Should Argentina Dollarize or Float?

Nouriel Roubini
New York University's Stern School of Business

Monetary policy independence in Argentina with a float

A number of authors challenge this argument in favor of floating exchange rates by arguing that, in the case of Argentina, there is no independent monetary policy nor there can be any under floating exchange rates since the country is so heavily dollarized. The argument is that, while other emerging markets, such as Brazil, Chile, Mexico (as well as others in Asia and in other regions) may have benefited from flexible exchange rates and are able to live reasonable well under them, Argentina could not benefit from flexible exchange rates and would have no monetary policy autonomy because of its extensive liability dollarization. For example, it has been argued Brazil may have financial indexation but liability dollarization there is limited (for example via legal restrictions to writing local financial contracts in foreign currency); thus, there is room for independent monetary policy in Brazil but not in Argentina. A somewhat different variant of the same argument is that Argentina, given its history of monetary mismanagement and high inflation, has never had an independent monetary policy and it will never will. These arguments appear to be flawed after some closer inspection. First of all, a nominal depreciation under flexible exchange rates will lead to a real depreciation and a change in the relative price of traded and non-traded goods regardless of the amount of liability dollarization; this point is clear from economic theory and practice. This real depreciation depends on the fact that, if nominal wages are downward inflexible but real wages are not downward inflexible, a nominal depreciation will reduce real wages and will increase real competitiveness regardless of liability dollarization. So unless, one wants to argue that real wages are downward inflexible in Argentina, there is room for a nominal depreciation to lead to a real depreciation. Indeed, as recent evidence show, both real and nominal wage are downward flexible in Argentina. So, this argument against flexible exchange rates is not valid. Second, one could argue that, given the history of high inflation in Argentina until 1990, any nominal depreciation will lead to higher inflation with no real depreciation, another way of saying that a nominal depreciation would not reduce real wages. But even this argument is flawed. In all episodes of a currency collapse in the 1990s (Mexico, Korea, Indonesia, Thailand, Russia, Brazil, Turkey) a nominal depreciation has been associated with a real depreciation. Actually, the surprise is why the pass-through to domestic inflation has been so small in all these episodes and why inflation rates have not surged (or they have surged for a year and then returned to single digits). Even in countries with a past history of high inflation and/or indexation (Mexico, Brazil, Russia) the pass-through has been small and inflation either did not surge or sharply fell to single digits after the initial surge. If countries such as Mexico, Brazil, Russia and others were able to design under float monetary regimes (such as inflation targeting) that provided an anchor for inflation expectations in spite of their history of high inflation, why shouldn't Argentina be able to do so? After all, if the pass-through and the surge of inflation after a devaluation depend on a country history of inflation, Argentina has had a fixed rate and low inflation for much longer (over a decade now) than Mexico, Russia and Brazil did (about 5 years each on average). Thus, the view that Argentina would move to high inflation after a move to a float is not warranted and this argument is independent of whether the country's financial assets are dollarized. The crucial factor is rather whether real wages are downward flexible or not. And all the evidence for Argentina is that they are downward flexible. In this regard, the fact that many private sector wages are today set in dollars is irrelevant; the issue is more whether, after a depreciation that requires a reduction in dollar wages, such real wages would fall. Since they are falling today both in nominal and real terms given the recession and the need to reduce unit labor costs, there is not reason why they would not fall in real dollar terms after a devaluation. Formal partial de-indexation of wages to the currency may occur over time and anyhow wages are already informally de-indexed. In conclusion, while the ability of Argentina to conduct an independent monetary policy under a float may be limited (but it is also limited in many other emerging market economies with flex rates), it ability to engineer a change in relative prices and the real exchange rate under a float would not be limited even with liability dollarization. Domestic and external shocks that lead to a nominal depreciation in an emerging market with flexible exchange rates lead to a real depreciation even if monetary policy independence is limited (see Brazil in 2001 whose monetary policy has been straight-jacketed by the inflation target but whose currency value has fallen in nominal and real term over the year as driven by market forces). So, flex rates can provide shock absorption benefits to an emerging market economy regardless of whether its monetary policy flexibility is somewhat limited by the need to maintain policy credibility and avoid excessive inflationary fall of its currency.

