Fixed exchange rates
The lessons from Argentina

Edwin Truman, senior fellow at the Institute for International Economics, argues that rigid fixed-exchange-rate systems, like that adopted by Argentina, do more harm than good.

Argentina is an economic, financial, political and social tragedy, a tragedy that should not be repeated. Argentina's experience over the past decade points to multiple lessons, especially about fixed-exchange-rate regimes. Does Argentina's experience reinforce the view that fixed-exchange-rate regimes are brittle? Does a hardened peg alleviate that brittleness? Is a pure floating regime the only realistic alternative? Is there a better way? Yes, no, no, and yes.

In 1991, to deal with hyperinflation, the Argentine authorities opted for a particularly rigid type of exchange-rate-based stabilization regime, one carved into law guaranteeing the convertibility of one peso into one dollar and supposedly backed by a currency-board type of monetary policy framework. Eleven years later, Argentina defaulted on its sovereign debt, its exchange-rate regime collapsed, its banking system imploded, and the economic and financial costs are mounting.

Was the experiment worth it? Only the citizens of Argentina can answer that question. Convertibility was associated initially with four years of spectacular growth, but the economy contracted by more than 8% over the past three years. Nevertheless, real GDP increased on average 3.4% a year over the 11 years to 2001, compared with a contraction of about 1% a year during the previous 11 years. In the not-unlikely event of a further 10% contraction in 2002, annual growth since 1990 would still have averaged 2.3%.

In the end, the failure of the Argentine economy to grow undermined political support for the policies necessary to sustain Argentina's exchange-rate regime and led to devaluation and default.

Fixed-exchange-rate regimes are brittle. By definition, they can break if the external and internal economic and financial forces arrayed against them are strong. Moreover, exchange-rate-based stabilization regimes – defined as regimes designed to rapidly bring down high or hyper rates of inflation by anchoring inflation expectations to a fixed or nearly fixed exchange rate – often end in economic and financial disaster and chaos; see also Turkey's recent experience.

Argentina's exchange rate was not only fixed, it was hardened by its convertibility law, currency-board type of monetary arrangement, and no exit strategy. That hardening provided inadequate protection against adverse external economic and financial developments: the sustained strength of the dollar, to which the peso was pegged, after 1995; the spillover from external financial crises in Mexico, Asia, Russia and Brazil; and the 2001 global slowdown. Unlike other emerging market economies, Argentina was too far gone by last year to benefit from the accompanying decline in dollar interest rates.

More importantly, Argentina's hardened exchange-rate regime did not guarantee the degree of probity in economic and financial policies that would have been necessary to sustain the rigid exchange-rate regime in the face of inhospitable external developments. Fiscal policy was profligate, in particular after the economy started to expand again in 1996 and 1997. The currency-board arrangement was a sham; the money supply did not expand and contract (and interest rates decline and rise) in line with increases and decreases in official reserves. Its factor and goods markets were not sufficiently flexible to achieve a real depreciation of the peso without sacrificing growth. Its widening current-account deficit pointed to a savings-investment imbalance and an overly protected and uncompetitive economy.

The result of these failures was economic contraction, deflation and an expanding government debt burden. A comprehensive debt rescheduling at an early stage might have eased that burden, but the basic problem was a lack of growth. If the Argentine economy had achieved nominal growth of 5% a year between 1998 and 2001 (the average in the previous four years) instead of contraction at a rate of 2%, government debt at the end of 2001 would have been less than 30% rather than more than 50% of GDP – without any improvement in Argentina's chronically low tax revenue yield.

A purely floating-exchange-rate regime is lower risk; it reduces the probability of economic contractions associated with adverse external developments and facilitates internal adjustment. However, pure floating by itself is also no substitute for sound economic and financial policies directed at maintaining a flexible and competitive economy. At the same time, while sound economic policies will go a long way towards achieving growth and price stability, they do not ensure exchange-rate stability.

In retrospect, of course, Argentina could and should have chosen a better way. Exchange-rate-based stabilization strategies are not the only way to bring down inflation, even if they contain realistic exit options, which Argentina's did not. If a country wants growth and price stability along with exchange-rate stability, it probably should set its sights low in the third dimension, but it need not give up entirely.

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The band, basket, and crawl approach advocated by John Williamson, a senior fellow at the Institute for International Economics, is a promising alternative. If the Argentine peso had been pegged in 1996 to a basket of currencies, it might have avoided a nominal effective appreciation of more than 30% over the following five years. If Argentina's basket exchange rate had a band of plus or minus 15%, the peso might have been allowed to depreciate, say, 10% in real terms in the face of adverse external economic developments. Argentina would not have had to resort to deflation as a means of adjustment, a deflation that only cut the peso's effective real appreciation in half. The result would have been more growth, smaller current-account deficits, and a better fiscal performance. Inflation might have been a bit higher than desired. In that case, the band might have crawled, and monetary and fiscal policy could have been directed at reducing inflation. A monetary-policy framework based on inflation targeting might have helped as long as it was operated flexibly and exchange-rate considerations did not dominate.

Alternatively, if a country is even less wedded to exchange-rate stability, it could follow an even more flexible exchange-rate regime supported by the same sound policies that were lacking in Argentina. For example, floating can be accompanied with a transparent regime of moderate exchange-market intervention when day-to-day exchange-rate movements are excessive.