Monetary Regime and Exchange Rate Policy: Lessons from the Argentinean Experience

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"Argentina is condemned to insignificance, probably for ever"
Hans Tietmeyer, 9-17-2002[1]

"Argentina's recovery is under way"
Joseph Stiglitz, 9-20-2002[2]

The quotes by Hans Tietmeyer and Joseph Stiglitz reflect very different opinions on the Argentine situation in September 2002. It is as if they were looking at two different realities. How can it happen that two top-level experts have so different opinions on the same economy, at the same time? The reason, I believe, is that while Tietmeyer was focusing his attention on the change of **Monetary Regime** that took place at the beginning of 2002, Stiglitz based his comment on the change in **Exchange Rate Policy**.

A balanced evaluation of the Argentinean Crisis that had its peak during the first semester of 2002 requires looking at both, the change of Monetary Regime and the change in Exchange Rate Policy that took place simultaneously. In this paper, I will look at the Argentinean experience in the broader context of the discussion on monetary regimes and exchange rate policies in emerging economies.

Exchange Rate Policy

The discussions on Exchange Rate Policy in emerging economies tour around the evaluation of advantages and disadvantages of fix versus flexible exchange rates. The advantages and disadvantages of different exchange rate policies come from looking at the effect of the exchange rate on the domestic prices of goods and services. When the main problem is inflation, most of the attention goes into the general level of prices. When the main problem is competitiveness, attention shifts toward the effect of the exchange rate on the relative price of tradable versus non-tradable goods and services. It is then natural that when the target is to curb inflation the preference goes in favor of a

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fix exchange rate regime while when the goal is to restore competitiveness the preference shifts towards flexible exchange rates.

Unfortunately, the change in exchange rate policy once an economy has solved its inflationary problem but faces a competitiveness crisis, is most of the time very traumatic. The entire monetary and financial crises since 1990 occurred because of the shift from a fix to a flexible exchange rate policy. The severity of these crises and their consequences on future economic growth depend upon the degree of destruction of financial wealth that they produce, as well as their effects on the property rights of the savers who invested their savings in that particular economy.

The Crisis in Argentina at the beginning of 2002 was particularly severe and it may significantly deteriorate the prospects of growth, because it provoked a terrible destruction of both financial wealth and property rights of savers. These side effects were not so much the consequence of the change in the Exchange Rate Policy, but much more the consequence of the dismantling of the Monetary Regime of the 90's. By the year 2001, Argentina could, and very likely had to, change its Exchange Rate Policy, but it should have never done it by destroying the Monetary Regime that had allowed conquering stability and growth during the 90's.

The choice of the Monetary Regime

For any country, the choice of its Monetary Regime is an institutional decision of higher hierarchy than the decision on the Exchange Rate Policy.

A Monetary Regime is an essential part of the institutional base of an economy. If an emerging economy is unable to create a good currency regime, it will thus lack financial and capital markets that are essential for the financing of productive investment. With those limitations, it will be difficult for such an economy to achieve, simultaneously, stability and growth.

A good Monetary Regime has to provide at least one currency to fulfill, efficiently, the following roles: a means of exchange for every kind of market transaction (spot, future, domestic, foreign) and a store of value. No doubt, the best currency regime for a national economy is that of the US today or that of the UK at the time of the British Empire. The Dollar today as the Sterling prior to the First World War is a global currency accepted worldwide for every kind of transaction and considered a secure store of value. Nowadays, only Europe, as a Monetary Union and eventually Japan if it finally decided to internationalize the Yen, are in a position to create such a Monetary Regime. In the three cases, the currency allows for the existence of spot and future markets of every imaginable kind, while long-term interest rates are close to some concept of a "natural rate," reflecting long term expectations of price stability.

The monetary institutions that different countries have adopted relate to their experience. Countries with a long history of price stability and responsible monetary policy have convertible national fiat currencies managed by independent monetary authorities and floating exchange rates.

Monetary Institutions in Emerging Economies

Countries that suffered inflationary processes encounter difficulties to build monetary institutions that will be trusted. To overcome these difficulties these countries have tried different institutional arrangements. The participation in an expanded monetary area is the best example. Countries like Italy, Spain, Greece and Portugal could remove the inflationary expectations from interest rates by joining the Euro; hence, they were able to benefit from a trustable currency and stable monetary institutions.

Nowadays, countries that are eligible to become members of the European Union enjoy the prospect of joining the euro. But this is not the case for emerging economies that do most of their foreign trade with the US or Japan, because neither of these two leading nations have demonstrated any intention of having their national currency regimes evolve into larger Monetary Unions. In an ideal world, a good way to move in the direction of building a better International Monetary System, one that would increase the prospects of stability and growth for the global economy, would be to have the US and Japan demonstrate willingness to use their currencies as the base for enlarged monetary unions. In such a case, their developing country commercial partners would have the possibility of adopting the best possible currency regime. However, so far, there are no signals that the US and Japan like this idea.

