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Argentina's Currency Crisis: Lessons for Asia

This Economic Letter *is based on a presentation Mark Spiegel prepared for a panel on "Optimal Currency Arrangements for Emerging Market Economies: The Experience of Latin America and Asia" organized by the Latin American and Asian Economics and Business Association on July 15, 2002, in Tokyo, Japan.*

Before Argentina's currency crisis erupted this year, renewed interest in pegged exchange rate regimes had been gaining momentum, especially in Asia. That region's 1997 financial crisis led many of its nations to explore whether formal currency arrangements might forestall a repeat of such crises. The initial efforts concentrated on developing institutions to raise liquidity regionally, and since then the feasibility of greater monetary policy coordination also has been considered.

Asian countries found particular inspiration from the successful launch of the European Monetary Union (EMU). The EMU consists of 11 European nations that adopted a single currency, the euro, and ceded monetary policy to a single central bank authority; at the same time, however, these countries retain a large amount of other policy independence, particularly concerning domestic public finance. As such, the EMU provides a model of a viable currency union that closely matches a potential ASEAN arrangement (the ASEAN nations are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam). The launch of the EMU was followed by the Chiang Mai Initiative in June 2000, in which the ASEAN nations plus Japan, China, and Korea agreed to adopt a system of swap arrangements. There was some speculation that the successful launch of these swap arrangements would lay the foundation for more intensive regional monetary policy coordination.

However, the difficulties experienced by Argentina this year have slowed much of the momentum for the adoption of formal fixed currency arrangements. The shock of seeing Argentina's currency board regime, which had been perceived as strong and credible despite some misgivings about the appropriateness of its currency peg, appears to have renewed doubts about the sustainability of *any* formal exchange rate arrangements.

In this *Economic Letter*, I review the circumstances surrounding the collapse of Argentina's monetary regime and describe some lessons these circumstances may provide for proposed Asian currency arrangements.

Argentina's currency board regime

Argentina maintained a currency board regime from April 1, 1991, through January 6, 2002, under which the Argentine peso was pegged one for one to the U.S. dollar. In several respects, the regime did not meet the criteria of an "orthodox" currency board, as defined by Hanke and Schuler (2002). These criteria include three key features: first, the board must maintain a fixed exchange rate with its anchor currency; second, it must allow for full convertibility, that is, it must allow holders of the currency to move into or out of the anchor currency without restriction; third, the monetary liabilities of the currency board must be fully backed in hard—that is, foreign currency—assets.

In addition, an orthodox currency board should not participate in activities such as purchasing government securities, regulating commercial banks, or acting as a lender of last resort. It is easy to see how any of these activities could undermine a currency board's primary goal of maintaining the peg with the anchor currency.

Argentina's currency board violated all of these rules at some point in its existence (Hanke and Schuler 2002). The charter governing Argentina's currency board allowed it to be partially backed by domestic—rather than hard foreign currency—assets. The currency board initially was allowed to hold as little as 66.6% of its assets in true foreign reserves. The remainder could be backed by Argentine government bonds. As such, the currency board could pursue discretionary monetary policy. In 2001 alone, the foreign reserve backing for Argentina's currency board ranged from a high of 193% to a low of 82%. In addition, the Argentine central bank set reserve ratios and, therefore, retained some financial regulatory power. The currency board also acted as lender of last resort, for example, during the Mexican peso crisis of 1995, when it extended funds to illiquid commercial banks (Spiegel 1999). Therefore, it

would be more accurate to characterize Argentina's exchange rate regime not as an orthodox currency board but as a fixed exchange rate regime with a hard dollar peg. Nevertheless, it must be granted that the rules faced by Argentina's currency board exceeded those commonly found in pegged regimes.

With the appreciation of the dollar in the late 1990s, the Argentine currency board experienced overvaluation. Argentina's exports became less competitive on the world market. These effects spilled over to the real side of the economy. Argentina has been in recession now for four years.

In addition, Argentina had been running massive fiscal budget deficits for some years. In 2000, the government raised income taxes in an effort to balance its budget, and in 2001 it levied a tax on financial transactions. But these efforts failed as Argentina's economic recession worsened. The climbing deficit led to an increase in devaluation concerns. Roughly $20 billion in capital fled the country in 2001. Peso interest rates climbed to between 40% and 60%, which further weakened the government's budget position.

At the end of 2001, Argentina moved to a dual exchange rate system, adopting a preferential exchange rate peg for exports. This move eliminated the characteristic of full convertibility—and with it any semblance of a currency board. However, this failed to reassure the public. The government then froze bank deposits, formally initiating a financial crisis, and in January 2002 it abandoned the exchange rate regime for a floating regime.

Asian currency arrangements

The currency arrangements proposed for Asian nations vary widely in intensity, ranging from regional insurance schemes aimed at forestalling future financial crises to agreements that could culminate in an Asian version of the EMU with a single currency for the region.

