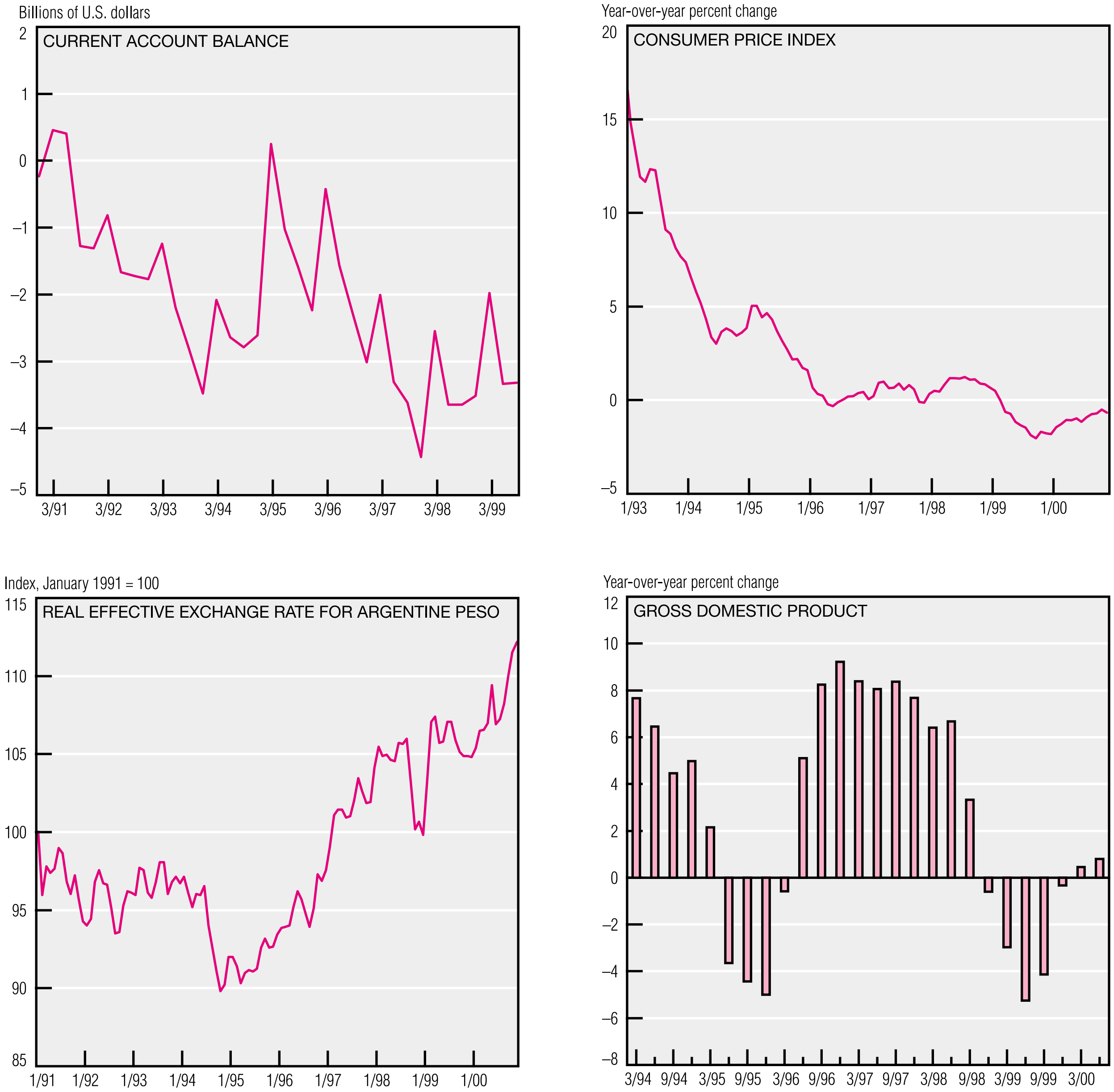
Argentina's Currency Board



SOURCES: International Monetary Fund, *International Financial Statistics*; Standard and Poors Corporation; and DRI/McGraw-Hill.

Countries fare best with either a perfectly fixed or a completely floating exchange rate rather than a hybrid. Choosing the best arrangement for a particular country, however, is a difficult task. To gain insight into the decision, economists have been watching Argentina's currency board, which began in 1991.

The board pledges to exchange Argentine pesos freely, one-for-one, against U.S. dollars; it supports this promise by backing the monetary base with dollar reserves. So its monetary base cannot expand unless there is a net inflow of dollars, and that will happen only if the inflow of private capital exceeds the country's current account deficit. Consequently, when former president Alfonsin suggested that Argentina might suspend repaying $124 billion in foreign debts, he inadvertently threatened the currency board's viability. That crisis now seems to have passed. On January 12, 2001, the International Monetary Fund approved a package to help Argentina continue financing its external debts.

The currency board has proven enormously successful at eliminating inflation and inflationary expectations, but it also restricts ability to adjust quickly to economic shocks. The dollar's overall appreciation in recent years and the devaluation of Brazil's *real* in January 1999 adversely affected Argentina's competitive position, particularly in Latin American markets. To regain its edge without depreciating the peso, it has had to lower domestic goods prices. Since early 1999, consumer prices have been falling, but Argentina's economy, particularly its labor markets, is not very flexible. Prices adjust slowly and as they do, output and employment typically fall. Limiting exchange-rate flexibility seems to require increasing domestic price flexibility.