LATIN AMERICA ECONOMICS FOCUS

Dollarisation not a silver bullet for Argentina

- **History suggests that dollarisation, which is at the heart of Argentine presidential candidate Javier Milei's policy platform, is a surefire way to get inflation under control. But whether this translates into broader macro stability would hinge on conversion taking place at a competitive exchange rate, as well as broader reforms to reduce fiscal profligacy and lift potential growth. We would not hold our breath.**
- The recent primary election results (known as the PASO) have led to increased scrutiny of leading candidate Javier Milei's radical proposal to dollarise Argentina's economy (that is, making the dollar legal tender and scrapping the peso). There are several channels through which dollarisation can improve macro stability. **The constraints imposed by dollarisation can help to get inflation – which is currently running at over 100% – under control**. Policymakers give up the ability to print local currency and hand over the monetary policy reins to the Fed. Dollarised economies in Latin America (El Salvador, Panama and Ecuador) have had markedly lower inflation than elsewhere in the region.
- On top of that, dollarisation might help to bring down risk premia on Argentine assets, supporting stronger investment and faster growth. There are also potential gains in terms of financial stability. Dollarising removes the threat of large and disorderly currency falls that have often triggered banking crises in EMs.
- That said, there are some potentially undesirable consequences. **In the event of an adverse shock that requires a sizeable adjustment in the real exchange rate to correct macro imbalances, that would need to come through lower wages and prices – known as internal devaluation**. What's more, the lack of power to print dollars also means that the central bank would have to surrender its role as a lender of last resort.
- **There are also practical considerations ranging from a lack of popular support to legislative hurdles to whether the central bank has enough dollars to dollarise**. Currently, the BCRA doesn't have the resources to convert all peso notes and coins in circulation to dollars while being able to meet its upcoming repayment obligations. That isn't necessarily a deal breaker, but Argentina would have to run current account surpluses (via weak demand) to secure the necessary dollars.
- **One underappreciated point in the debate around dollarisation is that the exchange rate at which conversion takes place will be key as to whether it is a success or not**. Dollarising without undertaking a large devaluation of the peso would leave Argentina with a highly uncompetitive economy.
- **Even if all of this is achieved, dollarisation is far from a cure for all of Argentina's economic ills**. Fiscal policy would still be left at the whims of politicians. Ecuador's government has defaulted twice since the dollar was made legal tender there. Mr. Milei's plans for a big fiscal squeeze would come up against opposition in congress and Argentina's institutional setup makes it very difficult to impose fiscal discipline.
- **If Argentina does dollarise, the nature of future economic crises would look different to those of the past**. While it may mean that Argentina would no longer endure large and disorderly currency falls and skyrocketing inflation, the adjustment to a large adverse shock would need to instead come via significant changes in domestic prices and wages. If that proves unpalatable, sovereign default risks would arise again.

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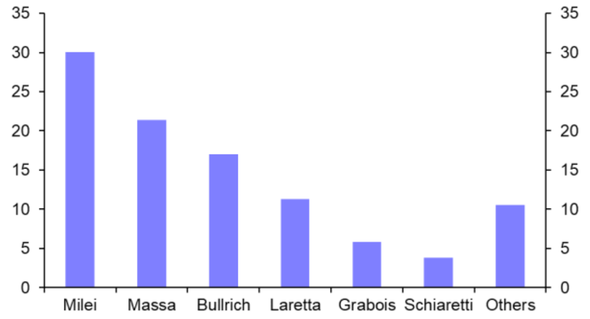
Dollarisation not a silver bullet for Argentina

There is currently a frenzied debate among Argentina watchers over the proposal by one of the leading presidential candidates to dollarise the economy. In this *Focus,* we assess both sides of the argument and, if Argentine policymakers were to go down this route, whether dollarisation would be a success.

Milei wins PASO, dollarisation tops agenda

Argentina's PASO elections which took place earlier this month saw far-right candidate, Javier Milei, come out on top. (See Chart 1.) There's no guarantee that he will ultimately secure the presidency in October but, even so, his strong showing has resulted in increased scrutiny of his radical policy proposals.

Chart 1: Presidential PASO Results (% of Total Votes)



Source: resultados.gov.ar

The most prominent among these are plans to dollarise Argentina's economy (or "burn down" the central bank as he likes to put it). This would involve removing the peso as legal tender and adopting the US dollar instead. The proposal has received the backing of the Washington-based think-tank, The Cato Institute, and been subject of a book by Argentine economics professors Emilio Ocampo and Nicholas Cachanosky – frequently referenced by Milei himself. In fact, there have been suggestions that Ocampo, who has officially joined Milei's campaign, will be appointed governor of Argentina's central bank and tasked with winding down the role of the institution.

