

THE ARGENTINE STRAW MAN: A RESPONSE TO CURRENCY BOARD CRITICS

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It is noticeable, on the one hand, that a large part of the best work on Money is topical. It has been prompted by particular episodes, by particular experiences of the writer's own time.

—Sir John Hicks (1967: 156)

Sir John certainly would have agreed that particular experiences prompt faulty work on Money, as well. Argentina's recent crisis is a case in point. It has spawned a deluge of commentary on alternative exchange rate regimes. The majority of this writing (aimed at both an academic and lay readership) contains elementary analytical and factual errors.¹ The most oft-repeated and egregious errors are the following:

- Argentina employed a currency board from April 1, 1991, until January 6, 2002, that rendered the central bank, the Banco Central de la República Argentina (BCRA), incapable of employing a domestic monetary policy.
- The peso's one-to-one exchange rate with the U.S. dollar was overvalued and made Argentine exports uncompetitive in world markets.
- The inflexible currency board and overvalued peso caused the Argentine crisis. A three-part reform consisting of a peso devaluation, "pesofication" of the economy, and a freely floating exchange rate would reinvigorate the economy.

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¹Not all of the works on the Argentine crisis suffer from these egregious errors. See Calvo, Izquierdo, and Talvi (2002), Powell (2003), and Schuler (2003) for a sampling of that literature. As for the faulty literature, I will limit the citations to a sample of writings that are most representative.

- Replacing the peso with the U.S. dollar—“dollarization”—was and is an infeasible alternative.

The Currency Board Misnomer

To put an end to hyperinflation, Argentina inaugurated something like a currency board system on April 1, 1991, by rechartering the BCRA. Argentines called the system “convertibility.” Convertibility maintained a fixed exchange rate between the peso and its anchor currency, the U.S. dollar, on the spot market. That nominal anchor checked inflation: the consumer price index at the end of 2001 was about where it was in 1994.²

The BCRA’s charter allowed it to behave more like a central bank than a currency board in many important respects.³ A currency board maintains a floor and a ceiling of 100 percent and 110 percent, respectively, for the foreign reserve cover of its monetary liabilities. Its net domestic assets are zero or frozen. Thus, a currency board cannot sterilize foreign currency inflows, offset outflows, or use discretionary monetary policy. The convertibility system had a floor under the BCRA’s foreign reserve cover, but no ceiling, and the BCRA’s net domestic assets were not frozen. Hence, the BCRA could sterilize inflows of foreign currency and offset outflows.

The BCRA used the central banking powers in its charter liberally. Indeed, in virtually every month of the convertibility system’s existence, the BCRA sterilized or offset changes in its foreign reserves, and in most months after 1994, it did so aggressively. During the system’s life span, there was, on average, a negative correlation between changes in net foreign and domestic assets on the BCRA’s balance sheet, with 59 percent of the changes in net foreign assets being either sterilized or offset with changes in the BCRA’s net domestic assets (Hanke 2002a: 210). The offsetting was especially dramatic in 2001. Foreign reserves fell by \$12 billion over the course of the year. This decline was offset 122 percent by increases in the central bank’s net domestic assets.

The above evidence demonstrates that, contrary to the musings of most observers, the BCRA under convertibility maintained considerable discretion, especially after 1994. In that period, the BCRA’s

²Key economic and financial indicators for Argentina from 1989 to 2002 are collected in Schuler (2003: Table 1).

³For an early appraisal of the convertibility system’s central bank-like features and the problems that might (and did) ensue, see Hanke, Jonung, and Schuler (1993: 72–76) and Hanke (1991).

net domestic asset position was more than six times more volatile than that of Chile's central bank, which clearly has an independent monetary policy and has had a floating exchange rate since 1999.

Under convertibility, the BCRA retained additional central banking powers, offering lender-of-last-resort facilities, adjusting reserve requirements, and regulating the banking sector. Over the lifetime of the system, the BCRA issued 1,588 new regulations via its Series A circulars—a truly staggering rate of intervention in the banking system.

The problems set in motion by Argentina's central bank were exacerbated by Argentina's economic czar, Domingo Cavallo. His policies caused convertibility to lose what little semblance it had to a currency board system. With his appointment on March 20, 2001, the peso risk premium—as measured by the spread between the 30-day Argentine interbank lending rates in pesos and U.S. dollars—jumped 50 basis points and rose in step with the confidence-defeating measures that were the hallmark of his tenure (Hanke 2002a: 210–12). The significant upward leaps in the peso risk premium began on April 25, 2001, when Cavallo began his attack on convertibility. After ousting Governor Pedro Pou from the BCRA on a pretext, Cavallo instituted forced debt swaps (property confiscations), multiple exchange rates, new legislation to change the peso's anchor from the dollar to a euro-dollar basket, and the prohibition of internal convertibility. The higher risk premium likewise reflected Cavallo's regular refrains about the beauty of a floating exchange rate. The resulting higher interest rates put Argentina's debt dynamics over the top, culminating in its sovereign debt default on December 23, 2001.

