

Inflation and the exchange rates: how do they relate to Brazil's "feeling of prosperity" and Argentina's "sense of frustration"

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Motivation

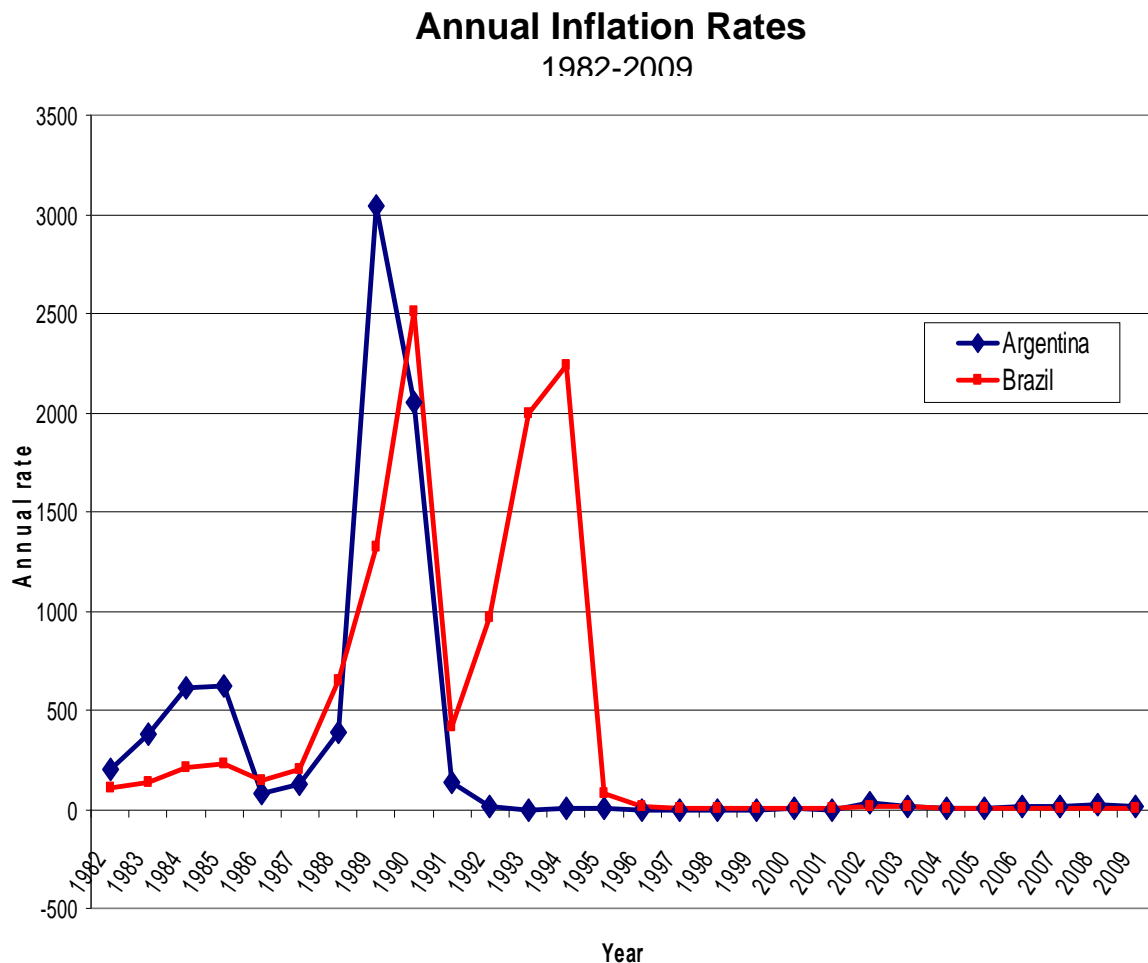
- Nowadays a feeling of prosperity prevails in Brazil. By contrast, in Argentina there is a feeling of frustration. I wonder why.
- For many, this phenomenon is puzzling because Argentina out-performed Brazil in per-capita GDP growth since the debt crisis of 1982, and its economy grew recently at “Chinese” rates, something that has not happened in Brazil.
- The answer I found to this question sends a message of caution to policymakers in the emerging world that are trying to imitate China’s formula for rapid growth: maintaining an undervalued currency for long periods of time.
- The answer is also relevant to think about the mistakes that should be avoided by the European countries that have given up monetary sovereignty and are now facing the risk of deflation



