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Perils of a Fixed Exchange Rate: The Collapse of the Argentine Economy

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Alexis Manning

I. Introduction

Once hailed as a successful model of liberal economic reform, Argentina's economy, and consequently the welfare of millions of people and numerous nations, exists in a precarious state, teetering on the brink of total collapse. A severe recession has plagued the Argentine economy since 1998, and signs indicate that the economy will continue to experience a particularly rapid decline this year. Unemployment has climbed to 25%, causing the country's once relatively large middle class, to shrink. Over 44% of the population now subsists below the poverty line, and this number continues to grow. Forecasts project that GDP will plummet between 5% and 10% for 2002. Argentina recently defaulted on its \$155 billion debt, which represents the largest single debt default in the entire world ("A Decline without Parallel," 2002). The Argentine banking system is in danger of collapsing and can only hope to survive with the aid of strong government intervention. Deteriorating economic conditions forced Argentina to abandon its decade-old fixed exchange rate with the dollar and devalue the peso.

Considering Argentina qualified as one of the ten richest countries in the world with living standards that rivaled France and Germany less than a century ago, one must wonder how the Argentine economy plummeted to its current dismal state ("A Decline without Parallel," 2002). Although no single policy or event can be identified as the sole culprit of Argentina's deterioration, a few factors clearly undermined economic stability and precipitated Argentina's demise.

Both loose fiscal policy, involving massive budget deficits and a fixed exchange rate pegged to the dollar at par contributed to the catastrophic collapse of Latin America's second largest economy and richest nation.

This paper asserts that while Argentina's fixed exchange rate provided short-term economic stability, it laid the foundation of the economy's current collapse. A fixed exchange rate or dollarization may represent a short-term solution to rampant hyperinflation, but it is not a long term, sustainable remedy to fundamental economic problems. Argentina's economic policy sacrificed the long-term interest of a country in favor of immediate, short-term benefits.

This paper develops as follows: Section II briefly chronicles Argentina's recent economic history, focusing on its economic condition and policies during the late 1980's and early

1990's, which prompt the implementation of a fixed exchange rate. Section III utilizes formal economic theory, including exchange rate models and the AS-AD model, in order to analyze the effects of Argentina's fixed exchange rate. Section IV discusses and reviews the conclusions of other economic research conducted on pegged exchange rates. Section V examines empirical evidence regarding the effects of the pegged exchange rate on various Argentine economic variables. Section VI concludes with a concise summary of the shortcomings of fixed exchange rates, and then offers a brief discussion of Argentina's options for the future.

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II. Overview of Argentina's Recent Economic History

The 1980's represented a very volatile period for the Argentine economy, which creates the desire, and perhaps even a need for an exchange rate pegged at par to the dollar. The country endured two severe bouts with hyperinflation during which inflation skyrocketed into the quadruple digits on several occasions. This exponentially increasing inflation, which reached 3,066% in 1989, imposed serious costs upon households and businesses (Cooper, 2001). Some businesses closed their doors, posting signs stating "We have no prices," because they could not accurately predict and mark up prices quickly enough (Anderson, 1999). Employees demanded frequent payment, and then quickly spent or converted their wages. Both businesses and households reduced currency holdings, and the US dollar served as the preferred medium of exchange and store of value (Cardoso, 1992). Both domestic and foreign investment plunged, and capital flight occurred. Large government deficits, which occurred in the absence of investment, further encouraged inflation. Prices failed to serve as signals for resource allocation and therefore, market forces could not reach an efficient outcome. As a result, productivity decreased, and GDP dropped 4% in 1990 ("A Decline without Parallel," 2002). The diminishing productivity capabilities of Argentina as well as the minimal consumer and investor confidence contributed to two severe recessions in the 1980's, and unemployment afflicted a quarter of the population. The combined effect of high inflation with high unemployment, a phenomenon known as stagflation, crippled the Argentine economy.

