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Crying for Argentina

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The collapse of Argentina's currency is a terrible tragedy, and not just for the big international investors who stand to lose a bundle. The Argentine people have paid dearly. Their economy has been in severe recession for four years, with unemployment approaching 20 percent. And because of their government's mishandling of the crisis, the economic situation will almost certainly worsen before it gets better.

The occasional currency bubble may or may not be an inherent downside to market capitalism: distinguished economists have argued both sides of this issue. What is clear, however, is that much can be done to make such crises less frequent and less costly. Hence it is important to take the measure of the recent rash of international financial crises, of which Argentina is the latest.

Many on the political left needed little time to distill the complex factors that led to Argentina's recent financial mess to a simple lesson. To them devaluation and default were just further proof of the bankruptcy of the neoliberal economic ideology at the heart of the so-called Washington consensus – the principles that guide the U.S. Treasury and the Washington-based international organizations such as the International Monetary Fund and the World Bank. The severe financial contagion that many policymakers feared would follow an Argentinean default has failed to materialize. But there is still a danger of an even more damaging type of contagion, which has been variously labeled intellectual or political contagion. From the perspective of the left, Argentina's trauma

demonstrates the need for national governments to turn their backs on the market and return to statist strategies.

So far, enthusiasm for the old ways has remained more the mantra of leftist intellectuals than an influence on people who make policy. True, the efforts of the International Monetary Fund to raise the principle of free international capital flows to the same exalted level as free trade has suffered a severe setback in the wake of Argentina. However, with the notable exception of Malaysia, the crisis countries of the late 1990s have resisted the impulse to regulate capital and to protect domestic industry. This has even been true of Russia, despite frightening early signs of a sharp reversal in policy.

Political analysts suggest, however, that the Argentine crisis presents a much more serious threat of policy reversals across Latin America. By this argument, Latin America is especially subject to policy fads. Liberal economic policies spread with little resistance throughout much of Latin America during the 1990's, but few of the political leaders and parties who initiated this change in direction are still in power. Thus, the thinking goes, a reversion to statism could occur just as rapidly.

Argentina's quick successions of governments since the crisis began illustrate the tension. The voices of populists, who blame the crisis on foreign corporations and banks, have been heard along with those of soberer analysts calling for the government to bring its fiscal house into order. Protectionist rhetoric and dark mutterings about the virtues of confiscating the equity of the banking system compete for attention with the hard reality of currency depreciation. The government's initial plan to jerry-rig a dual exchange rate,

with one rate for trade and one for capital flows, has given way to a unified exchange rate.

The IMF and U.S. Treasury have wisely been biding their time, refusing to support new financial assistance for Argentina until a credible and consistent economic policy strategy is put in place. In the meantime, the Argentine economy has virtually ground to a halt. The banks, whose debts far exceed their assets, are not lending; rather than force them to close their doors, the government has sharply limited withdrawals. Many corporations are slowing or halting production because they cannot obtain critical materials: you just can't sell good wine if you don't have corks to seal the bottles.

How did Argentina's seeming economic miracle of the early 1990's end in such a catastrophe? Argentina is experiencing two distinct, but reinforcing, crises. One was triggered by the insolvency of the government, which led it to default on loans. The other was overvaluation of the currency, which finally forced devaluation.

Argentina's fiscal distress was due in large part to the government's failure to collect taxes. Cheating has cost the government on the order of 40 percent of it expected revenues. That, however, never stopped Argentina's political leaders from buying power with a combination of populist spending programs and slush fund outlays to political allies. Profligacy at the top was mirrored by excessive spending in the provinces, where politicians refused to accept orders from Buenos Aires to put on the fiscal brakes. The free spending policies of the administration of Fernando de la Rúa elected in the late 1990s were the final straw.

