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Can the Argentine Peso Resist Competition from the Dollar?

Argentina has entered a severe crisis since the end of 2001: bank deposits have been blocked, controls have been imposed on capital outflows and the currency board, which had tied the peso to the dollar since 1991, has been abandoned. Rather than this just being another, classical case of a currency crisis linked to a banking crisis, the central issue at stake is monetary. This explains why the crisis is so violent and why it carries such economic and social risks. Indeed, the floating exchange rate puts the two currencies, which had been perfect substitutes for ten years, into direct competition. There is thus a danger that the weaker one will finish by being destroyed. This explains why the government has adopted a series of radical measures to "pesoise" the economy and the banking system. The key question now is whether the population will validate this attempt or whether it will impose a spontaneous "re-dollarisation", once access to deposits and forex markets has been reopened.

The acute crisis that Argentina is undergoing since December 2001 is one of the most serious that the country has ever experienced, despite a long history of economic decline and catastrophe. It is also exceptional when compared to similar episodes, in other countries. The violence of the crisis, the social and political context in which it is unfolding, and the long term costs that the country will bear can but strike observers. Indeed, State insolvency and banking crises are serious events, but they occur quite frequently. Argentina's crisis, however, adds to these phenomena a unique monetary dimension, which explains the force of the crisis.

The reason for this is the currency board framework adopted in April 1991, in the wake of the 1989-1990 hyperinflation. After two previous attempts at stabilisation based solely on the peso, the aim then was to create a bi-monetary rule which would be altogether public, institutionalised and easily verifiable. It was thus hoped that agents would still accept to hold a few pesos (rather than just dollars), despite the enormous inflationary losses incurred in the previous years. This very constraining mechanism should thus be seen as the last option available to policymakers before full dollarisation, when the central bank has already lost all capacity to act. While dollarisation, as undertaken by Ecuador in 1999, makes it extremely difficult to go back to a national currency, a currency board does allow for a return to a more active monetary policy, following a phase of stabilisation.

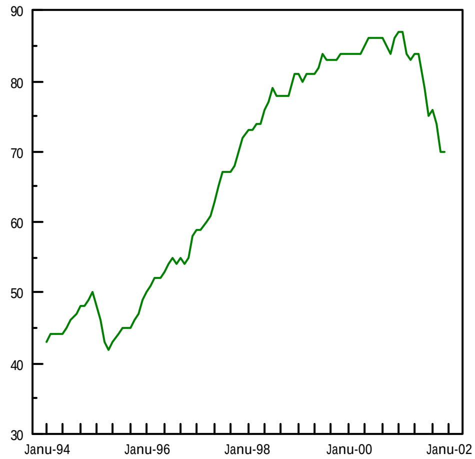
The technical principles on which it is based are known. On the one hand, the exchange rate against the dollar (or the euro) is definitively fixed. On the other hand, the only counterpart to base money is foreign reserves, i.e. dollars. As a result, any entry (or exit) of capital leads to an expansion (or contraction) of the money supply and to a positive (negative) credit multiplier, with no possible sterilisation. Real shocks (e.g. competitiveness) or financial ones (contagion) are thus transmitted directly to agents — first of all through the labour market or the financial system. Another corollary is that no lender-of-last-resort can support commercial banks when confronted with a liquidity crisis: in Argentina, they were nearly destroyed by the Tequilla crisis of 1995. Hence the paradox of this regime, at least in the short term: on the one hand it tries to save what is left of the national currency, while on the other one the possibility of using it as a policy instrument is almost non-existent.

In the medium term, the main problem is that of the conditions for an orderly exit from this regime and for the recovery of some scope for active policy initiatives. Thus, the obstinate defence of the currency board in Argentina over the last three years, despite the on-going recession and clear signs of insolvency, cannot be explained simply by political blindness. Ideological bias has certainly been pervasive in this monetary experiment, yet the authorities did not impose forty-two months of recession on the country for mere ideological considerations. Neither is the problem of exiting a board only technical. The main difficulty is that there is no appropriate moment for taking such a decision.

