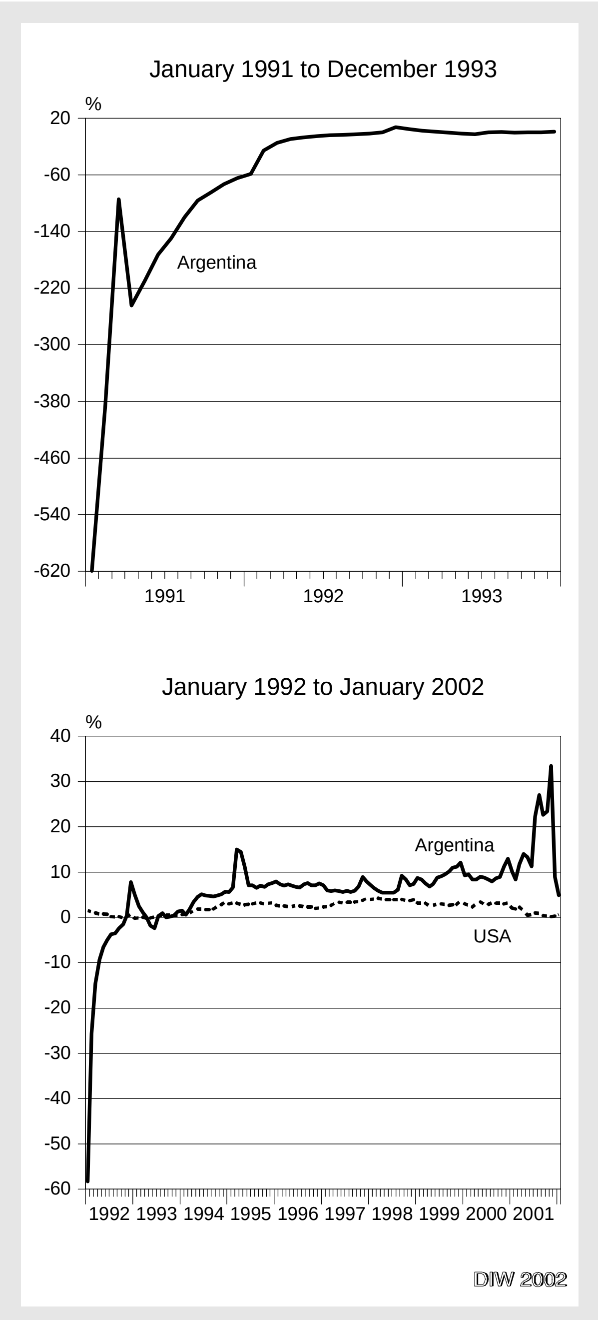
There is no doubt that the currency board played a major part in helping to curb the heightening inflationary trend at the beginning of the 1990s. The necessarily extremely restrictive monetary policy led to radical interest-rate increases of initially almost 200% (cf. figure 3). Nonetheless, in relation to the inflation rates, which were still extremely high, Argentina's real interest rates were negative (cf. figure 4). This effect is probably exaggerated because it is likely that inflation expectations decreased more rapidly than the annual inflation rate. The steadily decreasing inflation rates were accompanied by rising real interest rates, which further curbed growth. From 1994/95 onwards, Argentina's real inter-

Figure 3
Money Market Interest Rates



Sources: BCRA (Central Bank of the Argentine Republic); Statistical Bulletin; IMF; OECD.

Figure 4
Real Interest Rates[1]



1 Money market interest rates adjusted by consumer price index.
Sources: BCRA (Central Bank of the Argentine Republic); Statistical Bulletin; IMF; OECD.

