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Steve Hanke and Kurt Schuler

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Central Banking Publications Ltd
6 Langley Street, London WC2H 9JA, UK
Tel: +44 20 7836 3607, Fax: +44 20 7836 3608
E-mail: info@centralbanking.co.uk
Website: http://www.centralbanking.co.uk

What went wrong in Argentina?

Staunch defenders of currency boards *in theory*, Steve Hanke and Kurt Schuler scrutinise the Argentine arrangements. Where did Argentina fail – and what lessons can be learned?

One phase of Argentina's currency crisis ended with the devaluation and floating of the peso decreed on January 6 2002; another phase is now underway. The conventional wisdom about Argentina is that the peso had to be devalued because its currency board link to the dollar had made it overvalued, making the Argentine economy uncompetitive and stifling economic growth. Before central bankers accept the conventional wisdom, they should examine it carefully. The monetary system Argentina recently abandoned has never been well understood, either in its strengths or its weaknesses[1].

Was Argentina's monetary system an orthodox currency board?

Argentina's monetary system from April 1 1991 to January 6 2002 was known locally as convertibility. It was an unusual name for an unusual system. The convertibility system was not an orthodox currency board. Rather, it was a currency-board-like system: a mixture of currency board and central banking features. In writings dating back to 1991, we proposed that Argentina establish an orthodox currency board and criticised convertibility as an unstable, mixed system. The three defining features of an orthodox currency board are:

- a fixed exchange rate with its anchor currency;
- unrestricted convertibility into and out of the anchor currency at the fixed rate; and
- net reserves of 100% or slightly more of the board's monetary liabilities, held in foreign assets only.

Together, these three features imply that an orthodox currency board is a narrowly focused, rule-bound institution. In particular, an orthodox currency board lacks the power to conduct sterilised intervention, does not lend to the government, does not regulate commercial banks, and does not act as an official or unofficial lender of last resort.

The convertibility system lacked one or more of the defining features of an orthodox currency board throughout its lifetime. Last year, when the

1 For a full analysis, see Kurt Schuler and Steve Hanke, "How to Dollarize in Argentina Now," Cato Institute, Washington, January 2 2002, available through Kurt Schuler's Web site, www.dollarization.org.

convertibility system began encountering severe problems, the government fiddled with the exchange rate and restricted convertibility. Throughout the lifetime of the convertibility system, the Banco Central de la República Argentina (note that it was never officially renamed a currency board) held extensive domestic assets in addition to its foreign assets. The central bank was initially allowed to hold true foreign reserves of as little as 66.6% of its monetary liabilities. It was allowed to hold the difference between its true foreign reserves and 100% in the form of Argentine government bonds denominated in foreign currency, valued at market prices. Later, the minimum ratio was raised to 90%, although the central bank was allowed to breach that floor temporarily, and did so on a number of occasions, most recently from July 25 to September 7 2001 and from December 12 2001 until the convertibility system ended on January 6 2002.

Argentina's central bank was never subject to any *maximum* ratio of foreign reserves. In contrast, if an orthodox currency board holds reserves beyond 100% of its monetary liabilities, the purpose is to merely provide a small cushion to prevent reserves from falling below 100%. Many currency boards have held supplementary reserves of 5 or 10% to guard against losses, but they have not used their supplementary reserves to conduct discretionary monetary policy and have remitted to their owners all surpluses beyond what was necessary to maintain the core and supplementary reserves. Over the course of 2001, Argentina's central bank had a ratio of true foreign reserves to monetary liabilities that varied from a high of 193% on February 23 to a low of 82% at year-end. The central bank gained foreign reserves through the IMF loan of September 7. It lost foreign reserves by lending to commercial banks and indirectly supporting the market for government bonds, since government bonds were used as collateral for many loans.

The holding of domestic assets and the varying of the ratio of foreign reserves to monetary liabilities meant that the central bank engaged extensively in a discretionary policy of sterilised intervention, which an orthodox currency board does not do. The problem with sterilised intervention is that it forces a monetary authority to attempt to hit simultaneously two possibly incompatible targets – an exchange-rate target and a money-supply target. The convertibility system thus eventually encountered the problem common to all pegged exchange rates: which target to hit when the two came into conflict. Argentina chose the money-supply target, which involved giving up the exchange-rate target.

Under the convertibility system the central bank also retained the power to regulate banks, such as by setting reserve ratios. It was unofficially a lender of last resort, though it retained a constructive ambiguity about its role that reduced moral hazard risk.

In 1993 we predicted that Argentina's monetary system would eventually behave more like a typical central bank than an orthodox currency board. After a longer delay than we ever expected, we were proved correct[2].

