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Argentina's Currency Crisis: Lessons for Asia

By Mark M. Spiegel
Federal Reserve Bank of San Francisco

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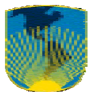

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LAEBA OVERVIEW

The Inter-American Development Bank (IDB), through the Integration and Regional Programs Department, and the Asian Development Bank (ADB), through the ADB Institute have undertaken a joint initiative to promote and launch a new professional association, the "Latin America/Caribbean and Asia/Pacific Economics and Business Association (LAEBA)." LAEBA will be dedicated to strengthening linkages between the Latin America/Caribbean and Asia/Pacific regions through a variety of activities including the promotion of research.

The LAEBA initiative results from a Partnership Agreement (supported by the Japan Program) signed on March 17th, 2001 between the IDB and ADB at the 42nd Annual Meetings of the Board of Governors of the IDB and the Inter-American Investment Corporation (IIC) in Santiago, Chile. The Partnership Agreement promotes the exchange of institutional and regional development experiences and expertise between the two regions.

The mission of LAEBA will be to:

- Encourage comparative and applied research in the areas of economics, finance, business, and public policy of both regions.

- Provide a framework to develop inter-regional networks and encourage research collaboration on issues of mutual interest between the regions.

- Facilitate and inform the process of economic policy-making and private sector decisions through enhanced interaction among policymakers, academia, and the business community.

LAEBA will initially be guided by an IADB-ADB Executive Committee and Secretariat to organize and sponsor LAEBA panels in major regional and international conferences and other thematic forums, produce original research, build and maintain a database of experts on relevant topics, disseminate information, and promote interaction and networking. It is anticipated that the activities of LAEBA will lead to the creation of an independent, non-profit association governed by a Board of Directors, supported by an Advisory Committee.

ABSTRACT

The popularity of fixed exchange rate arrangements has risen over recent years, especially among observers of the European Monetary Union (EMU). However, the collapse of the Argentinean currency board regime, previously perceived as a strong and credible arrangement, has stalled the momentum for the adoption of formal currency mechanisms. This paper reviews the major dynamics surrounding the collapse of the Argentinean monetary regime, and suggests that the failure of Argentina's exchange rate arrangement provides important lessons for potential pegged regimes in Asia.

This paper begins by delineating the characteristics of the Argentinean monetary regime. It maintains that while this regime was formally termed a "currency board," it could not be strictly defined as an "orthodox currency board." The Argentinean board pursued policies associated with standard central banking regimes, thus classifying it as a fixed exchange rate regime with a hard dollar peg. In addition, one clear difficulty faced by Argentina's board was overvaluation.

This paper concludes by acknowledging that the collapse of the Argentinean currency board has had a devastating impact on the country's "real economy," serving as a reminder to advocates of such schemes elsewhere. It observes, in addition, that even "good pegs" are likely to be less than perfectly credible. Thus, while there are good arguments favoring pegging exchange rates, countries in Asia must consider this option carefully.

Argentina's Currency Crisis: Lessons for Asia[1]

Mark M. Spiegel

Introduction

Prior to this year's financial crisis, the popularity of fixed exchange rate regimes appeared to be on the increase. Relative to many countries with less transparent "dirty-floating" exchange rate policies, the strong rules governing Argentina's currency board, under which the Argentine government maintained a fixed peso-dollar exchange rate, appeared to allow its country to avoid negative financial effects from the Asian financial crisis of 1997. The policy conclusion drawn by many observers from this experience was that credible fixed exchange rate regimes could serve to mitigate developing countries' exposure to foreign shocks.

One area with strong interest in the promise of exchange rate arrangements was Asia itself, where the Asian crisis experience led many nations to investigate the potential benefits of adopting some kind of formal exchange rate arrangement. While initial efforts concentrated on developing institutions to raise liquidity regionally to forestall repetitions of the 1997 Asian Financial crisis, there has also been speculation about the feasibility of more intense monetary policy coordination.

Asian countries found particular inspiration from the successful launch of the European Monetary Union (EMU). Prior to the launch of the EMU, currency arrangements were primarily either asymmetric arrangements, where a number of developing nations linked themselves to a single hard currency, or were accompanied by some form of political union [Bayoumi and Mauro (1999)]. In contrast, the EMU consists of a number of independent nations retaining a large amount of independence, particularly concerning domestic public finance. As such, the EMU provides a model of a viable currency union that more closely matches a potential ASEAN arrangement than its predecessors.[2] The launch of the EMU was closely followed by the Chang-Mai-Initiative in June of 2000, in which the ASEAN nations plus Japan, China, and Korea

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[1] This paper was prepared for a panel organized by the LAEBA at the 2002 APFA/PACAP/FMA Finance Conference, hosted by the International University of Japan, July 15, 2002, Tokyo, Japan. A shortened version of this paper has been released as an *Economic Letter* of the Federal Reserve Bank of San Francisco. Views expressed are those of the author, and do not necessarily represent those of the Federal Reserve Bank of San Francisco or the Board of Governors of the Federal Reserve System.