Not having the possibility of joining a monetary union, the second best Monetary Regime for emerging economies would involve the use of a domestic currency different from those used in foreign transactions, or simply the adoption of the Dollar, the Euro or the Yen for domestic transactions. Countries will find significant advantages in using one of the three foreign currencies for domestic transactions if two conditions apply: they have large amounts of trade with one of the three monetary areas and a long history of inflation has prevented the creation of future markets and long term financial contracts. Foreign currencies will free national economies of inflationary expectations and will allow the (immediate) creation of future markets that could not exist in an inflationary environment.

This means that the long-term interest rate will be much lower than otherwise. The difficulty that these emerging economies may face when they adopt a foreign currency relates to the inexistence of a central bank that may act as a lender of last resort. However, this might not be relevant in a context where monetary institutions are not credible enough, because in such scenario the chances of the central bank to provide lending of last resort would be very limited. Amidst a financial crisis, there is only demand for foreign currency, while increased supply of the domestic one only feeds hyperinflation. This explains why Panama, Ecuador and El Salvador have already adopted the Dollar as their currency, and why most of the economies in Central America and the Caribbean will very likely pursue the same course in the future.

When the second best Monetary Regime includes a domestic currency, the economy has to define two main features: the degree of convertibility between the domestic and the foreign currency, and the degree of flexibility of the rate of exchange. If experience allows a particular emerging economy to have a currency-regime that combines the maximum of convertibility with the maximum of exchange rate flexibility, then there is no doubt that the economy should choose full convertibility and a free float for the national currency. The UK, Switzerland, Canada, Australia, New Zealand, Singapore and a few other economies chose that path long ago.

Convertibility vs. Flexibility

The typical dilemma for an emerging economy that has had a long experience of persistent inflation, and even worse, hyperinflation is how to deal with the trade off between convertibility of the domestic currency and flexibility of the exchange rate.

The degree of convertibility needs to be somewhat restricted so that the Central Bank has some capacity to conduct an independent monetary policy through the flexibility of the exchange rate. Otherwise, everybody would use the foreign currency for most domestic transactions, particularly those involving long-term contracts. The typical restriction to convertibility involves prohibiting financial institutions from accepting foreign currency deposits from residents and prohibiting them from lending domestically in the foreign currency. As this limitation to convertibility may generate the flight of domestic savings in highly inflationary economies, some additional restrictions to transfer funds abroad normally accompany that prohibition.

These restrictions may impose significant distortions on the economy, particularly if residents interpret them as the government leaving the door open for the imposition of a future capital levy through sudden devaluation and inflation. These distortions will generate high long-term interest rates or, simply, the inexistence of long-term savings and financing. That is why some emerging economies may prefer, at least for a while, to sacrifice exchange rate flexibility but to grant full convertibility to their domestic currency by managing it through a currency board. This was the case of most economies in the world between 1870 and 1930, at the time of the Gold Standard, as well as Malaysia and Singapore immediately after independence, Argentina from 1991 until the end of 2001, and Hong Kong from 1983 to the present.

In sacrificing exchange rate flexibility in favor of full convertibility, the challenge is to minimize the risks of ending up in a catastrophe of the sort suffered by countries participating in the Gold Standard in the thirties and Argentina in 2002. The emerging economies that choose full convertibility should exit the fixed exchange rate as soon as a persistent inflow of foreign capital calls for an appreciation of the domestic currency. Such a persistent inflow is an indicator that the economy is ready to combine full convertibility of the currency with free floating of the exchange rate. This is what Singapore did in the early nineteen seventies.

Emerging economies that have had a history of inflation but consider it too risky to sacrifice exchange rate flexibility, particularly those that are prone to suffer severe external shocks, will probably try other institutional tools rather than full convertibility, in order to lower long-term interest rates and encourage medium and long-term savings and financing. Chile, and to some extent Brazil and Mexico, have successfully used financial indexation as an alternative to full convertibility. However, whatever the mechanism used to remove the distortions created by lack of full convertibility, crises will be unavoidable if there is not enough fiscal discipline in emerging economies that have a long history of inflation.

Recent Argentinean experience

In Argentina, the Convertibility Law characterized the decade of the 90's.[3] This law secured a right that Argentineans demanded: the right to use foreign currencies, in particular the US dollar, to protect their savings and to sign medium and long-term contracts.

The Convertibility Law originated as Common Law in a country with Napoleonic Law tradition. Indeed, this law owed its initial popularity to the fact that it ruled according to the already established customs of the people. [4], [5]

Many scholars interpreted that the Convertibility Law fixed the Peso to the US Dollar, and therefore they frequently referred to the convertibility Law as a "Currency Board".

