ARGENTINA AND EAST ASIA: THE PEG DOES IT YET AGAIN

by

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Viewed from Southeast Asia, the recent turmoil in Argentina provides 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.

There are at least two key differences between the two crisis episodes.

Argentina's external borrowings were accumulated to finance profligate government spending. The country managed to amass US$155bn in central government and provincial debt. This distinguishes it from East Asia where the external imbalances were largely private sector driven.

In addition, the Argentine crisis, having been well anticipated, did not lead to contagious fallout to other emerging economies in the region, let along the globe.

This, of course, is in sharp contrast to the East Asian crisis which began in Thailand and rapidly spread to Indonesia and other regional economies and some extra-regional ones too.

There are three obvious reasons for this difference in crisis dynamics.

One, Argentina's problems were long foreseen; it was a slow-burning crisis unlike that in East Asia which caught most observers and financial market participants by surprise. (Admittedly, the potential for a crisis in Thailand was foreseen by many but largely ignored).

Two, external financing by Argentina was primarily from bond markets rather than banks, as had been the case in Asia. Bondholders might well have been more discerning than banks in differentiating between indebted countries.

Three, emerging markets never really regained their lustre following the Asian crisis, with the result that the extent of capital inflows remained highly moderate.

Notwithstanding these differences, an important parallel between the two incidents was the pivotal role played by the US dollar pegs in instigating the vulnerabilities which eventually led to the countries succumbing to crisis.

In particular, like the East Asian economies pre-1997, the Argentine peso was linked to the US dollar. Unlike the East Asian economies which maintained "soft", unofficial

or *de facto* dollar pegs but were officially stated as being “managed floats”, Argentina maintained a hard peg via a currency board arrangement.

In fact, following the East Asian crisis, a number of observers argued that the problem in East Asia was not that the countries operated a US dollar peg per se, but rather, that the pegs lacked credibility.

But how can an exchange rate peg be made credible? Only by making it almost unshiftable, i.e. a “hard peg” or “firm fix”.

This might be done by effectively abandoning the domestic currency altogether by using domestically the currency of another country (dollarisation, yenisation or eurorisation), or by maintaining one’s national currency but creating a rigid commitment to permanently fixed or hard rates, through institutional arrangements such as a currency board arrangement.

Thus, a currency board regime was at one time promoted as the cure for Indonesia’s ills. Such a regime involves issuing a domestic currency whose value is fixed in terms of a currency issued by another country (“reserve currency”) and is fully backed by foreign currency assets. Currency boards are often compared to a vending machine that automatically exchanges reserve currency for local currency upon demand.

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

By acting as a safety valve, flexible exchange rates provide a less costly adjustment mechanism by which relative prices can be altered in response to such shocks as opposed to fixed rates which rely on gradual reductions in relative costs via deflation and productivity increases vis-à-vis trade partners to restore internal balance. This manner of adjustment to shocks can be prolonged and extremely costly. Altering the exchange rate is one means of attempting to bring about the necessary economic adjustments.

Argentina’s hard US dollar peg Argentina, which was the linchpin of Domingo Cavallo’s “Convertibility Plan” in 1991, was important in helping the country realise financial and monetary stability. Nonetheless, the recent large devaluations in emerging market economies (Mexico in 1994-95, East Asia 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 30 to 40 percent.

This, along with the failure to adjust internally to the loss of price competitiveness in international markets, meant that that the currency board arrangement had become a severe liability to the Argentine economy. Indeed, Argentina has been deeply mired in recession which has persisted for four consecutive years, along with high and rising unemployment (18 percent).

One recalls the experience of East Asia where the nearly fifty per cent nominal appreciation of the US dollar relative to the yen between June 1995 to April 1997 led to an appreciation of the regional currencies vis-à-vis the yen. This so-called "third currency phenomenon" contributed in part to the regional export slump which in turn set the stage for the crisis that ensued.

Interestingly, a great deal has been made of Hong Kong's ability to maintain its US dollar-based currency board arrangement in the midst of acute bearish pressures in 1997-98. Much less recognised is the fact that Singapore, which pursues a more flexible basket regime (referred to sometimes as a monitoring band arrangement), weathered the East Asian crisis comparatively well despite having much stronger direct trade and financial linkages with most of the crisis-hit regional economies.

While Hong Kong's overall GDP declined by 5 percent in 1998, Singapore's growth stagnated in 1998 (0.4 percent), a sharp contrast to the annual average growth of 9 percent in the first half of the 1990s. The primary reason for this difference in growth was that the nominal exchange rate flexibility in Singapore was able to cushion some of the negative shock, unlike Hong Kong where adjustments in the real exchange rate had to be fully realised via domestic deflation.

