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Dollarization: Will Argentina Go All the Way?

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During the past few decades, trends in economic policymaking in Latin American countries have been almost as volatile as the economies themselves. Latin America has attempted import-substitution, orthodox austerity, fixed exchange rates, floating exchange rates, and countless other experiments in an effort to bring about economic stability. There have been plans that last for only months, and other more firmly entrenched ones, like the Argentine "convertibility" plan that has lasted for almost a decade. Yet, despite having tried almost every imaginable macroeconomic policy mix, Latin American policymakers are still far from reaching a consensus on the best way to ensure stability.

One idea that currently enjoys very little popularity is that of managed exchange rates. Following the Asian crisis, conventional wisdom suggests that the only two viable options are fully flexible exchange rates or credible fixed exchange rates, which Argentina's currency board attempts to construct. While it is unlikely that managed exchange rates will come back into fashion in Latin America unless we suddenly find ourselves in a world of severely restricted capital flows, fixed exchange rates, even in solid incarnations such as convertibility, are being tested once again. Even if convertibility falls out of fashion, there remains another alternative besides flexible rates: dollarization. This option is an accepted policy alternative for those who feel that nominal currency stability enhances social welfare and economic growth.

Argentina currently serves as the stage for the dollarisation debate. Despite its currency-control arrangement, it has been bleeding reserves—$4 billion in two months. Argentine asset prices have fallen sharply as international and domestic investors have begun to doubt the future of the fixed exchange rate. Investors are concerned that Argentina is not competitive enough to generate the growth that is necessary to service its obligations. One alternative that has been suggested as a possible shield against speculative attacks is to dollarise the economy. If there is no domestic currency, it cannot be debased, and therefore investors cannot make a windfall profit from speculating against its value.

Dollarization is a drastic step that involves purchasing the entire stock of domestic currency in circulation in order to replace it with dollars. Recently it has been seriously considered as a policy option only in countries where there is severe economic and financial turmoil, such as Ecuador. While dollarisation in Ecuador has resulted in greater economic stability (as evidenced by slowly recovering bank deposits, declining inflation, and recovering economic growth), the experiment is still less than a year old, so its long-term success is still uncertain. Most other countries where the risk of hyperinflation or a payments crisis is smaller do not debate dollarisation very intensely.

Most observers agree that the probability of a devaluation in Argentina is low, as such an action would have potentially devastating effects on domestic balance sheets—most of which have substantial unhedged net dollar liabilities. Nevertheless, peso forwards show considerable currency risk (at the time of writing, one-month yields were quoted at 17 percent), and over 60 percent of bank deposits are dollar-denominated, implying that the economy is already largely dollarized. Furthermore, interest rates on dollar-denominated deposits and loans have been lower than those on peso-denominated instruments for the life of convertibility. Clearly, there is currency risk where there should be none. The result is a higher cost of capital and, consequently, slower accumulation of capital and economic growth.

While it is difficult to attribute Argentina's recent disappointing economic performance solely to currency risk (after all, currency risk also existed during the early boom years of convertibility), it is fair to say that without it growth would have been higher. The sluggish activity that has followed the 1999 recession is raising doubts about the sustainability of Argentina's economic

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policy regime. In particular, observers are questioning whether or not the currency board is consistent with the country's rapidly-growing indebtedness.

Currently financial markets, the inexorable judge and jury of economic policymakers, are becoming impatient with Argentina. Investors have been steadily selling Argentine assets in recent months, driving stock prices down and driving bond yields up to the point where the government is considering canceling upcoming treasury auctions due to prohibitive financing costs. The results have been higher domestic interest rates and record-low consumer and investment confidence. According to a recent survey, only 11 percent of Argentines expect economic conditions to improve in the near future.

Financial markets are demanding many things at once from Argentina: more competitiveness, less aggregate spending, and an improved government balance. The unfortunate consequences of this impatience are that the Argentine government and private sector must make higher interest payments on their floating rate debt, and they will find it more expensive to borrow and refinance existing debt. Higher interest rates also discourage consumption and investment and therefore lead to slow economic growth, which only aggravates the problem by putting pressure on government finances.

Argentina's interest rates are being affected by two distinct factors, both of which are pressuring them upward: currency risk and credit risk. Credit risk can be measured by the country spread (the premium at which Argentine sovereign bonds trade over comparable U.S. treasuries), but currency risk is more ambiguous. Part of the country-risk spread is, after all, currency risk; it is clear that a devaluation in Argentina would increase the probability of private and public sector payment difficulties since most liabilities, domestic and foreign, are denominated in dollars. However imperfect, this attempt at dissecting the Argentine country risk suggests that the elimination of currency risk would likely help, and at best not hurt, the cost of capital in Argentina. Dollarisation would largely remove currency risk from the equation, leaving only country risk to pressure the cost of capital.