2 Our early warnings about the Argentine system include Steve H. Hanke and Kurt Schuler, "Argentina Should Abolish Its Central Bank," *Wall Street Journal*, October 25 1991, p. A15, and Steve H. Hanke, Lars Jonung, and Kurt Schuler, *Russian Currency and Finance: A Currency Board Approach to Reform* (written with Lars Jonung), London: Routledge, 1993, pp. 72-7.

Moral: An unorthodox, currency-board-like system is an internally contradictory mixture of currency board and central banking elements. An orthodox currency board system is internally consistent and therefore does not encounter the same problems.

Was the original convertibility system in effect until January 6?

The original convertibility system began to crack in April 2001, when Domingo Cavallo, who had been recently appointed minister of the economy, sent a bill to Argentina's Congress to change the exchange-rate link of the peso from the dollar to a 50:50 basket of the dollar and the euro. As economy minister in 1991, when the convertibility system was established, Cavallo had considered but rejected a similar idea. Also in April, Pedro Pou, the independent-minded president of the central bank who preferred dollarisation to devaluation, was ousted on a pretext in favour of the more pliable Roque Maccarone.

By June the original convertibility system was definitively finished. Congress approved changing the exchange-rate link if and when the euro ever appreciated to one per dollar. More importantly, Cavallo announced a preferential exchange rate for exports – a dual exchange rate. This was contrary both to the intent of the original convertibility system and of an orthodox currency board. Cavallo's measures showed that the government was quite willing to tamper with the convertibility system. In previous episodes when confidence in the peso declined, the government had responded, sometimes after an agonising delay, by reaffirming the link to the dollar and the commitment to a single exchange rate. By removing those cornerstones of the convertibility system, Cavallo left the edifice shaky.

In December the government imposed a freeze on bank deposits. It was the last straw. Angry Argentines remembered how high inflation during similar freezes in 1982 (engineered by Cavallo) and 1989 had robbed them of the real value of their savings. Cavallo and president Fernando de la Rúa resigned in the face of widespread protests.

There was another way out: official dollarisation, which had been proposed by then-president Carlos Menem in 1999 and which we supported[3]. Dollarisation would have eliminated questions about confidence in the peso by eliminating the peso. Unfortunately, a lack of resolve by the Argentine government and a lack of support from the US government prevented this economically beneficial but politically somewhat difficult option from being implemented either in 1999 or subsequently. Instead, Argentina temporised and eventually suffered both a currency crisis and a political crisis.

Moral: When a currency-board-like system faces a crisis caused by lack of confidence in the currency, a "hard" exit, for example via dollarisation, is preferable to the "soft" exits of devaluation or floating.

Was the peso overvalued?

Many people assert that the crux of the Argentine crisis was an overvalued peso. Supposedly, the peso's link to the strong US dollar made the peso

3 Steve H. Hanke and Kurt Schuler, "A Monetary Constitution for Argentina: Rules for Dollarization," *Cato Journal,* vol. 18, no. 3, Winter 1999, pp. 405-19.

overvalued, rendering Argentina uncompetitive, causing the economy to slump, and forcing the government to default.

Does the story withstand examination? A classic sign of uncompetitiveness caused by an overvalued currency is declining exports. But Argentina's exports increased every year in the past decade except 1999, when Brazil, its largest trading partner, suffered a currency crisis. Exports during the first 11 months of 2001 were about 3.2% ahead of exports during the same period in 2000. Considering that estimated real growth in world trade was only 0.9% last year, Argentina's export performance was relatively strong. Indeed, the export sector has been one of the few bright spots in the Argentine economy. If the rest of the economy had been growing as fast as the export sector during the last two years, Argentina would not be in a recession.

In an attempt to bolster claims of overvaluation, some observers assert, on the basis of taxi rides from the airport or other casual impressions, that prices are high in Buenos Aires, and that high prices are evidence the peso is significantly overvalued against the dollar. A recent Union Bank of Switzerland survey of prices in 58 of the world's largest cities found that for a basket of 111 goods and services, weighted by typical consumer habits – including three categories of house rent – Buenos Aires ranks 22nd, about midway between the most expensive city, Tokyo, and the least expensive, Mumbai (Bombay). The survey also found those taxi rides that are allegedly so expensive cost about 8% less than in Rio de Janeiro.

There are other indicators that contradict the overvaluation story. For example, the *Economist* magazine's Big Mac Index indicates that the peso, before its devaluation, was 2% *undervalued*. And although the Big Mac Index, as well as more sophisticated estimates of equilibrium exchange rates, should be treated with great scepticism, a recent careful study of the matter using data from 1993 to 1999 indicates that the peso was always within 6% of its so-called fundamental equilibrium real exchange rate.

Moral: Look carefully at the evidence before claiming that a currency is overvalued.