[2] The ASEAN nations include Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

agreed to adopt a system of swap arrangements. There is some speculation that the successful launch of these swap arrangements laid the foundation for more intensive regional monetary policy coordination.

However, the difficulties experienced by Argentina this year have stalled the momentum for the adoption of formal currency arrangements. The shock of seeing Argentina's currency board regime, which had been perceived as a strong and credible arrangement despite some misgivings about the appropriateness of its currency peg, appears to have led to renewed doubt about the sustainability of any formal exchange rate arrangements.

In this paper, I review the circumstances surrounding the collapse of Argentina's monetary regime and examine if these circumstances provide any lessons for proposed Asian currency arrangements.

Argentina's Currency Board Regime

Argentina maintained a fixed exchange rate currency regime from April 1, 1991 through January 6, 2002. While this regime was formally termed a currency board, it is important to remember that Argentina's monetary regime was not in fact an orthodox currency board. As defined by currency board advocates Hanke and Schuler (2002), an orthodox currency board has a number of features. First, it must maintain a fixed exchange rate with its anchor currency. Second, it must allow for full convertibility, that is, it must allow holders of the currency to move into or out of the anchor currency without restriction. Third, the monetary liabilities of the currency board must be fully backed (100%) in hard, i.e. foreign assets.

In addition, there are a number of activities in which an orthodox currency board should not participate. These include purchasing government securities, regulating commercial banks, or acting as a lender of last resort. It is easy to see how any of these activities could undermine the primary goal of the currency board, which is the maintenance of the peg with the hard currency anchor. As Hanke and Schuler (2002) note, Argentina's currency board violated all of these rules at some point in its existence.

In particular, the charter governing Argentina's currency board allowed it to be partially backed by domestic -- rather than hard foreign currency -- assets. The central bank was initially allowed to hold as little as 66.6% of its assets in true foreign reserves.[3] The difference between these foreign reserves and 100 percent backing could be held in the form Argentine government

bonds. As such, the charter for Argentina's currency board opened the door to the pursuit of discretionary monetary policy. In 2001 alone, the foreign reserve backing for Argentina's currency board ranged from a high of 193 percent to a low of 82 percent [Ibid (2002)].

In addition to the pursuit of discretionary monetary policy, the Argentine currency board had financial responsibilities that exceeded those commonly associated with currency boards. The Argentine central bank set reserve ratios, and therefore retained some regulatory jurisdiction over commercial banks. The central bank also engaged in last resort lending, as in the case of the Mexican peso crisis of 1995 in which it extended funds to illiquid commercial banks [Spiegel (1999)]. Moreover, as Hanke and Schuler point out, many of these loans were collateralized with government bonds, so that the currency board was also indirectly supporting the bond market through its last resort lending activity.

Because it allowed its currency board to pursue policies commonly associated with standard central banking regimes, it would probably be more appropriate to characterize Argentina's exchange rate regime as a fixed exchange rate regime with a hard dollar peg. Nevertheless, it must be granted that the rules faced by Argentina's currency board exceeded those commonly found in pegged regimes. However, as I discuss below, when the resolve to maintain the initial exchange rate peg was lost, these rules were easily circumvented.

One clear difficulty faced in Argentina's currency board was that of overvaluation. As the dollar appreciated, Argentina's exports became less competitive on the world market, particularly relative to their main Mercosur trading partner, Brazil. Some estimated the severity of overvaluation to have been as high as 40 percent [e.g. Rajan (2002)].

The effects of overvaluation can be seen in the movement of domestic prices in Argentina. The nation has been experiencing a slow deflation as the economy moves to offset the impact of the dollar's appreciation [Roubini (2001)]. In an environment of nominal price and wage rigidity, decreases in the general price level can have a recessionary impact. These effects then spilled over to the real side of the economy. Argentina has been experiencing recession now for four years. Subsequent to devaluation and the financial crisis, the unemployment rate has grown to as high as 25 percent of the labor force.

