

## **Why Countries Shouldn't Break Their Currency Promises**

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Political analysts have long recognized the critical importance of predictable policies over time. The economic and social environment becomes erratic and uncertain when future governments can readily change the direction of public programs.

The advantages of a stable policy frame has been confirmed by the financial crises during the past two years in Asia and Russia, and more recently in Brazil. These nations promised to maintain pegged exchange rates between their currencies and the U.S. dollar. Unfortunately, they did not develop institutions that guaranteed stability when the going got rough.

Certainly, in the Brazilian case, many native and foreign investors did not believe the government's vow to maintain the real's value relative to the dollar, since in the past their central bankers and politicians often broke promises about exchange-rate policies. Investors began to convert their reals into dollars immediately after the Asian crisis erupted in 1997. They accelerated the withdrawal of funds when the government continued to run large budget deficits to finance generous pensions and other spending.

As Brazil's foreign reserves dwindled, the International Monetary Fund tried to rescue the real with a large infusion of dollars. Nevertheless, investors accelerated their switch out of reals because the IMF's efforts did not fundamentally alter Brazil's policies. They had little confidence in Brazil's commitment to maintaining the exchange value of the real, with or without IMF support. That forced a devaluation, and the real went into a free fall for a while because of the enormous uncertainty about Brazil's economic future. This included the possibility that foreign-exchange controls would be imposed once again.

**ARGENTINE MODEL.** Similar huge currency declines occurred in Thailand, Malaysia, South Korea, and Indonesia after these nations abandoned their pegged rates despite vowing to continue them. Although Korea, Thailand, and Malaysia show signs of recovery, international investors have not yet regained much confidence in the financial stability of any of these nations and continue to shun Indonesia.

The world financial crisis also affected Argentina, but its experience offers an instructive contrast to Brazil and these Asian nations. Argentina's finances so far have survived in much better shape mainly because it is committed to a rigidly fixed exchange rate between the peso and the dollar. Not only is the rate pegged at one-to-one, but all domestic transactions can be made in either currency, and local deposits are held in dollars as well as pesos. The government fully backs all pesos in circulation with dollar reserves, which prevents arbitrary printing of pesos to finance government spending.

A future Argentine government could abandon convertibility for a Brazilian-style system that pegs the exchange rate without a commitment to a stable currency. However, by

allowing dollars to circulate freely and by accustoming its businesses and households to trade between dollars and pesos, Argentina has raised political and economic obstacles to forsaking convertibility.

Indeed, convertibility has become so popular that leftist parties have also vowed to maintain it should they come to power in this fall's elections. Still, investors are demanding higher interest rates for private and public loans denominated in pesos than for comparable dollar-based loans, revealing some skepticism about the strength of the commitment to convertibility.

To remove such doubts, Finance Minister Roque Fernandez and President Carlos S. Menem recently proposed to abandon the peso entirely. They suggested the radical step of "dollarizing" the Argentinian economy by replacing all pesos in circulation with dollars, so that the greenback would become Argentina's sole currency.

Menem has also recommended that Brazil, Argentina's main trading partner, quickly introduce convertibility between the real and the dollar--and perhaps eventually move toward dollarization. Convertibility would help control Brazil's ability to fund government deficits by expanding the money supply. Dollarization is a much more radical and politically difficult step. Only two tiny countries, Panama and Liberia, have dollarized economies. But it might be necessary if investors remain skeptical of Brazil's commitment to a stable currency.

The ongoing financial crisis stems in large measure from weak political commitment to predictable exchange-rate policies, such as rigidly fixed or freely floating rates. This crisis has provided another painful lesson that effective public programs require clear and stable rules over time.