

Argentina's Currency Board: from Monetary Panacea to Fiscal Straitjacket

The Case for Currency Boards

Currency boards, once designed as a monetary arrangement for British colonies and then discarded as countries gained political independence, have been back in fashion recently. Currency boards now exist in Argentina, Bosnia, Bulgaria, Estonia, Hong Kong and Lithuania. They consist of exchange rates which are strictly fixed, not just by policy but by law. Domestic money can only be issued when it is fully backed by foreign exchange, removing monetary policy discretion from the government and the central bank.

Supporters of currency board arrangements have stressed that the regime provides credibility, transparency, low inflation and financial stability in countries where the central bank is unable to pre-commit to a low rate of monetary growth. While the traditional reason for the time inconsistency problem of monetary policy has been an employment creation motive, the desire to inflate away nominal debt and to strengthen external competitiveness have been considerations of greater importance to developing and emerging-market economies. Currency board supporters have argued that a particularly important feature of that regime is to lower and stabilise domestic interest rates, by reducing devaluation and default risk and by reducing countries' exposure to speculative attacks. Low and stable interest rates, in turn, should encourage investment and growth.

Such claims have been validated by the historical track record of currency boards. Ghosh *et al.* (2000) find that countries operating under a currency board arrangement have experienced lower inflation than those with either a floating or a simple-peg regime, reflecting both a discipline effect (lower rate of money growth) and a credibility effect (higher money demand growth). The authors find also that better inflation performance has not been bought at the expense of lower output growth, although they concede that this might be due to a rebound effect from the typically depressed output levels before a currency board was adopted.

Specifics of the Argentine Regime

Argentina provides one of the most-debated cases of a currency board regime. In April 1991, after a long history of macroeconomic mismanagement and two episodes of hyperinflation, the currency board started to operate, with the peso pegged to the dollar parity. The regime is based on the Convertibility Law passed in March 1991 by Congress, which grants the dollar legal tender status, and was subsequently supported by comprehensive deregulation of the economy and the full liberalisation of the current and capital accounts of the balance of payments.

Argentina's regime features some notable design elements that represent a deviation from a strict currency board. These elements were introduced to accommodate the loss of a lender of last resort which a currency board entails and which exposes the country to financial crises with insufficient provision of liquidity; this in turn requires strong and liquid domestic banks. First, the currency board is integrated into the central bank, there are no designated currency board accounts. Second, currently 20 per cent of the money–base cover can be provided in the form of dollar short–term Argentinian public debt, rather than through international reserves. Third, the Argentine system is characterised by demanding capital requirements and a series of liquidity provisions. Banks are obliged to hold 21 per cent of all deposits in liquid international reserves at the Central Bank or at Deutsche Bank New York. The Central Bank has also a contingent line of credit with a dozen international banks covering 10 per cent of deposits in the banking system.

A Performance Overview

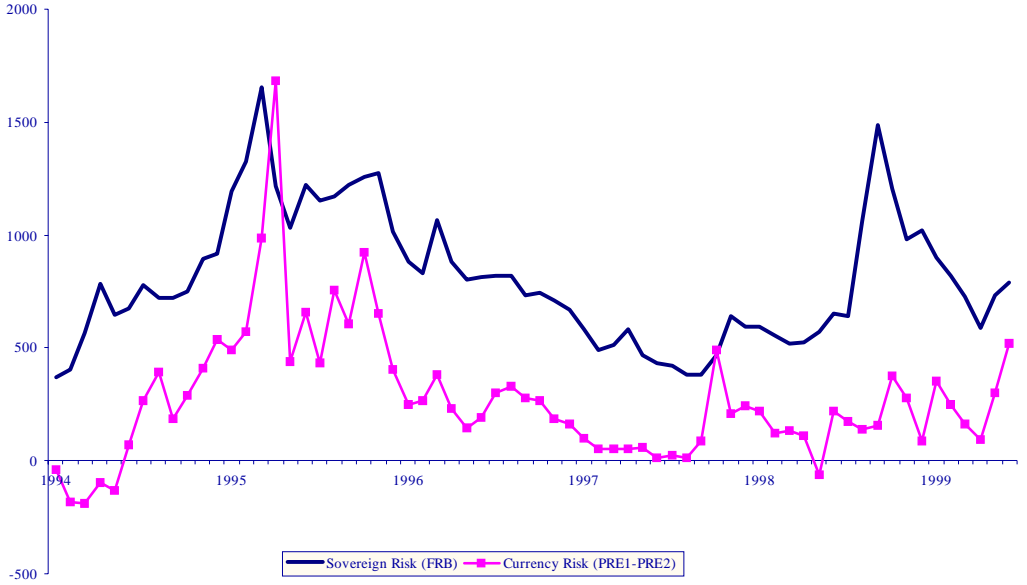
As seen from Figures 1.2 and 1.3, Argentina's economic performance has been mixed. The short–term contribution of the currency board to Argentina's economic performance was undoubtedly positive. The board arrangement provided a linchpin for deep reform of a very distorted economy and helped to bring inflation down quickly. Inflation and interest rates came down quickly, supporting rapid GDP growth (which was helped by idle capacity). Argentina's currency board has survived two major financial crises, with contagion from Mexico in 1994–95 and from Brazil in 1999, not least because of its strong bank regulatory system. Bank regulatory policy promoted privatisation, financial liberalisation, free entry and proper risk management by banks (Calomiris and Powell, 2001).