The relation between default and currency risk in Argentina A related issue in the debate between floating and dollarizing is whether the country default risk is high today because of the currency risk and would sharply fall once the country dollarizes. First of all, one thing is clear and self-evident. While dollarization eliminates the currency risk, it does not automatically reduce the country risk; the latter reflects mostly the ability (and willingness) to pay of the government and its private agents. Thus, to a first approximation, it is not affected by the currency risk. If Argentina is insolvent, it will remain insolvent with or without dollarization and will have to restructure/reduces its foreign debt regardless of its choice of the currency regime. And indeed the government is currently attempting this restructuring even while trying to maintain the current peg. Also, it is clear that, while dollarization by definition eliminates the currency risk and the risk of a currency crisis, it neither prevents and avoids debt crises deriving from liquidity runs on banks or rollover runs on the short term government debt. Dollarization also does not eliminate debt crises deriving from excessive debt (insolvency and semi-insolvency debt crises) as the experience of Panama with default and Brady restructurings suggests. So, dollarization does not eliminate liquidity/rollover risk nor insolvency risk. The more sophisticated argument in favor of dollarization suggests that, while country/default risk and rollover risk would not be eliminated with dollarization, it would be significantly reduced if the currency risk is eliminated. The argument goes as follows: the current default risk premium is high (a spread of over 30% on the dollar debt of Argentina in early December 2001) in part because of the currency risk. In fact, if a currency collapse leads to large balance sheet effects and banks/firm/government experience distress because of these balance sheet effects, the country risk will be higher because firms, banks and government with a higher burden of their dollar debts after devaluation are more likely to default. Thus, eliminating the currency risk would also reduce the country risk but reducing the risk of disruptive balance sheet effects. However, this argument is not convincing for a number of reasons: 1. Even if the default risk was partially related to the currency risk, the empirical issue is how much. One can argue that many agents in Argentina, including the government, are borderline insolvent regardless of the currency risk. So, the reduction of country risk is not going to be significant once dollarization occurs and currency risk is eliminated. After all, Ecuador's country spread is still one of the highest among emerging markets (at 15% the third highest after Argentina and Nigeria) even after dollarization and any reduction in this spread relative to its level in the default period has more to do with the economic reforms and better macro policies recently implemented rather than dollarization per se. 2. If, as argued above, balance sheet effect will be large even if Argentina dollarizes at the current parity, the government's real debt burden as well as the one of many other private agents will be large and increasing over time as deflation increased this debt burden and makes the balance sheet effects emerge. Thus, eliminating the currency risk would not eliminate the balance sheet effects deriving from the needed change in relative prices for some agents in the economy. Thus, elimination of the currency risk would not decrease such default risk premia. 3. If the country has structural rigidities, such as labor market rigidities that lead only to a slow reduction in nominal wages after real shocks that require them to fall in nominal and real terms, dollarizing as opposed to moving to a float, would exacerbate the effects of these rigidities and cause an increase in country risk. In other terms, if a real shock requires a fall in real wages and a real depreciation but these occur only slowly, via deflation in a dollarized economy, the negative effect of such rigidities on employment, output and growth may increase the country risk under dollarization. An economy with negative growth or low growth will experience a faster increase in its debt to GDP ratio and an increase in its default risk. So, being stuck in a regime that ensures low long run growth and inability to absorb shocks with a nominal depreciation may lead to a more unsustainable debt path and greater defaults over time.

The above discussion suggests that the frequently arguments that country risk would fall after dollarization because of the elimination of the currency risk are not very convincing. Quite to the contrary, the country risk may actually increase after dollarization.