Will the devaluation restart the economy?

For better or worse, devaluation is now a fact. The big question going forward is: will it revive the economy? Let's go through the arithmetic. The short-run price elasticity for Argentine exports is about -0.1. So, to stimulate exports by 1%, the real value of the peso (adjusted for inflation) has to depreciate by 10%. Exports in Argentina only accounted for 9% of GDP last year. Consequently, if the current devaluation of 50% (the floating peso is trading at two to the dollar) does not pass through to any domestic inflation – in short, if the nominal devaluation is a real devaluation – exports will increase by about 5%. Under this optimistic scenario, the current level of devaluation would add less than half a percent to GDP – a GDP that, thanks to the new exchange- rate regime, has collapsed.

Moral: When considering a regime shift, use the back of an envelope and make a few calculations.

Why was Argentina's devaluation unique?

The Convertibility Law gave a peso holder the right to convert a peso into a US dollar. That redemption pledge was made credible because the central bank was required by law to hold foreign reserves to fully cover its peso

liabilities. It was this redemption pledge that made the convertibility set-up unique and distinguished it from the typical fiat money system.

With the repeal of the Convertibility Law, the redemption pledge was thrown to the wind and the peso holders' claims on foreign reserves held at the central bank were revoked. Argentina's devaluation, then, represented more – much more – than a garden-variety devaluation. It was the great bank robbery. Foreign reserves equal to $17.8bn that were the property of peso holders were confiscated by the government.

That was just the beginning. In addition to taking the foreign reserves from people who held pesos, the government of Eduardo Duhalde has passed other laws and issued regulations that have annulled property rights and gravely injured the rule of law. The Congress acquiesced in the government's plans by approving the Law of Public Emergency and Reform of the Exchange Rate Regime on January 6. The law transfers extraordinary powers to the president and allows him to, in effect, rule by decree for two years (when his term will end).

Moral: In a country that fails to adhere to the rule of law, the domestic currency should be replaced with a foreign currency produced in a country that embraces the rule of law.

So, then, what caused Argentina's crisis?

Argentina's economy went into recession in September 1998 in the aftermath of the Asian and Russian currency crises, which resulted in a general decline in flows of investment to emerging market economies. The Brazilian currency crisis of 1999 dealt the economy another blow. Signs of recovery appeared in late 1999 and early 2000, but the incoming de la Rúa government choked the recovery by enacting large tax increases that took effect at the start of 2000. The government (and the IMF, which lent support to the government's program) thought the tax increases were necessary to reduce the budget deficit. Instead, tax collections fell. When Domingo Cavallo became minister of the economy in March 2001, he pushed through a financial transaction tax, which was increased in August to its current rate of 0.6% on bank debits and credits. Although the tax rate may appear low, it is not.

The tax increases added to the already heavy tax burden Argentines bear if they are part of the legal economy. Tax evasion is high in Argentina because the tax savings from going into the underground economy are huge. The value-added tax is 21%; social security and medical care taxes are 31.9%; and the top income tax rate of 35% starts at 102,300 pesos – currently equal to $50,000–60,000. Compare these with US state sales taxes of 0–9% (there is no federal tax); Social Security and Medicare taxes of 15.3%; and a top federal tax rate of 38.6% starting at about $300,000 (plus state taxes of 0–11%). Unlike Argentina, the United States does not tax bank credits and debits at all.

Tax revenue fell as higher tax rates aggravated the recession. Falling tax revenue made the government's debt more precarious. Particularly after Domingo Cavallo's changes to the convertibility system, concern about the consequences of a debt default spilled over into the currency market. Forward rates reflected an expected devaluation of the peso, and interest rates in pesos shot up to 40–60%. Concern about the consequences of a default also spilled over into the banking system, being reflected by

withdrawals of deposits and interest rates in dollars of 20–30%. (Most bank deposits and loans were in fact in dollars rather than pesos.) People feared that the government would not let the default remain compartmentalised as a problem of government finance, but would make it spill over into the rest of the economy.

Again, dollarisation would have helped contain the problem, by depriving the government of a national currency as a tool for devaluation and inflation. Dollarisation would not have guaranteed success – no monetary system can – but it would have improved the chances for success. It still would help today. In the dollarised system of Panama, the government's debt default during the Latin American debt crisis of 1982 caused problems, but credit remained available for the private sector and the government did not freeze bank deposits. □

Moral: During a recession, avoid raising tax rates and do not "tighten" monetary policy by meddling with monetary institutions.

Steve Hanke is a Professor of Applied Economics at the Johns Hopkins University in Baltimore. Kurt Schuler is a senior economist at the Joint Economic Committee of the US Congress; the views here are not necessarily those of the committee.