Ultimately, however, the currency board system has delivered a sustained reduction neither in devaluation risk nor in sovereign risk. Growth, apart from recovery episodes after the adoption of the currency board and after Mexico's 1994–95 crisis, has been low and volatile; investment and employment creation have remained anaemic. The failure of the currency board system in Argentina to deliver further reductions in risk premiums and to stimulate investment, growth and employment can be traced to insufficient fiscal discipline, an overvalued real effective exchange rate, and to the disincentives for savings promotion due to heavy liquidity requirements in the banking system.

Insufficient Fiscal Discipline, Decline in Competitiveness and Heavy Liquidity Requirements

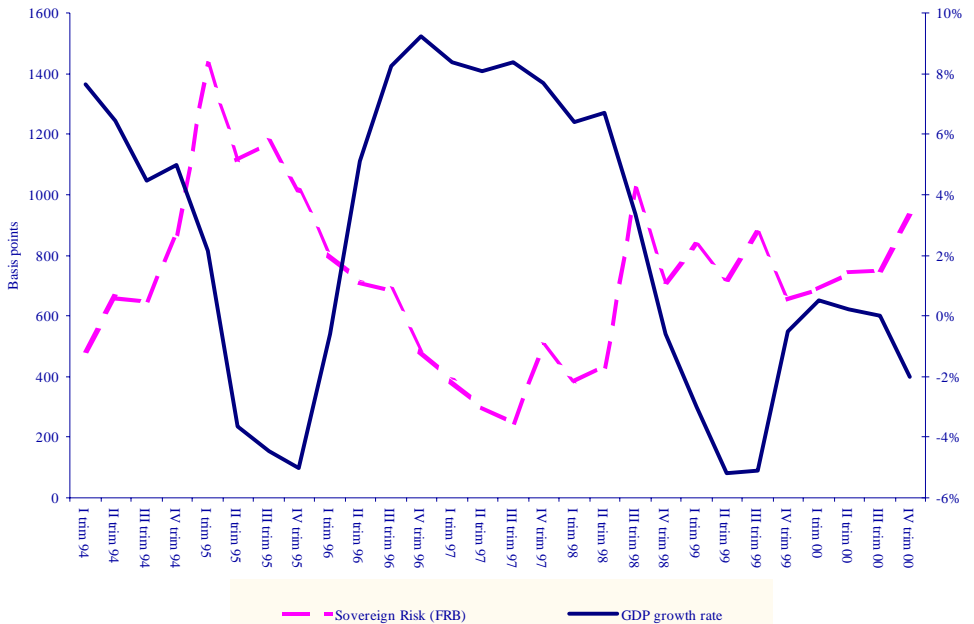
Argentina's currency board arrangement has ceased to confer sufficient *fiscal discipline* and the consolidated public–sector deficit has been gradually rising from 1995 on, culminating at 4.1 per cent of GDP in 1999. This has gradually set in motion a vicious circle of rising country risk premiums and depressed growth, in turn fuelling the public deficit through lower tax receipts and higher debt service cost.

Figure 1.2. Sovereign and Currency Risks, Argentina-Basis Points



Source: Grandes (2001).

Figure 1.3. Country Risk and Interannual GDP Growth Rate



Source: Grandes (2001).