Main findings

- Brazil and Argentina could renew growth during the 90s thanks to the drastic reduction of inflation rates
- The attempts to keep long periods of undervalued currency (high Real Exchange Rates) did not help growth, not even helped exports.
- The different current feelings in Brazil and in Argentina relate to the different monetary policies implemented in each country after abandoning the nominal exchange rate anchor.
- Inflation targeting, as implemented by Brazil, helped to keep inflation under control and this, I argue, explains the feeling of Prosperity
- Real Exchange Rate targeting, as implemented in Argentina since 2002, reintroduced inflation into the economy and this, in my opinion, explains the current feeling of frustration.

Hyperinflations and dollar-anchored stabilization plans are crucial to understand the economic performance in Argentina and Brazil



- Both countries suffered hyperinflations of similar intensities
- Argentina implemented its “Convertibility Plan” in 1991
- Brazil implemented “Plan Real” three years later



Although similar in intensity, the inflationary experiences of the two countries did have some relevant differences

- Brazil enjoyed lower relative price volatility than Argentina's, due to more extensive use of wage, price, and financial indexation
- Argentina suffered more severe income and wealth redistribution effects, and its inflation wiped out domestic debt and eroded domestic savings more often than in Brazil



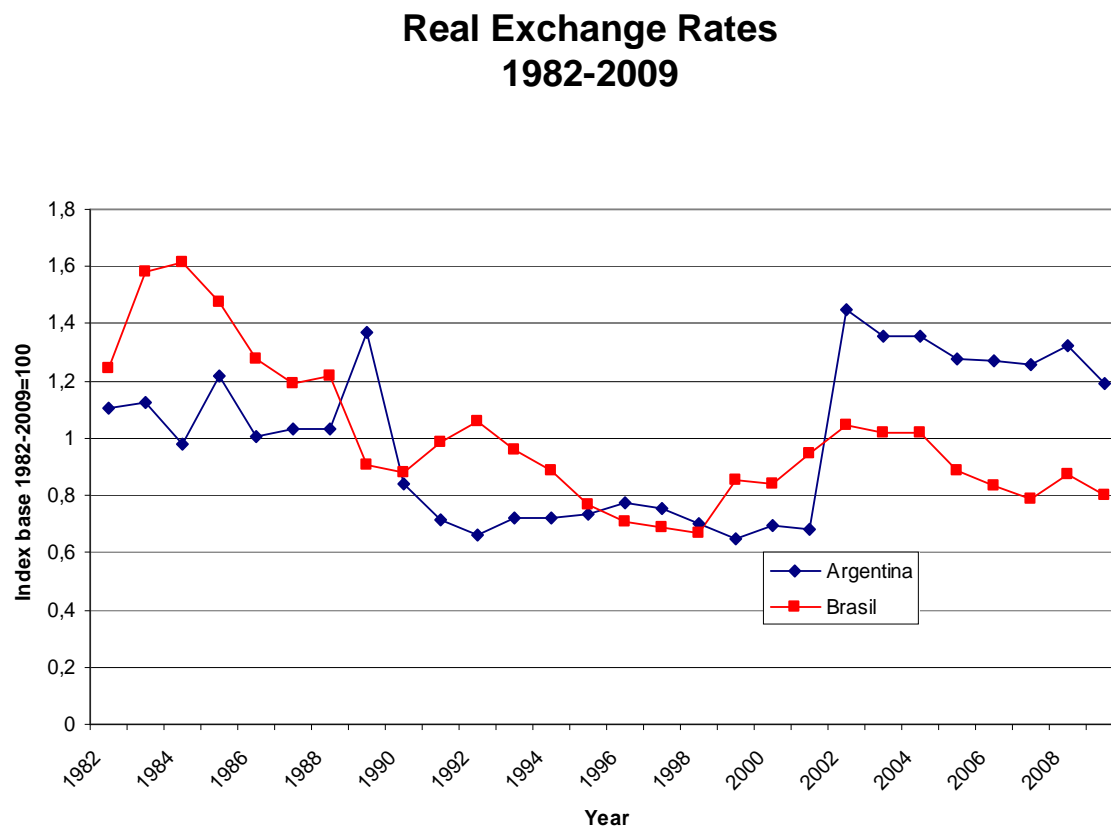
Inflation had a strong negative effect on growth in both countries

- The negative effect was more severe in Argentina. Not surprisingly the benefits of the stabilization were higher in Argentina than in Brazil
- There is a widespread opinion in Argentina that argues that the better performance of Argentina relates to the fact that during the last 7 years its government implemented an high RER growth strategy “*a la Chinese*”, while Brazil insisted with its “neo-liberal” inflation targeting monetary policy.

