Argentina in crisis? A debate between two fellow economists: Rapetti e Vernengo

Is Argentina going through a balance of payments crisis? Was it inevitable?

Martin Rapetti

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Last week, the Central Bank of Argentina let the nominal exchange rate rise from 6.7 pesos per dollar to 8. This devaluation mounted on top of another 10% devaluation that had occurred at a lower pace since early December 2013. Can we consider this as a currency or balance of payments crisis? Because the very notion of an economic crisis —whether it is fiscal, financial or a balance of payments crisis— is always blurry, let me start by providing what I believe is a shared definition of a balance of payments crisis. This happens when the Central Bank unsuccessfully tries to keep the nominal exchange rate around certain value and is forced —after loosing a substantial amount of foreign exchange (FX) reserves— to implement a discrete devaluation or to let the domestic currency depreciate.

Has this happened in Argentina recently? These are the facts. By July 2011, the stock of FX reserves was around U$ 52 billions. The exchange rate was 4.1 pesos per dollar, only 7% higher than in July 2009 (3.85 pesos per dollar). In August 2011 —three months before the presidential election— the Central Bank started loosing reserves. In November 2011, just a few weeks after Cristina Kirchner was re-elected, FX reserves were U$ 46 billions. Since the depletion of FX reserves showed no sign of stopping, the authorities started to implement a series of measures to limit the demand for foreign currency. The controls triggered the blossoming of black markets. FX reserves kept falling, softly during 2012 and very rapidly since early 2013. In November 2013, after a poor mid-term election, the president fired the governor of the Central Bank and put in charge a new economic team. FX reserves were U$ 33 billions and the exchange rate had reached 6 pesos per dollar. As I mentioned above, a week ago, the price of US dollar jumped to 8 pesos. FX reserves are now close to U$ 28 billions. The Central Bank has managed to keep the exchange rate at 8 pesos at the cost of loosing U$ 150/200 millions of reserves per day. There are still widespread expectations of further devaluation and few believe that authorities can sustain the exchange rate at the new level, especially because the rate of inflation has accelerated above 30% annually. In short, FX reserves have so far fallen by 46% and the exchange rate has risen by 95%. If it looks like a dog, walks like a dog and barks like a dog, then… it's probably a balance of payments crisis.

Some analysts still reject the idea that Argentina is going through a balance of payments crisis. Matías Vernengo´s recent piece is a good example. He argues that "this is not a balance of payments crisis" and supports his claim by pointing out the fact that Argentina has a small current account deficit and that the real exchange rate (RER) is not as overvalued as in Brazil. He is right: the current account deficit was only 0.5% of GDP in 2013 (although it would higher without the import controls) and the RER is certainly not as overvalued as in Brazil (which, by the way, is very overvalued). But these facts do not substantiate the claim that Argentina is not experiencing a balance of payments crisis. Matías seems to miss the important point that as long as expected depreciation at the exchange rate that the Central Bank is defending is higher than the yield of domestic assets, there would be an excess demand for foreign currency that would eventually lead to the depletion of FX reserves and the collapse of the domestic currency. Although it would be a rare event, this could even happen in a country with a current account surplus.

This kind of inconsistency was at the root of current Argentine crisis. Starting in 2007, inflation has been in the range of 25-30% per year. Since 2010, the central bank began to use the exchange rate as the main nominal anchor for inflation. During the two years before the 2011-election, domestic prices rose 54%

whereas the nominal exchange rate only 12%. As a result the RER appreciated significantly. Nominal interest rate during the same period was about 10% (negative 15% in real terms). A policy like this is clearly unsustainable and at some point expectations of devaluation/depreciation would start to emerge. The 2011-election served as an expectation-coordination device. Since governments do not take unpopular measures before elections, but they typically do after them, people began to anticipate a devaluation in mid-2011. This was why the run against FX reserves started just before the election.

Almost a year ago, I began warning about these inconsistencies and to argue that the controls imposed since late 2011 would not solve the problem but would only exacerbate it. I argued that a RER correction would be unavoidable and that the government should take care of the inconsistences as soon as possible. I was aware that a real devaluation would have a contractionary effect. My fear was (and still is) is that a RER correction done through a balance of payments crisis could lead to an exchange rate overshooting and a devaluation-inflation spiral beyond the government's control. Such a scenario would imply a significant fall in real wages and employment. This should be avoided.