The long recession, which was made worse by the overvaluation of the Argentine peso (and the resulting inability of domestic producers to compete successfully at home

or abroad), made the budget situation even worse. The downturn in the economy reduced tax revenues, while the poor prospects for recovery raised worries about how the government debt would be repaid. These concerns reduced capital inflows and forced greater monetary contraction, worsening the recession.

The deepening recession, in turn, began to raise doubts about the willingness or ability of the government to stick by its decade-old commitment to lock the value of the peso to the U.S. dollar. Fear of devaluation raised interest rates in pesos, while fear of default also raised interest rates on the government's considerable dollar-denominated debt. Higher interest rates increased the budget deficit and further worsened the outlook for avoiding default. Thus a vicious circle of worsening conditions and expectations spun out of control.

Two major planks of the Washington consensus preached by the IMF and the U.S Treasury are fiscal responsibility and the avoidance of over-valued exchange rates. It was not the failure of these doctrines, but the failure to follow them that led to Argentina's crisis. Not surprisingly, the Argentine government tried to shift the blame by charging that the crisis was all the fault of speculators and assorted foreigners. As the crisis mounted the government's official line was that the only real problem was excessive pessimism on the part of investors and depositors. If confidence could just be restored, went the party line, the hemorrhage of funds from the banks would stop and a virtuous circle could be initiated.

Market panics triggered by misinformation do occur on occasion. But this was not one of those occasions: the underlying problems scaring depositors and investors were all too real. And government policies did little to solve them. Under IMF pressure, the

government did make a stab at budget cutting, but the legislature and the provinces dug in their heels to such an extent that most of the psychological benefits of the government budget actions were nullified. Tactical mistakes further undermined confidence – among them, economic czar Domingo Cavallo's call for linking the exchange value of the peso to an average of the dollar and the euro. This was read by many as a crack in the government's commitment to avoid devaluation; yet floating the idea did nothing to remedy the immediate problem of overvaluation. Indeed, it was hard to avoid the impression that the government was just playing for time because it didn't know what to do. As might be expected, the government's impulse to put on a happy face fooled hardly anyone.

Argentina's problems may not be evidence that the free market model is bankrupt, as leftist intellectuals would have us believe, but there is a certain degree of truth to their condemnations. Argentina's tragedy does suggest the bankruptcy of a particular type of economic ideology that has been promulgated by a small group of economists -- and the editorial page of *The Wall Street Journal*.

Proponents of this view – what I call Fixed Rate Fundamentalism –argue that sound money is the key to economic success, and that a fixed exchange rate is the key to sound money. A few decades ago such arguments were promulgated primarily by those advocating a return to the gold standard. In recent years the mechanisms of choice have become the adoption of currency boards, or the replacement of the national currency with a strong foreign currency like the U.S. dollar.

A currency board is a kissing cousin to a precious metal standard. Under a currency board regime, a country fixes the value of its currency to another and allows its

own money supply to expand or contract only as its central bank's holdings of the foreign currency rise or fall. This is basically the same mechanism as the gold standard of the 19th century, with a foreign currency placing the role of the metal. For Estonia, the choice was the German mark (and now with the implementation of the European Monetary Union, the euro). For Argentina, the choice was the dollar.

The adoption of a currency board or dollarization, as the outright adoption of a foreign currency as your own is called, is sometimes a wise policy. But the operative word is "sometimes." A currency board has worked well in Estonia. But the fixed rate fundamentalists recommend currency boards as a solution for just about everyone and everything.

The Typical Cause of Currency Crises: Falsely Fixed Exchange Rates

Before turning to the case of Argentina, we should note that the proximate cause of the Argentine crises differed in one fundamental respect from that of most major currency crises of the 1990's – the European Monetary System in 1992 and 1993, Mexico in 1994, Asia in 1997, Russia in 1998 and Brazil in 1999. All these crises resulted from the failure of national governments to respect what has become widely known as the unholy trinity theorem of international monetary relations. The theorem says that the laws of nature and arithmetic won't allow countries simultaneously to pursue fixed exchange rates, independent national monetary policies, and free international capital flows.

