

Plan B: A way out for Argentina

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It is almost too late to avoid a catastrophe in Argentina. The economy is in a tailspin, destroying jobs, tax revenues and political support. The government has been forced to default on commitments to its workers, pensioners and provincial governments in a valiant attempt to continue paying the public debt. Markets don't think the Argentine government can keep this up: its dollar bonds are trading at default discounts, while the price of its peso bonds reflect the expected collapse of the currency regime. Sky-high interest rates make fiscal solvency, private investment and economic recovery impossible.

Historians and economists will spend the next decade arguing about the causes of the Argentine crisis. Some will blame the currency board and the loss of competitiveness it caused when the dollar strengthened and the Brazilian Real weakened. Others will blame the sudden and persistent collapse in capital flows to all emerging markets that followed the Russian crisis, forcing countries to cut their current account deficits through recession. According to this view, Argentina's currency board and high dollar-denominated debt just amplified the problem. For others yet, it is a case of self-fulfilling pessimism. Fears of a deep recession raised concerns about the ability of the government to collect enough taxes to service the public debt, which increased interest rates and prompted the recession. In turn, this increased the fiscal deficit, which led to a further loss of credibility and even higher interest rates.

The question now is how to get out of this situation, even if we cannot figure out how we got in. Argentina's well-structured public debt and its sound banks have delayed the collapse, giving policymakers and economists time to think. But the extra time has not sufficed to find a solution. Some have urged default. Others have proposed floating the currency. Others yet have proposed both.

Floating alone would be catastrophic. With almost all debts denominated in US dollars, depreciation will increase the cost of debt service, bankrupting the government, corporations and domestic banks. Fearing this, depositors will try to flee, further weakening the currency and the financial system and causing a financial meltdown *a la* Indonesia or Ecuador.

A pure default will not reestablish the competitiveness lost through the strong dollar and the weak Real. Interest rates would remain high. Argentina could not escape the vicious cycle of contraction and deflation it is in now.

A combination of a debt write-down and floating will not work either. After any conceivable haircut, the country would be left with significant dollar liabilities. Floating under these circumstances is a recipe for disaster. It would leave the country subject to self-fulfilling speculative attacks: if the currency were to weaken, borrowers would be

less able to repay, prompting investors and depositors to try to flee, thus precipitating the devaluation they feared.

Faced with these stark choices, the government has tried to find creative ways of reducing the debt burden and gradually gain competitiveness. But the strategy has run out of time.

The workable alternative has two main ingredients: first, de-dollarization of the foreign debt, the financial system and the domestic contractual environment; second, a floating exchange anchored by strict inflation targets.

Under this plan, Argentina would convert the dollar-denominated assets and liabilities of the banking system and public debt –excluding obligations to the IMF and multilateral banks– into Chilean style inflation-indexed pesos, at today's exchange rate of one peso for one dollar. All other contractual terms, including maturity and interest rates, would remain the same. An independent entity (why not the IMF?) would be designated to calculate the price index to be used for these purposes in a credible manner.

Achieving credibility of monetary policy would also be key. Floating plus inflation targets can achieve this, as the experience of Mexico, Chile and scores of developed countries shows. There is no reason why Argentina should be different, once the harmful fiscal effects of dollar debt have been eliminated.

The plan would also include a tight fiscal policy, framed by an IMF program with significant financial support. As in Brazil in 1999, low demand, the absence of currency mismatches and a sound fiscal program would keep inflation low.

This strategy is similar to that followed by Franklin D. Roosevelt in 1933 when he took the dollar off the gold standard, devalued the currency and suspended the gold clause on debt contracts, reducing the claims of investors in terms of gold points by the size of the depreciation.

It is important to point out that Argentina cannot inflate the new debt away: investors are protected from inflation through indexation. Nor should investors fear that Argentina would choose a very weak real exchange rate to save on its debt service. That would not be very popular with most voters.

True, the plan would initially lead to a much-needed depreciation of the currency. But this would not wreak havoc on the balance sheets of borrowers or banks, since their debts would not increase in value with the depreciation. Without this harmful financial effect, depreciation should have a salutary effect on output. And with a growing economy country risk would decline, putting Argentina on a virtuous cycle.

Investors should prefer this strategy to a traditional debt write-down. As the needed real exchange rate depreciation takes place, the *face* value of the new indexed-peso debt ~~terms~~ would decline substantially in dollar terms. But this real depreciation would likely be

temporary. When the time comes to repay debt –something that, given the 8-year average maturity of Argentina’s debt, is well into the future-- the real exchange rate may well exceed current levels, in which case there would be no haircut. This is more than a theoretical possibility: Mexico saw its real exchange rate plummet during the Tequila crisis of 1994 but today it is stronger than it was before the crisis.

Even if the *nominal* dollar value of the debt declines temporarily, its *market* value need not fall, and could even rise. Depressed market prices today reflect the fact that Argentina cannot grow, and hence is unlikely to repay. With a competitive exchange rate, the country becomes a much better credit risk. Moreover, Argentina’s real exchange rate would tend to appreciate in good times and depreciate in bad times, which would make debt service move in tandem with the repayment capacity of the country. Holders of the new indexed-peso bonds would be in possession of a safer asset.

The plan also protects the stability of the banking system: loans are made affordable to firms, so that depositors need to fear less about bank insolvency. It will also eliminate much of the tension on trade and integration policies in Argentina and Mercosur. With a more flexible exchange rate system and more similar to that of its neighbors, Argentina could embrace free trade.

This strategy is not without its risks. Inflation has to be kept under control. Depositors and investors need to understand and accept the new inflation-indexed instruments. Legal challenges from both local and foreign investors will have to be overcome. The year 2002 would be very difficult, but less so than under alternative scenarios. But after putting this program in place Argentina will be left with a Chilean-style monetary regime (which has now worked successfully for over a decade), a sound banking system and a competitive economy. Those are sound foundations on which to regain growth, credibility and, most important, hope.