When the economy is running well, the regime is not really a problem, and anyone who would suggest relaxing its rules would immediately be accused of disturbing the markets and undermining growth. But when things deteriorate, the incentives for defending the board at all costs increase steadily as the crisis deepens. This is because in the wake of a collapse of the board, the Central Bank would lose all credibility and would have no instrument and no clear rules of behaviour for managing the currency and the exchange rate. In a general context of panic, the Central Bank would then be confronted with the immediate danger of a spontaneous dollarisation, which could destroy altogether the national currency, the banks and a large share of domestic savings. Hence, since the Brazilian devaluation in 1999, shear uncertainty and the extreme risks associated with a precipitous exit from the board are the main reasons for the paralysis of both the politicians and the Monetary Fund confronted with the on-going recession. And indeed, leaving the board proved extremely hard to manage.

Hence the exceptional dynamics of the Argentine crisis. With the currency board constructed so as to resist technically any attack against the exchange rate, it was only abandoned after a massive contraction of money aggregates (Graph 1), the breakdown of internal and external payments and a default on the public, foreign debt. It is usually the rise of precisely such risks which leads even the most determined Central Bank to scrap its currency peg.

Graph 1 - Bi-monetary M2 aggregate in billions of current pesos



Source: Central Bank of Argentina.

From Financial Crisis to Monetary Breakdown

The first signs of a breakdown appeared in August 2001 with the creation of parallel currencies — especially the "patagons" — by the town of Buenos Aires and the provinces. Unable to balance their budgets and without access to capital markets, these public bodies effectively resorted to running their own printing presses. The authority of the State was thus challenged because this broke both a ten-year old monetary rule and the State's monopoly on money issuing. In principle there is no such thing as private or local monies competing against each other, in any market economy.

As of November, pressure began to build up in the banking system. As depositors began to anticipate a breakdown of the exchange rate regime, as well as solvency problems in the banking sector, they started withdrawing their deposits massively. In the absence of a lender-of-last resort, the only solution to preventing a complete collapse was (on 3rd December) the introduction of tight quotas on withdrawals, either in pesos or in dollars. Later on, a ban was imposed on the convertibility of peso assets into dollars, and on capital exports. While the former set of measures protected the liquidity of commercial banks, the latter represented ***de facto*** severe foreign exchange controls, which aimed at protecting the Central Bank and the peso.

The consequence was that internal and external payments were largely impaired, with all the usual consequences: agents were caught up in payment backlogs, the delays of inter-bank settlements became excessively long, and a standstill on debt payments had to be enacted to prevent the failure of companies suffering from liquidity problems. Lastly, real transactions were directly affected, which led to a new fall in the level of production, retail sales and even exports, as of January. The only advantage gained from these measures was that they allowed the peso to come off the currency peg: with capital flight severely controlled, an immediate collapse of the peso could be avoided. On 11 January 2002, the country scrapped the link to the dollar and some weeks later the peso was officially floated and it rapidly fell to 50% of its initial level against the dollar. However, even this new exchange rate did not correspond to a market equilibrium: each time the internal and external controls on liquidity were relaxed, even marginally, everyone rushed to withdraw deposits and then to convert pesos into dollars.

What strategy did the government, formed in January by President Duhalde, try to adopt to meet this situation? To begin with, it tried to limit the exposure of banks' balance sheets to the fall in the exchange rate. The aim was to support the overall solvency of banks, so that the expectation of their immediate collapse would not lead to a large-scale depositors' run, when controls would be lifted. Hence the attempt at a voluntary "pesoification": i.e. the conversion of dollar deposits and some dollar assets into pesos (65% of the total, see Graph 2), with the aim of limiting the exchange rate risk. Agents were thus offered a faster unfreezing of their peso deposits, with an exchange rate higher than the market rate[1].