The fact that Argentina did not have a full-fledged, orthodox currency board did not stop critics, as they dissected the Argentine crisis, from pointing an accusatory finger at currency boards. Indeed, some even claimed that Argentina had a “pure currency board” (Eichengreen 2002: 112). Paul Krugman (2001a), in particular, lamented: “Because the currency board allows no flexibility in monetary policy, policymakers cannot respond, Greenspan-style, by opening the monetary spigots.”

If the currency board critics had bothered to read the BCRA's charter, examine its balance sheet, and recognize the flood of regulations pouring from the pens of the central bankers, they would have concluded that the convertibility law did not create a true currency board. Instead, what Argentina really had was a central bank with a pegged exchange rate and a domestic monetary policy, distinguished by the unique feature of the convertibility of pesos into dollars on demand. And like most central banks employing a pegged exchange

rate, the Argentine system proved vulnerable to conflicts between the peg (the exchange rate policy) and domestic monetary policy (Hanke 1998). A proper examination of the convertibility system would have led any informed and objective observer to conclude that the rules of the game contained in the BCRA's charter were flawed and that garden-variety missteps by the authorities led to the system's eventual demise.

It is worth noting that F. A. Hayek concluded in 1932 that critics of the gold standard also attacked a straw man:

There has been much talk about the breakdown of the gold standard, particularly in Britain where, to the astonishment of every foreign observer, the abandonment of the gold standard was very widely welcomed as a release from an irksome constraint. However, it can scarcely be doubted that the renewed monetary problems of almost the whole world have nothing to do with the tendencies inherent in the gold standard, but on the contrary stem from the persistent and continuous attempts from many sides over a number of years to prevent the gold standard from functioning whenever it began to reveal tendencies which were not desired by the country in question. Hence it was by no means the economically strong countries such as America and France whose measures rendered the gold standard inoperative, as is frequently assumed, but the countries in a relatively weak position, at the head of which was Britain, who eventually paid for their transgression of the "rules of the game" by the breakdown of their gold standard.

That the otherwise conservative managements of the central banks deviated in a relatively lighthearted manner from the traditional rules of monetary policy can be attributed to the influence of new ideas on monetary policy, propagated by the academic fraternity, which obtained wide circulation during the postwar years [Hayek 1999: 153].

Hayek stressed that under a classical gold standard, as with a currency board, the money supply should vary in a one-to-one correspondence with changes in the monetary authority's net foreign reserves. As sterilization of foreign currency inflows or offsetting of outflows was an anathema for Hayek, so too are they for advocates of currency boards.

The Overvaluation Canard

Currency board critics assert that the peso's one-to-one link with the dollar under convertibility left the peso overvalued and made Argentine exports uncompetitive, contributing to a general economic malaise. Krugman (2000), for example, declared "Argentine producers

find themselves priced out of world markets.” Martin Feldstein (2002) agreed: “Because the exchange rate was fixed at too high a level, Argentina exported too little and imported too much.” Thomas Willett (2002: 52) also concluded that Argentina’s recession was deepened by the overvalued peso and the “inability of producers to compete at home and abroad.”

Does their story withstand examination? Argentina’s exports increased every full year during convertibility except 1999, when Brazil, its largest trading partner, suffered a currency crisis. Even during the first 11 months of 2001, exports were about 3.2 percent ahead of exports during the same period in 2000 (Liskey 2001). Argentina’s export performance was relatively strong, outpacing a mere 0.9 percent real increase in world trade. Indeed, the export sector was, at the time, 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 2000 and 2001, Argentina would not have experienced a recession.

In attempts to demonstrate the peso’s overvaluation, some observers asserted (on the basis of taxi rides from the airport or other casual impressions) that prices were high in Buenos Aires, and that high prices were evidence that the peso was significantly overvalued against the dollar. A Union Bank of Switzerland survey of prices in 58 of the world’s largest cities found that for a weighted basket of 111 goods and services—including three categories of house rent—Buenos Aires ranked 22nd, about midway between the most expensive city, Tokyo, and the least expensive, Bombay. The survey also found that taxi rides that were so expensive in Buenos Aires cost about 8 percent less than in Rio de Janeiro (Union Bank of Switzerland 2000: 6, 19).