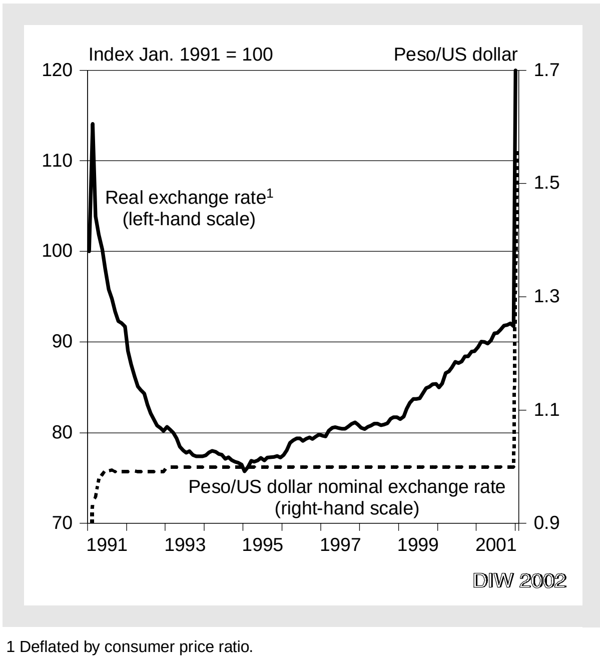
est rates were constantly higher than the USA's, with corresponding negative consequences for GDP growth. Growth was also encumbered in the early years of the exchange-rate peg by the related strong real appreciation of the peso, especially against the US dollar (cf. figure 5), which significantly reduced the competitiveness of Argentine companies on the world markets.

Due to the resulting extremely low inflation rates, the real appreciation of the peso against the US dollar not only came to a halt: but Argentina's currency actually gradually began to depreciate. The export situation improved again for the Argentine economy. Foreign exchange earnings increased and the money supply expanded accordingly (cf. figure 6).

However, the positive trends only served to conceal the fundamental crisis Argentina was steering towards under its chosen exchange-rate regime. At the root of the instability were the real economic and monetary effects of the currency board itself, for Argentina was monetarily integrated with the USA – a country in an entirely different situation. At the beginning of the 1990s, Argentina was an emerging-market economy in recovery, whose wage and price formation structures and monetary policy were not geared towards price stability, quite unlike the USA. Orienting this kind of structure towards increased price stability by means of a currency board will almost inevitably lead to deflation and economic depression.

The fact that inflation rates were still extremely high when the currency board was established led to an excessively high real exchange rate. The adjustment of

Figure 5
Peso/US Dollar Exchange Rate
January 1991 to January 2002



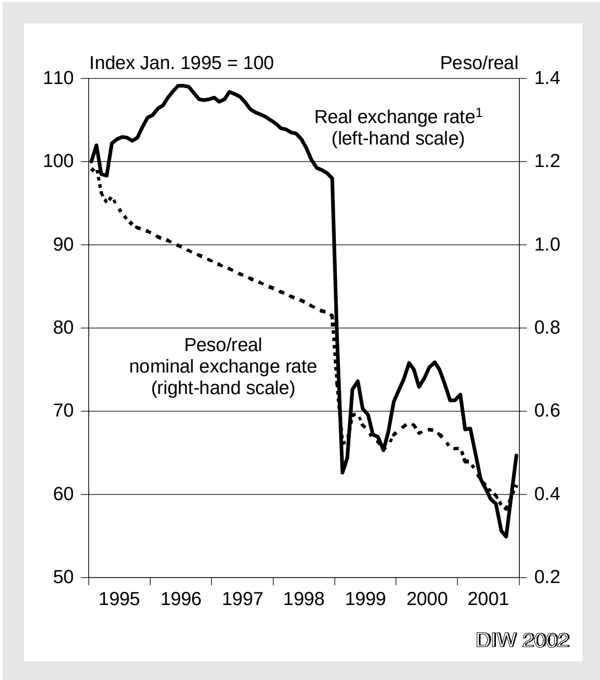
1 Deflated by consumer price ratio.
Sources: Secretariat of Economic Policy; DIW Berlin calculations.

this rate – a necessary step if competitiveness is to be restored – requires an inflation trend which is lower in the long term than that of the anchor country. If the adjustment is to be made rapidly, then a deflationary trend is actually essential. If the foreign trade deficit is the result of an excessively high real exchange rate, then adapting the inflation rates to those of the anchor country is simply not enough to rapidly even up the foreign trade balance. This would only prevent the deficits increasing further. Under these circumstances, an investment and growth crisis was unavoidable in Argentina. When negative inflation rates persist for a long time, then all incentive to invest declines because of the necessarily high real interest rates. Moreover, without investment the growth potential is also diminished because given the declining capacities, a return to the old growth trend can only come about gradually.