Japan first proposed creation of an "Asian Monetary Fund" in 1997 in the wake of Asia's financial crisis. The proposal was for an institution that would provide a framework for financial cooperation and policy coordination. Opposed by both the United States and the IMF, the proposal was shelved. However, policy coordination in the region was reborn with the Chiang Mai Initiative in 2000. This initiative would expand existing swap arrangements to the ASEAN nations as well as to China, Japan, and Korea. The swap arrangements are designed to provide liquidity support for member countries in distress in an effort to prevent regional contagion and systemic risk.

A full-fledged intra-Asian currency arrangement analogous to the European Monetary Union also has been considered (see, for example, Bayoumi and Mauro 1999). The argument in favor of such a regime is that it would stabilize exchange rates within the region, while allowing for flexibility against the three major global currencies, the dollar, the euro, and the yen.

However, Ogawa and Ito (2000) have argued simply for a greater weighting of other currencies in Asian monetary arrangements. They argue that the excessive targeting of the dollar fueled the Asian crisis of 1997. If Asian countries had instead adopted a currency basket with a yen weight commensurate with Japan's share in trade, the nations would not have experienced as significant a boom over the 1993–1995 period, as their currencies would have appreciated with the yen. More importantly, the depreciation of their currencies along with the yen in 1996 and 1997 would have mitigated their recessions.

Lessons from the Argentine experience

One obvious and important lesson for the Asian countries from Argentina's failed currency board is that an improper exchange rate peg is doomed to failure, no matter how rigorously one imposes conditions to engender credibility. A basket peg is likely to serve the ASEAN nations best, because their trade volumes with the United States, Europe, and Japan are of similar magnitudes. For example, Rajan (2002) notes that during the 1997 Asian crises, Singapore, which pursued a flexible basket peg, outperformed Hong Kong, which pursued a dollar peg.

Another lesson is that exchange rate arrangements are no cure for problems in the area of macroeconomic policy. Despite the relatively strong set of rules governing the conduct of Argentina's currency board, the regime collapsed in relatively short order when domestic and foreign investors determined that the Argentine government's fiscal policies were unsustainable.

One important implication for prospective Asian currency arrangements is that the degree of disparity in development levels across these countries is likely to prove difficult. The Asian nations as a group, particularly if Japan is included, represent a more heterogeneous set of nations than the EMU, making it

more likely that the nations differ in their desired macroeconomic policies.

A third lesson is that rules can go only so far in enhancing the credibility of an exchange rate regime. It is generally understood that a nation can buy credibility by increasing the cost of abandoning the announced peg. In the case of Argentina, this cost was clearly very high. Nevertheless, the collapse of the Argentine regime demonstrates the ease of circumventing the rules of an exchange rate regime. The introduction of a dual exchange rate system and the freezing of bank accounts were readily adopted policies in Argentina, despite currency board rules to the contrary.

This lesson raises the question of whether dollarization would have done much better, and the answer is, not necessarily. Under dollarization, Argentina would have experienced the same exchange rate appreciation and therefore the same loss of competitiveness vis-à-vis its primary trading partners who were not tied to the dollar. Therefore, the government probably would have ended up in a similar unsustainable fiscal situation. Moreover, there is little reason to believe that dollarization would have precluded the government from abandoning the peg. For example, one proposal to deal with the current crisis that is now being circulated is the forced conversion of asset claims into bonds, presumably at depreciated peso prices. There is no reason that the same reduction in liabilities could not be achieved under a dollarized regime. The government could simply freeze all deposits and convert them to bonds with a financial haircut in place. Once the legal protection of property claims is open to abrogation, no exchange rate regime can ensure asset values.

Finally, many would argue that the ultimate lesson from Argentina's currency crisis is that no fixed exchange rate regime, even one as institutionally strong as Argentina's, is completely sound. As a result, it will sooner or later lose its credibility. Moreover, since financial contracts will have been written in the domestic currency, this loss of credibility will have real effects and likely will precipitate a financial crisis, or at least a severe disruption to the real side of the economy. As such, floating may be a superior policy over the long run.

At the same time, floating exchange rate regimes pose important difficulties for developing countries. First, because many of these countries are relatively open, external shocks can do more damage to them than to most developed nations. Second, because developing countries lack the ability to issue debt in their own currency, depreciations immediately correspond to increases in indebtedness in domestic currency. As a result, floating regimes may exacerbate the potential for financial crises stemming from widespread bankruptcies.

Finally, floating regimes place responsibility for maintaining price stability back squarely in the hands of the national central bank. Because developing country institutions are often less well-established, it may be difficult for a developing nation's central bank to resist, for example, monetizing the deficit of its treasury. As a result, price stability may be unattainable domestically. Instead, nations may look to exchange rate pegs as mechanisms to import developed nations' monetary policies that are otherwise unattainable given their own level of institutional development.

Conclusion

The collapse of Argentina's currency board has had a devastating impact on that nation. Perhaps the most important lesson from Argentina's experience is that an exchange rate regime is only as good as its peg. No set of rules surrounding the regime, regardless of their strength, can force a nation to remain attached to a peg that has outlived its usefulness. As a result, even "good" pegs are likely to be less than perfectly credible. Despite the drawbacks outlined here, the alternative of pure floating must be seriously considered.

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