Partly as a result of reduced export revenues attributable to its overvalued exchange rate, Argentina faced massive fiscal budget deficits. These led the government to raise taxes in an effort to balance its budget in 2000. In 2001, a tax on financial transactions was also levied. However, these efforts failed as Argentina's economic recession worsened.

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[3] This figure was later raised to 90 percent.

The climbing deficit led to an increase in concern about the possibility of a devaluation. Roughly $20 billion in capital fled the country in 2001. Peso interest rates climbed to 40 to 60 percent, which further deteriorated the government's budget position.

Argentina's initial attempt to repair its exchange rate regime was directed at addressing the problems with its peg. In April 2001, Economy Minister Domingo Cavallo proposed a move to a 50:50 basket peg with the dollar and the Euro. The congress decreed in June that it would move to a basket peg if the Euro reached parity with the dollar.[4] In addition, Argentina moved to a dual exchange rate system, adopting a preferential exchange rate peg for exports. This move eliminated the characteristic of full convertibility from the Argentinean regime, and therefore formally terminated the currency board regime.

Unsurprisingly, these measures failed to reassure the public concerning the viability of the exchange rate regime. In December 2001, the government froze bank deposits, formally initiating a financial crisis. This led shortly to abandonment of the exchange rate regime for a floating regime on January 6, 2002.

The situation is likely to deteriorate further. The government is currently dealing with the terms of defaulting on $155 billion in debt. A movement to convert deposits into bonds was rejected by the government. Domestic financial markets are also in turmoil, as bankruptcies appear to be inevitable.

Asian Currency Arrangements

Prior to assessing the lessons from the Argentinean experience for potential Asian currency arrangements, it is useful to review the spectrum of proposed arrangements. These vary widely in intensity, ranging from regional insurance schemes aimed at forestalling future financial crises to full-fledged currency arrangements that could culminate in a regional currency. Before moving on to the Argentina experience, we review these proposals.

Japan first proposed the creation of an "Asian Monetary Fund" in 1997 in the wake of Asia's financial crisis. The proposal was for an institution that would provide a framework for financial cooperation and policy coordination [Park (2000)]. Opposed by both the United States and the IMF, the proposal was shelved. However, policy coordination in the region was reborn with the Chiang Mai Initiative in 2000. This initiative was designed to expand existing swap arrangements to all 10 ASEAN nations as well as China, Japan, and Korea. The swap

arrangements are designed to provide liquidity support for member countries in distress in an effort to prevent regional contagion and systemic risk [Ibid. (2000)]. As such, these arrangements would only be used in crisis episodes.

A full-fledged intra-Asian currency arrangement analogous to the European Monetary Union has also been considered [e.g. Bayoumi and Mauro (1999)]. The argument in favor of such a regime is that it would stabilize exchange rates within the region while allowing for flexibility against the three major global currencies.

Ogawa and Ito (2000) have argued simply for a greater weighting of other currencies in Asian monetary arrangements. They argue that the excessive targeting of the dollar fueled the Asian crisis of 1997. If Asian countries had instead adopted a currency basket with a yen weight commensurate with Japan's share in trade, the nations would not have experienced as significant a boom over the 1993-1995 period, as their currencies would have appreciated with yen. More importantly, their depreciation along with the yen in 1996 and 1997 would have mitigated their declines.

However, "flexibility," would not come without a cost. In particular, an intra-Asian currency arrangement would face a tradeoff between rigid adherence to a fixed peg or a fixed basket peg, or a loss of credibility. Some attribute the Asian currency crisis at least in part to a lack of credibility concerning commitment to what was perceived as a soft dollar peg [Rajan (2002)].

Lessons from the Argentine experience

Since Argentina's exchange rate regime was a hard peg currency-board like scheme, its demise is more likely to shed light on potential pegged regimes in Asia than other proposals, such as liquidity funds or enhanced swap arrangements. In this section, I discuss some of the lessons of the collapse of Argentina's regime.

Lesson 1: The peg's the thing

One obvious lesson from Argentina's failed currency board is that an improper exchange rate peg is doomed to failure, no matter how rigorously one attempts to impose credibility. This

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[4] Hanke and Schuler (2002).

is an important lesson for the ASEAN nations because a basket peg is likely to serve them best as their trade patterns are diversified across the United States, Europe and Japan.

Many have argued that the performance of the Hong Kong during the 1997 Asian financial crisis demonstrates that the appreciation of the dollar alone did not bring the Asian countries down during that episode. However, Rajan (2002) notes that the performance of Singapore, who pursued a flexible basket peg rather than a dollar peg and thus did not experience as much of a currency appreciation, outperformed Hong Kong over the crisis period.