In a simulation exercise for Argentina, Grandes (2001) demonstrates the strong endogeneity of these variables. In a forecast variance decomposition, he finds that 40 to 60 per cent of the variance of the seasonally adjusted fiscal deficit, seasonally adjusted output growth and the sovereign risk premium can be explained by a shock to these very variables. While these findings may confirm the hypothesis of hard-peg supporters that *in theory* super-fixed exchange-rate regimes can trigger off a virtuous cycle of lower deficits, lower yield spreads and higher growth, the cycle has *in practice* turned very vicious indeed. Deutsche Bank (2000), in a thorough study on debt sustainability in Latin America, recently concluded that “Argentina will have to close an underlying fiscal gap that extends beyond improved tax collections associated with growth (p. 3)”. The bank, which calculated the non-interest (primary) budget balance at 0.63 per cent of GDP for 2000, saw a need for a further 2 per cent of GDP improvement in the primary balance in order to stabilise the public debt to GDP ratio. By comparison, in 2000 both Brazil and Mexico, countries on an exchange-rate float, showed sufficient fiscal discipline to ensure debt sustainability according to Deutsche Bank indicators.

Initial inflation inertia and ongoing nominal wage rigidity have implied real appreciation of the Argentinian peso, with attendant current account deficits and a recessionary impact on the economy. While disinflation undid much of the initial overvaluation during the 1990s, Brazil’s devaluation in early 1999 has strongly impacted on Argentina’s *real effective* exchange rate, an indicator for external competitiveness. In early 2000, real overvaluation of the peso was estimated at between 7 and 17 per cent according to estimates by Deutsche Bank, Goldman Sachs and JP Morgan (Edwards, 2000). Even if estimates of exchange-rate disequilibria have to be consumed with caution, the fact that influential investment banks issue such estimates cannot fail to damage the credibility of Argentina’s currency board regime. More importantly, the dollar is an anchor currency for Argentina that is certain to destabilise its real effective exchange rate: just 8 per cent of Argentina’s exports are directed towards the United States. Business cycles in the United States and Argentina have not been synchronised over the 1990s and, given the different structures of the two economies, are not likely to coincide for long.

Indeed, Domingo Cavallo — the architect of Argentina’s convertibility law — suggested that, based on growing confidence in the Argentine economy, an eventual currency union between Mercosul members might be based on a currency basket also including the euro (*Financial Times* of 17th March 1999, “Cavallo says Argentina could float its currency”). The reaction of the markets to the proposal was negative, with a sudden increase in the currency premium (measured by the spread of local peso time deposit rates over local US dollar interbank deposit rates with maturities up to two months, see Schmukler and Servén, 2001).

Finally, to make up for the lack of the lender-of-last-resort function in a currency board (or in a fully dollarised system), high liquidity requirements are needed for the domestic banking system to withstand a drawdown of deposits in times of crisis. Just like any minimum reserve requirement, the need for more liquidity drives is an important wedge between lending rates, which are increased, and saving rates, which are lowered (McKinnon and Mathieson, 1991). Such a wedge obviously discourages both savings and investment. This again may support a vicious cycle of growth being constrained by low investment and foreign debt fuelled by the lack of local savings. This may go up to a point where exploding debt dynamics (driven by the difference of debt cost over the growth rate) and rising default risk leave the country with just three options: exit from the currency board, default, or new foreign finance.

In early 2001, the IMF board approved a loan agreement to cover Argentina's borrowing needs for 2001 (and beyond), with the Fund offering \$13.7 billion, \$6 billion from the IDB and Spain, and some \$20 billion from private, including domestic, sources. The currency board arrangement had got another, perhaps the last chance, to prove itself right.

In March 2001, Domingo Cavallo was called to defend the regime he introduced a decade earlier. In mid-June, the congress approved Cavallo's plan to add the euro alongside the dollar in the peso's peg. Interestingly, the initial reaction of the markets was again a sudden increase in the currency premium. Furthermore, the onerous liquidity requirements imposed on the country's banking system were alleviated, while a financial transaction tax that had proved an effective tax raiser in Brazil allowed corporate taxes to be reduced and public accounts to be rebalanced. These policy measures rectified the essential elements that caused the vicious cycle of Argentina's rigid currency board scheme. They should help stabilise effective exchange rates (hence halt the decline in competitiveness), and lower the wedge between saving and borrowing rates (hence stimulate savings and investment).