There are other indicators that contradict the overvaluation story, too. For example, *The Economist’s* Big Mac Index indicates that the peso, before its devaluation, was 2 percent *undervalued*. Although the Big Mac Index, as well as more sophisticated estimates of equilibrium exchange rates, should be treated with skepticism, a recent study using data from 1993 to 1999 indicates that the peso was always within 6 percent of its so-called fundamental equilibrium real exchange rate (Hristov 2001).

To determine whether claims about the overvaluation of the peso before the abandonment of convertibility were justifiable, I computed an equilibrium exchange rate for the peso on the basis of the relative movements of prices in Argentina and the United States. First, I recentered producer price indexes from Argentina and the United States so that the index number for April 1991 (the beginning of

convertibility) would be 100 for each index.⁴ The ratio of the index numbers multiplied by the base period exchange rate (in this case, 1) gives the equilibrium exchange rate for any subsequent date. I then subtracted the actual exchange rate (in all cases, 1) from the equilibrium exchange rate prediction to obtain the peso's hypothetical deviation from its equilibrium exchange rate.

I then used the same method to compute an equilibrium exchange rate on the basis of consumer price indexes in both economies.⁵ The results from the consumer price indexes tell a much different story from that told by the producer price indexes. But to use consumer price indexes for an equilibrium exchange rate calculation is to commit a serious analytical error. Because international arbitrage is responsible for bringing an exchange rate into line with its purchasing power parity level, the relevant prices to consider in a equilibrium exchange rate calculation are those of traded goods. Consumer price indexes include a number of nontraded goods that are exempt from the forces of arbitrage, whereas traded goods generally account for the lion's share of producer prices condensed into an index. Accordingly, the predictions made using producer price indexes more closely reflect an equilibrium exchange rate. The results of my calculations are displayed in Figure 1. It is clear that, using the producer price indexes, there is no merit to the overvalued peso story.

The Devaluationists

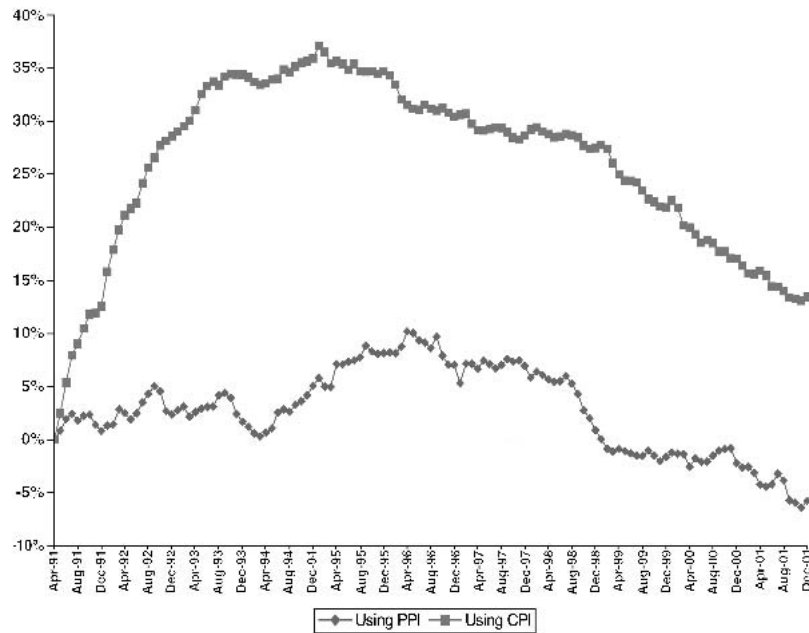
Having conjured up news of a fire, the devaluationist bucket brigade set out to douse the flames. For them, a peso devaluation, pesofication of the economy, and a floating exchange rate would save the day.

Ricardo Hausmann (2001) took the lead, advocating "first, de-dollarization of the foreign debt, the financial system and the domestic contractual environment; second, a floating exchange rate anchored by strict inflation targets." Michael Mussa (2001) and Paul Krugman (2001b) concurred. And while Martin Feldstein (1999) once observed that Argentina had "stayed competitive because its domestic producers lowered the cost of Argentine goods by increasing

⁴The Argentine producer price index is from the Ministry of Foreign Relations; the U.S. producer price index is from the Bureau of Labor Statistics (index of all manufactured goods).

⁵The Argentine consumer price index is from the Ministry of Foreign Relations; the U.S. consumer price index is from the Bureau of Labor Statistics (CPIU, all urban consumers, all items).

