The Latin American Economies and the Global Monetary Disorder

(why "Pesofication" or "de-dollarization" is a bad idea)

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The economy is becoming increasingly global as a consequence of declining transportation and communication costs. Since the creation of the GATT, later transformed into the WTO, a Global Commercial Order has been emerging. In previous episodes of globalization, international monetary institutions like the Gold Standard and the Bretton Woods' System provided also a Global Monetary Order. But that is not the case nowadays. Outside Europe monetary institutions and policy decisions continue to be predominantly national with almost no global coordination.

Global Monetary Disorder

Each country is assumed to have a national currency and it is advised to grant independence to its Central Bank to pursue price stability. So, there are almost as many so-called "independent monetary policies" as national economies and the exchange rates fluctuate widely as consequence of those different policies interacting with real cross-border shocks affecting national economies.

Globalization of financial markets and the increasing facilities for cross border capital mobility offer savers of a particular national economy the opportunity of investing abroad whenever their savings are in danger of being eroded by inflation, taxation or any kind of confiscation. That is why the fluctuations of exchange rates have a much larger impact on emerging than on mature economies making their financial systems more vulnerable to external shocks.

In contrast with the order imposed in the past by the Gold Standard and the Bretton Woods' System, I call the current situation a "Global Monetary Disorder".

There is strong intellectual support for the idea that trade negotiations to establish global trade institutions will strengthen growth potential in all the engaged national economies. But that is not the case for the organization of a truly international monetary system. This is unfortunate for emerging economies because monetary institutions are at least as important as trade institutions to facilitate investment decisions in a Global Economy context.

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I will argue that for the Latin American economies, inadequacy of national monetary institutions and absence of an international monetary system capable of providing an anchor for national institutions may be a more important impediment for growth than the existing restrictions to foreign trade.

Latin American economies have tried to overcome these obstacles through total or partial dollarization, but nowadays the mood in Washington is that they should de-dollarize their economies. This is the point I will argue against in this presentation. Instead I suggest that emerging economies should enlarge the monetary choices of their people by facilitating the use of the Euro together with the Dollar.

Growth, Investment and Productivity

Growth comes from investment and increased factor productivity. For sure, investment projects will start to be evaluated if there is demand for the goods and services that the increased capacity is able to produce. Eliminating distortions through deregulation and trade liberalization at the national level and engaging in fruitful international trade negotiations is for sure a good strategy for emerging economies to create investment opportunities. The competition created by deregulation and trade liberalization reassures that the investment opportunities that are created will call for the most productive technologies and will push up factor productivity.

But once the investment opportunities are created, investment will only be decided and implemented if there is capital available. And capital originates in savings. The first step for an emerging economy to make capital available to investors is to create the institutions that will mobilize domestic savings as to accumulate capital within the national economy. Once foreign savers see that the nationals of a particular country are investing their savings in their economy, they will start considering taking cross border risk and invest in that country.

Monetary institutions

The monetary institutions that different countries have adopted relate to their past experience. Countries with a long history of price stability and responsible monetary policy have fully convertible national fiat currencies managed by independent monetary authorities and floating exchange rates. This is the case of the United States of America, The United Kingdom, Japan, Canada, Australia, Singapore and most European Union nations before the creation of the Euro.

Countries that in the past 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 and started to get the benefits of a trustable currency and stable monetary institutions. Eastern European nations will have the possibility of using this mechanism to find an anchor for their still unstable national monies.

Monetary institutions in Latin America

Not having the possibility of joining a monetary union, most Latin American economies very often have used the US dollar as an anchor for their domestic monetary regimes. The use of the dollar as a crucial ingredient of national monetary institutions in Latin American economies adopted different forms.

Most of the Latin American economies have, at least for some period of time, adopted a weak peg to the US dollar. Chile did it in the early 80's, Mexico in the early 90's and Brazil in the mid 90's.There are nations that have fully dollarized their economies. This is the case of Panama, El Salvador and Ecuador. Some countries have let their currencies to compete with the US dollar. This is the case of Peru and Uruguay, countries where most of the time deposits and longer term contracts are written in dollars.

Finally there are countries that have not only made contracts in dollars legally enforceable but in addition have adopted a strong peg through a currency board arrangement for the national currency. This is the case of Argentina.

The opinion of the International Financial Institutions

The opinion of International Financial Institutions and the economic profession on the merits and pitfalls of these 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 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 "de-dollarization".

In my opinion they are making a wrong reading of the Argentinean crisis. They overlook 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 an anchor for their monetary institutions and as a protector for the property rights of savers.

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 mobilizing domestic savings as to provide financing for domestic investment.

The advice to transform dollar contracts into peso contracts at the exchange rate prior to the floatation tries to prevent the insolvency of debtors in dollars that follows a large devaluation. But as a consequence of the forced de-dollarization, the creditors, including the depositors in the banks, 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 Estate to get back their dollars. This adds uncertainty to the end results, 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 be advised to 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 that their financial wealth will be protected 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 if financial indexation is permitted.

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 is used, like in the past, to wipe out debts, the country will continue missing the monetary and financial institutions that nourish economic growth.