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Argentina and Currency Boards

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Throughout its currency board experience, Argentina had a highly dollarized economy. A high percentage of banks' portfolios were dollar-denominated, and by late 2001 more than 80 percent of the public debt was denominated in foreign currency. Because of this high degree of dollarization, even authors that had questioned the wisdom of the hard peg and had argued that the peso was overvalued, were skeptical about the benefits of a devaluation of the peso. In the presence of a high degree of balance sheet dollarization, they argued, a (real) devaluation would result in a large increase in debt burdens, and would unleash a string of bankruptcies.

The tragic events of Argentina showed that in a de-facto dollarized economy a devaluation can be very messy indeed. Bank and corporate balance sheets were wrecked, and depositors clamored to get their money back. Populist promises by the government did not help, and months after the currency was devalued the country was still paralyzed.

The economic theory of monetary overhangs is well known and simple, and goes back at least to David Hume. Under fixed exchange rates the undesired domestic money leaves the economy through a reduction in international reserves. This is, indeed, the main insight emphasized by the monetary approach to the balance of payments. This option, of course, was not available to Argentina, as the country had virtually run out of foreign exchange reserves. Under flexible exchange rates a monetary overhang is

resolved through jumps in the nominal exchange rate and in the price level. These nominal adjustments have to be large enough as to eliminate the difference between the desired and actual stocks of (real) money. While in theory, these could be once-and-for all jumps, in reality this type of adjustment tends to generate all sorts of macroeconomic pressures, and usually unleashes an inflationary process that is difficult to control. It is indeed for this reason that throughout the first half of 2002 the IMF argued that lifting the deposit freeze would generate chaos. As an alternative they proposed substituting long term bonds for frozen deposits – the characteristics of these bonds, and in particular whether the exchange was to be voluntary and mandatory became a source of heated debate.

Although the economic profession is still digesting the lessons from Argentina's traumatic crisis, it is already possible to extract some clear conclusions:

At the most obvious level the Argentine crisis shows that a super-fixed exchange rate regime is not on its own a solution to a country's macroeconomic problems. In simple words, a currency board is not "a panacea."

The existence of a currency board does not "force" politicians to run a prudent fiscal policy, nor does it result into a lasting low-inflation equilibrium.

A perverse fiscal dynamics – where the country fails to generate a primary surplus large enough as to stabilize the debt to GDP ratio – usually generates a vicious circle, where failure to stabilize the debt ratio results in higher cost of funds, lower growth, and in an even larger required primary surplus.

Situations of real exchange rate overvaluation are very costly, and lead to low growth and in some cases even stagnation. Moreover, under super-fixed nominal exchange rate regimes overvaluation is very difficult to resolve.

Economies with a low degree of openness to international trade have difficulties adjusting to external shocks.

In the presence of de facto dollarization, large devaluations wreck balance sheets, and generate very costly bankruptcies. This, in fact, was also one of the most important lessons of the Chilean currency crisis of 1982.

Defaulting on the public may be very costly. Indeed, contrary to what a number of foreign and Argentine analysts had claimed the experience of Argentina during 2002 indicates that there isn't such a thing as a "painless" default. Some may argue that it was not the default per se what caused so much havoc, but rather the awful policies that accompanied it. But that is exactly the point. Defaults don't come in a clean, surgical way. They are messy and costly.

Perhaps the most important lesson stemming from Argentina is that, contrary to what a number of authors have claimed, a banking system dominated by major foreign banks may still be subject to a run on deposits.

Related to the previous point, there are a number of serious risks associated to a highly dollarized banking system. In particular, in the absence of a lender of last resort – as is almost always the case when the banking system is highly dollarized - a crisis may be transformed into a major catastrophe. An important question is whether it is wise for emerging markets to encourage foreign-currency denominated deposits in their banking system.

The recurrence of currency crises during the last few years has prompted analysts and academics to reconsider the traditional wisdom regarding exchange rate policy. They should either opt for a floating exchange rate or for a hard peg – a currency board or strict dollarization.

For many years Argentina was considered to be the greatest example of the merits of super-fixed exchange rate regimes. The abandonment of the currency board in early

2002, and the massive collapse of the Argentine economy, have opened a host of questions regarding the selection of exchange rate regimes in developing countries. While for some authors this episode reflected the fact that super-fixed regimes were highly inflexible and inhibited the adjustment process, for others it was an illustration that “true” super-fixity – that is dollarization – was the only feasible exchange rate regime for the emerging economies. Recent discussions have also dealt with the feasibility of having genuine floating rates in countries with underdeveloped capital markets. The economic performance under dollarization has been mixed: while inflation has been lower in dollarized countries than in countries with a currency of their own, growth has been significantly lower.

Proponents of the “fear of floating” view argue that emerging countries cannot have a true floating regime: they systematically intervene in the foreign exchange market, creating a highly unstable economic environment. I argue that in many cases it is optimal for these countries to react to exchange rate developments. It is not “fear of floating,” it is “optimal floatation.”