I explained in several occasions that the fixing was only temporary.[6] The Convertibility Law set a cap to the exchange rate pesos per dollars but it did not set a floor. Consequently, the peso could have floated and appreciated at times of strong capital inflows. This characteristic created a natural exit mechanism from the fixed exchange rate regime, without abandoning the convertibility system and, at the same time, maintaining the enforceability of contracts made in foreign currencies.

In fact, in 1997, when Argentina had overcome the Tequila Crisis and was growing vigorously, the Peso should have begun to float. At that time, the outcome would have been an appreciation of the domestic currency, and, Congress could have eliminated the ceiling (1 to 1) without introducing any noise. For the astonishment of all of those who confused the convertibility with a fixed exchange rate system, Argentina would have had convertibility with floating exchange rate, as they have it in most advanced economies including Euroland, Canada, Australia, Great Britain and Singapore. The case of Singapore is particularly interesting because it dropped the fixed exchange rate without eliminating the convertibility, precisely through the flotation, at a time that the Singaporean currency needed to appreciate vis-à-vis the Sterling Pound.

Why Argentina did not let the Peso to float in 1997 when that would have eliminated the Damocles' Sword of a traumatic devaluation? The reason is political. By 1997, the rivalry between Menem and Duhalde for the presidential candidacy of the Justicialist Party 1999 had already unraveled. Both decided to use the provincial public expenditure as a tool to win the candidacy. The appreciation of the Peso would have stopped the inflow of short-term capital and, therefore, financing the growing provincial expenditure would have become more difficult. Instead of focusing on consolidating the monetary system that had given back trust to Argentineans, the Government facilitated the financing of increasing fiscal deficits in the provinces. This created a problem of excessive and costly indebtness that made the fixed exchange rate unsustainable and, at the end, destroyed convertibility.

To summarize, the convertibility and not the fixed exchange rate was the important and permanent necessary tool of the Argentinean economy. What was important for the correct functioning of the economy was the freedom of choosing currencies. During the initial phase, the Currency Board that backed all pesos with dollars at a fixed exchange rate was necessary to recuperate people's confidence in the Peso. However, when capital inflows became large, the Currency Board became unnecessary since the Peso could have become a trustable currency due to responsible management of an independent Central Bank. Unfortunately, this opportunity of having convertibility without fixed exchange rate was lost in 1997 and after the Russian and Brazilian crisis it did not resurrect.

However, why regretting on the loss of the convertibility system? Why was important for Argentineans the use of foreign currencies in medium and long-term contracts? Why the Government does not obligate Argentineans to save in their national currency? The answer to these questions is the clue to understand what happened and what is happening in the Argentinean economy. It is also clue to understand how Argentina can achieve again sustainable economic growth.

Convertibility and Investment of the Nineties

The most important effect of the Convertibility Law, in addition to eliminating inflation, was to foster investment. For the first time in many years, national savings channeled towards investment through the financial system. This had not happened before because saving and lending in foreign currency was forbidden or severely restricted.

When foreign investors realized that Argentineans were investing in their own country, they started to evaluate direct and financial investments that were not previously in their plans. This process was encouraged by a deep deregulation of the economy and the privatization of inefficient state owned corporations. The deregulation and the privatization process created investment opportunities for the private sector that until that moment did not exist.

Annual Investment per capita (in US dollars at 1995 constant prices)		
Decade	80s	90s

Argentina	1,134	1,421
Brazil	843	909

Source: IMF-IFC CD-ROM. 2002 World Development Indicators CD-ROM, World Bank.

The largest investments went into the energy, transportation, communications, storage and commercialization, financial services, mining, agriculture and manufacturing sectors. All the indicators of level and quality of services and goods reflected the strong increase in investment. That would not have happened if the Convertibility Law had not protected property rights.

The comparison between the average annual per capita investment in constant 1995 US dollars in Argentina and Brazil demonstrates that the increase in investment was higher in Argentina. In spite of Plan Real, financial intermediation in Brazil continued along the lines of the previous decades and, therefore, there was not significant increase in the availability of domestic and foreign financing for investment.

Productivity and Growth

GDP growth was higher in Argentina during the decade of the 1990s than in the 80's not only because investment was higher, but also because productivity increased much more than in previous decades. This difference comes from the fact that the new investment took place in a context of opening the economy to international trade, deregulation and privatizations.

Growth accounting exercise[7]

Argentina	**1970 - 1990**	**1990 – 1998**
Average annual GDP growth	0.7	6.3
Average annual capital stock growth[8]	0.9	0.6
Average annual labor force growth[9]	0.9	1.4
Average annual total factor productivity growth[10]	-1.1	4.3

Brazil		
Average annual GDP growth	4.9	2.7
Average annual capital stock growth	1.9	0.8
Average annual labor force growth	2.2	1.3
Average annual total factor productivity growth	0.8	0.6

Source: IMF-IFC CD-ROM. 2002 World Development Indicators CD-ROM, World Bank.

