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Restoring Argentina's Financial Health

by

Ronald I. McKinnon
Stanford University

Argentina's hard money policy almost recaptures the spirit of the 19th-century gold standard. This current policy fixes the peso at a one-to-one parity with the U.S. dollar and requires that domestic base money in pesos have 100 percent dollar backing—much like gold-backed domestic note issues in the earlier era. However, the Argentinean government, the International Monetary Fund, and the numerous critics of Argentina's fixed exchange rate have forgotten one important rule from the gold standard that could be the key to resolving Argentina's current crisis.

In the 19th century, such crises did happen. An outflow of capital caused a gold drain—read dollar drain in present-day Argentina—that tended to shrink the domestic monetary base and, with it, the economy's stock of deposit money. For minor crises, the consequent moderate increase in short-term interest rates was enough to attract gold back into the domestic banking system because people were generally confident that the country's traditional gold parity would be maintained.

But for major crises the domestic monetary contraction could become unbearable—as with the current sharp fall in Argentina's domestic money supply. Thus, to prevent depression from the monetary contraction, governments occasionally had to suspend gold convertibility, i.e., refuse to repurchase domestic money with gold at the traditional exchange parity. This suspension restored internal monetary balance by enabling the government to undertake temporarily new issues of domestic money not backed by gold (or by dollars in the current case).

However, the unwritten rule of the gold standard was that the suspension of convertibility would be temporary, and that the authorities would nudge the country's exchange rate back to its traditional gold parity as soon as they were able—usually after some restructuring of the country's debts. Because markets were confident that restoration would occur eventually (although the exact timing was always somewhat uncertain), exchange expectations were regressive: any near term depreciation would induce the belief that the exchange rate was more likely to appreciate in the future. Thus, during the floating rate interval after suspension, currency depreciation in the foreign exchanges was naturally limited and the necessary increase in domestic interest rates to defend the currency was moderate.

Today, Argentina's government should suspend—but not abandon—its parity commitment of one peso to one dollar. The country needs breathing space in the form of

a debt moratorium to restructure its foreign and domestic debts (almost all in dollars) to much lower interest rates with longer maturities. A temporary suspension of its currency board's obligation to redeem pesos with dollars from official exchange reserves is necessary to prevent further shrinkage in the domestic monetary base. The shortage of domestic money is now so striking that provincial governments have taken to issuing their own "funny monies"—as with the new patacones issued by the province of Buenos Aires. Instead, new issues of federal pesos are badly needed—and patacones should be retired.

At the time of the suspension, however, the Argentinian federal government should announce that its traditional dollar parity will be restored as soon as the crisis is resolved. Indeed, if the term to maturity of the restructured debt were lengthened sufficiently, a return to the traditional foreign exchange parity within the same time frame would give foreign creditors assurance that the restructured debt was viable and could be paid as promised.

Although the peso must float after suspension occurs because the government would refuse (correctly) to spend its last dollar reserves to prop it up, the forward parity commitment would prevent the currency from falling into a "black hole" with no well-defined bottom (as happened in the East Asian crisis of 1997–98). Instead, a relatively modest near-term float downwards would set in motion regressive expectations, i.e., the belief that the peso was likely to appreciate in the future. Thus the depreciation would be self-limiting.

In contrast, the worst of all possible worlds would be a one-time devaluation of the peso (possibly in a panicky move to an unconstrained float) with no dollar debt restructuring and no long-term parity commitment. Then, with no expectations that the peso will appreciate in the future (indeed, people believe that it is more likely to continue depreciating), the high-interest-rate crisis would resume almost immediately.

Of course, it would be a big help if Argentina's neighbors, such as Brazil and Chile, which are close competitors in foreign trade, also adopted long-term dollar parities. Over the last three years, depreciations of the Brazilian real and Chilean peso have had (inadvertent) beggar-thy-neighbor effects on Argentina and on each other. Monetary stability within Brazil and Chile is also at risk. But such a trilateral exchange rate agreement is probably too much to hope for in the immediate future. Nevertheless, Argentina's current crisis is acute enough for it to act unilaterally—and hope that the others, possibly with a push from the IMF, follow suit before too long.