Inflation and per-capita GDP growth

Period	Argentina (Annual % change)	Brazil (Annual % change)
High Inflation	-1,8	0,3
Low Inflation	2,7	1,4
1982-2009	1,3	1,1

The RER was higher in Brazil until 2001 and lower afterwards



- In Brazil the RER had a downward trend
- In Argentina there were three sub-periods marked by the real appreciation in 1991 and the even larger real devaluation in 2002
- After 2002, Argentina's RER was higher than Brazil's

Economists that support currency undervaluation argue that the higher RER caused higher GDP growth in Argentina

- Consistent with this opinion, the annual rate of GDP growth was higher in the country with higher RER: Brazil before 2001 and Argentina after 2001. The advantage seems to be much larger for Argentina in the second period.
- If the analysis looks at what happened after Argentina got rid of hyper-inflation, the picture looks rather different.

Per-capita GDP growth in three key sub-periods

Period	Argentina (Annual % change)	Brazil (Annual % change)
1982-2001 (Higher RER in Brazil)	0,5	0,6
2001-2009 (Higher RER in Argentina)	3,4	2,1



The superior performance of Argentina in terms of per-capita GDP growth started with the Convertibility Plan

- The devaluation of the peso had no impact on the relative growth performance. In both periods the rate of growth of per capita GDP was 1,3 percentage points higher in Argentina than in Brazil.

Per-capita GDP growth in two key sub-periods

Period	Argentina (Annual % change)	Brazil (Annual % change)
1991-2001	2,7	1,4
2002-2009	3,4	2,1



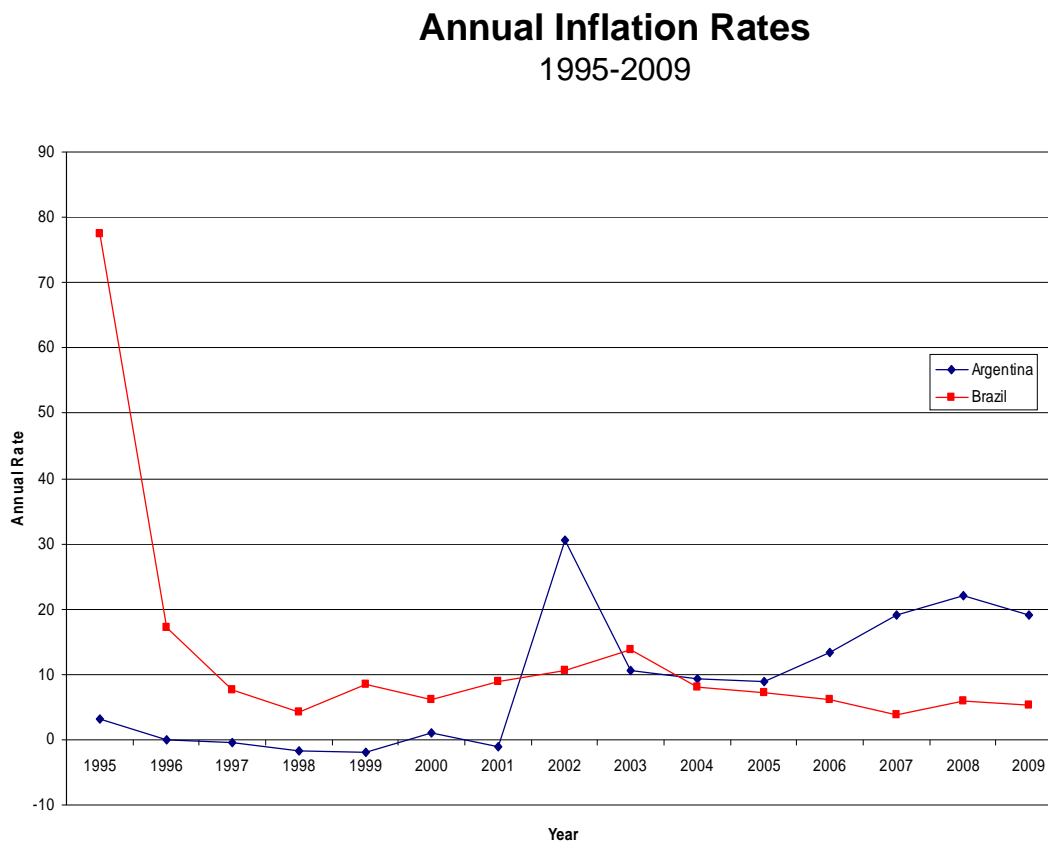
A high RER was not associated with a better export performance.