The table above shows that, during the 1990s, productivity growth turned positive, and significantly so, in Argentina. On the other hand, in Brazil, during the 1990s productivity growth was lower than for the average of the previous decades. These figures suggest that the key to explain economic growth in Argentina during the 1990s is the growth in total factor productivity.

The opening of the economy would have been not possible without the credit expansion allowed by the Convertibility. Without such credit increase, the agriculture and manufacturing sectors could not have invested in new capital and technologies and without these investments, the competition with foreign economies would have been impossible.

Privatizations were possible because the Convertibility Law authorized medium and long-term contracts in foreign currency. With the long inflationary experience of Argentina and with so many distortions created by the combination of indexation and price controls it would have been impossible to sign concession contracts with 30 years terms without the Convertibility Law. The deregulation that eliminated restrictions to competition was possible only in a context of price stability. Under high inflation, the competition would have been more than imperfect and many markets would not have existed. Convertibility was crucial to restore stability after the hyperinflation process of the late 80s.

GDP and Exports by decades		
Decade	80s	90s

Average annual GDP growth rates (Constant prices)		
Argentina	-1.5	4.6
Brazil	1.5	2.7
Average annual Export growth rates (Current US$)		
Argentina	4.4	7.9
Brazil	4.5	5.8

Source: IMF-IFC CD-ROM. 2002 World Development Indicators CD-ROM, World Bank.

In summary, the increase in investment, as well as productivity growth were a consequence of the convertibility system, and investment and productivity growth explain why Argentina's economy performed so well in the past decade. The table above compares GDP growth and export performance during the 1990s in Brazil and Argentina. Evidently, during the 1990s the historical trend towards declining GDP and Export growth reverted into rapid growth.

The causes of the recession that started in mid '98

Inflation disappeared and the Argentine economy grew fast during the 1990s. However, the economy entered into a recession by mid 1998, and since then, it has not found its way out. Is the convertibility system responsible for this recession? The answer to this question requires an analysis of the relationship between convertibility, fixed exchange rate and fiscal deficits.

The recession that started in 1998 had its origin in the significant expansion of provincial expenditures financed by local banks. This policy characterized the 1997-1998 period when Eduardo Duhalde, current President and then Governor of the Province of Buenos Aires, competed with the former President Carlos Menem for the candidacy of the Justicialist Party for the next presidential election. The huge assistance provided by the banks to the provinces crowded out the credit for the private sector. This phenomenon increased after the Russian crisis when the influx of capitals to the emerging economies started to decrease.

The recession became more severe and less manageable because of the devaluation of the Real in February of 1999 and the sustained depreciation of the Euro between 1999 and the middle of 2001. The fixed exchange rate to the dollar did not allow the peso to depreciate, as it would have happened in a floating exchange rate system. Consequently, a deflation, imperative to reestablish long-term equilibrium of the relative prices between exportable and non-tradable goods, aggravated the recession.

An alternative to soften the deflationary impact of the depreciation of the Euro and the Real would have been to adopt beginning on January 1999 the Dollar-Euro standard instead of the original Dollar standard created by the convertibility. The authority ignored this possibility by that time in a similar way in which they ignored the possibility of floating by 1997. Only two years after, in March of 2001, the Ministry of Economy proposed and obtained the approval from Congress to change from the Dollar standard to the Dollar-Euro standards. However, the economy had already suffered the deflationary effects of the strong devaluation of the Real.

In summary, the fiscal deficit originated in the expansion of the provincial expenditure and the fixed exchange rate between the peso and the dollar explains the recession and deflation that the Argentine economy has suffered since mid 1998. Was the abandonment of the convertibility necessary to get out of the recession? Our answer is no. On the contrary, we believe that abandoning the convertibility to end the recession was like demolishing a house to unblock a pipe. The right approach to find a way to eliminate the fiscal deficit and correct the relative prices without affecting the protection that the convertibility offered to the property rights of savers and investors.

The elimination of the fiscal deficit required the reduction of salaries in the public sector jointly with a restructuring of the public debt that would imply a strong reduction in interest payments, especially at the provincial level. With convertibility, and consequently, without destroying the system of financial intermediation based on foreign currency, it was easier to obtain the reduction in salaries in the public sector and the interest payments, because the maintenance of a monetary and institutional stability, would have allowed an ordered management of both processes.