This argument makes dollarisation look quite tempting as an alternative. It is useful, however, to look more carefully at the differences between Argentina's currency board and outright dollarisation.

One important difference between a currency board and dollarisation is that a currency board will always experience currency risk. A currency board is, in essence, a firm promise not to debase the currency. In the Argentine case, the promise is backed by the convertibility law of 1991, which states that the Argentine peso exchange rate will be fixed at one peso per dollar. However, the Argentine constitution gives its legislature the power to coin money, and to regulate its value in relation to foreign currency. While the currency peg is more credible in Argentina since debasing the currency requires a congressional decision, Argentines and foreigners know well that the decision could still be overturned, and they demand to be compensated for that risk.

Dollarisation effectively takes fixed rates to their farthest extreme, making it almost impossible to debase the purchasing power of locals. In order for a dollarized economy to experience a devaluation, the government has to actually convince citizens that they should hold its currency as a store of value. Of course, coercion is possible if the government declares it illegal to settle debts in foreign currency. However, the extreme difficulty that the government would encounter in trying to re-introduce a domestic currency substantially reduces (in fact, almost entirely eliminates) the so-called currency risk. Dollarization, then, would simply tie the government's hands even further than a currency board in an attempt to ensure confidence. The choice of whether to dollarise comes down to whether the costs of dollarization outweigh the benefits of minimising, though probably not eliminating, currency risk.

One of the most convincing arguments in favor of common currencies is that the elimination of currency risk encourages international portfolio diversification. The removal of currency risk will ease the economy's external constraint, as well as encourage foreign investment and hence invite capital inflows. If there is less risk of losing value due to a debasement of the currency while expected returns stay constant or possibly increase, a greater share of the world's assets will be invested in the dollarised country. The effects of external shocks are distributed across borders. If countries share a currency and also have claims on each others' output denominated in that currency, then they will share in the loss associated with a shock specific to one country. With flexible exchange rates or non-credible fixed rates, the costs of the shock fall disproportionately on the country facing the shock itself, as its residents find that their depreciating currency loses purchasing power in world markets.

A country that dollarizes will still need to ensure that its macroeconomic policies are consistent with solvency, both today and in the future. There is no guarantee that foreign investors will not want to reduce their claims on Argentine assets at some point in time. After all, country risk will remain alive and well. Therefore, dollarization is no escape from the government—or private sector—budget constraint. In fact, dollarization leaves the country just as exposed to domestic shocks as ever, even if the costs of external shocks are more efficiently shared. If investors chose to lower their allocation of Argentine assets relative to the world's assets, the result would be a forced reversal of the current account deficit. Since the exchange rate is fixed, the only way to achieve this is by exporting more or importing less. The adjustment, unfortunately, would likely be very painful for the domestic economy. At the moment, Argentina would need a trade surplus of $11 billion, or roughly 4 percent of GDP, in order to narrow its current account deficit to zero. The necessary adjustment is even more daunting considering the relatively small size of the country's export sector.

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A currency board and dollarisation both help to circumvent the problem economists like to refer to as "time inconsistency." In short, the time inconsistency of macroeconomic policy is the temptation that policymakers feel to renege on their promises or stated policy objectives. For example, a government might be tempted to expand the money supply more than it promised in order to stimulate domestic demand. The most common solution to the problem of time inconsistency is to set rules for policymaking rather than allow for discretion. For example, there are several Latin American countries, including Argentina, that have enacted legislation targeting the fiscal deficit. Since governments often view rules as made to be broken, frequently the rules are made into law to prevent corruption. Such is the case with Argentine convertibility.

A currency board severely limits the monetary authority's ability to finance government spending through money creation. As long as the monetary authority prints currency, there will be seigniorage, the revenues the government collects from printing money. However, convertibility does not allow the government to print currency without backing at least 80 percent of it with foreign reserves.

The fixed exchange rate introduces an automatic punishment if the government deviates from its rules. If too much money is printed, the result will be higher inflation. People who want to protect themselves from this loss of value will start abandoning the peso in favor of foreign currency. As capital leaves Argentina, interest rates are pressured up and the central bank runs down its reserves. The process discourages spending and investment, and the economy slows as a result. The idea is that the government, knowing that its actions will be counterproductive, will shy away from printing too much money.