- This is another indicator that the main explanation of the superior growth performance of Argentina is not the high RER policy after 2001 but the low inflation achieved after 1990

Per-capita export growth in two key sub-periods

Period	Argentina (Annual % change)	Brazil (Annual % change)
1991-2001	4,9	4,5
2002-2009	3,4	3,4

Now, let's address the initial question: how can we explain the very different current feelings in Brazil and in Argentina?



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- The answer is related to the sharp real devaluation of the Peso in 2002 which had damaging effects on Argentine Society:
- The sharp devaluation, that came as a consequence of the decision to compulsorily convert dollar assets and liabilities into pesos at parity, reintroduced inflation as a pervasive phenomenon.



The main damaging effects of the sharp devaluation and the high RER policy after 2001 were:

- 1) As in the past, inflation generated wild fluctuations in relative prices, real wage deterioration, and increased government intervention in many markets.
- 2) The default and the forced restructuring of all kinds of debts destroyed domestic and foreign credit for the private and public sectors.
- 3) Investment in modern infrastructure and advanced capital equipment was discouraged by price controls and regulatory uncertainties
- 4) Goods and services that embody modern technologies or require advanced technical equipment to be produced, became very expensive. The reduced purchasing power of wage income in terms of these kind of advanced goods and services severely affected the middle classes.



The previous description suggests that a comparison of per-capita GDP at constant import prices may provide a more realistic picture of the performance of the two economies..

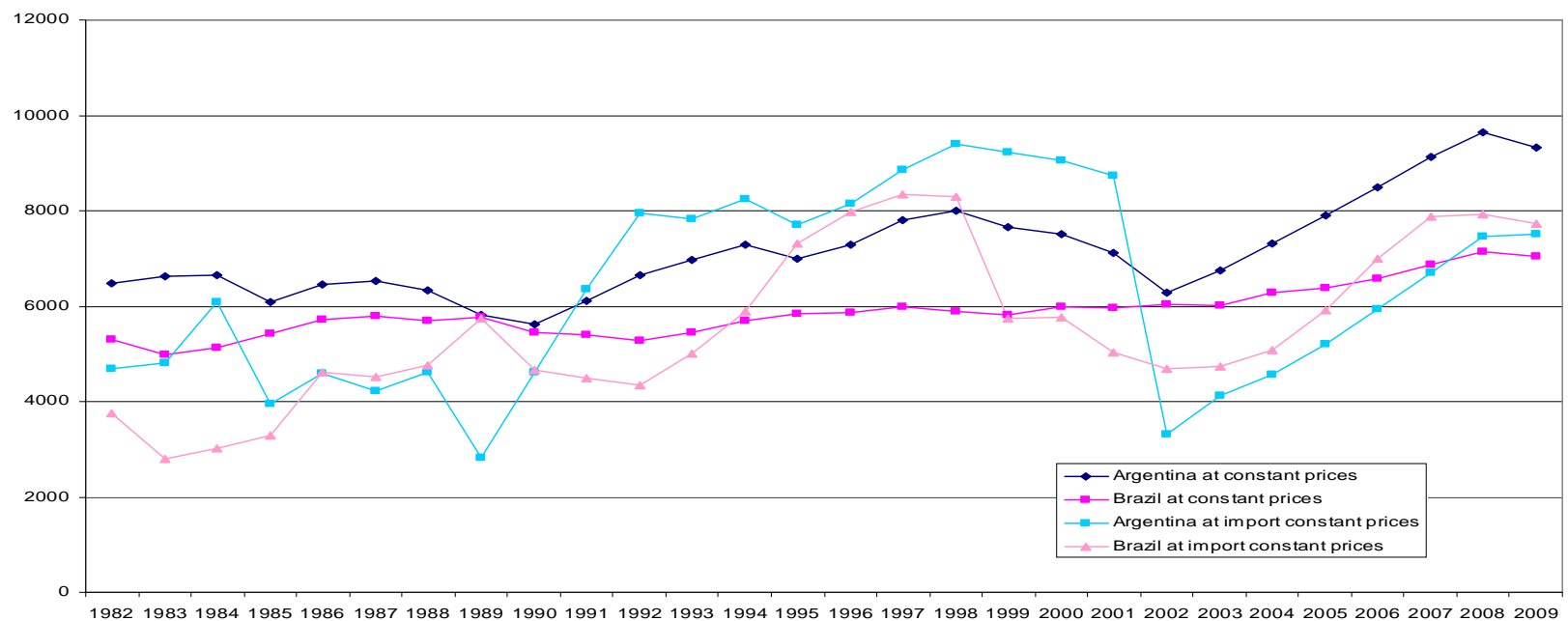
- Measured at constant import prices, Brazil's per capita GDP grew 5,6% during the last eight years, while Argentina declines -1,9%
- In sharp contrast, during the Convertibility Plan, Argentina's per capita GDP expanded 6,0% per year, while in Brazil only 0.7%