In fact, the Congress passed a law that allowed the reduction of nominal salaries in the public sector and, if convertibility had continued, the Supreme Court would have backed these decisions, in a similar way as it did with other salary reductions decided in previous years. The banks, pension funds and local holders of Argentine bonds responded positively to the proposal to exchange for guaranteed loans (with lower interest rates and longer terms} the old bonds. This exchange allowed the restructuring of US$ 55 billion of public debt and saved 4 billion of interest per year. This shows that with convertibility it could have been possible to finish an ordered process of debt restructuring. In fact, the exchange of bonds for guaranteed loans gave the government the voting power necessary to impose the so called “exit consent clauses” on the old bond contracts to discourage the non participation in the coming exchange of bonds held by foreigners.

The correction of the distortion in relative prices would have come from persevering in the elimination of distorting taxes, insisting with the Dollar-Euro standard and progressively moving towards flotation once restructured the debt and balanced the budget. These circumstances would have existed by the beginning of 2002 if the institutional coup of December 20, 2001 had not occurred.

The destruction of the convertibility by the combination of devaluation, generalized reprogramming of deposits in the financial system, pesification of contracts, default of the internal debt already restructured and ulterior flotation of the peso implied the demolition of the institutional and contractual base of the economy and a generalized violation of property rights. Far from facilitating the fiscal balance, it made it more difficult to achieve due to the pressure towards the increase of public expenditure originated in the devaluation and the additional fall of economic activity following the collapse of domestic demand.

Prices of exportable goods went up and relative prices reversed, the exchange rate misalignment was larger than before, but in the opposite direction. The credit crunch and the difficulties for importing goods did not allow a positive response of exports. Import substitution was encouraged by the large devaluation but it could turn out to be inefficient and unsustainable under normal conditions. Simultaneously, the fall of domestic demand has been so large that the outcome is a deepening of the recession never seen before in Argentina's history.

The political discussion on unemployment and poverty

In the years that followed the implementation of the convertibility system, Argentina's GDP grew by more than 10 per cent per year. Statistics showed a substantial reduction in the unemployment rate. Furthermore, the significant fall in the inflation rate contributed to a sharp decline in poverty. However, these trends started to change in 1993 and 1995 for unemployment and poverty respectively. Since then, both problems have shown a firm tendency to grow.

The discussion about the strategy to address these problems extended all through the 1990s. Those economists, like me, who were persuaded that the opening and deregulation of the economy, the privatization policies, and the protection of property rights were the best instruments to ensure sustainable economic growth, insisted that labor, tax and welfare system reforms were necessary. This was a key factor to allow the growth in GDP to continue while allowing a reduction in the rate of unemployment and poverty. As far as labor deregulation is concerned, we insisted to have more flexible employment contracts. Regarding taxation, we proposed and started to eliminate payroll taxes and other distorting taxes. Regarding the welfare system, we demanded that provincial governments should conduct social policies in a less biased and more efficient way, especially in the fields of education, health care and social aid.

However, some other national leaders started to lobby for a "change of rules" referring to the economic reforms implemented in Argentina throughout the 1990s as "the neo-liberal model". According to them, such policies had triggered the rise in unemployment and poverty. Consequently, only "changing the neo-liberal model" could reverse the negative trends of the last half of 1990s. That meant, by destroying the economic reforms. It was necessary to revoke the Convertibility Law that had became the epitome of "neo-liberal reforms". The strongest advocates of this idea were Eduardo Duhalde (Justicialist Party) and Raúl Alfonsín (Radical Party). Neither Alfonsín nor

Duhalde had won in the election process in which they proposed the abandonment of the convertibility. Still, they thought that the evolution of economic and social events during 2001 proved them were right. Therefore, when Duhalde came into office with Alfonsín's support, he was convinced that his mission was to repeal the Convertibility Law and to "change the neo-liberal model". They both expected that this would bring down unemployment and poverty rates.

The professional discussion about the public debt and the currency regime

While the political arena showed different standpoints regarding the diagnosis of the problem and the strategy to fight unemployment and poverty, professional economists discussed about the sustainability of the public debt and the currency board system.
The strongly opposing views about these issues congregated into two distinct groups. On the one hand, there were those who supported dollarization arguing that adopting the US dollar as the only currency, the fiscal discipline would be enough to ensure the payment of the debt. On the other hand, there were those who recommended floating the currency. Most of them thought that Argentina should default on its debt and restructure it compulsively. The former group emphasized that by maintaining monetary stability and servicing the debt confidence would return and interest rates would decrease, enabling the economy to recover. The latter group considered that unless relative prices of tradable goods increased, the economy would continue to be stagnant and the country would no longer be able to serve its debt.