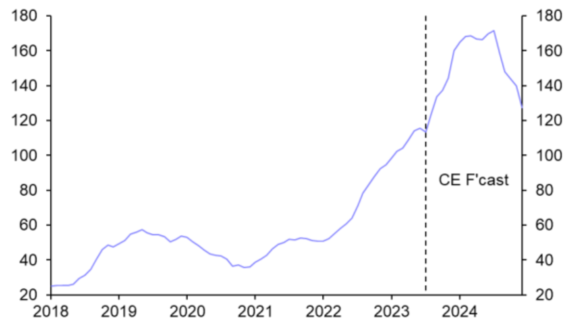
The case for dollarisation

Given Argentina's economic history, it's not really a surprise that this proposal has been put forward. The overarching rationale is that adopting the dollar – as other countries in Latin America such as Ecuador, El Salvador and Panama have done – is seen as a way of imposing policy discipline, tackling inflation and fostering broader macroeconomic stability.

Some form of peg to the dollar has formed a key and successful element of macro stabilisation policies in Latin America in the past. A classic example is the real plan (Plano Real) that was implemented in Brazil in 1994. In Argentina's case, however, the lack of credibility among policymakers means that implementing a hard dollar peg or a return to the currency board arrangement (the "convertibility plan") that Argentina adopted in the 1990s – and abandoned in the 2001/02 crisis – is out of the question. Dollarisation is the only game in town if officials want to import policy discipline since, in contrast to a currency board, it is much more difficult (if not impossible) to reverse.

There are several channels through which dollarisation can improve macro stability. **To start with, the constraints imposed by dollarisation can help to get inflation under control**. This is something that is sorely needed in Argentina right now, where the devaluation of the peso soon after the PASO election is likely to push inflation towards 170% y/y. (See Chart 2.)

Chart 2: Argentina Consumer Prices (% y/y)

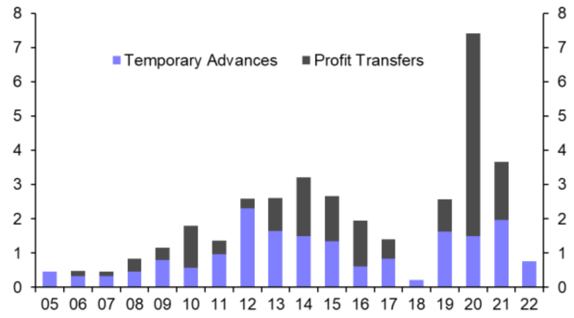


Sources: Refinitiv, Capital Economics

By dollarising, policymakers give up the ability to print local currency – a perennial problem in Argentina where the government leans heavily on the central bank to finance the budget deficit (see Chart 3) – and hand over the reins of monetary policy to a credible inflation-fighting institution in the Fed.

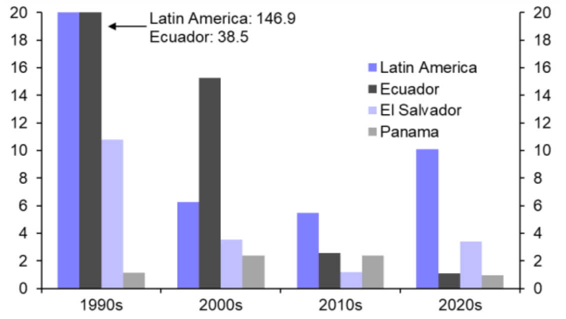
The evidence shows that Ecuador and El Salvador have both had better experiences with inflation since dollarising in the early 2000s. Both countries suffered from very high inflation rates in the 1980s and 1990s, but over the past 10-15 years, inflation has averaged around 2%, much lower than in other parts of Latin America. (See Chart 4.) Panama, which has used the dollar since independence in 1904 has a history of low inflation. Dollarisation also helped Zimbabwe move out of hyperinflation in the late-2000s.

Chart 3: Central Bank Financing to the Government (% of GDP)



Sources: Refinitiv, Capital Economics

Chart 4: Consumer Prices (% y/y)



Sources: Refinitiv, Capital Economics

As well as getting the inflation genie back in the bottle, there are a number of other potential benefits from dollarisation. It may be perceived as a permanent shift towards more credible and orthodox policymaking, which would help to bring down risk premia on Argentine assets. In turn, that may support stronger investment spending and faster growth.

There are also potential gains to be made in terms of financial stability. Dollarising removes the threat of the large and disorderly currency falls that have often triggered banking crises in EMs (including in Argentina itself in 2001/02). Currency mismatches on banks' balance sheets are eliminated. Dollarisation may also improve confidence in the stability of the banking system and boost financialisation across the economy. Meanwhile, some argue that, by reducing transaction costs and eliminating exchange rate risk, dollarisation can support integration with the US.