Per-capita GDP at constant import prices growth in two key sub-periods

Period	Argentina (Annual % change)	Brazil (Annual % change)
1991-2001	6,0	0,7
2002-2009	-1,9	5,6

Now, we should look at the evolution of real per-capita GDP and per-capita GDP at constant import prices

The Figure explains not only why nowadays a feeling of prosperity prevails in Brazil, but also why a similar feeling, that prevailed in Argentina during the 90s, vanished in the last decade. The devaluation of 2002 reintroduced inflation and provoked a big fall in the standard of living of the middle classes.





But, before accepting this conclusion, the following question should be answered: could Argentina have avoided a large undervaluation of the Peso after 2002?

- The answer is yes. The old dollar assets and liabilities should have been restructured without changing the currency denomination, and monetary policy should have followed an inflation target.
- Why this alternative was not chosen? Simply because there was a myopic political decision to get rid of the debt problem by inflating debts away.
- Inflating debts away looks like the easy option for debtors, but it destroys credit and entrepreneurship, encourages government intervention, creates room for heavy taxation of export activities, creates incentives for rent seeking, generate distributional conflicts and many other social vices. In the long run, it reduces growth and leads to stagflation



Policymakers in emerging economies are encouraged by many economic advisors to keep undervalued currencies for a long period of time. What do our findings say about this proposed strategy?

- This is not good advice. Particularly if to keep an undervalued currency for long periods of time, means to start with a large real devaluation, and afterwards:
 - 1) to admit accelerating inflation, or
 - 2) to introduce many micro economic distortions (like export taxes and price controls)

- The Chinese could implement such policies because their undervaluation came from increased productivity and it did not require an initial large nominal devaluation. Their sterilization policies and administrative control of many prices created relative price distortions, but their high rate of savings allowed them to compensate and finance their investment inefficiencies. Not many emerging economies have the same initial conditions.



Several nations in Europe are facing the same dilemma that Argentina did in 2001: how to avoid entering in a long period of deflation and recession. Is there anything to learn from the Argentinean experience?

- For those countries that are already in the Euro Area, the Argentinean experience suggests that they should not abandon it unless they are forced to exit. If a country is forced to go back to its national currency, it should not compulsorily convert existing assets and liabilities into the new currency.
- For those that are pegged to the Euro but are still non members, the Argentinean experience suggests that they should try to be accepted as a formal member, but enter after making the minimum devaluation necessary to restore a sustainable current account deficit. If instead they decide to let their currency float, that should be done only after closing a successful orderly debt restructuring process.
- To cope with the debt problem, countries should conduct orderly debt restructuring processes. If instead they try to “inflate away” their debts, they will suffer the same disease that Argentina is suffering now: stagflation and a feeling of reversal of its previous prosperity.