1. This method may be compared to that used by President Roosevelt in the spring of 1933. Faced with a similar banking and dollar-gold peg crisis, and having largely suspended banking and capital outflows, he issued a decree to suppress all forms of indexing on gold for loans and long-term bonds. He was thus able to allow the exchange rate to slip, without there being any destabilising effects on banks or private wealth. Without this measure, it has been calculated that the later deterioration of the dollar would have implied a re-evaluation of internal debt, which was equal to about 90% of GDP. See Randall Kroszner, "Is it Better to Forgive Than to Receive? Evidence from the Abrogation of Gold Index Clauses in Long-Term Debt During the Great Depression", University of Chicago, November 1999, <http://gsbwww.uchicago.edu/fac/randall.kroszner/research>.

But this operation was interrupted quite rapidly, when it became clear that the key issue was not the banking crisis, but the survival of the peso. Ultimately, the stabilisation of the exchange rate would depend less on the resistance of private balances sheets than on the answer to a novel question: Can two units of account, which shared the monopoly over monetary functions for ten years, with the same institutional and legal guarantees, co-exist once their exchange rate starts to float? In other words, is it possible to have viable, direct competition between the peso and the dollar in a free market, given the very unequal confidence they command and the major redistribution in wealth entailed by any shift in their relative value? To our knowledge, there has only been one historical parallel which allows this situation to be assessed: Hungary's hyperinflation of 1946.

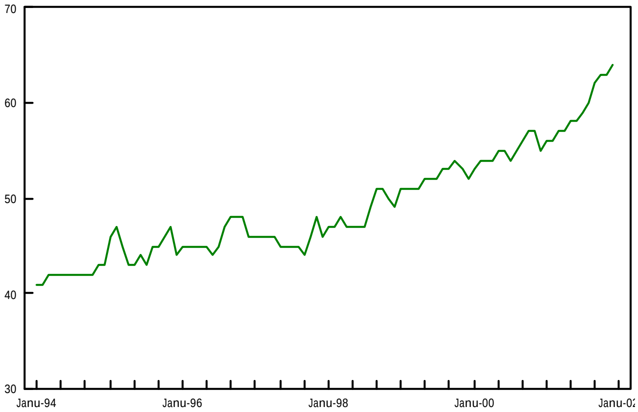
The Hungarian Experience

In a country which had been ruined by World War II, both economically and financially, the State had resorted increasingly to the monetary financing of its spending[2]. Soon, accelerating inflation started to erode the real value of the State's limited tax receipts, given the time lag between the moment taxes were fixed and spending settled (the Olivera-Tanzi effect). In January 1946, the State thus indexed the agents' tax obligations on domestic prices (using a daily index), as well as the bank accounts in which it held its treasury balances. This protective device was then offered to the population, and was rapidly generalised, as was expected. Furthermore, a rising share of public spending as well as of prices for public services were later allowed to be settled in the new, indexed money: bank notes were even issued as of May. Thus, the unit of account had also became a means of payment, so that the economy became bi-monetary, with one currency fully-protected against price erosion and the other not at all. The result was straightforward: the latter, weaker money was completely destroyed within two months. In July 1946, inflation in the older currency reached 4.2 x 10^{16}, an absolute historical record, and when this unprotected part of the money supply was withdrawn from circulation, at the end of the same month, its counterpart value on the black exchange market had fallen to a mere $2300. The older currency was thus totally destroyed by a violent substitution effect, once it had been put into competition with a stronger unit.

Restoring the Peso

This experience, along with the other parameters of the Argentine crisis, also suggest that any immediate move to a floating exchange regime, once the Currency board was abandoned, would have carried extreme risks. Starting from an institutional framework based explicitly on full substitutability, direct competition between the dollar and the peso would not have led to a market exchange rate, but would instead have destroyed the weaker currency. The issue at stake would not be the convergence towards a standard market price, comparable to that of a security, or car model, but a collective choice between two institutional arrangements: such as driving on the left or the right side of the road.

Graph 2 - The dollarisation of bank deposits, in %



Source: Central Bank of Argentina.

