

Argentina's pseudo currency crisis

Argentina's currency board system is not working quite as intended. Steve Hanke, professor of economics at John Hopkins University explains why.

Pseudo currency crises are associated with currency board systems. Yes, currency board systems occasionally come under speculative attack. Unlike central bank currencies, however, those issued by currency boards have always survived speculative onslaughts without devaluations.

Argentina, which has had a currency board-like system since 1991, is part of this history. In 1995, the speculators misread the situation and engaged in a massive attack on the Argentine *peso*. It was to no avail. And currently, the peso is under attack, trading at a deep discount on the forward market. The annualised implied yield on the one month forward market is currently (1 August) 90% and was over 150% two weeks ago. The current pseudo crisis will end like the one did in 1995, with the peso remaining firmly fixed to the dollar at parity. When the storm abates, the speculators will once again scratch their heads and lick their wounds. Why?

Currency boards Central banks have broad latitude to create base money by altering their net domestic assets via purchases or sales of either T-bills or government bonds. Currency boards do not have that flexibility. A currency board system requires that domestic notes and coins, as well as deposit liabilities at the monetary authority, be fully covered by foreign reserves denominated in a foreign anchor currency, and that the domestic currency must trade, without restrictions, at an absolutely fixed exchange rate with the anchor currency.

Currency boards have an exchange-rate policy (a fixed rate), but no monetary policy. With a currency board there cannot be conflicts between monetary and exchange-rate policies because a board has no monetary policy. Monetary policy is on autopilot, with changes in base money determined solely by changes in the demand for base money. Therefore, changes in base money are determined by the balance of payments, and market forces act automatically to rebalance financial flows and avert balance of payments crises. That is why currency crises that occasionally engulf a currency board system are pseudo, not real.

The Convertibility Law How did Argentina get tangled up in yet another currency crisis? Early in 1991, former President Carlos Menem embraced the currency board idea. To make it happen, he moved his foreign minister, Domingo Cavallo, over



Domingo Cavallo

to the Ministry of Economy. Cavallo and his team quickly drafted a Convertibility Law for what Argentines call a convertibility system – an uncommon term for an unusual system. Indeed, convertibility deviates in important ways from an orthodox currency board system.

Argentina's convertibility system engages in limited lender-of-last-resort activities; it regulates reserve requirements for commercial banks; it can hold up to one-third of the dollar-denominated reserves it keeps to back its monetary liabilities in the form of bonds issued by the government of Argentina; and the Convertibility Law only requires that the central bank's monetary liabilities be covered by a minimum of 100% in dollar-denominated assets. Consequently, when

the assets are greater than 100%, the one-to-one link between foreign reserves and the monetary base can be broken, indicating discretionary sterilisation.

On 1 April 1991, the central bank was put into convertibility's loose-fitting straitjacket. It did the trick. Annual inflation, which was 1,345% in 1990, fell like a stone. Trade barriers were reduced, and in 1993, YPF, the national oil company, was privatised in what was then the largest initial public offering (\$3 billion) in the history of the New York Stock Exchange.

During the glory days of reform (1991-94), Menem maintained a unified command of the political scene. The reforms – which were developed without the IMF's guiding hand – were simple and implemented with speed in large packages. The results in the 1991-94 period were spectacular. GDP per capita measured in dollars increased by 72.8%.

However, convertibility's deviations from currency board orthodoxy have resulted in a less than perfect unification of the peso with its anchor currency, the US dollar. Indeed, even though the peso-dollar exchange rate has remained absolutely fixed at one-to-one, pseudo currency crises have occasionally erupted, notably in 1995 and at present.

In the wake of the 1995 Mexican tequila fallout, Argentina's reform agenda lost momentum. Even though Argentina pulled out of the tequila crisis and GDP grew at a 7% clip in the 1996-97 period, the reform agenda did not regain its former vigour as it should have. Menem's second term was winding down and losing altitude fast as the 1999 presidential elections approached. To make matters worse, the economy was slumping in the aftermath of Brazil's currency crisis of 1999.

Many breathed a sigh of relief when Fernando de la Rúa was installed as President in December 1999. They thought a new team would inspire confidence and put some life into the sagging economy. It was not to be. The de la Rúa government was a weak left-wing coalition. It proved early on that it was incapable of reforming the supply side of the economy and putting order in Argentina's fiscal affairs. The crisis deepened.

**From pseudo
crisis to panic**

Eventually, de la Rúa was forced to appoint Domingo Cavallo as his economic czar. At first glance, that seemed like a good idea. After all, Cavallo had successfully weathered the pseudo crisis of 1995. But things have not gone well for Cavallo. Cavallo has made several blunders that have pushed Argentina from crisis to panic.