Figure 7

Peso/Real Exchange Rate

January 1995 to December 2001



1 Deflated by consumer price ratio.
Sources: Secretariat of Economic Policy; OECD; DIW Berlin calculations.

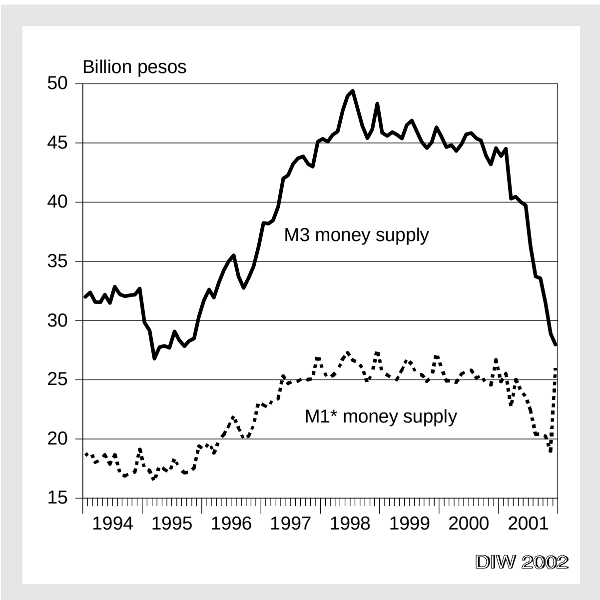
Economic policy paralysed

Expansive impulses are needed to combat a deflation. But Argentina's economic policy makers had their hands tied by the currency board – indeed it was this self-regulation which made the model chosen to combat inflation seem so attractive. Monetary policy 'automatically' aligns the money supply to the foreign exchange balance and cannot react to a crisis with appropriate interest-rate reductions unless there is a substantial surplus. Under these circumstances, an expansive fiscal policy with higher public deficits is of no use because, due to the rigid restrictions on money supply growth, every additional demand by the state is counteracted – or crowded out – by higher interest rates. As a result, stimulating effects can only be expected from abroad. This, then, would be the stabilisation expected by the advocates of a currency board. A real depreciation process was introduced in Argentina in the mid-1990s by means of inflation rates which were lower than those in the anchor country with the intention of stimulating exports and thus overall growth. However, the effect did not ensue to the expected extent because of the appreciation of the anchor currency, the US dollar, against the currencies of Argentina's important trading partners and especially against the Brazilian real (cf. figure 7). Thus, pegging the peso to the US dollar entailed a substantial risk because Argentina does most of its trading with the other Mercosur countries (cf. figure 8) and actually trades more with the countries in the euro zone than with the USA.[2] The appreciation of the dollar against almost all the important currencies set off a downward