I shared most of the views held by the proponent of the flotation of the Peso. However, I was also persuaded, as the supporters of dollarization, that if property rights of those who had trusted in the country and saved locally were severely affected by a devaluation, economic growth would not resume, no matter how rapidly and firmly were relative prices adjusted in favor of exports. For that reason, I tried to find a balance between both positions. I tried to apply all possible non-monetary resources to correct relative prices, without violating convertibility. Regarding the exchange rate policy, the plan was to move into a more flexible system once the reduction of interests obtained after restructuring the debt in an ordered manner would have balanced the budget.

Instead of forcing a change in the currency of the contracts, towards either dollarization or pesofication, the government wanted to preserve people's freedom to choose between the Argentine Peso and the US dollar for their transactions. Unfortunately, this idea lacked an adequate professional support, possibly because both pesification and dollarization advocates were focused mainly on a debate about the exchange rate regime –currency board system versus floating exchange rate system- rather than on the monetary regime and the protection of property rights. The Convertibility Law had provided the monetary system people demanded and, under the proper fiscal conditions, it was perfectly compatible with the two different exchange rate regimes or even with any other intermediate alternative.

An unfortunate tactical coincidence

On November 1, 2001, I announced the two-phase restructuring scheme for the public debt. Unfortunate, the political leaders who wanted to "change the economic model" and the economists and entrepreneurs who favored a devaluation allied to work against the orderly restructuring. Some of the major media groups subscribed to the ideas of this virtual "tactical alliance", since they thought that abandoning convertibility through devaluation would be a way of reducing their excessive indebtedness. Such strategic coalition tried to gather support from both public and private debtors. After all, they would all end in simultaneous and generalized default, which would lead to a substantial reduction in the real value of debts.

However, the national leaders, economists and entrepreneurs who supported the tactical alliance failed to see that creditors were not just "foreign financial investors" but also actually millions of savers who had trusted in the Argentine financial system and millions of workers who contribute to the pension system for their future retirement. Measures such as the compulsorily rescheduling of deposits, the pesofication of contracts originally written in US dollars and the devaluation of the peso would drastically affect property rights. They would therefore discourage investment and the purchase of durable goods; furthermore they would create a sense of legal uncertainty, that would lead to a virtual paralysis of the financial system and consequently to the saving and investment mechanism.

A further rise in unemployment and poverty

The measures carried out by Eduardo Duhalde's administration -supported by Raúl Alfonsín[11]- since January 2002 has extremely exacerbated the recession. This is the reason why unemployment and poverty have risen so critically. Was this situation predictable?

It certainly was. For that reason, those of us who were in charge of governing the country spent all the year 2001 struggling to avoid the default on the debt and the devaluation of the peso[12]. However, was there any better alternative than the one eventually applied? Was not the default and currency crisis inevitable for Argentina? Furthermore, had not this already occurred on December 1, 2001 when the government imposed restrictions on cashing bank deposits?

The alternative was to continue eliminating the fiscal deficit by forcing the provinces to reduce salaries in the same way that the Federal Government did in July 2001 and by cutting interest payment on public debt and by deferring capital maturity dates. This alternative certainly implied some degree of compulsiveness and rescheduling plans, the reduction of financial repayments. However, it was necessary to minimize the negative impact on the property rights of savers, investors and workers.

To halt the critical run on the financial system, some temporary restrictions on cash withdrawal of deposits –which became known as *corralito*- had to be implemented on December 1, 2001. This implied only a temporary control on transactions in foreign currencies, similar to the ones imposed by several countries between 1870 and 1930 via a measure called "suspension of convertibility". The *corralito* was a mere curb on cash withdrawals and financial transfers abroad. In fact, deposits did not lose their value and savers could use their funds to make payments within the country using debit cards, checks and inter account bank transfers. Furthermore, these methods of payment actually helped to improve tax administration. Far from aiming at a default on the debt or the termination of convertibility, the corralito focused on preserving the value and availability of savings while the government implemented the debt restructuring process and the national and provincial fiscal consolidation.

Why did Eduardo Duhalde's administration, backed by Raúl Alfonsín, take such a wrong path? My answer is that the professional discussion among the economists and the lobby of heavily indebted media groups misled them to such an extent that they truly believed that they were implementing "the change" that would lead to recovery of the economy, and would ease poverty and unemployment. In this paper, I would like to emphasize the role of professional economists as contributors to the confusion of national leaders.

"Right Prices" versus "Property rights"

Those who pointed out the recessive effects caused by the divergence between the prices of tradable goods and non-tradable ones recommended the replacement of the currency board regime by a free-floating exchange system. They thought that by setting prices rightly, the economy would recover through an increase in the production of exportable goods and the substitution of import[13]. However, they did not realize that the adjustment of relative prices via the destruction of the convertibility system would affect property rights in such a way that medium and long-term contracts would become highly unfeasible and saving inside the country as well as investment would almost disappear.

