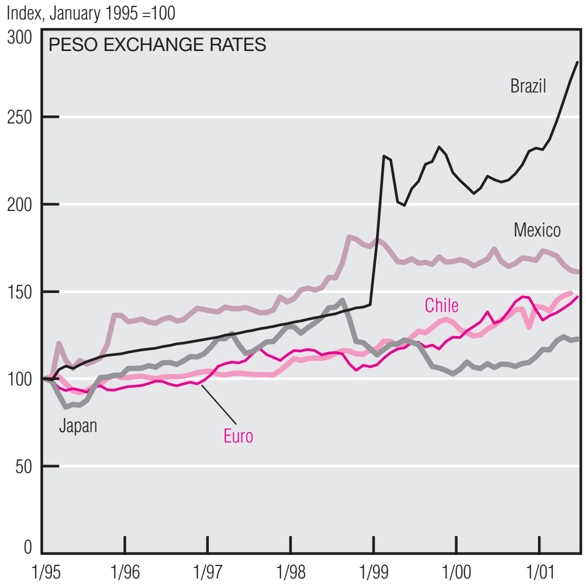
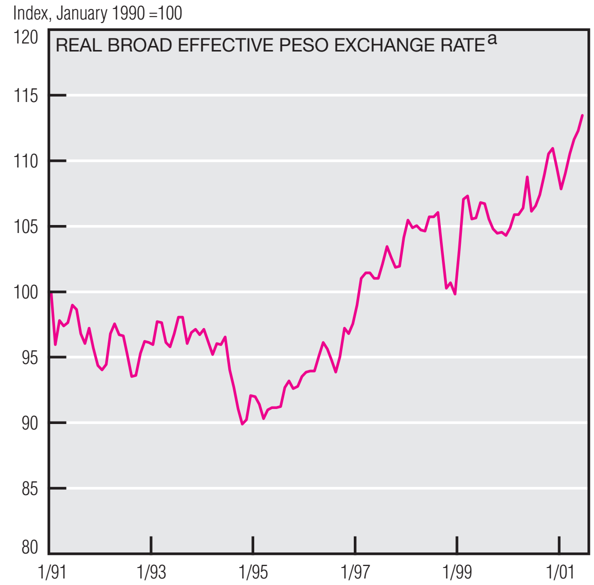
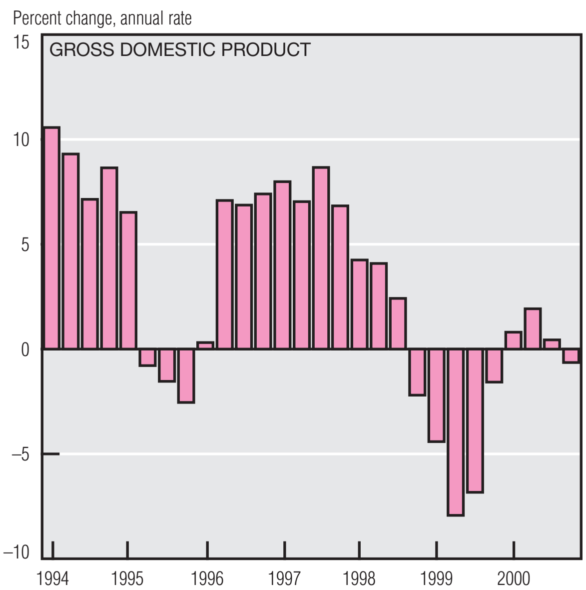
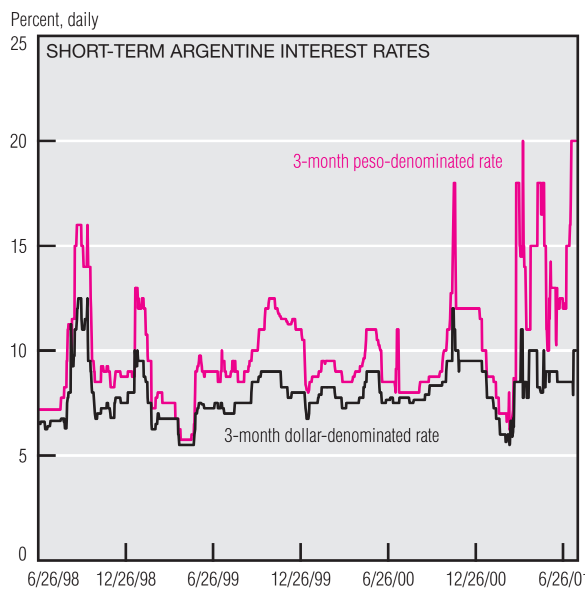
Argentina









a. The real peso exchange rate index is a ratio of the Argentine consumer price index to the trade-weighted average of foreign consumer price indexes, multiplied by the broad nominal peso index.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund; J.P. Morgan Securities, Inc.; and Bloomberg Financial Information Services.

In 1991, Argentina adopted the "convertibility plan" to reduce its four-digit annual inflation rate. Under this plan, Argentina pegged the peso one-to-one to the U.S. dollar and held a dollar in reserve for every peso the central bank issued. This currency board arrangement enabled the government to eliminate inflation.

Brazil's 1999 devaluation and the dollar's sustained appreciation represent serious shocks to the Argentine economy. With the peso pegged to the dollar, domestic prices and wages must decline if Argentine products are to remain competitive with Brazilian and other non-U.S. goods; however, prices and wages adjust slowly, typically only after the country slips into recession. Looking for a little exchange rate flexibility, Argentina has modified its currency board arrangement so that the peso effectively depreciates for non-energy trade but is unaltered for all other transactions. The proposal has weakened investors' already-waning confidence in the nation's economy.

The sustainability of the currency board hinges on Argentina's fiscal position. The country runs persistent budget deficits and has amassed nearly \$130 billion in external debts, most of them dollar denominated. Reflecting devaluation concerns and uncertainties, the market has recently been attaching a substantial—and volatile—risk premium to peso-denominated debt in Argentina. The International Monetary Fund continues to offer financial assistance, but this will prove only palliative in the absence of fiscal reform.