The reason governments so often fail to heed this theorem is that it only applies to the medium- or long-term. In the short run, countries can use international currency reserves (from its own central bank, or borrowed from public and private sources) to

finance international payments imbalances. If these imbalances are temporary, stopgap finance gives countries the ability to avoid changes in either their exchange rates or their monetary policies. And since either is typically seen by government officials as being costly, they tend to adopt overly optimistic judgments of what is temporary -- especially if an election is on the horizon. As a result, governments tend to wait too long to acknowledge the seriousness of international payments problems.

Unencumbered by such political considerations, international market participants – everyone from hedge fund speculators to risk-averse corporations -- generally recognize that a currency is seriously out of line long before governments take action. Thus while the timing is uncertain, the direction of major changes in pegged exchange rates are usually clear. This paradise for speculators is known as the one-way gamble. It is what allowed George Soros to take home almost one billion dollars from the British Treasury in the early 1990's, which was vainly attempted to defend the value of the pound. And it is widely regarded as a major reason for the breakdown in the early 1970's of the system of pegged (but adjustable) exchange rates established at the end of World War II.

The designers of this Bretton Woods system (named after the town in New Hampshire where it was negotiated) didn't worry about currency speculation because they assumed controls on capital flows imposed during the war would be remain in place. As capital market liberalization proceeded, however, so did the frequency of currency crises. Thus in today's world of substantial capital mobility, most economists believe that what can be called falsely fixed exchange rate regimes virtually guarantee periodic currency crises.

The adoption of “crawling pegs” that allow small, frequent changes in exchange rates offers a way to diffuse pressures on currencies, especially when the rules call allow a substantial margin for fluctuation above and below parities (crawling bands). These aren’t always sufficient to avoid crisis, however. While Thailand had an old-fashioned narrow band fixed peg before the forced baht devaluation began the east Asian currency crisis, Brazil, Indonesia, Korea, Mexico and Russia all had versions of crawling bands or pegs. In principle, the members of the European Monetary System also had scope to use more flexible arrangements and had indeed done so in the early days of the EMS, but by the late 1980’s the system had ossified into the traditional narrow band adjustable peg variety.

This combination of theory and experience has led to the popularity among international monetary economists of what is called the “unstable middle” or the “two corners” hypothesis. In this view, bad exchange rate policy wasn’t always the only cause for the rash of international currency crisis during the 1990’s, but it was an important contributor in all of the major ones. Thus one need not invoke evil speculators or inherent market instability, just the simple failure of governments to remember the lessons from the breakdown of the Bretton Woods system two decades before.

The policy recommendation that follows is straightforward. Countries should avoid the unstable middle of falsely fixed exchange rates and move toward one of the two corner solutions: genuinely fixed or fully flexible exchange rates. Economists differ at present over whether it is necessary to move all the way to one extreme or the other, or only to move away from the dead center of the narrow band adjustable peg. But the

Argentine case certainly suggests that avoiding the unstable middle is not a sufficient condition for avoiding currency crises.

Some fixed-rate enthusiasts argue that Argentina just didn't go far enough: if the government had made the U.S. dollar the official currency, the crisis would have been avoided. We'll see, however, that while the relative merits of currency boards and dollarization are worth debating, the idea that dollarization would have saved Argentina is far-fetched.

The False Promise of Exchange Rate Based Stabilization

Why did so many governments fail to heed the lessons of the breakdown of the Breton Woods system? This is an under-explored question, but there's little doubt that economists are partly to blame. Several influential theoretical papers, along with the apparent success of some western European and several developing countries in using pegged exchange rates to control inflation during the 1980's, gave rise to a widespread view that pegging the exchange rate was the best option for stabilizing prices. The buzzwords were "exchange rate based stabilization" (ERBS) or the need to use the exchange rate as a "nominal anchor" for the domestic economy. These views not only had a major impact on the academy, but were actively promoted by governments of the European Monetary System and found favor with some top officials at the International Monetary Fund. In turn, many emerging market economies fell prey to its attraction.