At the same time, those who supported the defense of savers and financial investors' property rights would be critical with any government action tending to correct relative prices without abandoning convertibility.[14] In this context, it is understandable that national leaders such as Duhalde and Alfonsín, who had always favored a "change of the neo-liberal economic model", considered that this was a good moment to reverse the economic reforms applied.

The future

The destruction of the convertibility system put an end to the free selection of currency and to the system that assured the respect of the original currency of the contracts. The change of conditions will surely discourage investment and productivity, two key factors for sustainable growth. Difficulties to fund investment will limit economic recovery through the promotion of exports and import substitution.

The forecast can turn more optimistic if the following issues are addressed:

1. The Supreme Court restores the Rule of Law declaring the pesofication unconstitutional.

2. The new government commits itself to rebuild the necessary conditions to attract new investment and to foster productivity, as was the case during most of the 90s.

3. Welfare policies eradicate corruption, favoritism and inefficiency and investment in human capital reaches the poor.

Without any doubt, a challenge for the Argentineans and for their national leaders is daunting. Professional economists can help to find a solution. They have to realize that the strategy to promote exports cannot go against property rights of savers, investors and workers.

The contribution of economists to Argentina's institutional and moral recovery should turn to rules and institutions capable of regaining the balance of relative prices in a way that does not violate property rights. Unfortunately, this is not the advice International Financial Institutions give to emerging economies since 2001.

The opinion of the International Financial Institutions

The opinion of International Financial Institutions and the economic profession on the merits and pitfalls of the monetary arrangements has been changing.

Since the Mexican and Brazilian crises, they have definitively disregarded the weak pegs and have advised the countries to move toward flexible exchange rates and to organize independent Central Banks capable of conducting inflation targeting as national monetary policy.

After the crisis in Argentina, the same institutions and economists are starting to disregard strong pegs as well as partial and full dollarization. Although they have not been very specific on it, they have been pushing the new monetary alchemy: "Pesofication" or "forced de-dollarization".

They are making a wrong reading of the Argentinean crisis. They are overlooking the responsibility that the changes in monetary institutions had in making the crisis deeper and more intractable.

What they do not realize is how important the dollar is in each one of these emerging economies as anchors for their monetary institutions and as a way of protect the property rights of savers.

Forced de-dollarization or Pesofication is a bad idea

Forcing changes in monetary institutions to facilitate desired adjustments in relative prices is a bad idea because it leaves the economy without reassurances of legal protection for savings and destroys the mechanisms that allow the mobilization of domestic savings that in turn provides financing for domestic investment.

The advice to transform dollar contracts into peso contracts at the exchange rate prior to the floatation aims at preventing the insolvency of debtors in dollars that follows a large devaluation. However, because of the forced de-dollarization, the creditors, including the holders of bank deposits, suddenly find that the currency composition of their portfolios is not the desired one. Their attempt to rebuild the desired Dollar-Peso composition sharply increases the demand for dollars provoking a much larger devaluation of the Peso.

In addition, most of the creditors will sue the debtors and the State to get their dollars back. This adds uncertainty to the outcome of this policy, including the budgetary impact of the Pesofication.

The case of Argentina 2002 shows clearly that the attempt to set the "right prices" by changing the monetary institutions of the 90's have aggravated the recession and destroyed the "property rights" of savers.

No emerging economy should follow that strategy if it wants to preserve the possibility of renewing growth through investment and productivity increase. Argentina itself will have to work hard and soon to rebuild its monetary institutions as to reassure savers the protection of their financial wealth from arbitrary changes in the rules of the game.

Rather than banning the use of dollars for domestic financial intermediation and trying to force the savings in pesos, the new rules of the game should enlarge the monetary choices of Argentines. Facilitating the use of the Euro will give the Argentinean Central Bank the possibility of having not only the Dollar but also the Euro as an institutional monetary anchor. The Peso will also be available for medium and long-term contracts after authorizing financial indexation.

If the Central Bank manages monetary policy in such a way that overtime Argentines are convinced that the Peso provides as good protection to their savings as the Dollar and the Euro, they will probably end up using Pesos most of the time. By then Argentina will have the monetary system that prevails in economies with a long history of price stability.

If instead, Argentines are obliged to save in Pesos and from time to time monetary policy, like in the past, wipes out debts, the country will continue missing the monetary and financial institutions that nourish economic growth.

Lessons from the Argentinean experience

This review of the recent Argentinean experience in connection with the crisis of both its Monetary Regime and its Exchange Rate Policy allow drawing lessons relevant for emerging economies with a long history of monetary and financial problems:

1. In emerging economies where inflation did not destroy the domestic currency and de facto Dollarization was not extensive, it is possible that the use of price adjustment clauses will allow the existence of medium and long-term financial contracts denominated in the domestic currency. Chile is the best example of this alternative.