Capital controls and banking freeze in the move to dollarization Let us consider next the third issue above, whether dollarization at the current parity can restore confidence and prevent the ongoing bank run and attack on the reserves of the central bank. I will argue that strict capital and exchange controls, as well as a broader bank freeze, will have to be maintained to have an orderly restructuring of domestic and foreign claims of the government, firms, banks and households even if the country decided to dollarize at the current parity. The reason is that, at this point, the transition to a dollarized system (even without a final devaluation) will be messy and disorderly as the confidence in the safety of the banking system, convertibility and the peg has been undermined and as economic agents realize that a costly restructuring of the liabilities of the government and of many private agents is unavoidable. First, note the run on the banks is not the result of irrational panic. The asset side of the balance sheet of the domestic banks has lost value in a number of ways while the real cost of bank liabilities has been going up because of: 1. The semi-coercive placing of government bonds on banks balance sheets whose mark-to-market value is falling with the rise of government bonds rates while the domestic debt restructuring imposes interest rate caps on these bank assets. 2. The increase in non-performing loans after three years of a severe recession. 3. The realization that many firms and households that hold dollar liabilities to banks will be severely distressed if a real depreciation occur and will also be distressed if the nominal depreciation will not occur (as the balance sheet effects of the real devaluation via deflation unfold). 4. The mismatch between the currency denomination of assets (where a fraction is still in pesos) and that of liabilities in a situation where agents can (and will soon) instantaneously switch peso deposits into dollar deposits. 5. The increase in the cost of banks liabilities, as overnight rates were surging and peso deposit rates were also surging made inevitable the need to cap the interest rate on peso deposit even if those policy actions undermined the confidence in the banking system.

At the same time that banks' solvency was being undermined, all agents in the non-traded sectors (households holding dollar liabilities such a mortgages and firms in the non traded sector) were also facing increased financial distress as the ongoing change in relative prices (price deflation) was increasing their effective real interest rates and the real burden of their dollar debts. Thus, the growing concern that widespread bankruptcies would become unavoidable. Finally, at the government level an already high debt burden and the failure to reduce fiscal deficit to levels compatible with a sustainable debt dynamics was leading to the need to restructure debt obligations on coercive terms. Also, the currency board was becoming increasingly unsustainable and not credible given all the external shocks hitting the economy and the policy mistakes that increasingly undermined its credibility. Thus, the increasing loss of forex reserves as domestic and foreign agents started to hedge to cover their currency exposure. At the end only drastic capital controls and a freeze on bank liabilities may prevent a financial meltdown and a twin currency and banking crisis. But, even if the current turmoil will lead the authorities to move to dollarization without a devaluation, the damage to the balance sheets of most economic agents is already severe and the confidence in the domestic financial system seriously undermined. Also, dollarizing without devaluing will not solve the competitiveness problem while not preventing the balance sheet effects of the ongoing real depreciation via price deflation from taking place. All these vulnerabilities that undermined investors confidence imply that extensive capital controls and restrictions on bank liabilities will be necessary even if the dollarization option will be chosen.