Lesson 2: Exchange rate arrangements are no cure for improper macro policies

Despite the relatively strong set of rules governing the conduct of Argentina's currency board, the regime collapsed quickly when domestic and foreign investors determined that the policies pursued by the Argentine government were unsustainable. As discussed above, Argentina's public debts at the time of its devaluation exceeded $155 billion.

One important implication for prospective Asian currency arrangements is that the degree of disparity in development levels across these countries is likely to prove difficult. The Asian nations as a group, particularly if Japan is included, represent a more heterogeneous set of nations than the EMU members. As such, the predilection of these nations to fall into the pursuit of poor macroeconomic policies is likely to be higher. However, it should be remembered that the ASEAN nations as a group enjoyed relatively healthy fiscal situations going into the 1997 Asian crisis.

Lesson 3: Rigidity vs. Credibility

Another lesson from the Argentine experience is the relative ease with which the currency board regime collapsed once the government fiscal situation was perceived as unsustainable. Much of the literature on the relative desirability of pegged exchange rate regimes discusses a tradeoff between rigidity, which can hinder a nation's ability to adjust to external shocks, and the credibility of the regime itself. It is generally understood that a nation can buy credibility (at the cost of reduced flexibility) by adopting formal rules designed to increase the cost of abandoning the announced peg.

In the case of Argentina, this cost was clearly very high. In response to the relatively rigid mandate to the currency board, contracts were written in both dollars and pesos interchangeably. As a result, the terms of the devaluation will have crucial distributional implications and result in numerous bankruptcies.

Nevertheless, one of the main lessons of the collapse of the Argentinean regime was the ease with which the rules of its currency board were circumvented once the government lost its interest in maintaining the currency board regime. The introduction of dual exchange rate system and the freezing of bank accounts were readily available policies despite currency board rules to the contrary.

Lesson 4: Dollarization?

An immediate corollary with the previous lesson is that dollarization would not necessarily have done much better. Under dollarization, Argentina would have experienced the same exchange rate appreciation and therefore the same loss of competitiveness vis-à-vis its primary trading partners. It follows that the government would have likely ended up in a similar unsustainable fiscal situation.

But, would dollarization preclude the government from abandoning the regime? It seems unlikely. Recall that one important proposal now being circulated is the forced conversion of asset claims into bonds, presumably at depreciated peso prices. There is no reason that the same reduction in liabilities could not be achieved under a dollarized regime. The government could simply freeze all deposits and convert them to bonds with a financial haircut in place. Once the legal protection for claims is open to abrogation, no exchange rate regime can ensure asset values.

Lesson 5: Vindication of floating?

Of course, many argue that the ultimate lesson from the Argentine currency crisis is that no fixed exchange rate regime, even one as institutionally strong as Argentina's, is completely sound. As a result, it will sooner or later lose its credibility. Moreover, since financial contracts will have been written in the domestic currency, this loss of credibility will have real effects and will likely precipitate a financial crisis, or at least a severe disruption to the real side of the

economy. As such, the main lesson from the Argentine currency crisis is that floating is a superior policy over the long run, despite the fact that it may exhibit more volatility in limited episodes.

However, there are important difficulties with floating exchange rate regimes for developing countries. First, because many of these countries are relatively open, external shocks can do more damage to them than most developed nations. Second, because developing countries lack the ability to issue debt in their own currency, depreciations immediately correspond to increases in indebtedness in domestic currency. As a result, floating regimes may exacerbate the potential for financial crises stemming from widespread bankruptcies.

Finally, floating regimes place responsibility for maintaining price stability back squarely in the hands of the national central bank. Because developing country institutions are often less established, it may be difficult for a developing nation central bank to resist, for example, monetizing the deficit of its treasury. As a result, price stability may not be attainable when left in the hands of the national government. Instead, nations may look to exchange rate pegs as mechanisms for "institutions substitution" [Mendoza (2002)], by which they can import developed nation monetary policies that are unattainable given their own level of institutional development.

Conclusion

The collapse of Argentina's currency board has had a devastating impact on that nation. It serves as reminder to those advocating such arrangements in Asia and elsewhere of a number of lessons. Perhaps the most important of these lessons are that an exchange rate regime is only as good as its peg. No set of rules surrounding the regime, regardless of their strength, can force a nation to remain attached to a peg that has outlived its usefulness. As a result, even "good" pegs are likely to be less than perfectly credible. Despite its drawbacks, the alternative of pure floating therefore must be seriously considered.

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