2. However, in Countries with a very high degree of de facto Dollarization that in order to allow the expansion of domestic financial intermediation decided to enter a Monetary Union or to allow free choice of the currency to the residents, any later decision to force Pesofication will only generate chaos.

3. When the possibility of entering a Monetary Union as a way to get a unique high quality currency does not exist, the alternative use high quality foreign currencies in competition with the domestic currency will allow the existence of every kind of financial contracts. This means that it will still be possible to enjoy a large expansion of domestic financial intermediation that will create credit and provide financing for investment.

4. If in order to create domestic demand for the local currency in competition with foreign currencies it is necessary to create a currency board with fix exchange rate, this regime should be transitory and once inflation disappears, it is very important to take advantage of the earliest opportunity of favorable conditions for exiting the fix exchange rate. They will come when there is a significant inflow of foreign capital and the floating of the currency will generate an initial appreciation.

5. To reduce the risk of vulnerability to foreign shocks that call for a real depreciation when the nominal exchange rate is still fix, it is very important to avoid excessive public debt accumulation.

6. When a strong external shock makes it impossible to avoid devaluation, prior to the change in exchange rate policy it is very important to achieve fiscal balance and extend the terms of the debt in order to reduce the risk of exchange rate overshooting.

7. The Monetary Regime should always protect savers and creditors in general. Forced Pesofication is not a feasible tool to solve a crisis. Any help for private debtor should never come from destroying the financial wealth of the savers that trusted the monetary and financial institutions of the country.

8. Once the local currency starts to have a flexible valuation, price indexation becomes a necessary condition to allow the existence of medium and log term financial contracts denominated in the local currency. The combination of price indexation

and responsible management by the Central Bank of Monetary Policy may shorten the period that will be necessary to improve the quality of the local currency as to make it the preferred choice of local economic agents. This, after all, is the decisive test for the graduation of any Monetary Regime.

[1] See Dier Welt, Germany, 9-16-2002

[2] See El País, Spain, 9-20-2002

[3] From a historical perspective, the 90's decade in Argentina's began on April 1, 1991 and ended on December 20, 2001

[4] The popularity of this law came clearly out in every election since its promulgation, including the last one in October 2001. In a debate about this issue all candidates to senators for the Federal District backed the maintenance of the Convertibility law.

[5] Hernando de Soto, a Peruvian studious of the spontaneous organization of "Pueblos Jóvenes" of Peru, concluded that formal legality of underdeveloped countries prevents families operating in the informal sectors to make their contracts worth and to defend their property rights. He recommends the creation of a new legality, one that imitates the spontaneous norms created by these people. In this way, these marginalized communities could start enjoying the benefits of access to credit and the benefits of an economy capable of accruing wealth and growth. In the case of Argentina, allowing the use of foreign currency proved to be the best way to incorporate millions of Argentines who until then, in order to protect themselves from inflation and hyperinflationary chaos, had saved and invested in foreign currency and had been outlawed in the informal sector. See Hernando De Soto´s book entitled "The Mystery of Capital", Basic Books, New York, 2000.

[6] See Cavallo, Domingo in collaboration with Sonia Cavallo "Lessons from the stabilization process in Argentina" in Symposium on Achieving Price Stability- Jackson Hole, Wyoming, Federal Reserve Bank of Kansas City, 1996; also "La Qualite de la Monnaie". Economie Internationale, N. 80- 4 trim 1999- Paris 1999; Cavallo, Domingo Felipe y De Pablo, Juan Carlos, "Pasión Por Crear", Editorial Planeta. Buenos Aires, Argentina, 2001.

[7] Based on the Solow growth equation: ¶Y/Y = a*(¶K/K) + (1-a)*(¶L/L) + (¶B/B), where (¶Y/Y) is output growth, (¶K/K) is growth in the capital stock, (¶L/L) is growth in the labor stock, and (¶B/B) is total factor productivity growth. "a" is the factor share income for capital and it is assumed to be equal to 1/3. The methodology follows closely: Jones, Charles I. (1998) "Introduction to Economic Growth", W.W.Norton & Company, Ins. New York. USA.

[8] Weighted by a=1/3

[9] Weighted by 1-a=2/3

[10] Solow residual

[11] For a description of the origin of Eduardo Duhalde's government, see "An Institutional Coup", by Domingo F. Cavallo, at www.cavallo.com.ar

[12] For a description of this situation, see "The Fight to Avoid Default and Devaluation", by Domingo F. Cavallo, at www.cavallo.com.ar

[13] Joseph Stiglitz has recently pointed out in an article that such situation was certainly going to happen. Moreover, that it is already happening! See "La recuperación Argentina", *El País* newspaper; Spain; September 20, 2002.

[14] Consider the arguments of those who praised "dollarization" and criticized convertibility, the inclusion of the euro, and the successive attempts to reschedule debts.