Reasons for caution

That said, there are some potentially undesirable consequences from dollarising an economy. Giving up control of monetary and exchange rate policy may help to foster macro stability, but it also leaves officials with only limited policy levers to deal with external shocks. The monetary policy stance in the US may not be appropriate for Argentina at any given time since their business cycles are not well synchronised. **In the event that a sizeable adjustment in the real exchange rate is needed to correct macro imbalances, that would need to come through lower wages and prices – known as internal devaluation – rather than a weaker currency.**

The lack of power to print dollars also means that the central bank would have to surrender its role as a lender of last resort. Officials could establish savings vehicles to be used solely for the case of providing emergency liquidity to banks and protecting deposits. Ecuador has established the Liquidity Fund, funded partly through contributions from financial institutions, to help provide emergency liquidity during times of financial stress, as well as a Deposit Insurance Scheme that guarantees deposits up to $32,000. Even so, these still only offer limited firepower to respond to bank runs. The government would certainly not be able to credibly commit to a blanket guarantee of banks' deposits.

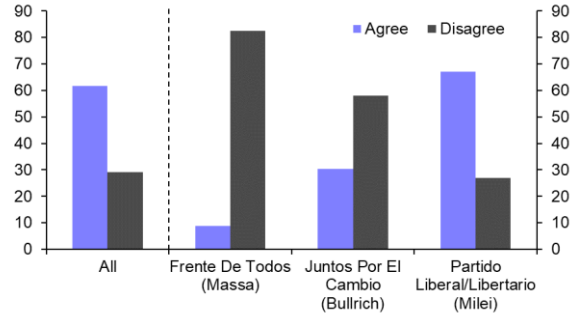
Meanwhile, stopping the money printing presses means that the government also loses out on future seigniorage earnings – that is, the profit made by the government that represents the difference between the cost of producing currency (notes and coins) and its value, although these are generally considered to be quite small. For instance, Argentine economist Emilio Ocampo mentioned earlier estimates that seigniorage revenues in Argentina are equal to just 0.2% of GDP.

Theory meets reality

If policymakers still decide to push ahead, more practical considerations will quickly come into play. For one thing, dollarisation doesn't appear to be

popular. Surveys suggest that less than a third of Argentines favour dollarisation. (See Chart 5.) That suggests that, if officials do decide to go down this route, there would need to be a concerted effort to explain why they are doing so. There are also potential legislative hurdles – even if Milei becomes president, the constitution states that he would need to get approval from congress to dollarise. Milei has suggested that he could seek a referendum on dollarisation in a bid to skirt around congress but a referendum would still need congressional approval.

Chart 5: Do you Agree or Disagree with Dollarising the Economy? (% of Respondents by Party Affiliation)

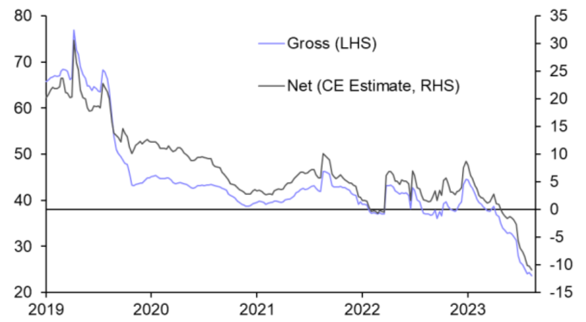


Source: Zuban Córdoba

Then there is the more fundamental issue of whether Argentina would actually be able to dollarise. The process would require the monetary base (most of which consists of peso notes and coins currently in circulation) to be converted into dollars which, based on the current official exchange rate, would cost approximately $18.5bn. If the peso were devalued closer to the parallel rate, the cost would be about $9bn. Argentina's gross FX reserves amount to $23.7bn but, once short-term FX liabilities are accounted for, they are actually negative $11bn. (See Chart 6.) In other words, the central bank does not currently have the resources to convert all existing pesos into dollars while being able to meet short-term repayment obligations.

That isn't necessarily a deal breaker. Conversion of physical notes and coins could take place over time (perhaps with the peso and dollar both being legal tender for a period), although Argentina would eventually still need to acquire sufficient dollars. Achieving this would require current account surpluses and/or large capital inflows from abroad. Given the difficulty of the latter, the former is the most plausible option – but that would require a prolonged period of weak demand.