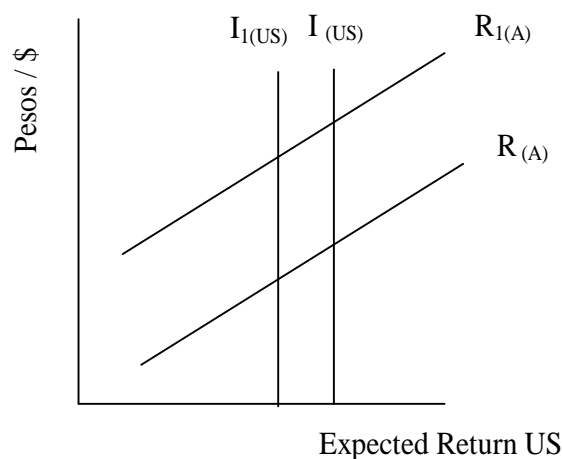
In order to combat hyperinflation and promote economic growth, Carlos Menem, the former President of Argentina, and his economic minister, Domingo Cavallo, created the Currency Board in 1991, which became the cornerstone for the revival of the Argentine economy. The Currency Board pegged the Argentine peso to the US dollar at a one-to-one ratio by law, known as the Convertibility Law (Allen, 2002). The Currency Board supported this fixed exchange rate by accumulating US dollars and other strong foreign currencies in its reserve. Fixing the exchange rate immediately halts inflation and restores economic growth. However, the fixed exchange rate creates the origins of future economic problems. The following models explain how Argentina's fixed exchange rate created short-term economic stability

and prosperity and how it eventually contributed to the economy's recent demise.

III. Formal Model

Nominal exchange rates, which are generally market-determined, measure the price of one currency in terms of another. The nominal exchange rate changes in the short run as the real exchange rate, domestic inflation, or foreign inflation varies. Inflation will cause depreciation, thus reducing the purchasing power of that currency, which reflects the Argentine economy during the 1980's. All other factors held constant, hyperinflation will cause a large upward shift in the Argentine expected return curve, because inflation erodes purchasing power, creating depreciation. This effect is depicted in the shift from $R(A)$ curve to $R_1(A)$. The US expected return curve will experience a small leftward shift as seen in the movement from $I(US)$ to $I_1(US)$ due to the higher nominal interest rates in Argentina that make Argentine financial assets more attractive. However, the first effect dominates, and hyperinflation will cause the peso to de-

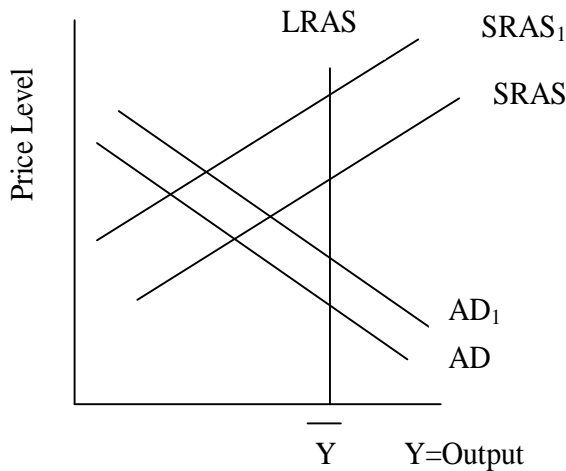
Figure 1: Inflation and Exchange Rate



preciate against the dollar, as seen in figure 1.

Inflation negatively impacts the economy and will decrease output, which can be seen using the Aggregate Supply-Aggregate Demand (AS-AD) model. Inflation will increase the cost of inputs, which will cause the short run aggregate supply (SRAS) curve to shift left, which increases the price level and decreases output, as illustrated in figure 2. In summation, the hyperinflation of the 1980's in Argentina caused the depreciation of the peso, an increase in

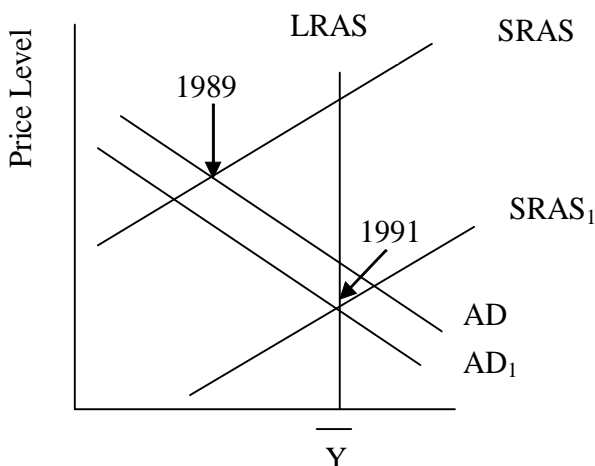
Figure 2: Hyperinflation and Recession during 1980's



price level and a decrease in output.