Does Argentina satisfy the criteria for dollarization? No The final issues in discussing the arguments for dollarization is whether Argentina satisfies the traditional and non-traditional criteria to assess whether dollarization makes sense from a long run perspective (see the second part of this paper for a more detailed discussion of such criteria). These criteria are useful to assess whether dollarization would be optimal in the long run (compared to the alternative of a float) regardless of whether a final devaluation before dollarization occurs. In summary, it does not seem that Argentina makes an overall good case for dollarization from a long-run perspective. Consider the following shortcomings of dollarization. First, the Argentinean business cycle is not highly correlated with the U.S. one as the country is mostly a producer and exporter of commodities and raw materials. Indeed, the Fed sharp monetary tightening in the 1999-2000 period, at the time when the US was growing very fast while Argentina was in a recession, shows how inappropriate it may be for Argentina to adopt the monetary policies of the U.S.. Second, Argentina is a closed economy that trades very little with the US. Its export to GDP ratios is barely above 10% and only about a quarter of its exports go to the U.S.. While trade liberalization, FTAA and/or bilateral trade expanding agreements with the U.S. may increase over time its trade integration with the U.S. this will occur only slowly over the long run. Third, dollarizing will imply that the exchange rate of the Argentina (its nominal and real exchange rate) will be tied to the U.S. dollar; if the dollar keeps on strengthening relative to the Euro and the Yen, further losses of competitiveness of Argentina relative to these trading areas will ensue. Also, if as likely, most Latin American economies maintain flexible exchange rates and their currencies depreciate over time relative to the US dollar, further losses of competitiveness of Argentina's traded goods sectors compared to its regional partners will result. Already the sharp fall of the Brazilian peso this year, on top of the 1999 depreciation, and of other Latin American currencies has lead to further nominal and real appreciation of the Argentine peso relative to these currencies and to severe stress on the Mercosur free trade arrangements. Such divergence of relative prices may occur in the long run if these currencies remain on a float while Argentina dollarizes. Fourth, Argentina will keep on being buffeted over time by real external and domestic shocks that require a real depreciation; for example, terms of trade shocks. If such depreciation cannot be achieved via a nominal depreciation because of dollarization, it will have to be achieved via painful domestic price and wage deflation. Fifth, Argentina's labor markets are rigid and nominal wages are downward inflexible in the short run. Thus, any real shock requiring a fall in real wages may cause instead unemployment and low growth if real wages cannot be reduced via a nominal depreciation. Hong Kong was able to absorb the 1998 overvaluation shock by reducing rapidly nominal wages in a very flexible labor market and thus restore growth by 1999. Argentina, instead, has been stuck in a recession for three years now. Sixth, while room for independent monetary policy is limited in emerging markets in general and heavily dollarized economies in particular, this does not mean that Argentina would have no flexibility to use monetary policy to partially absorb shocks that require a real depreciation. Using monetary policy to allow a nominal and real depreciation under a float may be necessary and useful to dampen the real output effects of such shocks, While liability dollarization further constraints the autonomy of monetary policy, as long as real wages are not downward inflexible, monetary policy can be used to allow a nominal and real depreciation and stimulate demand and output. At the same time, as in many other emerging market economies, inflation credibility can be maintained through alternative monetary regimes such as a formal inflation-targeting regime. Seventh, the fiscal position of the country is still severely imbalanced and the debt situation unsustainable. Thus, dollarization may not prevent further debt and rollover crises. Eight, the soundness of the banking system is by now undermined (see the discussion above) while, at the same time, dollarization will further limit the ability of the central bank to provide lender of last support to the banking system. While such support is limited even under flexible exchange rates in emerging markets as liquidity injections may lead to sharp capital flight and currency depreciation, the loss of all forex reserves in the passage to dollarization is a further loss of lender of last support resources that is specific to dollarized economies. How will lender of last resort (LOLR) support will be provided in a dollarized economy? This is not clear. Panama prides itself for not having any LOLR facility but the country is an international financial center, most of its banks are foreign owned and the IMF has been effectively providing support to the country as Panama has been the most assiduous client of the IMF for the last 25 years (over 12 IMF programs). In Ecuador, that recently dollarized, most of the banking system is still insolvent and in the hands of the government while the recapitalization of the banks has not fully occurred yet. Also, the issue of how to pay for the implicit liabilities to the government from the losses incurred by the Ecuadorian banking system has not been solved yet. And there are no meaningful lender of last resort resource today. Finally, limiting future government liabilities via partial and market priced deposit insurance may not prevent future bank runs. Ninth, the amount of labor mobility between Argentina and the US is very limited as there is no free and unrestricted migration. And the amount of implicit fiscal federalism