Crying *for* Argentina

by Thomas D. Willett

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

The occasional currency bubble may or may not be an inherent downside to market capitalism. What is clear, however, is that much can be done to make such crises less frequent and less costly. Hence, the need to take measure of the recent rash of international financial crises, of which Argentina's is the latest.

To many on the political left, Argentina's devaluation and default were just further proof of the bankruptcy of the neo-liberal economic ideology at the heart of the "Washington consensus" – the principles that guide the U.S. Treasury, the International Monetary Fund and the World Bank. The financial contagion many policymakers feared would follow an Argentinean default has failed to materialize. But there is still a danger of political contagion: From the perspective of the left, Argentina's trauma demonstrates the need for 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 policy. True, the efforts of the IMF to raise the principle of free international capital flows to the same exalted level as free trade has suffered a severe setback. However, with the notable exception of Malaysia, the crisis countries of the late 1990s have resisted the impulse to regulate capital or protect domestic industry.

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

Argentina's quick succession of governments since the crisis began illustrates the tension. The voices of populists, who blame the crisis on foreign corporations and banks, have been heard along with those of more sober 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 IMF and the U.S. Treasury have wisely been biding their time, refusing to support new financial assistance for Argentina until a credible 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 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 1990s end in 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 currency overvaluation, which forced devaluation.

Argentina's fiscal distress was due in large part to the government's failure to collect taxes. Cheating has cost the government roughly 40 percent of its expected revenues. That, however, never stopped politicians from buying power with populist spending programs and slush fund outlays to political allies. Excessive spending in the provinces, where politicians refused to accept orders from Buenos Aires, mirrored profligacy at the top. The free-spending ways of the Fernando de la Rua administration in the late 1990s

AP/WIDE WORLD PHOTOS (ALL)

proved the last straw.

The long recession which was made worse by the overvaluation of the Argentine peso (and the resulting inability of producers to compete at home or abroad), made the budget situation even worse. The economic downturn 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, raised doubts about the 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 on loans denominated 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 expectations spun out of control.

Two major planks of the Washington consensus preached by the IMF are fiscal responsibility and the avoidance of overvalued 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 the fault of assorted foreigners. As the crisis mounted, the government's line was that the only real problem was 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 problems scaring depositors and investors were all too real. 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 – among them, the call by Domingo Cavallo, Argentina's economics minister, for linking the exchange value of the peso to an average of the dollar and the euro – further undermined confidence. This was read by many as a crack in the government's commitment to avoid devaluation. Indeed, it was hard to avoid the impression that the government was just playing for time because it did not know what to do.

Argentina's problems may not be evidence that the free-market model is bankrupt. But 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 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 advanced primarily by those advocating a return to the gold standard. In recent years, the mechanisms of choice have become "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

THOMAS WILLETT is director of the Claremont Institute of Economic Policy Studies and Horton Professor of Economics, Claremont Graduate University and Claremont McKenna College.

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 replacing the role of the metal. For Estonia, the choice was the German mark (and now the euro). For Argentina, the choice was the dollar.

The adoption of a currency board, or dollarization, as the outright adoption of the U.S. dollar as one's 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 to just about everything.

THE TYPICAL CAUSE OF CURRENCY CRISES: FALSELY FIXED EXCHANGE RATES

Before turning to 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 1990s – those of the European Monetary System in 1992 and 1993, Mexico in 1994, Asia in 1997, Russia in 1998 and Brazil in 1999. The latter resulted from the failure of 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 will not allow countries simultaneously to pursue fixed exchange rates, independent monetary policies, and free international capital flows.

The reason governments so often ignore this theorem is that it only applies to the medium- or long-term. In the short run, countries can use foreign currency reserves to finance international payments imbalances. If these imbalances are temporary, countries can thereby avoid changes in either their exchange rates or their monetary policies. And since governments typically see either as being costly, they tend to adopt overly optimistic judgments of what is temporary. As a result, they tend to wait too long to acknowledge the seriousness of international payments problems.

Unencumbered by such political considerations, international-market participants – everyone from 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 is usually clear. This paradise for speculators is known as the one-way gamble. It is what allowed George Soros to take home almost a billion dollars in the early 1990s from the British Treasury. And it is widely regarded as a major reason for the breakdown in the early 1970s of the system of pegged (but adjustable) exchange rates established after World War II.

The designers of this Bretton Woods system did not worry about speculation because they assumed controls on capital flows imposed during the war would remain in place. As capital market liberalization proceeded, however, currency crises became frequent. 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.

