The crisis in Argentina: Is the Currency Board to blame

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The crisis in Argentina has raised major concerns about the functioning of the global economy in general and emerging markets in particular. Long viewed as one of the darlings among the emerging group of middle income countries, Argentina's problems have set many alarm bells ringing. A fundamental question is again being asked. What is the appropriate exchange rate system for an emerging economy – pegged, floating, hybrid or a completely dollarised system?

Much of the blame, for Argentina's current woes, has been put on the country's Currency Board System, which was introduced in 1992. The move formed part of a comprehensive set of measures taken by the government to arrest hyper inflation and restore the faith of the general public in the country's currency. By announcing that each unit of domestic currency would be backed by a US Dollar, the country effectively promised not to use the printing press to bridge future budget deficits. By committing themselves to rigorous monetary discipline, which would in turn ensure fiscal discipline, the Argentine policy makers sent out clear signals that they meant business.

The currency board system which was implemented by the now infamous, Domingo Cavallo, was a roaring success. Inflation was drastically cut down. The strong commitment to monetary discipline, necessitated a major fund raising program which ensured that privatisation took off in full swing. Lured by an attractive market, which was just opening up, foreign direct investment inflows picked up. Growth was restored. By the mid 1990s, it looked as though Argentina's past glory achieved during the early part of the 20th century had been restored.

But starting from 1998, Argentina began to feel the rigidities of the currency board. The country watched helplessly as currencies in other parts of the world, especially neighbouring Brazil, plunged making their exports more competitive. Under these circumstances, Argentina quickly slid into recession. But it could not reduce interest rates, as under a currency board, monetary policy cannot be independently pursued. Interest rates closely track the interest rate of the currency to which the domestic currency is pegged. As the US economy peaked during 2000, US interest rates soared, causing interest rates in Argentina to go up as well. Even though the US economy did slow down in 2001, the dollar has continued to be strong. As a result, in spite of the 11 interest rate cuts by the Federal Reserve since the beginning of 2001, there has been no respite for Argentina.

Now, of course, Argentina has decided to break the peg and float the currency. This decision has been welcomed with glee by many economists who feel that a rigid peg is not desirable for emerging economies. They argue that these economies depend on sustained exports to earn valuable foreign exchange and facilitate imports of vital goods not available in the domestic market. By following the currency board, not only does the domestic currency become overvalued but the country loses the flexibility to cut interest rates and stimulate the economy during a recession.

But this argument does not sustain the complete story. We must remember that in most emerging markets, governments tend to spend money indiscriminately. Printing presses work overtime to facilitate such policies! The currency board acts as an inbuilt mechanism for imposing monetary discipline. It also sends a clear signal that artificial props such as devaluation of the domestic currency are not available to exporters. This puts pressure on domestic manufacturers to cut costs, become lean and mean and grow innovative whenever possible. A good example is Hong Kong which has been following the Currency Board for almost 20 years now. When other currencies in the region plunged during 1997-98, Hong Kong maintained its peg. But its companies remained as competitive as ever.

We must emphasise that currency appreciation need not necessarily undermine the competitiveness of a nation. Countries like Germany and Japan have had no problems exporting even when their currencies were strong. So, the relative appreciation of the Argentina Peso should not take all the blame for the country's problems. When currencies appreciate, the really competitive companies look for new ways to cut costs and provide value to customers in innovative ways. Argentina has been traditionally dependent on exports of agricultural commodities which are highly vulnerable to cyclical movements in prices. If only Argentina had emphasised the manufacture of high value-added items and diversified its export basket, it would have flourished. Instead, Argentina chose to concentrate on commodity exports and compete on price. Also, deregulation of industries and markets and tightening of fixed policies did not proceed far enough.

The point to note is that a country's competitiveness has little to do with the kind of exchange rate system its policy makers adopt. It has more to do with the ability to produce innovative value added goods that will continue to find markets irrespective of the exchange rate. By forsaking the currency board, the Argentine authorities might well have given up an opportunity to press ahead with the reform process which began in the early 1990s

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