deriving from workers' remittances (important for many central American economies) is absent in the case of Argentina. Finally, the loss of seignorage deriving from dollarization, while not being huge is not economically insignificant as it amounts to about 0.5% of GDP per year. On the positive side, Argentina satisfies some of the non-traditional criteria for optimal dollarization. First, the economy is already partially dollarized; so moving to full dollarization will be relatively easy. Second, Argentina has already a currency board with all the costs of the lack of monetary independence while paying the costs of the partial credibility of the currency board peg. Thus, giving up altogether monetary autonomy with dollarization will imply small marginal costs relative to the current regime of a currency board. Third, given its history of poor monetary credibility and high inflation as well as liability dollarization, Argentina has very limited monetary policy autonomy. So, at the margin the full loss of monetary autonomy would be relatively small while the benefits of low inflation would be permanently locked in. Fourth, dollarization may force the political system to undertake the macro and structural reforms required for dollarization to succeed. But the dollarization straitjacket (as Ulysses tied to the mast to resist the lure of the Sirens' song) may or may not incentives the necessary economic reforms. For example, Panama has been fiscally irresponsible for decades, in spite of the dollarization straitjacket, eventually defaulted on its foreign debt and has permanently relied on the financial IMF life support. Fifth, Argentina does have enough gross forex reserves so far to dollarize if it wishes to do so. But given the amount of foreign liabilities owed to the IMF, net international reserves are lower and net reserves may not be sufficient to allow dollarization unless a final devaluation is engineered before the dollarization. Finally, large sections of Argentina's population may support dollarization; thus, there is significant political support for dollarization. Considering both pros and cons, a careful assessment suggests that the cons dominate the pros and that Argentina does not make a good candidate for successful dollarization from a long run perspective. This suggests that Argentina may be better off by floating its currency; it would then have to avoid currency overshooting and ensure monetary stability and low inflation via inflation targeting and the choice of a credible, independent and conservative central banker. The risks of a float are high, especially in the short run; they are the possible return to high inflation and disorderly balance sheet effects if the nominal and real exchange rates overshoot. But dollarization may be a more risky long-run strategy, even with a final devaluation before dollarization. Some may argue that even Ecuador did not make an obvious case for dollarization as its fiscal balances were in shambles, its debt unsustainable, it banks bankrupt and other dollarization criteria not satisfied. And some argue that, in spite of not satisfying these formal criteria for dollarization, dollarization has be so far a success in Ecuador. But the jury on whether dollarization will be successful in the long run in Ecuador is still out. Fiscal conditions have improved but not enough; positive terms of trade shocks, such as the increase in the price of oil until recently as well as new production and distribution of oil via a new pipeline have improved the country prospects; the country defaulted on its foreign debt and reduced the principal value of its foreign debt but, in spite of that, the foreign debt to GDP ratio is still close to 100%; financial conditions in the banking system have improved, the bank deposits freeze has been phased out but the financial system still remains very fragile, many banks are still under government control, the bank recapitalization still to be finished (and the resources to finance it not yet found) and the issue of how to provide lender of last support under dollarization is still unresolved; finally, significant IMF and other multilateral support to Ecuador has significantly helped to finance the transition to dollarization. Thus, the relative improvement in Ecuador's conditions in the last year does not yet prove that this is a successful case of dollarization. And any inferences from Ecuador to Argentina would be a matter of speculative guesswork.

Need for sound monetary and fiscal policies and structural reforms regardless of the currency regimes and the amount of debt restructuring Regardless of the new currency regime and the amount of debt restructuring/reduction, radical economic reforms will have to be undertaken to ensure long run fiscal discipline, openness to trade and structural changes that ensure changes in the functioning of the state and a greater structural flexibility of the economy. A better currency regime may help and debt restructuring may help to reduce the burden of foreign debt but, unless the political system is able to ensure sound money, sound fiscal balances and structural reforms that open the economy and provide the necessary efficiency and flexibility of the economy, any monetary regime will be bound to fail and recurrent financial and debt crises may occur.

It is better to float in Argentina Subject to the above caveat that sound macro and structural policies are necessary in any regime, overall a move to a float makes more sense than dollarization for Argentina. The risk of overshooting and high inflation may be limited with an alternative monetary regime (inflation targeting) while the balance sheet effects of the real depreciation can be addressed through a larger writedown of sovereign debt and a selective writedown of some private debt. Some monetary autonomy, however restricted, will be maintained under a float and the nominal exchange rate adjustment will allow a change in real exchange rates when internal and external shocks require it.