Argentina in a fix
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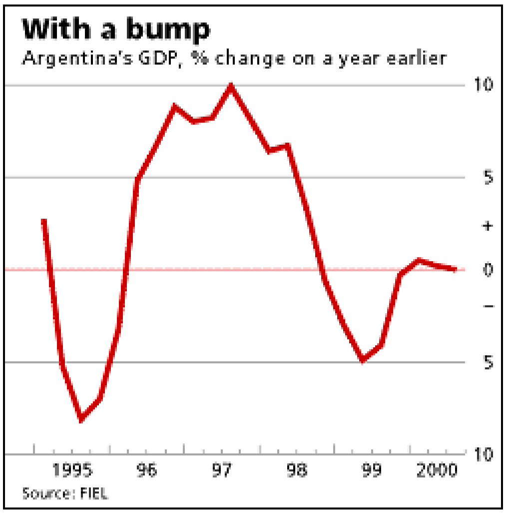
An economic crisis in Argentina is also a crisis for the current orthodoxy over how governments in emerging markets should manage their exchange rates .

To lose one economics minister smacks of misfortune, or perhaps policy disarray. To lose two in two weeks, as has happened in Argentina, looks like a rout. The resignation late on Monday night of Ricardo Lopez Murphy aggravated the already

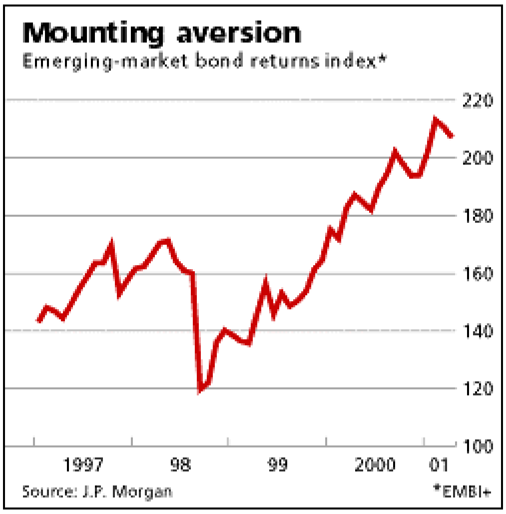


severe political difficulties facing the government of President Fernando de la Rua. Late last week, three government ministers and six senior officials had resigned after Mr Lopez Murphy had unveiled a tough two-year austerity plan. It was intended to meet fiscal targets agreed with the International Monetary Fund, which in December promised to contribute $14 billion to a $40 billion financial-rescue package. But Mr Lopez Murphy's proposed spending cuts—especially insofar as they affected education—proved politically unacceptable.

Yet his appointment was originally welcomed abroad precisely because of his known fiscal hawkishness. After more than 30 months without economic growth, the government had a swollen budget deficit, unemployment stood at 15% of the workforce, wages were falling and fears about its solvency had curtailed its access to international capital markets. In the bond markets, where its borrowings account for more than a fifth of the emerging-market index, there were fears that it might default.

There still are, and they are affecting the cost of emerging-market borrowing. Nerves have been somewhat soothed, however, by the appointment of Domingo Cavallo as Argentina's new economic-policy chief. Mr Cavallo is popular in the international markets as the architect of policies that, a decade ago, vanquished Argentina's once endemic inflation. In particular, Mr Cavallo's reputation rests on the decision to peg the Argentine currency, the peso, to the US dollar by means of a

Convertibility Law, which requires that every peso in circulation be backed by a dollar in reserves.



In recent years it has become increasingly fashionable among both private economists and those working for the multilateral aid agencies to advocate such "currency-board" exchange-rate regimes for emerging markets. A succession of currency crises in emerging markets such as Mexico, Thailand, South Korea, Brazil and, most recently, Turkey—as well as, in the early 1990s, among the members of Europe's exchange-rate mechanism—had led to a loss of faith in looser sorts of currency peg. It was argued that countries had only two choices: to allow their currencies to float freely, or, conversely to fix them by means of a currency board. Short of outright dollarisation, this is the strongest imaginable way of fixing a currency: it amounts to an open-ended promise to exchange dollars for pesos at the promised parity.

This system worked, for example, for Hong Kong, whose dollar weathered the Asian currency crisis of 1997-98. It means that the government forgoes its right to set its own monetary policy. But in return, it gains a strong weapon against inflation and the advantages of lower interest rates than would be needed to maintain a less solidly backed peg. The currency board has indeed delivered these benefits to Argentina. Inflation was brought under control, and, for most of the 1990s, interest rates were lower than in Brazil, which had a much looser exchange-rate system.

But Argentina is now coping with some of the drawbacks to a currency board. First, the strength of the dollar has pulled the peso up to giddy and damaging heights. It has looked particularly overvalued since Brazil was forced two years ago to float its currency, the real, which has since sunk by more than 40% against the dollar. Second, a currency board rules out devaluation, or at least makes it a very drastic option: far more so than it was even for Brazil, where the crisis surrounding the flotation of the real was bad enough.

Parity games

But if currency boards bring troubles of their own, so do all the other options. Soft pegs, such as the one Thailand used to keep its currency, the baht, stable against a basket of other currencies dominated by the dollar, are now seen to be very dangerous. When investors lose confidence in the government's policies, as happened in Thailand in 1997, interest rates soar, and the government is forced either to spend its foreign-exchange reserves propping up the currency (as Thailand did), or to impose capital controls (as happened in Malaysia the next year).

Similarly, crawling-band regimes have had a bad press. Variants of this system were used, with bad results, in Indonesia, Brazil and Turkey. Instead of fixing the currency at a set parity to another currency, its value is allowed to fluctuate within a pre-set range; and that range itself moves over time against the other currency (usually downwards). Despite the difficulties some countries have faced, this system is a response to a well-founded fear of free-floating exchange-rate systems. Although many governments (India's for example) say they allow free floats, few in practice leave the exchange rate entirely up to the market. For good reason: pure floats are vulnerable at times of extreme market turbulence to shuddering exchange-rate shocks. And, even in the medium- to long-term, foreign-exchange markets are capable of producing currency misalignments—just like, at the other extreme, Argentina's hard fix.

In many emerging markets, the apparent failure of an exchange-rate system also looks like the failure of the IMF, on whose authority the policy has been followed, and whose shareholders' money has backed it. But in most cases, and certainly in Argentina this month and Turkey last month, the real dangers have been political. It is not so much the exchange-rate system that has crumbled, as investors' faith in the government's ability to deliver the policies needed to maintain it. The biggest challenge facing Mr Cavallo is to restore that faith.