Letting go

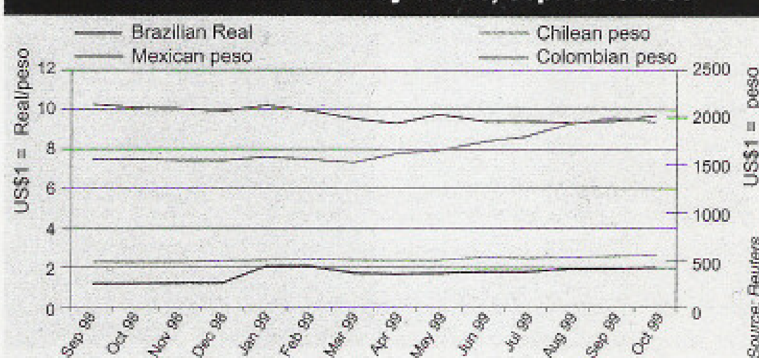
The currency band, once praised as a sound middle ground between volatile free-floating money and unpatriotic dollarisation, has fallen out of fashion in Latin America. Mary D'Ambrosio reports

Less than a year ago, currency bands were all the rage in Latin America. Now they are being unceremoniously dumped. The currency band – under which a country commits to holding currency values within publicly-stated ranges against hard currencies such as the US dollar – was seen to have several advantages. It could limit inflation, comfort investors about the direction and value of money, and satisfy a government's political need to keep printing tender stamped with the national flag. But struggling to cope with deep recession, Brazil, Chile and Colombia all abandoned their currency bands this year, to avoid spending precious foreign reserves to prop up their currencies. They were prepared to allow depreciation if necessary, in order to encourage export-led recovery.

To the surprise of many foreign investors, fears of inflationary spikes and currency plunges proved overblown. Brazil, the first of the three to let go of its band in January, is likely to have an inflation rate of under 10% this year, in line with government forecasts. When Chile suspended its peso band in early September, the peso weakened only slightly. Colombia, in severe economic doldrums, followed suit at the end of September. So far it has experienced neither significant depreciation nor rising inflation.

Foreign investors do not appear to miss the bands. Some even argue that they were always a damp squib. "Bands are not a solution. I think that's clear," says Claudia Calich, Latin America analyst at Oppenheimer Funds in New York. "The fact that you have a band doesn't make currency volatility any less." Calich pays more heed to a country's growth pattern, fiscal system and monetary policy than to the value of its currency. "Currency is a symptom of everything else that goes behind it," she says.

The contrasting experiences of Mexico and Argentina have also cast doubts on the wisdom of bands. Mexico was forced to abandon its currency band in December 1994 – disastrously, it seemed then – when its government was unable to defend the peso against heavy selling. That led to a halving of the value of the peso, and the 18-month Mexican peso crisis. Yet, five years later, Mexico is enjoying a period of renewed foreign direct investment and economic resilience, and its free-floating currency is relatively stable (see figure).



Meanwhile Argentina, which in the early 1990s took the hardest line against its own currency and created a currency board – pegging one peso to one dollar – is experiencing its worst recession for 50 years. Its economy is predicted to shrink by as much as 4% in 1999. Argentina has fewer recovery tools: the currency board has eliminated the option of using monetary policy. And a peg is much harder to undo than a band.

The Argentine spectacle is scaring other Latin American countries away from locking in strong or overvalued currencies, according to Thomas Trebat, a Latin America analyst at Salomon Smith Barney in New York. He says that the disappearance of Latin American currency bands goes in tandem with rapidly dwindling support for dollarisation in US policy quarters. Dollarisation "was everything six months ago," he says. But scepticism in the US government and International Monetary Fund about the prospect of a dollarised Latin America has given the region another reason to be wary of currency fixes.

Recovery in Rio

When Brazil proved it could let go of its band without kicking up inflation, other Latin American countries began gravitating towards the Brazilian model – and away from Argentina's. "Argentines sneered at Brazil when it devalued its currency in January," recalls Walter Molano, Latin America analyst at BCP Securities in Connecticut. "A lot of Argentines are now scratching their heads, while Brazil is recovering, and Argentina is in its worst recession since the [Great] Depression."

Molano argues that Latin American countries have historically used pegs and bands to keep currencies from getting too strong, not too weak. The first Latin American bands were established in the early 1990s. This was a period of high global liquidity, when the US was running a more expansive monetary policy, Latin America was beginning to restructure and repay defaulted foreign debt and capital was flowing into the region for the first time in a decade. Pegs and bands, Molano suggests, were hedges against currency overvaluation.

Now investors are clamouring for Venezuela to abandon its band, too. Some argue that the Venezuelan bolívar is overvalued by as much as 50% and suggest it follow the Chilean and Colombian examples and let go of its band from a position of strength. While the price of its chief export – oil – is high, the bolívar is less likely to plunge. Eliminating the band – and allowing devaluation – should improve the economic health of the non-oil sector by stoking exports.

If Venezuela does let its currency float, Argentina alone will have formally referenced money. Unlike its neighbours, Argentina cannot casually let go of its policy. "The cost of abandoning it is higher than keeping it," says Calich. Some 70% of Argentine private sector debt, and 90% of public debt, is in dollars. Ending the currency board would cause major defaults and bankruptcies. "It would set Argentina back another decade," Calich warns. ■