ERBS is not an inherently dumb strategy. The initial effects tend to be an economic boom accompanied by a rapid deceleration of inflation. It doesn't take a rocket

scientist to favor good times and rapidly falling inflation over a recession and continuing inflation. No wonder ERBS strategies were so popular.

There was a dirty little secret, however, discovered by researchers but not emphasized in most policy advice. While inflation tended to fall rapidly after fixed rates were imposed, it rarely fell rapidly enough to prevent the currency from becoming overvalued. As exports lost competitiveness, the booms turned to busts and currency crises followed.

Crawling as opposed to fixed pegs literally offered a bit of wiggle room, but political considerations typically kept governments from allowing currencies to depreciate rapidly enough. This problem was reinforced by the behavior of international financial markets, because investors frequently failed to take a long view. Thus with the initial success of stabilization policies, capital tended to rush in. And these surges typically masked the deterioration in the country's competitive position.

Of course this usually wasn't the whole story behind the rise and eventual fall. Often there were other contributing factors beyond a country's control, such as the appreciation of the dollar (which overpriced dollar-linked currencies) and depreciation of competitors' currencies, which added to the problems facing Argentina and Thailand. In the case of Russia, the decline of oil prices hit hard. And in the case of Mexico, the tightening of U.S. monetary policy (which raised capital costs) and a political assassination in the run-up to elections made a difference. But the basic pattern of ERBS is too clear to miss: extraordinary success early, failure later.

Some countries have managed to beat the odds by adopting sufficient exchange rate flexibility (Poland) or by making a genuine fixed exchange rate work over the long

run (Estonia). But the examples of Mexico, Brazil, and Argentina are more representative. Argentina's commitment to a fixed exchange rate via its currency board delayed the currency crisis for much longer than is typical with ERBS. But this turned out to be more of a cost than a benefit. It would have been much better if the current crisis had come several years earlier, saving the Argentine people years of recession.

I have little doubt that top officials such as Domingo Cavallo, the original architect of the currency board who was brought back to try to save the system, genuinely believed that devaluation and default could be avoided. But few economists outside of the Argentine government, save a small band of fixed rate fundamentalists, shared this view.

Fixed Exchange Rates: Not for Everyone

To understand why most economists didn't share Cavallo's optimism, we need to look briefly at what economists call the theory of optimal currency areas. The central insight of OCA theory is that there is not one best exchange rate system for all countries. There are costs as well as benefits to all exchange regimes, and the ratio of these will vary systematically across countries according to factors identified by the theory. Fixed rate fundamentalists tend to focus only on the costs of flexible exchange rates and the benefits of fixed rates. (Of course some flexible rate enthusiasts do just the opposite).

The early contributions to OCA theory focused on two major considerations: the size and openness of the economy, and the flexibility of its internal adjustment mechanisms. Under fixed exchange rates, domestic production is forced to respond to signals from international markets, while under flexible rates the international sector does most of the adjustment. Which sector should adjust to the other?

Clearly this depends in part on their relative size. For a tiny economy like Estonia, where the international sector is large relative to purely domestic economic activity, a fixed exchange rate makes the most sense. But with a large economy like the United States, it's just the opposite. While our international trade and investment is large in absolute terms, it is small compared to the domestic economy. Thus fixing exchange rates in the United States would amount to letting the tail wag the dog.

Under fixed exchange rates, the international sector dominates the domestic sector through the effects of the balance of payments on the national money supply. Under any system of truly fixed exchange rates such as the gold standard or currency boards or dollarization, balance of payments surpluses directly lead to increases in the national money supply, while payments deficits cause decreases. With highly flexible wages and prices and high labor mobility, these changes in the money supply cause the price level to increase or decrease in tandem. That, in turn, corrects the payments imbalance.