Chart 6: Foreign Exchange Reserves ($bn)

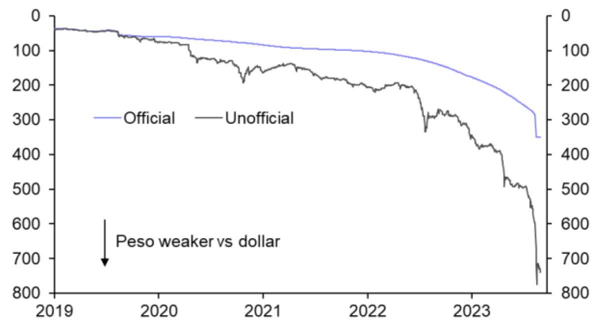


Sources: Refinitiv, Capital Economics

Conversion rate is key

One underappreciated point in the debate around dollarisation is that the exchange rate at which conversion takes place would be key to its success. Even after its recent devaluation, the peso remains significantly overvalued, with the currency trading at a rate 50% weaker against the dollar on the parallel market. (See Chart 7.) We think the peso would need to fall to around 700/$ in order to bring the real effective exchange rate closer to fair value. Dollarising without devaluing would leave Argentina with a highly uncompetitive economy. This could only be fixed through a prolonged period of weak domestic demand that generates low wage and price pressures compared with trading partners.

Chart 7: Argentine Peso (vs. $, Inverted)



Sources: Refinitiv, Capital Economics

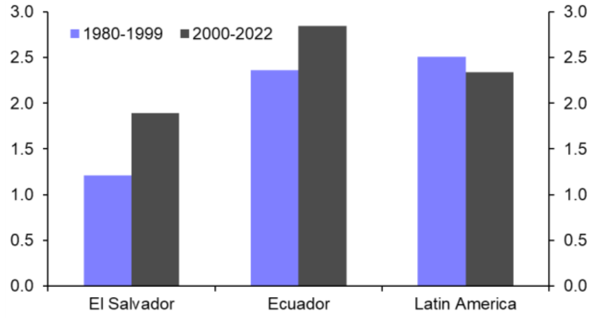
Dollarisation will not cure Argentina

Even if all of this is achieved, dollarisation is far from a cure for all of Argentina's economic ills. Importing monetary discipline still leaves fiscal policy open to the desires of politicians. Ecuador shows that, even in a dollarised economy, fiscal profligacy can place the public finances on an unsustainable path – its government has defaulted twice since the dollar was made legal tender. This followed a series of legislative changes that abandoned many of the fiscal prudential rules imposed in the wake of dollarisation and paved the way for a more pro-cyclical fiscal stance, partly financed by the central bank. In 2009, central bank officials adopted a resolution that allowed it to acquire government bonds from public banks. This was followed, in 2014, by a new "Monetary and Financial Code" that enabled direct credit operations between the central bank and the finance ministry. In other words, policymakers found ways to get around the hard constraints imposed by dollarisation. (For more details, see this IMF report from last year.)

In Argentina, Mr. Milei has called for an aggressive fiscal squeeze alongside dollarisation. But, even if he is elected, it remains to be seen whether he could impose these cuts in spending given that he is unlikely to hold significant power in congress. Moreover, fiscal discipline would probably need to be enshrined in some form of fiscal rule to tie the hands of future politicians. At the very least, the current institutional setup which incentives fiscal profligacy would need to be reformed. (See here.)

Dollarisation is no guarantee of strong growth either. Admittedly, both Ecuador and El Salvador have recorded faster economic growth since dollarising in the early 2000s compared with the previous two decades. In contrast, growth across the rest of Latin America slowed over the same period. And it's probably safe to say that economic outcomes have been better than if Ecuador and El Salvador hadn't dollarised. Even so, the improvement in economic growth was modest and, at 2-3% per annum, it has been broadly in line with the Latin American average. (See Chart 8.) In Argentina's case, reducing inflation would certainly help by easing distortions in the economy. But there's a long list of factors that hold back growth, running from high trade barriers to high informality in the labour market to low levels of investment.

Chart 8: GDP (% y/y, Avg.)



Sources: Refinitiv, Capital Economics

Summary

All told, history suggests that dollarisation is a surefire way to get inflation under control. But whether this translates into broader macro stability and stronger growth in Argentina would hinge on conversion taking place at a competitive exchange rate, as well as if politicians can move away from fiscal profligacy and implement broader structural reforms.

Perhaps one key difference that dollarisation may bring is with regards to the nature of future crises in Argentina. While it may mean that Argentina would no longer endure large and disorderly currency falls and skyrocketing inflation, the adjustment to a large adverse shock would need to instead come via significant changes in domestic prices and wages. If that proves unpalatable, sovereign default would rear its head once again.