A fixed exchange rate occurs when a government sets and maintains the exchange rate at predetermined levels. If an inflation-prone currency, such as the Argentine peso, is pegged to a stable currency, such as the US dollar, then the Argentine money supply will stabilize and inflation will significantly drop. A fixed exchange rate prevents excessive money growth, because the country must maintain the predetermined convertibility. As long as US monetary growth is not excessive, Argentina's currency will remain stable. Neither appreciation nor depreciation will occur under a fixed exchange rate. Figure 3 illustrates the effects of a fixed exchange rate in terms of the AS-

Figure 3: Fixed Exchange rate in 1991



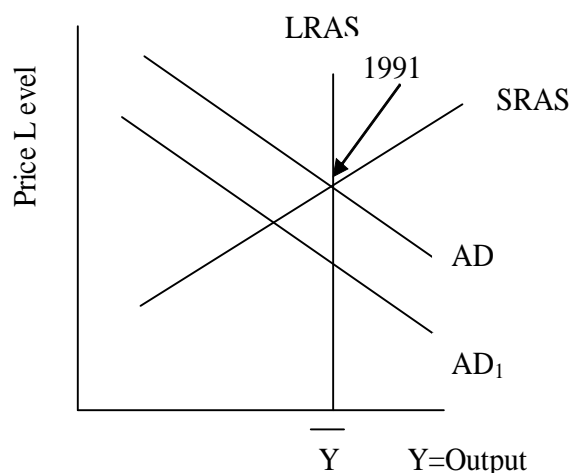
AD model.

The initial drop in inflation produced by the fixed exchange rate will decrease the price of inputs, causing the SRAS curve to shift right and price level

will fall, while output increases. The decrease in money supply will cause the AD curve to shift left, further decreasing the price level and creating a small decrease in output. As a whole, the Argentine fixed exchange rate will decrease the price level and increase output. In addition, a fixed exchange rate will initially lower domestic interest rates, because both inflation and inflationary expectations decrease. Consequently, both domestic and foreign investment will increase and borrowing/lending by households, firms, and government will reemerge, thus promoting economic growth. A credible fixed exchange rate will effectively eliminate exchange rate risk with respect to the US dollar, which will further promote foreign investment.

However, a fixed exchange rate must remain constant despite changing economic conditions. Overvaluation often occurs when weak currencies are pegged to strong currencies. As a direct result of the implementation of the fixed exchange rate, the peso greatly appreciated in order to achieve the one-to-one convertibility with the US dollar. If a currency appreciates, then the country's exports will become more expensive and net exports will decrease. In addition, a country must relinquish all monetary and exchange rate policy in favor of the rigidly fixed exchange rate. Consequently, a country with a pegged exchange rate cannot effectively combat external shocks. External shocks to the Argentine economy, such as Mexico's financial crisis, the devaluation of the Brazilian real, the appreciation of the dollar relative to other currencies, and increasing capital costs caused the economy to contract and create depreciative pressures upon the peso ("A Decline without Parallel," 2002). In order to combat depreciation pressures and maintain the fixed exchange rate, the government will purchase its own currency with dollars and raise interest rates. Due to increasing interest rates, investment will decrease and capital flight will occur in expectation of depreciation, which in turn, decreases credit availability. The decrease in investment and net exports will cause AD to shift left, decreasing output and lowering the price level as depicted in Figure 4.