This expectation was apparently the main factor behind the government decision to change its strategy, at the end of January 2002: i.e. when it became clear the precondition for reopening the banks and the foreign payment was to break, as much as possible, with the past bi-monetary rule. Although everything had been done until recently to establish full substitutability between the peso and the dollar, a complete U-turn was then decided, which was to give back to the peso as large a monopoly as possible on domestic monetary functions. From being an option for private agents, "pesofication" thus became compulsory, and was applied to all bank assets and liabilities (though strangely enough at different rates). Logically, the domestic public debt was also converted, as were all prices, wages and commercial contracts. In other words, the State set out to re-establish a single national currency, by coercive means and direct intervention in private contracts. The underlying principle was that the choice of the currency unit used by agents, throughout the national territory, was an act of sovereignty on a public good, and could not be considered as a private choice to be included in commercial or financial contracts.

Three Scenarios

Since the beginning of February, three main scenarios for the future can be envisaged. In the best case, pesoification and a viable macroeconomic framework would allow for a progressive unfreezing of bank deposits and domestic

2. See in particular, W.A. Bomberger and G.E. Makinen (1983), "The Hungarian Hyperinflation and Stabilization of 1945-1946", ***Journal of Political Economy***, 91: 5, October, pp. 801-824.

payments. This scenario also assumes that convertibility on the current account would be re-established soon, with the exchange rate converging towards a level commensurate with the competitiveness of the real economy. The sustainability of this equilibrium would eventually depend upon the real interest rates: if they have to be held at between 40% and 60%, then a new breakdown would be inevitable, sooner or later, as both private and public agents cannot deal with such borrowing terms. The same would be true in the case of a sustained acceleration in inflation. As for capital movements, it is likely that they would remain under tight controls for quite a while, provided public institutions are able to manage them. As a rule, such measures always carry a major risk of being bypassed or undermined by corruption, to which Argentina is obviously vulnerable.

Secondly, a muddling-through scenario would result from difficulties in loosening controls on domestic liquidity without incurring an immediate slide of the exchange rate. The delay in unfreezing internal and external payments would then have a major recessionary effect. Financial contracts would be suspended permanently, the monetary circuit would remain fragmented, and agents would be caught up in long chains of non-payment. Having neither fully opted for the dollar, nor reconstructed a viable monetary regime, the economy would be caught in a unique economic no-man's land (perhaps recalling the Russian experience of the 1990s), in which any upturn in activity or credit would be hard to obtain.

Lastly, there is a Hungarian-style scenario, which is perhaps the most probable. It would lead either to a voluntary dollarisation, possibly by a new government, or to the ***de facto*** destruction of the peso, after bank deposits have been reopened. A sharp fall in the exchange rate would lead to a short term explosion in peso prices, in a context which would look like hyperinflation, although the driving force behind price increases would not be excessive money creation but the collapse of the exchange rate due to a one-off, full substitution of the peso by the dollar. Although such an outcome would eventually provide a degree of monetary and price stability, many issues would remain outstanding, beginning with, the solvency of the State and the banks, the integrity of the domestic payments system and the overall money supply. Indeed with all peso balances in cash destroyed and possibly few remaining foreign reserves, a violent "re-dollarisation" of the economy would imply a massive contraction of monetary aggregates. This would have potentially a further, powerful recessionary impact: as peso prices explode, dollar prices could contract, due to a severe shortage of means of payment. Moreover, no monetary institution could ensure a re-monetisation of the economy so that the dollars needed for domestic trade could only come from a current account surplus or foreign aid. Providing such support would be the IMF's first task under these circumstances.

Later on, in such a devastated economic context, with a payments system that is largely destroyed and many insolvent agents, a probable outcome would be the emergence of a two-speed monetary regime. Unregulated, local currencies would expand further, thus contributing to a rather opaque market environment, while official and foreign payments would be run in dollars, on the basis of a small-sized banking sector. These would hardly be the best conditions for restarting growth and restructuring the real economy.

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