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Argentina Agonistes

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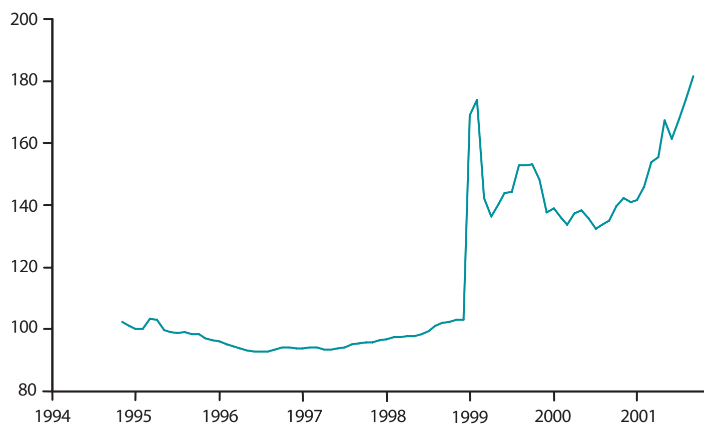
Since December 2001, Argentina has experienced a tumultuous currency devaluation, sovereign debt default, and a freeze on bank accounts that followed a ten-year period in which the Argentine peso was tied one-to-one with the U.S. dollar. During this era, Argentina took steps to privatize state-owned enterprises and open itself to international trade—especially with Brazil, which became Argentina's largest trading partner through the Mercosur customs union. In the 1990s, foreign companies purchased numerous privatized enterprises and foreign investors acquired large holdings of private and sovereign debt from Argentina. For these foreign owners to repatriate interest and profits, Argentina would have to generate substantial export earnings.

However, one big obstacle to Argentine exports was the appreciation of the dollar, and thus the peso, against other major currencies, starting in 1995. That is, prices in Argentina—combined with the one-to-one exchange rate with the dollar—made Argentine goods relatively expensive to the rest of the world. Argentina and Brazil were at least in the same boat during the mid-1990s when Brazil was also pegging to the U.S. dollar. In contrast to the European Union, however, the Mercosur customs union did not impose exchange-rate commitments between the member countries, and Brazil unilaterally devalued the real in January 1999. Depreciation of the nominal exchange rate would have been the most direct way for Argentina also to reduce the high real exchange value of the peso. With the exchange-rate straitjacket in place, however, the only way market forces could reduce the real exchange value of the peso was for prices in Argentina to fall relative to prices in the United States. But it was not easy for prices in Argentina to ebb below those in the United States, given the U.S. productivity boom which held down U.S. inflation and elevated real rates of return.

With the fixed exchange rate, nominal interest rates in Argentina could not fall below those in the United States, although they could be higher due to default risk. This interest-rate floor meant that any fall in prices in Argentina relative to the United States implied correspondingly higher real borrowing costs in Argentina's domestic credit markets. Between November 1994 and September 2001, for example, the price level in Argentina fell 16.2 percent relative to the price level in the United States. The resulting high real borrowing costs hindered any economic recovery that would have reduced Argentina's unemployment rate from double-digit levels. Nevertheless, the accompanying chart shows that not even this painful decrease in relative prices between Argentina and the United States was sufficient to prevent substantial appreciation of the real exchange value of the peso relative to the Brazilian real following Brazil's devaluation in January 1999. This evolution of the Argentine economy—one step forward and two steps backward—satisfied no constituency: not domestic borrowers, labor unions, exporters, or foreign creditors. In such circumstances, domestic politics generally holds the trump card, whereupon default and devaluation became the inevitable outcome. ■

Real Exchange Rate Index Between Argentina and Brazil



NOTE: 1995 index = 100; higher values indicate that Argentine exports are more expensive.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.