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Research Focus

Argentina and East Asia: To Peg or not to Peg?

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The recent economic turmoil in Argentina provided a stark reminder, if reminders were necessary, of the acute financial, economic and socio-political problems that plagued Southeast Asia in 1997–98, particularly the region's largest country, Indonesia.

The Argentine crisis, having been well anticipated, did not lead to contagious fallout to other economies in the region, let alone around the globe. The East Asian crisis, in contrast, while beginning in Thailand, rapidly spread to Indonesia, to other regional economies, and to economies outside the region. There are three obvious reasons for this difference in crisis dynamics.

First, Argentina's was a slow-burning crisis unlike that in East Asia which caught most observers and financial markets by surprise. Admittedly, the potential for a crisis in Thailand was foreseen by some but largely ignored.

Second, Argentina's primary source of external finance involved the bond markets rather than banks, as had been the case in East Asia. Bondholders appear to have been more discerning than banks in differentiating between indebted countries.

Finally, emerging markets never really regained their lustre following the East Asian crisis, with the result that capital inflows to emerging economies in general were fairly subdued post 1998. Consequently there was little scope for a generalised, large-scale flight of capital following the Argentine debacle.

This notwithstanding, an important parallel between the two incidents was that both Argentina and East Asia had pegged their currencies to the US dollar. Before 1997 the East Asian economies maintained managed floats, which in reality were 'soft' or de facto US dollar pegs, while Argentina maintained a 'hard peg' to the US dollar via a currency board arrangement (CBA), until this was revoked in January 2002. The US dollar pegs played a pivotal role in the vulnerabilities that eventually led to the countries succumbing to crisis.

Following the East Asian crisis, a number of observers argued that the problem in the region was not that the countries operated a US dollar peg per se, but that the pegs lacked credibility. A credible exchange rate peg is almost unshiftable; that is, a 'hard peg' or 'firm fix'. This can be achieved by effectively abandoning the domestic currency for the currency of another country (dollarisation, yenisation or euroisation), or by maintaining the domestic currency but committing to permanently fixed or hard rates through institutional arrangements such as a CBA.

A CBA was at one time promoted as the cure for Indonesia's ills. Such a regime involves fixing the value of the domestic currency in terms of another currency (the 'reserve'), fully backing it up with foreign currency assets. CBAs are often compared to a vending machine that automatically exchanges the reserve currency for the local currency on demand.

The Argentine case has made clear that the issue is not solely one of credibility. Small and open economies are far more susceptible to large external shocks, such as regional contagion effects and changes in foreign interest rates and terms of trade. Economic theory tells us that a greater degree of exchange rate flexibility is needed in the presence of external or domestic real shocks.

Flexible exchange rates act as a safety valve by providing a less costly mechanism for relative prices to adjust in response to shocks, as opposed to the slow and often costly reductions that occur under fixed rates through deflation and productivity increases vis-à-vis trade partners.

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Research

Christopher Findlay will attend meetings of PECC's Standing Committee and Coordinating Group on 4–6 April in Kuala Lumpur. On 15 April he will participate in a seminar in Tokyo on a new research project on Australia's wool trade with Japan. On 17–18 April he will present a PECC report on recent developments in regional automobile markets at the APEC Auto Dialogue in Kuala Lumpur.

Peter Drysdale will speak on free trade areas at the Boao Forum for Asia on 12–13 April. The forum, which is being held in Hainan province in China, will discuss pressing issues confronting economic development and cooperation in Asia. Over 1,000 distinguished participants are expected to join the forum. On 22–23 April he will take part in a Conference at the Research Institute for Economy, Trade and Industry in Tokyo on 'East Asian Economic Integration'.

Mardi Dungey (Economics Division, RSPAS) will present a paper on 'International Contagion Effects from the Russian Crisis and LTCM Near Collapse' to the Reserve Bank of New Zealand's Macroeconomic Workshop on 4–5 April. The paper was written with Renee Fry, Brenda Gonzalez-Hermosillo and Vance Martin.

Raghbendra Jha (Executive Director, Australia South Asia Research Centre, RSPAS) has been elected a Fellow of the World Innovation Foundation.

On-line seminar series

In 2002 the National Centre for Development Studies will draw on its internationally recognised expertise for professional training, policy development and outreach related to international economic relations, management and governance in the Asia Pacific region to offer a range of seminars on-line through the ANU's Video Conference facilities. These programs are a new initiative in

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Argentina's hard US dollar peg, which was the linchpin of Domingo Cavallo's famous 'Convertibility Plan' in 1991, was important in helping the country realise financial and monetary stability. Nonetheless, several large devaluations in emerging market economies (Mexico in 1994–95, East Asia in 1997–98 and especially Brazil in January 1999, a principal trading partner) required exchange rate adjustments that were not forthcoming. According to some estimates, the peso was overvalued by some 25 per cent to 40 per cent. This loss of price competitiveness in international markets meant that the CBA had become a severe liability to the Argentine economy. Argentina was mired in recession for four consecutive years and unemployment had been high and rising.