This is an old tale told often, one that originates with the great philosopher David Hume in the 18th century. But the model breaks down when domestic labor markets are not highly flexible. Then the monetary contraction caused by a balance of payments deficit causes recession rather than falling wages. This is just what happened to Argentina.

Argentina's decision to adopt a currency board in the early 1990's was defensible. The economic situation was desperate: repeated efforts to bring hyperinflation under control had failed and the government had little credibility. Thus there was a strong case for taking the printing presses out of the hands of policymakers.

There are many ways to do this. But with some justification, it was felt that faith in government was so low that less decisive measures such as the creation of an independent central bank or the adoption of a firm set of marching orders for the central bank (à la Milton Friedman) would just not be taken seriously. Thus the adoption of the currency board seemed the only credible way to produce sound money. In any event, the rapid depreciation of the Argentine currency had led already to widespread use of the dollar by Argentines. Thus the creation of a dollar-based currency board seemed the obvious solution.

In its early years the experiment proved a wonderful success. Inflation was conquered and growth soared. Add a lot of talk and some action on privatizing industry and deregulating markets to the brew, and it is clear why Argentina became a darling of international investors. By the time worries about the soundness of their investments set in, the bonds of the national and provincial governments of Argentina accounted for almost one fourth of the international holdings of government debt from all emerging market countries.

As discussed above, initial success with exchange rate-based stabilization is not unusual. This success can easily generate a false sense of security, however. While Argentina did score well on the OCA criteria of large private holdings of foreign currency, other important OCA criteria suggested problems. Argentina was – and is -- one of the most closed economies for its size on the planet. Its exports still don't exceed ten percent of its GDP.

Some have argued that the market's concerns about excessive government debt were greatly exaggerated because the ratio of Argentina's total debt to GDP wasn't

particularly high. What this overlooks is that most of this debt is payable in US dollars, not Argentine pesos. And as a portion of Argentina's foreign exchange earnings, the debt had indeed become dangerously high even as the overvalued peso was making it more difficult to export and to increase foreign exchange earnings.

In the apologist's scenario the growing levels of debt were the fault of the Argentine government, but the overvaluation of the peso was not. The currency board had been quite successful in stopping inflation in its tracks and inflation rates in Argentina were frequently even lower than those in the United States. The problem was that the dollar had appreciated against most currencies and the peso was fixed to the dollar; thus the peso appreciated against the currencies of most of its trading partners.

Another optimal currency area criteria is that you trade a lot with the country whose currency you have, in effect, adopted. By this criterion (though) fixing to the dollar would make great sense for Canada and Mexico, but not for Argentina. Over 70 percent of both Canada and Mexico's trade is with the United States. For Argentina, not only is the overall level of international trade quite low, only 11 percent of its exports in 1999 found their way to the United States. Thus the peso's appreciation against most of its trading partners currencies in the late 1990's was initially driven by the rise of the dollar, even though Argentina's trade with the US amounted to less than one percent of its economy. Argentina's competitive position was further undermined by the large depreciation of the Brazilian real following its crisis in 1999. And Brazil is one of Argentina's major trading partners.

With a currency board or any other form of fixed exchange rate, if your currency becomes overvalued adjustment must come through changes in wages and domestic

prices. In Argentina, these adjustments did not go smoothly. The Argentines, with their history of strong, highly political unions, have never been known for flexible labor markets. Thus they scored low on another important OCA criterion.

"Don't worry," argued the first fixed rate fundamentalists. What is important is not meeting the criteria before the fact but meeting them after. No matter that labor markets are chock full of rigidities now. Adopting a fixed rate will make the maintenance of such rigidities much more costly and will thus propel reform. One hears the same optimistic scenarios posited for the European Monetary Union.

While there is some truth to the argument, it misses a crucial point. The pursuit of economic efficiency is rarely a government's highest priority. Indeed, if efficiency were really were at the top of the list, the economic rigidities would have been dealt with long before currency rates made reform so critical.

