

Role of exchange rate regime in argentina's 2001 crisis



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Discuss the role of the exchange rate regime in contributing to the 2001 crisis in Argentina.

Introduction

For much of Argentina's history, the country has been plagued by a cycle of economic and political instability. Despite the country's rich resource base, the economy performed badly from the 1950s to the early 1990s. According to the Economist (2002), ' between 1976 and 1989, income per person shrank by more than 1% per year. Two bouts of hyperinflation, and two banking collapses, destroyed confidence in both the peso and economic policy.' In order to combat this, in 1991, Menem and his economy minister Domingo Cavallo pegged the Argentine peso one-to-one with the dollar, and this succeeded in halting inflation. However, within ten years this came to be seen as a mistake. Aside from being a means to control inflation, the exchange rate regime can also be seen as Menem deliberately " tying his hands" in order to avoid taking responsibility for sensitive or unpopular decisions. For example, prices could now rise without wage increases due to currency devaluation.

Menem had been a very popular president but in the end he left his second term of office in 1999 very much discredited. His government oversaw the development of sharp inequalities and the increasing resentment of the discluded. He lacked any systematic pro-poor or pro-development policies. Menem reduced inflation from a high of about 5000% to 0 and until about 1999, the economy was doing well with stable inflation and stable growth (an average annual rate of 6. 1% between 1991 and 1997). From 1999, however,

there was serious recession in Argentina and by 2001 just about everything that could be wrong with an economy (aside from inflation) was wrong with the Argentinian economy, and in early 2002 the country defaulted on its \$155 billion public debt. The Economist (2002) spoke of the 'awe-inspiring severity of the economic, financial, political and social collapse' of Argentina.

This essay first examines the theoretical arguments in favour of adopting a pegged exchange rate. Turning to the case of Argentina, the essay then investigates why the exchange rate regime implemented by Menem did not work, how this contributed to the 2001 crisis, and what other factors contributed to the crisis.

Pegged exchange rates

A government has various different options in terms of exchange rate mechanisms (Fischer 2001). The currency can be allowed to float freely, the exchange rate can be pegged to another currency or group of currencies in a soft way such that the relevant authorities agree to defend the peg but can re-value it if the exchange rate comes under heavy pressure, or it can be pegged hard. Alternatively, some countries have chosen to do away with their national currency altogether and use only the dollar – this is known as full dollarization. Argentina opted for the hard peg – a currency board – in 1991. A currency board maintains a fixed exchange rate with a foreign currency thus subordinating conventional monetary policy objectives to the exchange rate target (a peg with the US dollar, for example, maintains interest rates and inflation very close to those in the United State). For an orthodox currency board, the country's foreign currency reserves must be

sufficient that all holders of the domestic currency could convert it into the reserve currency.

The key advantage of a currency board is that currency stability is no longer an issue because the exchange rate is fixed to a hard currency and the level of inflation is determined in the country of that hard currency. On the other hand, a country which adopts a currency board gives up the ability to manipulate monetary policy according to domestic considerations.

Furthermore, the fixed exchange rate will determine the country's terms of trade.

The exchange rate regime in Argentina

The dollar peg made exports expensive and imports cheap. This resulted in dollars flowing out of the country, and this combined with a heavy debt burden reduced the reserves of dollars. The government ended up with only a fraction of the reserves necessary to maintain the currency board successfully and this was one of the major reasons for the crisis of 2001.

While there were clearly other contributing factors, de la Torre et al (2002) argue that the relationship between the exchange rate regime and the Argentine banking system is key to understanding the crisis, and that an early move from the pegged board to full dollarization could have reduced the magnitude of the economic collapse. ' The establishment of the currency board in 1991 helped develop the Argentine financial system. Despite its strengths, the financial system remained vulnerable to real exchange rate misalignments and fiscal shocks. After 1998, Argentina fell into a currency-growth-debt trap. It tried to break away by focusing on growth, but

failed to address the currency and debt components of the trap, dramatically raising uncertainty. This unleashed a depositor run, which led to the abandonment of the currency board' (de la Torre 2002: abstract). Being tied to the highly valued dollar also hurt the economy as Argentine exports became relatively more expensive. As demand for exports fell, Argentina had to turn to the IMF for emergency loans worth \$21.6 billion.

What other factors contributed to the crisis?

It is important to remember that this was not the first crisis that Argentina has suffered. In order to fully understand the causes of the 2001 crisis, it is necessary to put it into historical perspective. Arguably every president since Peron came to power in 1946 had aggravated the country's economic, political and social problems with an over-personalised style of leadership characterised by corruption and the use of patronage (financed by printing money) to maintain favour. The historical mismanagement of the economy may have sowed the seeds for the 2001 crisis. In addition various external factors can be seen as trigger causes, contributing to the specific timing of the economic collapse.

In the first place, the prices for Argentina's exports stopped rising. Although the total value of exports did grow from 1999 to 2001, the rate of growth was hampered by protectionism and subsidies in rich countries, and many industries could no longer compete abroad. Argentina's largest export partner was Brazil, a country which was facing economic difficulties of its own. The negative effect on the Argentine economy was two-fold: Brazilian economic problems and a devaluation not only reduced demand for

Argentine exports, but lower wages in Brazil attracted many Argentine manufacturers to move their factories across the border into Brazil.

Ollier (2003: 184) points to the fragmentation of the politico-institutional system and the extreme dependency of the economy on foreign credit as the major causes of the collapse. The loose fiscal policy of Menem's second term certainly did nothing to help the economy. While his predecessors had encouraged hyperinflation by printing money to buy political support, Menem now printed bonds to finance the fiscal deficit, and the country's public debt rose and rose.

Conclusion

Argentina is not a country which should have any problems: it has a rich resource base and a relatively homogeneous population. Yet Argentina has long suffered various economic problems (as well as political and social problems). High levels of expectation have consistently not been matched by performance. Severe sectoral conflict between the agricultural and industrial sectors has hampered economic development. The existence of three highly organised social groups, each attempting to shape economic policy has also impeded the ability of the government to manage the economy effectively: landowners may have few votes but they have immense economic power; the Argentine union movement is one of the most powerful in the world; and the business sector is highly organised and incorporated into the state apparatus. In addition the political systems and institutions have fostered high levels of corruption with devastating effects on the economy. The federal government is unable to curb the fiscal expenditure of the provincial

governments. Neo-liberalism requires effective, independent regulatory mechanisms but in Argentina the legal system is too weak and is incapable of scrutinising audit commissions etc. Furthermore, the presidency is too strong and there are no institutional safeguards to keep the presidency in check. The liberal policies of the 1980s and 1990s stabilised the economy, but at the cost of rising unemployment which, coupled with cuts in welfare provisions, took poverty to new depths. Various external shocks brought about the crisis in 2001 but had the exchange rate regime not been in place, the economy may have been sufficiently flexible to respond to, and recover from, these shocks. The rigidity of the currency board and the corresponding inability of the government to manipulate exchange rate policy or monetary policy is what permitted these shocks to lead to such a severe economic collapse.

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