"Crawling pegs," which allow small, frequent changes in exchange rates, offer a way to diffuse pressures on currencies – especially when the rules allow a substantial margin for fluctuation above and below parities known as "crawling bands." These are not always sufficient to avoid crisis, however. Brazil, Indonesia, Korea, Mexico and Russia all had versions of crawling bands or pegs before the East Asian currency crisis.

This combination of theory and experience has led to what is called the unstable-middle, or two-corners, hypothesis. In this view, bad exchange-rate policy was not always the only cause for the rash of international currency crises during the 1990s, but was an important contributor in all of them. Thus, one need not invoke speculators or inherent market instability, just the simple failure of governments to remember the lessons from the breakdown of the Bretton Woods system.

This paradise for speculators is known as the one-way gamble. It allowed George Soros to take home almost a billion dollars from the British Treasury.

The policy recommendation that follows is straightforward. Countries should avoid the unstable middle of falsely fixed exchange rates and move toward 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. 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 did not go far enough; if the government had made the dollar the official currency, they say, the crisis would have been avoided. Yet 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 Bretton Woods system? Economists are partly to blame. Several influential theoretical papers,

along with the apparent success of some Western European nations and several developing countries in using pegged exchange rates to control inflation during the 1980s, gave rise to the view that pegging the exchange rate was the best option for stabilizing prices. The buzzwords were exchange-rate-based stabilization (ERBS) – the need to use the exchange rate as an anchor for the domestic economy. These views not only had a major impact on academics, but were also actively promoted by governments of the European Monetary System and found favor with some top officials at the IMF. 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 does not 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 their 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 pegs, as opposed to fixed ones, offered a bit of wiggle room, but politics typically kept governments from allowing currencies to depreciate rapidly enough. This problem was reinforced by international investors, who 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 was not the whole story. 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 Russia, the decline of oil prices hit hard. And in Mexico, the tightening of U.S. monetary policy, which raised capital costs, and a political assassination in the runup 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 crisis had come years earlier, saving Argentina years of recession.

I have little doubt that top officials, like Domingo Cavallo, the original architect of the currency board, genuinely believed that devaluation and default could be avoided. But few economists outside of the Argentine government shared this view.

FIXED EXCHANGE RATES: NOT FOR EVERYONE

To understand why most economists did not share Cavallo's optimism, look briefly at what is called the theory of optimal currency areas. The central insight 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 across countries according to a variety of factors. 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 that 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 nternational 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 domestic economic activity, a fixed rate makes the most sense. But with a large economy like the United States, it is 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, like 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 David Hume in the 18th century. But the model breaks down when domestic labor markets are not flexible. Then the monetary contraction caused by a balance-of-payments deficit causes recession rather than falling wages. That is what happened to Argentina.

Argentina's decision to adopt a currency board in the early 1990s 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 faith in government was so low that less decisive measures, like 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 currency board seemed the only credible way to produce sound money. In any event, the rapid depreciation of the Argentine currency had already led to widespread use of the dollar by Argentines. Thus, the creation of a dollar-based currency board seemed the obvious fix.

In its early years, the experiment proved a great 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 optimal-currency-areas theorem's criteria of large private holdings of foreign currency, other important criteria suggested problems. Argentina was – and is – one of the most closed economies for its size on the planet. Its exports still do not exceed 10 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 was not particularly high compared to GDP. But most of this debt is payable in U. S. 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 thereby to earn foreign-exchange.

In the apologists' 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.

As exports lost competitiveness, the booms turned to busts and currency crises followed.

Another optimal-currency-area criteria is that you trade a lot with the country whose currency you have, in effect, adopted. By this criterion, fixing to the dollar would make great sense for Canada and Mexico, since more than 70 percent of both Canada and Mexico's trade is with the United States. But not only is Argentina's 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 1990s was initially driven by the rise of the dollar, even though Argentina's trade with the United States amounted to less than 1 percent of its economy. Argentina's competitive position was further undermined by the large depreciation of the Brazilian real after

its crisis in 1999. And Brazil is one of Argentina's major trading partners.

With any 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 optimal-currency-area theorem criterion.

Don't worry, argued the 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 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 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 Argentina's ability to pay. In late 2000 the financial markets began to give strong warnings of impending problems, and the interest-rate 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 like Argentina's currency board can provide it. Sound money, however, can neither ensure 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 did. (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 – 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 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 IMF. 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 international financial markets. Serious contagion can occur, but the norm is milder spillovers that cause ripples, not crises. The lack of serious contagion following both the recent Turkish and Argentine crises illustrates this point.

A second lesson is that IMF cash cannot save countries with overvalued fixed exchange rates. 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, 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 reform. 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.