Figure 6

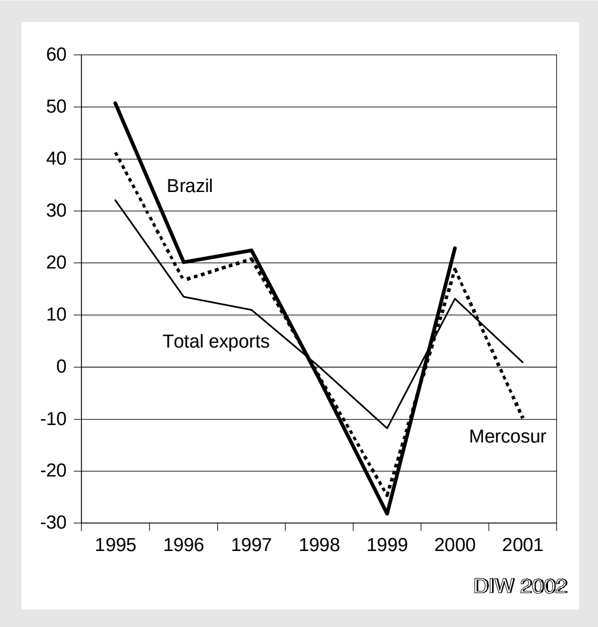
Argentina: Monetary Aggregates[1]

January 1994 to December 2001



1 M1* = M1 plus sight deposits in US dollars. End-of-month figures.
Sources: BCRA's Statistical Bulletin.

Figure 8
Argentine Exports to Mercosur[1] Partner Countries, 1995 to 2001
% change on previous year



1 Common Market of the South (Mercosur): Argentina, Brazil, Paraguay and Uruguay.
Sources: INDEC; DIW Berlin calculations.

spiral in Argentina, which ended perforce its exit from the currency board.

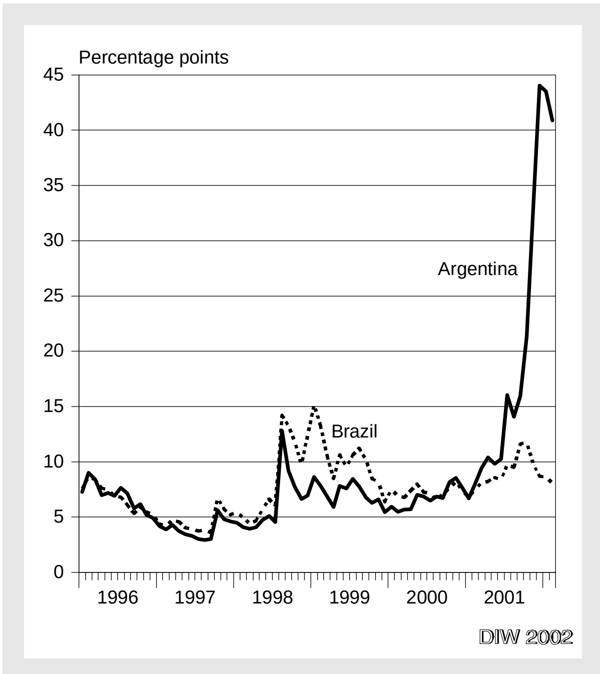
Burden of high foreign debt

The persisting deflationary trend presented Argentina with a dilemma, for even the constantly falling prices were not enough to bring about a fundamental improvement in the foreign trade balance. Thus, Argentina was left with two options: either intensify the deflationary trend in order to even up the foreign trade balance, or else increase the foreign debt to cover the deficits. It was against this background that Argentina's foreign debt rose steadily from the early 1990s onwards (cf. figure 10). The foreign debt of the private sector and of the entire financial sector, in particular, which was still low at the beginning of the 1990s, expanded significantly. The national debt also increased, albeit to a much less significant extent.

The exchange-rate peg changed the conditions for would-be borrowers. In addition to the domestic capital market, they now also had access to the US market with only a (supposedly) minor exchange-rate risk. Given the lower nominal interest rates in the USA, there was even a considerable incentive to take out loans abroad, especially in the USA.[3] The fact that interest rates were lower in the USA reflects the capital market's estimation of the risks associated with loans in pesos, despite the exchange-rate peg. Calculations of these risk premiums show that a surcharge of no less than five percentage points was still demanded up until 1998 (cf. figure 9). This means that the capital markets were not entirely convinced of the durability of the currency board. Another probable reason is the fact that a currency board does not have a 'lender of last resort'. In the event of a banking crisis, it is thus difficult to rapidly provide liquidity in order to prevent the collapse of credit institutions. Providing such liquidity is only possible when additional reserves are available beyond the legally stipulated protection of the domestic money supply. Ultimately, then, the domestic banking system is at much greater risk than the banking system in the anchor country.

