

No right answer?

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The turmoil in Argentina and the collapse of the ten-year link between the peso and the dollar has revived the debate about currency regimes for emerging-market economies. Was Argentina wrong to adopt the link in the first place, or wrong to try so hard and so fruitlessly to maintain it?

Reuters

It's a disaster

WHAT DO Argentina, Hong Kong, Bulgaria and Bosnia have in common? Not that much, in terms of politics, culture or standard of living. But until a few weeks ago, they did share a controversial economic policy: during the 1990s, all of them introduced currency boards—essentially a system of legally-binding fixed exchange-rates. It is hard to remember just how radical this approach to exchange-rate policy seemed when currency boards came back into fashion many decades after they had last been used. But earlier this month, after weeks of growing political unrest which toppled the government of President Fernando de la Rúa, Argentina finally abandoned its currency board and the fixed-parity link between the peso and the dollar.

For months, Argentina had been staring catastrophe in the face. Expectations that the government would devalue the peso and default on the country's huge public debt were rife. But few could have predicted just how great the crisis would be. Domingo Cavallo, the country's economy minister until late December, is now a fading memory—even though he had been the driving force to preserve the currency peg, and had indeed been its creator back in 1991. The new President, Eduardo Duhalde, is the fifth man to hold the job in a matter of weeks and has yet to establish a grip on the country's enormous economic problems. Argentina is now formally in default, and the peso has been devalued by around 40%. But policies to stimulate the economy—now in its fourth year of recession—and to stabilise the banking system have yet to be put in place.

As Argentina struggles to get to grips with its dramatically-changed economic and political circumstances, questions are already being asked about the currency regime it adopted in 1991. At the time, the then government of President Carlos Menem won lavish praise. Yet in retrospect was the policy a mistake? Or was the problem simply that the country clung on too long to a

policy which had ceased to be appropriate?

Opinion among economists has been divided. This underlines the intellectual shift that has taken place, at least with respect to Argentina's problems. A decade ago, few mainstream economists doubted the wisdom of Argentina's currency board (such a board issues currency backed only by foreign assets, and at an exchange rate fixed by law, rather than by government decision or the market. Each dollar's worth of domestic currency is backed by a dollar's worth of foreign reserves). This rigid link was seen as only one step away from full dollarisation—ie, the use of American dollars rather than domestic currency. At the time, the currency board represented a desperate attempt to get to grips with Argentina's hyperinflation.

AFP

Duhalde has yet to deliver

And it worked. The dollar link had a dramatic impact on expectations and behaviour. Inflation fell sharply, and Argentina's economic performance and prospects improved. Yet after three years of recession, the strains of Argentina's dollar-link were showing through clearly. The country's exchange rate—wholly dictated by the movement of the American dollar—had become greatly overvalued. Suspicion that the link would be broken sooner or later put Mr de la Rúa's economic policies under enormous pressure, as people rushed to withdraw pesos from the bank to convert to dollars in anticipation of a devaluation. Foreign investors were unwilling to lend the government money because they, too, feared a devaluation that would force the government to default on its huge debts. Events showed their fears to be entirely justified.

As the value of the dollar rose in the 1990s, the peso's link with it became an acute problem for Argentina, especially after its most important neighbour, Brazil, devalued in 1999, giving it a competitive edge over Argentina in world markets. But another factor was the residual inflation left in the Argentine economy after the link was introduced, particularly between 1991 and 1995. In normal circumstances, exchange rates can adjust to take account of one country's inflation rate relative to others. But Argentina could not do that under the currency board. In response to this point, the Argentine government could argue that since 1996, as a result of deflation in the economy, with nominal falls in wages, the country has made up at least part of the gap.

For some, the currency board was only a stepping stone to full dollarisation and, indeed, the now-defeated Mr Cavallo hinted more than once that he favoured this. In many ways, though, tying its currency so closely to the American dollar was always an odd choice for Argentina. Long before the latest crisis, Jeffrey

Frankel, an economics professor at Harvard University, had pointed out that Argentina did not fit well with the traditional criteria for an optimal currency-area: it is not small or open, it does not have high labour mobility, and it is not closely correlated with the American economy. Exports to America, for example, only account for about 10% of total exports. Many other countries have closer trade ties with the United States.

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Cavallo clung on for too long

In fact, Mr Frankel pointed out how much some other countries have, ultimately, benefited from weakening their ties with the dollar. Introducing more flexibility at the right moment—when its currency became overvalued—helped Israel, according to Mr Frankel, while he noted that both Mexico and Brazil suffered by clinging on to their exchange-rate pegs for too long. Many economists came to believe that Argentina was repeating the latter's mistakes; and that the pain of the adjustment to a new currency regime, with a devalued peso, would be greater the longer it was postponed. The scale of social and political upheaval over the past weeks has amply vindicated this view.

One unlikely parallel for Argentina's current predicament is the British experience with the European Union's exchange rate mechanism (ERM) in 1992. After two years of membership, the British economy was in recession; the financial markets began to doubt that the pound's position within the mechanism (a looser peg than that between the peso and the dollar) was sustainable; and the government's protestations that it was irrevocably committed to the ERM began to sound hollow. Finally, market pressure became overwhelming and, as a result of huge outflows of capital during a single day, the pound was forced out of the ERM.

But that did not necessarily mean that membership of the ERM was a mistake from the beginning, although some have argued that. During the two years which the pound spent in the ERM, inflation in Britain fell sharply, along with inflationary expectations. The temporary boost which the British economy gained from devaluation turned out to be far longer-lasting than economists had predicted. The gain from membership was significant; and so was the gain from a timely, if embarrassing exit.

The lesson to be drawn from Argentina's painful experience may be that no currency regime can be right for all time. Mr Frankel has pointed out that the trick of escaping from a difficult situation gracefully is often the main challenge facing governments in the predicament Argentina found itself in. In the end, that challenge proved too great for Argentina and in its failure lies a lesson for other emerging-market countries.