Formulations like mine seem to be the source of another confusion in Matias' analysis. He argues that people like Luiz Carlos Bresser Pereira, Roberto Frenkel and me were advocating for a devaluation because we support the idea that maintaining a competitive real exchange rate (CRER) is good for growth. I do support a CRER strategy for development, but if you read my articles (here in English; here and here in Spanish), you will see that my claim was based on the inconsistencies of macroeconomic policy and not on my frustration about the abandonment of the competitive RER strategy that Argentina carried out between 2002 and circa 2008.

The source of Matias' confusion is, in my view, clearly exposed in this piece. He claims that growth is wage-led, thus real exchange rate devaluations affect growth negatively (as in the Krugrman-Taylor paper) and not positively (as in the Frenkel-Taylor paper). Are the two papers by the same author contradictory?

No, the problem is that Matías confuses an important distinction between short-run and long-run effects of the real exchange rate on economic performance. In Krugman-Taylor, a real devaluation (a *change* in the RER) has a negative effect on output and employment in the *short run*; in Frenkel-Taylor, a competitive RER *level* has a positive effect on long-run growth. These are theoretical arguments that should be evaluated empirically in each historical circumstance (I've done some work on the latter here and here), but we can't properly do that if we misunderstand the economic reasoning behind them.

A reply to Rapetti

Matías Vernengo

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Back in the mid-1990s I was a student of John Eatwell (his last TA in the microeconomics course at the New School, I think, before he went back to Cambridge), and one thing that has stuck with me over the years is that he argued no economic debate was ever solved by empirical evidence. Hyperbole aside, and I should say it is not a great exaggeration, logic has also not been particularly good a clarifying debates in economics (just think of the Capital Debates).

So last week I wrote this post on why the Argentine devaluation is not a traditional Balance of Payments crisis. As I noted it was a policy decision in the works for a long while. At any rate, neither the real exchange rate, nor the current account are in a position that per se is unsustainable. That is still true, however, Martín Rapetti from the Centro de Estudios de Estado y Sociedad claims I am confused in my criticism of his work, as much as that of Frenkel and Bresser-Pereira, the so-called New Developmentalists, which believe that devaluation is good for growth.

He suggests now that he does not claim that devaluation is good for long run

growth (my quote from Bresser in the previous post was very clear suggesting that is in fact what New Developmentalists think). In his words:
"Formulations like mine seem to be the source of another confusion in Matias' analysis. He argues that people like Luiz Carlos Bresser Pereira, Roberto Frenkel and me were advocating for a devaluation because we support the idea that maintaining a competitive real exchange rate (CRER) is good for growth."
He argues now that the reason for wanting a devaluation was:
"based on the inconsistencies of macroeconomic policy and not on my frustration about the abandonment of the competitive RER strategy that Argentina carried out between 2002 and circa 2008."
Althought Martín does not quite spell out what the contradictions are (and they are not the current account or the real exchange rate apparently, since he says: "He [that would be me, Matías] is right: the current account deficit was only 0.5% of GDP in 2013 (although it would higher without the import controls) and the RER is certainly not as overvalued as in Brazil (which, by the way, is very overvalued [that has no run on the currency, I might add])." The imbalances are one might assume inflation, and the cause of inflation as Frenkel and others have suggested is the excess demand (read fiscal deficits). So he wanted, and by the way I've heard this from almost anybody connected to CEDES, more fiscal adjustment. In fact, in the CEDES story, the government started to move away from good macro policy when Roberto Lavagna, which included several CEDES insiders, left the government at the end of 2005.