However, the government cannot devalue the currency to make its goods more competitive abroad nor can it use monetary policy to stimulate the economy. The government lacks the necessary tools to effectively manage a recession (Murphy, 2001). The government may utilize fiscal policy to stimulate

Figure 4: Collapse of the Argentine Economy

the economy, though large government deficits encourage inflation, which serves to increase depreciation pressure (Salma, 1993). Nonetheless, economies with fixed exchange rates will experience severe recessions in response to external shocks.

IV. Previous Research

Both economic theory and case studies clearly indicate that a fixed exchange rate can effectively eliminate hyperinflation, and thus provide economic stability and growth in the short run. Fixed exchange rates and dollarization help to break the self-perpetuating cycle of hyperinflation, and some economists view these policies as the only viable solution for many of the inflation-prone Latin American countries. Dollarization involves fixing a currency to the US dollar regardless of market influences. Currency boards create credibility, which many Latin American countries lack due to recent histories of hyperinflation (Salma, 1993). Until recently, many economists extolled Argentina as the success story of Latin America and viewed the Argentine currency board as the foundation of the country's seven years of economic growth (Murphy, 2001).

According to economic research, small open economies, heavily dependent upon trade with the US, will experience the most success from dollarization or an exchange rate pegged to the dollar. Examples of successful dollarization include Ecuador, El Salvador, and Panama (Von Furstenber, 2000). However, the Argentine economy is much larger and essentially a closed economy, considering that consumption rep-

resents 83% of GDP. Therefore, many economists viewed the Argentine peg as unsustainable (Anderson, 1999).

Historically, larger economies have failed to maintain fixed exchange rates for more than a decade. Economists cite the loss of monetary independence, which reduces the ability of a country to respond to external shocks, as the primary drawback of a fixed exchange rate (Gajewski, 2001). In retrospect, Argentina's fixed exchange rate should have served as an intermediate step to control hyperinflation. A fixed exchange rate cannot create long run economic prosperity nor can it replace healthy macroeconomic policy. The thesis of this paper, which asserts that Argentina's fixed exchange rate undermined long run economic welfare for short run benefits, supports these conclusions.

V. Evidence and Results

Empirical evidence supports the assertion that a fixed exchange rate can effectively combat hyperinflation, thus providing economic stability. Immediately following the implementation of the fixed exchange rate, inflation plummeted from the quadruple digits to less than 1% in 1991, which is one of the lowest rates in the world (Anderson, 1999). The inflation rate averaged around 4% while the peso remained pegged to the dollar during the 1990's. Argentina's pegged exchange rate achieved its primary goal of immediate price stabilization.

Statistical data also confirms that a fixed exchange rate can promote economic growth in the short run. During the 1980's, GDP declined annually at a rate of 1.1% due to recessions and economic instability. Following the implementation of the fixed exchange rate, GDP increased 10.6% in 1991 (Anderson, 1999). GDP growth averaged 6.1% from 1991 to 1997, the highest in Latin America, thus securing seven years of economic growth ("A Decline without Parallel," 2002). The fixed exchange rate promoted economic growth, because it restored confidence in the Argentine economy by achieving price stability. Interest rates fell from 69.2% in '91 to 6.8% in '98 (Anderson, 1999). Lower interest rates and a stable economy spurred a large increase in both domestic and foreign investment. Capital rapidly flowed into Argentina following the implementation of the fixed exchange rate, which helped promote economic growth (Gajewski, 2001). Productivity also increased as investment modernized both the industrial and ag-

gricultural, sectors further increasing GDP.

Argentine economic variables support the conclusion that a fixed exchange rate can jeopardize long-term economic welfare. In order to achieve a one-to-one convertibility ratio, the peso had to appreciate significantly. The fixed exchange rate, which forced the relative appreciation of the peso, caused Argentine goods to become relatively more expensive abroad due to the peso's inflated value. Consequently, net exports decreased from a record trade surplus of \$8.3 billion during 1990 to a deficit just two years later ("Argentina: History in the Making?" 1992). A decrease in exports hinders the growth of GDP, which negatively impacted the Argentine economy.