Meanwhile the need to restore fiscal balance was made even more acute by the rising spreads on Argentine debt instruments. A policy of zero borrowing in 2001, confirmed by the Senate in late July, overcomplied with IMF targets (and was deemed "impressive" by the US Treasury), in spite of recurrent market concerns about whether long-term debt sustainability was thereby insured. Even under stable debt dynamics, a repetition of the run on bank deposits observed after Mexico's crisis would interact perversely with the social and political unrest associated with strenuous fiscal adjustment. The well-designed banking supervision scheme that has been put in place provides for greater transparency than usual in emerging markets but it does not, by itself, add more commitment to discipline banks than already exists (Diamond, 2001). In any event, if the zero borrowing fiscal policy does not succeed in stabilising debt dynamics, a financial crisis might occur at a time when no new payments on the existing debt are due. This would be the cruel revenge of the fiscal straitjacket.

Lessons From the Two Case Studies

In short, one cannot properly address the benefits of a hard peg without first answering the question: where does the relevant financial instability come from? It may stem from the lack of credibility of governments with respect to fiscal sustainability and underlying inflation; or from the extrinsic noise that arises from the booms and busts of financial euphoria. The question then is whether dollarisation can fit the bill and protect the emerging countries from these risks.

As we have seen, the answer is not obvious. In the case of a financial crisis, the risk that the local banks will lose access to the international inter-bank market remains intact. The (expected) optimal response of the authority confronted with such risk is easily derived from the textbook: it is the suspension of convertibility. The risk of a credit crunch and of generalised default is therefore still alive.

Dollarisation in itself does not protect the country against the risk of distrust geared by the threat of default and suspension of convertibility. In that sense, dollarisation may be a fast lane to import credibility, but long-term policy credibility cannot be imported, it has to be earned. As the domestic reforms that earn credibility abroad are often unpopular, the exchange-rate regime is but one of the difficult choices to be made by emerging markets and developing countries.

If one thinks that the critical driving force behind such risk is the lack of fiscal discipline, dollarisation can only be an answer if one believes that governments' debt will be held in check, once it is denominated in dollars. The massive defaults on international bonds in the past show that this is not a generalised outcome.

One can argue that — at the least — the rest of the economy would be better insulated from government default. But this is not obvious either: regional banks and the private sectors are likely to hold government bonds, and it can actually become harder to differentiate default to foreigners and nationals, raising systemic risk rather than lowering it. One cannot avoid thinking that dollarisation can only go well if some fiscal straitjacket is also provided. Taking for granted that semi-constitutional commitments to low deficit are feasible, the question then becomes whether it remains optimal to go all the way towards dollarisation.

A second important policy lesson that we derive from both the CFA and the Argentine experience is the choice of a *numeraire*. Whenever the anchor currency reflects a shock, the endogeneity of structural variables is not high enough to prevent peggers becoming victims of asymmetric shocks. This suggestion of the optimal currency area literature carries the proviso, attributed to Frankel and Rose (1996), that the criteria for the choice between floating and pegging the currency are in fact endogenous (we return to this later). The criteria suggest that countries which are seen to be small (with the non-tradable sector negligible) and open (in terms of trade shares

in GDP) would be advised to peg. Such countries will exhibit a high degree of regional concentration of trade towards the country that could provide a potential monetary anchor and they would also face shocks similar to the country with the *numeraire* currency. Varieties of the Barro–Gordon model in open economies would suggest a peg for countries with a bad record of abusing monetary discretion. These countries can reach a lower inflation equilibrium if they can credibly commit to sustaining the peg with the anchor currency that enjoys a better reputation than the local currency. A peg becomes hard to the extent it makes exit hard.

The foregoing discussion of the CFA and Argentine experiences showed that a hard peg, or dollarisation, does not automatically bring about long–term policy credibility. The importance of the choice of the *numeraire* was also noted, and indeed reference was made to euroisation and to basket pegs. This might suggest that the creation of a European single currency was equivalent to a hard peg. While the euro certainly reflects the “don’t fix, don’t float” conundrum, we believe it must be interpreted as the outcome of a process of convergence among EU members sharing a common MSF. In this regard, the euro is rather a case of “float in order to fix” and more portable outside the euro zone than generally thought. This is what we shall proceed to show later. First we describe the experience of the EMS, then we embed it in a view of European integration based on “peer pressure” and suggest that this is a way to earn credibility that is accessible to emerging markets worldwide, interested in acquiring financial reputation.