On this new position, let me quote again from my previous post (from March 2012) in which I quoted a paper Frenkel presented at a conference organized by Bresser, in which he said:
"the monetary and fiscal policies required to accompany the adoption of a SSCRER target must also have special features: the permanent expansionary stimulus that is part and parcel of the SSCRER heightens the importance of the restraining role to be played by fiscal and monetary policies."
Let me emphasize this, the notion was that a stable and competitive real exchange rate is so powerful (permanent expansionary stimulus he says, sic) as an instrument for growth that you need fiscal and monetary contraction. Note

that devaluation and macroeconomic contraction are the traditional tools of the IMF for countries with balance of payments problems. Part of what I suggested in my previous post is that heterodox authors tended to be more circumspect about the incredible advantages of depreciation. Martín's nuance about disequilibria (fiscal expansion) and not the effects of devaluation on growth are really not clear. If I was confused, he must explain how. Did Frenkel and him changed their position? If so I'm glad, but certainly I'm NOT the one confused here.

His other critique is decidedly bizarre. He argues
"Matías seems to miss the important point that as long as expected depreciation at the exchange rate that the Central Bank is defending is higher than the yield of domestic assets, there would be an excess demand for foreign currency that would eventually lead to the depletion of FX reserves and the collapse of the domestic currency."
First of all, in the post Martín criticizes I say the following:
"Note that if the government on top of the current measures adds fiscal contraction (*monetary tightening is a given, since higher rates of interest will be needed to avoid more capital flight*; and the effects of monetary contraction can be compensated by subsidized public credit) as the New Developmentalists wanted (since for them inflation was caused by excess demand) then the slowdown will be significant and even a recession could take place."
In other words, yes the government must increase the rate on interest to avoid the expectations of a devaluation. My point indeed was that back in 2012 they should have done that, when the blue was closer to 5, and it was easier to do and avoid a depreciation (which Martín wanted and I didn't) and that he used to think it was good, but now that happened he has second thoughts (you'll see why in a second).

Second, exactly because the problem is the low rates of interest when compared with holding dollars, you see that this is not a problem associated to the exchange rate being overvalued or the current account being unsustainable in the short run. It is something that could have been solved long ago with a higher rate of interest. Mind you, Martín is simply wrong when he says that since 2010 the Central Bank of Argentina was using the nominal exchange rate as an anchor for prices (he is really confused on this one; just check the rate of depreciation), and I should know since I was at the bank at some point during this period (actually Brazil did that, and that explains lower inflation in Brazil).

But here comes the cherry on top of the ice-cream. Why would depreciation still be good for Martín? Because the long-term exchange rate elasticity of exports is actually high. The short-term isn't and that's why in the short run the depreciation will be contractionary and he has some doubts about it. But in the long run things are hunky dory. So here is NOT about imbalances, but depreciation is good for growth because it increases competitiveness and exports (wink, wink, devaluation is not good, but yes it is, and I'm confused!). In his words:

"The problem is that Matías confuses an important distinction between short-run and long-run effects of the real exchange rate on economic performance. In Krugman-Taylor, a real devaluation (a change in the RER) has a negative effect on output and employment in the short run; in Frenkel-Taylor, a competitive RER level has a positive effect on long-run growth."

I guess I missed that class by Lance, and that's the source of my confusion. I should note that I had a few exchanges with Martín on Twitter (see below in Spanish) on which he also suggested that in the long run was good for growth. Here is the problem, Martín (nor Frenkel or anybody else as far as I know) has shown this great long-term elasticities that show that depreciation in the long-run (the Frenkel-Taylor, not Krugman-Taylor story) is good for growth. The evidence I cited here (from this paper by Fiorito and Silvio and Nahuel Guaita) actually shows that there is no evidence for a positive elasticity in any run. If Martín shows that there is some evidence on positive and significant long-term real exchange elasticities for exports (I'm really interested in what methodology he suggests for finding this result, and separate the short and long run elasticities), like Keynes I will change my mind, and try to prove Eatwell wrong on the role of empirical evidence in economic debates. But if you (Martín) cannot come up with evidence to support your nice theoretical model (the Frenkel-Taylor that rules in the long run, are we clear?!), what should we call you?

Confused does not seem the correct definition for someone that keeps defending an idea for which there is no evidence (don't worry, I'm not in the game of name calling).

Finally, I should add here, that while I do think that the government has committed mistakes, and allowing the blue (the black market) exchange rate to depreciate and not hike interest rates earlier is one of those (I would the need of a more aggressive Import Substitution policy to reduce the external constraint, something I defended as early as March 2012; see here), I still think that this government should be supported and is much better than the alternative (Martín is certainly not in favor of the government).