The recent decline in the value of the yen relative to the US dollar has seen many Asian currencies, including the Singapore dollar, trending down. This has inevitably fuelled further concerns about Hong Kong's external competitiveness (the Hong Kong dollar remaining pegged at 7.78 per US dollar).

There is a widespread belief that a pegged regime induces increased policy discipline, as fiscal profligacy will lead to reserve depletion or burgeoning debt and an eventual currency collapse. However, the effects of unsound macro policies become evident immediately under flexible rates through exchange rate and price level movements (i.e. depreciation-inflation spiral).

Flexible rates ought therefore to instill greater fiscal restraint/discipline, as the costs of macroeconomic policy transgressions have to be paid upfront. In other words, the key distinction between fixed and floating rates is in the intertemporal distribution of costs and benefits.

In addition, the greater the degree of flexibility of the exchange rate regime, the keener the incentives for agents to undertake appropriate foreign currency risk management techniques in response to the higher element of exchange rate risk, while simultaneously reducing the extent of moral hazard which could lead to "excessive" unhedged external borrowing (so-called "fixed exchange rate bubble").

The introduction of these transactions costs and exchange rate risks may also help moderate the extent of capital inflows, consequently dampening the intensity of boom and bust cycles.

What is the appropriate lesson to draw from these experiences? Is a floating regime, where the exchange rate's value is completely market-determined, an appropriate one?

Notwithstanding the recent weakness of the Australian dollar, its successful experience with a floating arrangement, 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.

However, such advocacy does not pay due consideration to the fact that there are important structural differences between industrial countries such as Australia, on the one hand, and developing countries, on the other.

For instance, countries like Australia and the US have well-developed and diversified financial systems that are able to minimise real sector disruptions due to transitory exchange rate variations. Most notably, industrial countries are able to borrow overseas in their domestic currencies. Many developing countries are unable to do so, leading to accumulation of foreign currency debt liabilities that are primarily dollar denominated and unhedged (i.e. "liability dollarisation").

In such countries, sharp depreciations in their currencies magnify the domestic currency value of their external debt and hence slash the net worth of individuals, corporations and the domestic financial system at large. This so-called "balance sheet" effect could potentially lead to massive bankruptcies.

It is no surprise that devaluation both in Mexico in 1994-95 and East Asia in 1997-98 led to plummeting exchange rates, intensified capital outflows and left the economies in a tailspin. Things got much worse before they got better.

There is also a valid concern that devaluation could pass through directly and rapidly into domestic prices, hurting consumers and pension earners whose compensation may not be indexed to inflation. The inflationary impact of devaluation is of particular concern to countries like Argentina which have had a history of hyperinflation. Such experiences are not easily forgotten.

All of this may explain the widespread "fear of floating" exhibited by many developing countries, including those in East Asia. It is also the reason why Argentina has, until recently, stoically adhered to inflexible exchange rates despite the hardships it has brought about. Thus, Argentina has been faced with an unenviable conundrum -- a classic case of "damned if you do, damned if you don't"!

It is important to keep in mind that the harmful balance sheet effects do not disappear if the currency peg is maintained. Under a fixed exchange rate or in a dollarised regime, there will be a fall in the relative price of non-traded goods, consequently increasing the real local currency value of dollar debt.

What does all of this imply for the medium and longer-term choice of exchange rate regime for Argentina and small and open emerging economies more generally?

Choosing the exchange rate regime should represent a consistent part of choosing a coherent macroeconomic strategy. No exchange rate regime will deliver stability if domestic macroeconomic 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 involve a "fairly high" element of flexibility rather than a single-minded defense of a particular rate.

This could be achieved in one of two ways.

One option is a Singapore-type variant on sliding parities and wider bands around an appropriately weighted currency basket, the extent of which varying across countries depending on individual circumstances and policy preferences.

A second option is to adopt a floating regime with a flexible "inflation target" as in the case of Brazil, Korea, Mexico and others. The inflation target is meant to operate as a nominal anchor for monetary policy and act as a way of introducing some financial discipline domestically and breaking inflationary inertia.

Coming back to Argentina's current situation, a number of informed observers have discussed the country's short-term policy options in some detail. It is clear that a judicious combination of nominal devaluation, significant fiscal readjustment, adoption of a transparent and coherent monetary policy, partial redenomination of domestic dollar debts from US dollars to pesos to minimise bankruptcies, and a rescheduling of external debts, must clearly form the core of any macroeconomic strategy. Urgent steps must also be taken to ensure the liquidity and overall soundness of the domestic financial system.

One hopes that the transition in Argentina will be better managed than has hitherto been the case. Indonesia for one is, unfortunately, still reeling from the acute mismanagement of its crisis in 1997-98.