

## Could the Dollar Era end in global inflation?

Written by Domingo Cavallo for the "Astana Economic Forum 2011", to take place in Kazakhstan on May 3-4, 2011

This is the question I am more frequently asked in discussions on the future of the Global Economy. Those that ask me this question assume that being an Argentinean I should be more aware than other economists of what policy mistakes can increase the risk of inflation.

In answering this question I start saying that I am not pessimist on the future of the market economic system. So far, the market economic system has been expanding and spreading all over the world. Even in ostensibly communist China, the economic system has become more and more market oriented in the sense of using markets and economic incentives associated with well defined property rights to produce and distribute goods and services that satisfy people's needs.

In general, the market economic system has improved the standard of living of billions of people and has helped to reduce poverty during the last two centuries. The contribution of the market economic system to increase people's welfare came mainly from a particular kind of entrepreneurship that flourishes under its reign: an entrepreneurship that pushes the adoption of efficient innovations and helps to spread them in all productive activities across all corners of the world.

There have been past crises and exceptions, but crises and exceptions have, more frequently than not, helped to correct the wrong courses and to revive the market economy in a more responsible and sustainable trend.

There is, nevertheless, the risk that the crisis that started in the US in 2008 may push the global market economy into a labyrinth. **That risk is no other than the Dollar Era ending into a global inflationary process.**

I will use my knowledge of Argentina's history and my experience in managing its economy during the nineties, to identify the risks that the global economy is

facing today. I will also identify the wrong policy approaches that have to be avoided in order to make the market economy sustainable and more socially responsible.

Argentina offers lessons in “what not to do” and explains what can cause the market economy to fail, because unfortunately my country is one of the few exceptions in the general successful experience of capitalism as a social system. Argentina was an early capitalist success story which together with that of the United States, Canada, Australia and New Zealand followed the steps of the process that started in Great Britain in the nineteenth century and generated the first big wave of globalization. But from the mid forties of the Twentieth Century, Argentine market economy started a long term decline that, even with all the aggressive economic market oriented reforms of the nineties has not yet been reversed.

Why did it happen? Why did a country in which efficient and innovative entrepreneurship had previously flourished and transformed its agriculture into a world power failed to build on its success? The answer is simple: **Argentina failed due to persistent use of inflation as an instrument to soften the burden of private and public excessive indebtedness.**

In Argentina, since the mid forties until now (with the only exception of the nineties) equity capital was eroded by arbitrary taxation and expropriation; and debts were, most of the time, not paid but inflated away. Even in 2002, after 10 years of successful stabilization and renewed growth, the recession that was caused by very unfavorable terms of trade since 1999 and excessive leverage of the provinces, was “resolved” by abandoning monetary discipline, inflating away domestic debts and defaulting on the foreign debt. That is why today -after eight years of very favorable external conditions the Argentine economy is suffering again from persistent inflation. This is a clear signal that its rapid growth of the last eight years is non-sustainable and poverty is aggravating.

Argentinean bad experience offers lessons for the current state of the global economy. It is relevant in the sense of indicating what mistakes have to be avoided as we emerge from the current global crisis.

**The crisis that started in the US in 2008 was the consequence of excessive leverage.**

In some countries it was excessive leverage at the level of families and businesses, in other countries it was excessive leverage at the level of governments and in most places, excessive leverage of the financial intermediaries. This excessive leverage, particularly that of households and corporations was encouraged by taxation and regulation that discriminated against equity capital and provided encouragement to debt financing. Excessive leverage of financial intermediaries may have been the result of greed and lax regulations on capital requirements. Excessive leverage of governments was primarily due to rapidly increasing public expenditure, tax evasion and bail outs of private debt, including those of financial institutions. In this sense we can say that the significant parts of the global economy have been infected of the "Argentine Economic Disease".

The big risk for the future arises from the possibility that governments, financial institutions and big businesses finally decide that the solution is also to deal with it the "Argentinean way", that is, inflating the debt away and generalizing default.

This is a relevant warning these days. Look at the policies that are being implemented in the US, the economy that provides the most important global currency and listen to the proposals of leading American economists. They propose increasing the inflation target to 4-5 % annually, for several years, in order to generate negative real interest rates and soften the burden of debts.

It will not be easy for Europe, the UK and other advanced economies to counteract with their local monetary policies the excessively expansionary monetary policy of the FED. Keeping locally monetary restraints may generate excessive appreciation of their respective currencies and make even more difficult to prevent financial crisis of their own. So, **there is the risk that monetary policies became globally very expansionary and inflation becomes a persistent phenomenon all over the world. In that case the Dollar Era may end in global inflation.**

Inflation makes ample room for unethical behavior, corruption and widespread inefficiency. Inflation destroys entrepreneurial spirits and feeds destabilizing speculation. That would be a dangerous course for global capitalism: a socially unjust and politically unsustainable course for the economic system that for two centuries served humanity well.

**Fortunately there is an alternative solution to the excessive leverage that provoked the global crisis.**

Instead of inflating away debts and generalizing default, national states and global institutions could work together to encourage equity capital to reinforce viable corporations, both financial and non financial, and to facilitate the creation of new ventures.

At the same time, regulations that limit leverage and elimination of tax incentives for debt financing should reverse the past trend to excessive leverage.

To cope with the debt problems that created the current crisis, the solutions should not be “bails outs” that simply transform private debts into public debts but “bails in” through orderly processes of debt restructuring. Governments and International Financial Institutions should concentrate their interventions in the financial field primarily on facilitating the debt restructuring processes and not bail out creditors that took excessive risks.

For the future, **an international monetary system that offers a global currency to target global inflation and protects monetary reserves from national inflationary pressures, will encourage “bails in” rather than inflationary “bail outs” as the solution for debt crises.**