In East Asia's case, the nearly 50 per cent nominal appreciation of the US dollar relative to the yen between June 1995 and April 1997 led to an appreciation of the region's currencies against the yen. This 'third currency phenomenon' contributed in part to the slump in exports that set the stage for the crisis that ensued.

There is a widespread belief that a pegged regime induces greater policy discipline, as fiscal profligacy will deplete reserves or build up debt, leading to an eventual currency collapse. However, the effects of unsound macroeconomic policies become evident immediately under flexible rates through exchange rate and price adjustments, in a depreciation-inflation spiral. Flexible rates ought, therefore, to instill greater fiscal restraint, as the costs of policy transgressions have to be paid upfront.

Does this make a market-determined floating regime the wisest choice?

Despite the recent weakness of the Australian dollar, its successful experience with floating, particularly in terms of withstanding the East Asian crisis, has often been cited as evidence of the 'superiority' of such a regime, and has sometimes been held up as a model for Asian countries. But there are important structural differences between industrialised countries, such as Australia and the United States, and developing countries.

Industrialised countries have fairly well-developed and diversified financial systems that are able to minimise the impact of transitory exchange rate variations on the economy. Most notably, they are able to borrow overseas in their domestic currencies. Many developing countries are unable to do this, leading to the accumulation of foreign currency debt that is primarily in US dollars and unhedged.

In such countries, sharp depreciations in the currency magnify the domestic currency value of external debt and hence slash the net worth of individuals, corporations and the domestic financial system. This 'balance sheet' effect could potentially lead to massive bankruptcies. It is no surprise that devaluations in Mexico in 1994–95 and East Asia in 1997–98 led to plummeting exchange rates and huge capital outflows, and left the economies in a tailspin.

The inflationary impact of devaluation is also of concern to countries such as Argentina that have a history of hyperinflation. Such experiences are not easily forgotten. All of this helps explain the widespread 'fear of floating' exhibited by many developing countries, including those in East Asia. It is also why Argentina stoically adhered to inflexible exchange rates for so long despite the hardships it brought about.

What does this imply for the choice of exchange rate regime for small and open emerging economies in general?

The choice of an exchange rate regime must be consistent with a coherent macroeconomic strategy – no regime will deliver stability if domestic policy is unsound, with large fiscal deficits, rapid monetary growth and inflation. In the absence of strong capital controls, currency intervention ought *not* be framed as a specific target for the exchange rate. Such targets inevitably tempt speculators by offering them the infamous one-way option. Exchange rate and monetary policy strategies must therefore involve a 'fairly high' element of flexibility rather than a single-minded defence of a particular rate. This appears to be the policy now favoured by Argentina and a number of East Asian economies.

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On-line seminar series (cont.)

conjunction with the World Bank's Global Development Learning Network (GDLN) and will be sponsored by the Australian Agency for International Development (AusAID). The seminars will cover such topics as human resource management, the prospects for East Asia, corporate governance principles and codes, and governance in the financial sector.

For further information contact Liz Ingram, Project Officer, GDLN:
telephone 612 6125 5559;
e-mail Liz.Ingram@anu.edu.au.

Events

4 April, *Australia–Japan Education Linkages*, Roundtable, ANU.

10 April, *Australian Air Transport – New Directions in 2002*, Christopher Findlay (ANU) and Henry Ergas (Network Economics Consulting Group), public seminar, 12.30 pm, Lecture Theatre, Innovations Building, ANU.

3 May, *WTO Accession of Asia Pacific Countries*, Ron Duncan and Malcolm Bosworth (ANU), 12.30 pm, Law Lecture Theatre, ANU.

6 May, *East Asian Trade Strategies*, Joint Workshop with KIEP, Canberra.

12–15 May, Second ABAC Meeting for 2002, Sydney.

16–17 May, ABAC/PECC Symposium on Risk Management, Pricing and Capital Provisioning, Sydney

Publications

Books

New from Asia Pacific Press:

China 2002: WTO Entry and World Recession, Ross Garnaut and Ligang Song (eds), 200 pp., A$35.00.

East Asian Trade and Financial Integration: New Issues, Peter Drysdale and Kenichi Ishigaki (eds), 246 pp., A$35.00.

A Zone of Asian Monetary Stability, Tetsuji Murase, 320 pp., A$40.00.

Resource Management in Asia Pacific Developing Countries, Ross Garnaut (ed.), 259 pp., A$32.00.

Asian-Pacific Economic Literature, Volume 16, Number 1, May 2002.

Asia Pacific Press books can be bought on-line at <http://www.asiapacificpress com>.

Pacific Economic Paper

326 Regulatory Regimes *Shinichi Yoshikuni.*

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