In addition, growing foreign liabilities increase the incentive to stock up on foreign currency because there

Figure 9
Risk Premium[1]
January 1996 to February 2002

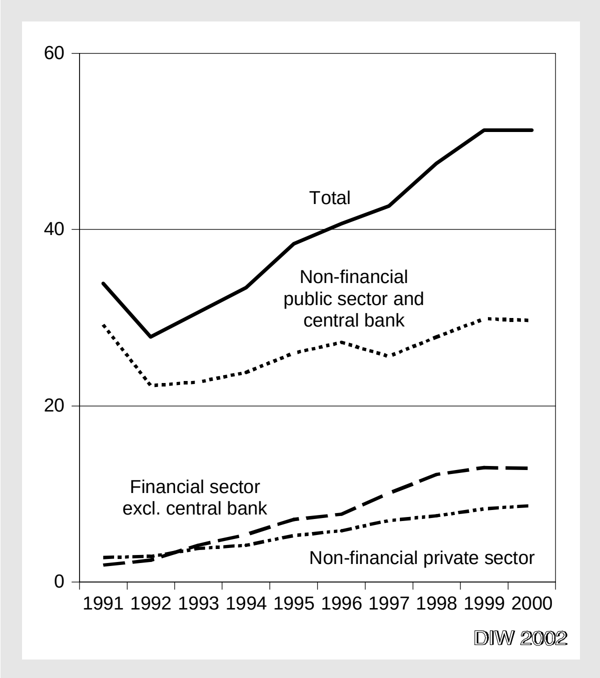


1 Sovereign risk; end-of-month figures.
Source: J.P. Morgan indicators.

[2] Cf. Mussa et al., loc. cit.

[3] Cf. Mussa et al., loc. cit.

Figure 10
External Debt
As % of nominal GDP



Sources: National Bureau of National Accounts; Financial Statements of Financial Institutions; BCRA; DIW Berlin calculations.

is an ever greater risk of a currency and financial crisis. This in turn accelerated the loss of faith in Argentina's currency.

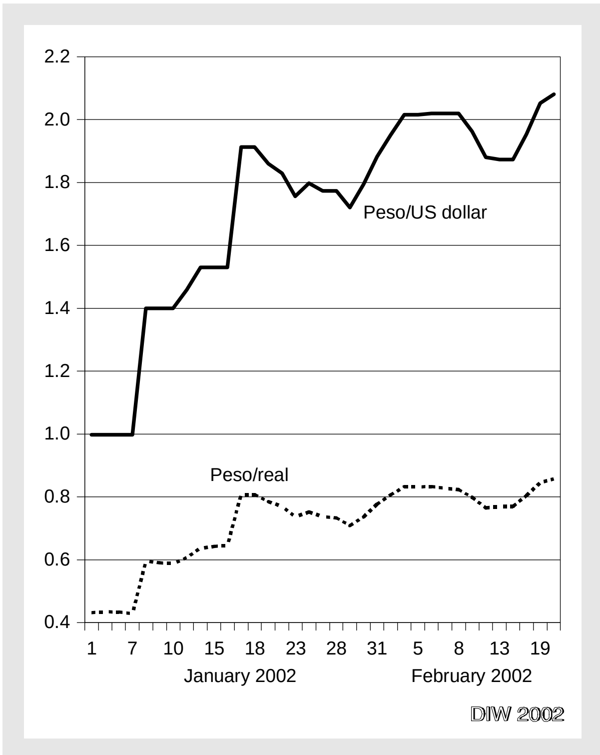
As a result of these developments, the foreign currency reserves diminished from 1998 onwards and the risk premium for Argentine loans continued to rise. The deterioration in the external economic position forced the central bank to again reduce money supply expansion via the currency board, and real interest rates rose again. This in turn intensified the economic downturn and gave further impetus to the deflationary trend. The problems intensified from 1999 onwards and led to the current currency crisis. At the end of last year, there was a risk premium of 30 percentage points on Argentine loans and real interest rates had also risen to 30%.