The inability to debase the currency forces the government's budget to be met almost entirely through taxation. Given the government's large stock of debt ($148 billion or 49 percent of GDP if you include local governments), higher interest rates and country risk exert pressure on the government's fiscal accounts, and hence result in a higher tax burden.

However, completely eliminating the domestic currency through dollarisation will have its own costs. A recent IMF paper has estimated the cost of dollarisation in terms of foregone seigniorage to be $1 billion per year. This is approximately a fourth of the forecast budget deficit for 2001, but is only about 2 percent of total revenues. Moreover, some analysts have raised the possibility of seigniorage-sharing agreements with the U.S. Federal Reserve whereby Argentina would receive its share in the revenues that stem from printing dollars. In addition, there would be an initial $15 billion cost of purchasing the entire stock of domestic currency. After this, the government would have no international reserves in the traditional sense of the word. At present, Argentina has sufficient foreign reserves to purchase its entire stock of currency in circulation. Otherwise, it would be forced to borrow or run current account surpluses for some time in order to accumulate reserves.

Thus, one of the strongest arguments against dollarisation is that the government's "exit option"—its ability to devalue the currency—should be kept open, even at the cost of currency risk. This view is pessimistic in the sense that its adherents consider it too difficult for the economy to adjust through other mechanisms given political and social constraints. Argentina's rigid labor system, for example, keeps labor costs inflexible and therefore exposes the country to extended periods of high unemployment, since deflation is the only way that Argentine prices relative to the rest of the world can decline and lead to a reversion to flexible rates.

In the Argentine case, however, it is difficult to argue that a devaluation would be the preferred method of adjustment, since a devaluation would have a devastating effect on the public and private sectors' balance sheets. As mentioned, over 60 percent of bank loans are dollar-denominated, as is most of the government's debt. A devaluation, then, would immediately increase the cost of servicing liabilities without any compensation (in fact, with a reduction) in asset values. The export-promising benefits of a devaluation are also unclear since Argentina's export sector is very small, accounting for less than 10 percent of GDP. Even if export growth were to double, the overall contribution to GDP would be small.

While flexible rates are an unattractive option for Argentina, there are also valid arguments that suggest dollarisation is a dangerous proposition. One of the strongest arguments against dollarisation involves the monetary authority's ability to serve as a lender of last resort. Under dollarisation, there will be no domestic authority with the ability to expand the money supply if banks are in trouble. While opponents of dollarisation argue that this puts the domestic financial system at great risk, supporters of dollarisation claim that arrangements could be made with the U.S. Federal Reserve in order to circumvent this problem. On the other hand, in the United States, some opponents of dollarisation argue that allowing foreign countries to dollarise would expose the U.S. Federal Reserve to liability in the event of the collapse of a foreign dollarised financial system.

Dollarization was proposed as a serious alternative in Argentina by the previous administration, but the chosen policy of the current government, at least for the moment, is to maintain convertibility despite its cost. The government has stated that it is willing to maintain the currency board system, but it does not wish to eliminate the domestic currency. Obviously, the decision to dollarise is very difficult when $1 billion per year in seigniorage revenues could be involved. It could be argued, however, that the expenditure reduction of lower interest payments on domestic and foreign debt, in addition to the possibility that government revenues would increase in other areas due to improved economic confidence, would more than make up for the lost seigniorage. Many questions remain, and their answers will be known only after the experiment is undertaken. For that reason, dollarising the economy involves taking a risk.

Although it seems unlikely that the Argentine government will dollarise in the near term, it seems just as unlikely that the issue will go away. Argentina's best course of action would be to eliminate the middle-of-the-road approach—to either dollarise or devalue. As long as there is currency risk, it will make sense to try to minimize it by dollarising, as this benefits consumers, firms, and the government. However, there will always be a strong incentive to maintain domestic monetary autonomy, so that devaluation's "exit option" can be used if all else fails.

Finally, the issue of patriotism remains. A national currency is one of the starkest symbols of autonomy and independence, and a country that dollarises will therefore face stiff opposition from those who view the process as relinquishing self-determination. On this issue, it is worth noting once more that the dollar already plays a large and important role in the Argentine economy. A large proportion of Argentine assets and liabilities are dollar-denominated, and Argentines can freely turn their checking accounts into dollars, all of which can be used to settle debts. It remains to be seen whether Argentina will go all the way.