Deviations in the system Not surprisingly, Cavallo's mistakes have been tied up with convertibility. Recall that it was Cavallo who designed the convertibility system, a regime that deviates from currency board orthodoxy. In June this year, Cavallo injected two more deviations into the system. First, he introduced a dual currency regime. Under this set-up, all exports (excluding oil) take place at a devalued peso exchange rate and all imports take place with a revalued peso rate. All other transactions take place at a peso-dollar rate of one-to-one. Second, a law was passed in which the peso's anchor will switch from the dollar to a basket of 50% euros and 50% dollars once the euro reaches parity with the dollar. These two new deviations from orthodoxy were viewed as moves designed to prepare for an exit from convertibility. Cavallo gave this view legs on 9 July, when he told the Agence France Presse that Argentina "will leave the peg one day". All this led speculators to conclude that Argentina was starting down a slippery slope. It did not take long for the markets to start pounding the peso. A panic has ensued and interest rates have shot up in anticipation of an exit from convertibility and a devaluation.

Exit strategies This brings me to the issue of exit strategies for exchange-rate regimes. Countries that have exited from flawed soft regimes and adopted currency boards or "dollarised" in the 1990s have all realised dramatic improvements in the macroeconomic indicators. Exits from soft to hard regimes have always stopped currency crises in their tracks. That is not the case for exits from hard regimes to soft regimes. Recall Hong Kong's exit from its currency board in November 1974. The floating Hong Kong dollar became wildly volatile and steadily lost value against the US dollar. The volatility reached epic proportions in late September 1983, after the fourth round of Sino-British talks on Hong Kong's future. Financial markets and the Hong Kong dollar went into tailspins.

At the end of July 1983, the Hong Kong dollar was trading at HK\$7.31 to US\$1. By "Black Saturday", 24 September, it had fallen to HK\$9.55 to US\$1, with dealer spreads reported as large as 10,000 basis points. Hong

Kong was in a state of panic, with people hoarding toilet paper, rice and cooking oil. The chaos ended abruptly on 15 October, when Hong Kong reinstated its currency board.

Cavallo obviously has not read his monetary history carefully. Even talk of exiting a hard regime in the middle of a crisis is playing with dynamite. Indeed, in July, the dynamite exploded. And incidentally, you do not have to read monetary history to learn about the dangers of discussing exit strategies. Military history teaches the same lessons. General Wesley Clark, former Supreme Allied Commander in Europe, makes that perfectly clear in



Wesley Clark

his new book, *Waging Modern War*. Every time the Pentagon spoke of exit strategies for US troops in Bosnia, the Bosnian Serbs would intensify their shenanigans, causing no end of problems for the allies.

At present, Argentines are slowly and voluntarily dollarising the economy, switching from pesos to dollars. This is a torturous process. Indeed, speculators are massively short on Argentine pesos that they do not yet own, the peso is trading at a deep discount on the forward market and the annualised implied yield for a one month peso forward contract is 90%.

An elegant strategy

To stop the financial panic, a dollarisation law should be passed, now. By doing so at one dollar = one peso, which is the current spot rate, a massive short squeeze would ensue as the bears attempted to cover their short positions. Dollarisation would, by definition, immediately eliminate the peso discount, the currency risks and lower interest rates. It is time for Argentina to exit its semi-hard regime and adopt a totally hard one, the dollar.

The nuts and bolts for Argentina's dollarisation are contained in the following draft law:

1. The Banco Central de la Republica Argentina (BCRA) shall cease to issue pesos. It shall withdraw from circulation the Argentine peso monetary base and shall replace it with US dollars at the exchange rate of one dollar = one peso. The BCRA shall preferably accomplish the bulk of this task within 30 days after this law enters into force. Peso notes currently accepted for redemption into dollars shall continue to be accepted by the BCRA or the government for five years after this law enters into force. After five years, all peso notes in circulation may be demonetised by a decree of the Executive Power.
2. Wages, prices, assets and liabilities shall be converted from pesos to US dollars at the exchange rate of one dollar = one peso. By 30 days after this law enters into force, wages and prices shall cease to be quoted in pesos.
3. Interest rates and other financial ratios shall remain the same in US dollars as they were in pesos. The maturities of loans and other financial obligations shall remain unchanged.
4. The Executive Power may appoint a committee of experts on technical issues connected with this law to recommend changes in regulations that may be necessary.
5. Nothing in this law shall prevent parties from a transaction using any currency that is mutually agreeable. However, the US dollar may be established as the default currency where no other currency is specified.
6. Previously enacted legislation conflicting with this law is repealed.
7. This law becomes effective immediately.

With an economy that is officially dollarised, Argentina will be ready for the fiscal medicine that has recently been prescribed. Add to that a strong antidote for corruption, and Argentina will once again be in the fast lane.

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