Although low interest rates helped create economic growth, low interest rates and newly available credit allowed the Argentine government to accumulate a very large debt, totaling \$155 billion. Debt composed 34% of GDP in '91 and then rose to 51% by '99. The large government debt placed a strain upon the economy, because it consumed a large portion of GDP, which could have been used to stimulate the economy. Debt servicing composed 25% of government expenditure and 3% of GDP in '98 (Anderson, 1999).

In order to maintain the overvalued peso against depreciation pressures, the government raised interest rates and purchased its own currency with dollars. In addition, the sale of dollars reduced the central bank international reserves, causing the cause interest rate to increase and money supply to fall. Interest rates, which hovered around 6% from 1996 to 2000, rapidly rose to 45% 2001 (Latin Focus, 2002). Due to increasing interest rates and falling investor confidence, investment growth rate decreased from 17.7% in 1997 to -12.6% in 1999 (Latin Focus, 2002). Evidence indicates that the one-to-one peg overvalued the peso. Although officially one peso could be exchanged for one dollar, the market suggested otherwise. The peso interest rate surcharge of 500 basis points over the dollar casts doubts on the one-to-one convertibility (Von Furstenber, 2002). Evidence also indicates that Argentina's fixed exchange rate compromised its ability to respond to external shocks, which caused severe contractions in the Argentine economy. As a result of Mexico's devaluation of the peso, the Argentine economy suffered and GDP contracted 5% in '95. When Brazil devalued the real in '98, once again, Argentina fell into a recession (Gajewski, 2001). Despite large, often irrespon-

sible government investment and expenditures, aggressive expansionary fiscal policy failed to stimulate the economy. Since the fixed exchange rate eliminated monetary policy as an option, the government continued to futilely rely upon ineffective fiscal policy. Eventually, rapidly deteriorating economic conditions, forced Argentina to default on its \$155 billion debt in January of 2002, which represents the largest single default in the world ("A Decline without Parallel," 2002).

Due to the rapidly deteriorating economic conditions and the obviously overvalued state of the peso, the president of Argentina, Eduardo Duhalde devalued the peso to a 1.4 exchange rate in January of 2002. Currently, the economy remains in a recession with unemployment reaching 25%. Forecasts predict that the recession will worsen, and GDP will decrease 5%-10% in 2002 ("A Decline without Parallel," 2002). Argentina's experience indicates that a fixed exchange rate can produce disastrous effects upon an economy in the long run.

VI. Conclusion And Policy Implications

In hindsight, Argentina's situation clearly illustrates the dangers of relying heavily upon a rigidly fixed exchange rate for prolonged periods of time. While a fixed exchange rate can effectively eliminate hyperinflation, thus promoting economic growth in the short run, it can create acute economic problems in the long run. A fixed exchange rate can decrease a country's competitiveness abroad and it relinquishes control of monetary policy. Consequently, a fixed exchange rate compromises a country's ability to cope with adverse shocks to the economy. Argentina's downfall was not that it chose to adopt a fixed exchange rate in order to combat severe hyperinflation, but that it failed to modify this policy as the economic conditions changed. A fixed exchange rate can serve as an intermediate step towards economic development, but it is not a panacea for irresponsible government spending or other fundamental macroeconomic problems.

Unavoidably, Argentina will have to modify its monetary policies, including former exchange rate policies, as well as address more fundamental economic problems, such as imprudent government spending, ineffective tax collection, and inflexible labor markets. In terms of currency reform, Argentina has already devalued its peso, though further devaluation appears inevitable. If Argentina adopts a float-

ing, market-based currency, it could utilize monetary policy to help manage the country's prolonged recession. In addition, Argentina's recent default of \$155 billion emphasizes the country's need for fiscal reform. In order to promote the future economic welfare of Argentina, the country must begin repairing its reputation and establishing its potential among investors, banks, and governments. Perhaps most important, Argentine politicians must regain the trust of its people in both the government and the economy, in order to achieve economic recovery and eventual prosperity. Although Argentina's economic recovery will inevitably involve hardship, hope exists for this country. According to the World Bank, Argentina's productive potential is "unsurpassed in Latin America" ("Argentina: History in the Making?" 1992).

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