At the beginning of this year, Argentina had no other option but to float the exchange rate for the peso. Thus, it abandoned one of the IMF's corner solutions and adopted the other. The desired result was drastic depreciation (cf. figure 11). The value of the peso rapidly fell by 40%. Even if this development is likely to have a positive effect on Argentina's exports, the problems have by no means been resolved. However, there is probably little danger of Argentina's credibility suffering as regards combating inflation now that it is no longer linked to a foreign stability anchor. The depreciation will be accompanied by a significant increase in import prices, but Argentina is still in a deflation and a deep recession. Moderate acceleration of inflation expectations, at least, could thus even stabilise economic growth. The much more difficult problem is the burden of foreign loans, which has increased sharply as a result of depreciation. It is uncertain whether the Argentine economy will even be able to service its interest-rate liabilities for foreign loans, which have increased due to depreciation. Much more likely is the need for international debt re-negotiation. In addition, the Argentine banking system has fallen into deep crisis as a result of the exchange-rate float.

A way out: middle path instead of corner solution

Many observers attribute considerable success to currency boards as regards both fighting inflation and stabilising adequate growth.[4] Argentina's strategy of fol-

Figure 11
Peso's Nominal Exchange Rate
Beginning of 2002



Source: (www.exchangerate.com).

lowing the logic of the currency board ultimately foundered on the currency board's inherent tendency to destabilise economic growth.[5] This demonstrates – as, incidentally, did the Asian crisis of 1997/98 – the dangers associated with badly conceived exchange-rate systems. The basic error was underestimating the restrictive potential of monetary policy and the consequences of accumulating foreign debts. Pegging the exchange rate to the USA meant linking up with currency zones with which Argentina had less intensive trade relations than other countries and regions. In the case of the south-east Asian countries, most exports go to Japan. In Argentina's case, the most important trading partners are Brazil and the other Mercosur countries. In addition, a fully developed economy was linked to an emerging-market economy. In such circumstances, countries with a strict exchange-rate peg and a high foreign debt end up in a no-win situation. No matter what they do, the consequences are negative. If they try to defend their exchange-rate system they end up in a deflation. If they abandon the fixed exchange-rate system they are crushed by the burden of foreign debts.

What emerges from these considerations is that 'corner solutions' represent a currency and stabilisation strategy which is difficult to maintain in emerging-market economies. What would be preferable are 'middle paths', for example agreed margins for exchange-rate fluctuations such as those stipulated in the past in the European Currency System. Thus, on the one hand, a stabilisation anchor would be established. On the other, the central bank would have room for manoeuvre in the event of serious crises or significant structural distortions either to undertake discretionary depreciations in agreement with the other partners in the system or to reduce the pressure on the currency through joint interventions. Both could take place without modifying the exchange-rate regime, and this alone would stabilise expectations.

As emerges in theoretical discussions of optimal currency regions, it is essential that the economies that join up in such systems are, first, linked by intensive trading relations and, second, able to credibly agree on the aim of price stability. Then there is a credible stability anchor, on the one hand, while on the other, Argentina's most important trading partners are incorporated into the system so that there is greater external stability than in the case of a currency board.

Gustav A. Horn, Ulrich Fritsche

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[4] Cf. Atish Gosh, Anne-Marie Gulde and Holger C. Wolf: Currency Boards: more than a quick fix? In: *Economic Policy*, 31/2000.

[5] Eichengreen and others also note the inherent destabilisation tendency of currency boards. Cf. Barry Eichengreen, Paul Masson, Miguel Savastano and Sunil Sharma: Transition Strategies and Nominal Anchors on the Road to Greater Exchange Rate Flexibility. *Essays in International Finance*, no. 213, Princeton 1999.