Any reform of markets inevitably generates losers as well as winners, and often as not, the potential losers have a lot of political influence. Thus while the adoption of fixed exchange rates does tilt the balance of forces in the direction of reformers by removing an alternative means of adjustment, the magnitude of the shift may be slight. This is what happened in Argentina. Wages and prices did become more flexible and both have been falling in recent years -- but not by nearly enough to avoid a serious recession.

This problem is even more serious with respect to fiscal policy. With wage discipline, fixed rates at least shift the dynamic in the right direction. With fiscal discipline, the effects are often quite perverse. The combination of fixed exchange rates and high capital mobility make fiscal deficits easier to finance during their early stages. Thus they tend to retard rather than to increase pressures for fiscal reform. That explains

why fiscal reform lagged during Italy's early days as a member of the European Monetary System, and it explains why fiscal reform lagged in Argentina. Even during its years of wine and roses in the early-1990s, Argentina continued to run budget deficits.

These deficits began to grow rapidly as the economy slowed, of course. Provincial government spending faced little pressure for restraint, and the tax collection system remained one of the most inefficient in Latin America. Thus the primary reason for default was the issuance of excess debt relative to the country's ability to pay. In the fall of 2000 the financial markets began to give strong warnings of impending problems, and the risk premium on Argentina's debt began to soar. But the signals came too late to avert a hard landing.

Hindsight

The most important lesson of the Argentine crisis is that fixed rate fundamentalism, not open markets or the Washington consensus, failed Argentina. Sound money is valuable and fixed exchange rate regimes such as Argentina's currency board can provide it. Sound money, however, can neither assure the adoption of, nor substitute for, responsible fiscal policy. Nor can it guarantee sufficient wage and price flexibility to make it possible to adjust to an overvalued currency without beggaring the working classes.

Many fixed rate fundamentalists suggested late in the game that there still was a way out for Argentina: scrap the national currency and adopt the dollar. Dollarization might have worked better than the currency board. (The central consideration here is whether the gains from lower interest rates due to reduced currency risk would more than offset the loss in the government's profit from issuing its own currency). But

dollarization could do little to solve the two major problems facing Argentina – namely its unsustainable fiscal situation and the overvaluation of the currency. Thus the debate over dollarization was like a discussion about alternative types of cosmetic surgery while the badly disfigured accident victim was bleeding to death. The only alternative to devaluation was continued recession – and this would have done nothing to stave off default.

The Argentine crisis also suggests lessons concerning international financial contagion and the policies of the International Monetary Fund. These subjects can't to be explored here in the detail here, but a few comments seem in order.

First, the policy community has exaggerated the dangers of currency crisis contagion. The Asian and Russian crises were special cases that are not typical of the workings of the international financial markets. Serious contagion can occur, but the norm is milder spillovers that cause ripples in currency and financial markets, not crises. The lack of serious contagion following both the recent Turkish and Argentine crises illustrate this point.

A second lesson from these recent crises is that IMF cash can't save countries with fixed exchange rates that have become overvalued. The IMF should not have agreed to Argentina's request for a major loan in the summer of 2001. But exaggerated fears on the part of many political leaders as well as some IMF officials combined with strong pressures from the United States led the IMF to go against the recommendations of many of its top economists.

The cost of such mistaken lending is far more than the wasted money. It damages the credibility of the IMF. Indeed, with its reputation already tainted by ill-fated loans to Russia, Brazil and Turkey, it is clear the IMF must learn to say no.

Ironically, the case for an IMF loan to Argentina may be much better now than before the crisis. The Argentine people, if not their leaders, deserve help in cushioning the blow of the crisis, and the prospect of IMF lending could tip the scales in favor of sensible policies over the statist populism that has for so long been the Argentine way.

But IMF money will help only if the new government is serious about reforms. The IMF must remember that actions speak louder than words, and be willing to practice tough love. Argentines will have to decide to make the sacrifices to break away from their statist past. But it is in the interests of the international community to use carrots to nudge them in the right direction.