FIGURE 1
 PERCENTAGE OVER/UNDERVALUATION OF THE ARGENTINE PESO, LIFETIME OF CONVERTIBILITY



productivity,” he now wrote, “A market-determined floating exchange rate is the only way to avoid these [competitiveness] problems” (Feldstein 2002).

Needless to say, the bucket brigade’s water turned out to be gasoline. President Duhalde chose to abandon the convertibility system by decree on January 6, 2002, “pesofy” the economy and bank balance sheets asymmetrically, and float the peso on February 12, 2002. It is important to stress that the Duhalde devaluation was more than a garden-variety devaluation because he violated the convertibility law’s redemption pledge—the government’s legal obligation to redeem 1 peso for 1 dollar. Even though the Argentine courts subsequently ruled, in September 2002, that the pesofication of the economy and devaluation were illegal, a confiscation of peso holders’ property (i.e., the central bank’s dollar reserves of \$17.8 billion) occurred in January 2002 (Hanke 2003).

The devaluation did indeed push Argentina’s trade account into surplus—making imports three times more expensive will do that.

Exports fell in dollar terms by 4.5 percent from 2001 to 2002, while imports imploded, shrinking by 55.7 percent over the same period.

Before the suspension of internal convertibility (the *corralito*) and the asymmetric pesofication of bank balance sheets, the Argentine banking system was robust. Extensive foreign ownership, regulations that required a high level of capital, and prompt action to close insolvent banks made the banking system much stronger than it was when the tequila crisis hit in 1995, rendering it one of the healthiest in Latin America (Powell 2003: 16, n. 24). The Duhalde administration, however, reversed all that when it decreed the asymmetric pesofication of bank balance sheets. Under the terms of pesofication, dollar reserves were seized from banks and converted into pesos at the rate of 1.4 pesos per dollar. Bank loans made in dollars were converted into pesos at one peso per dollar in a populist move to reduce consumers' personal debt service cost. Finally, bank deposits made in dollars were converted into dollars at the 1.4 peso per dollar rate. Unable to withdraw their deposits, Argentines have seen the losses on their deposits fluctuate with each new decree and proposal for bailing out banks and depositors. The impact of those measures on the banking sector was considerable. The windfall loss from the measures immediately following their implementation exceeded the capital of the consolidated banking system.

The confiscation of private property and the collapse of the banking system (and ensuing credit crunch) have decimated the economy. Indeed, industrial production fell by 10.6 percent during 2002, and consumer confidence reached an all-time low. And that is not the end of the story. In the interest of promoting its often-neglected strategic engagement with Latin America, the Bush administration urged the IMF to bail out Argentina in January 2003. The IMF complied by rolling over \$6 billion in Argentine debt.

By turning a blind eye toward the Duhalde government's theft and the utter collapse of the Argentine economy, which has sent millions into abject poverty, the Bush administration jettisoned the principle of property rights—a principle whose importance was clearly stated in the 2003 *Annual Report of the Council of Economic Advisers*. Chapter 6, "A Pro-Growth Agenda for the Global Economy," states: "Institutions that protect property rights are central for economic growth" (Council of Economic Advisers 2003: 237). Moreover, it states that countries that fail to enforce the rule of law and private contracts will fail to qualify for U.S. bilateral assistance through the President's new Millennium Challenge Account.

The Argentine economy is beginning to show superficial signs of recovery, but those short-term benefits have been achieved at the cost

of future growth. Neopopulist policies have promoted capital consumption. In 2002, depreciation exceeded investment by 6.5 percent of GDP, and is expected to do so by at least 4.5 percent of GDP this year (Mondino 2003: 44). While capital consumption might give temporary relief, it portends a more comprehensive future collapse (Hayek 1984).

The Case for Dollarization

The case for dollarization—the liquidation of the central bank and replacement of the peso with the dollar—is stronger today than ever. Dollarization, combined with off-shore banking, could give Argentina the confidence it so desperately needs. Argentina has never had a stable central bank-issued currency (della Paolera and Taylor 2001). Since the central bank was established in 1935, the peso has depreciated against the dollar by a factor of about 9,000,000,000,000. Understandably, Argentines do not trust the peso. Indeed, Argentines continue to dollarize the economy spontaneously and unofficially at a rapid rate. In 2001, the greenbacks circulating in Argentina totaled \$28 billion, and in 2002 the total grew to \$35 billion. This \$7 billion increase exceeded the dollar value of new peso base money emitted over the same interval. To eliminate the possibility of more Argentine monetary mischief and restore confidence, the central bank should be liquidated, its power to issue currency should be repealed, and private Argentine banks should be allowed to issue U.S. dollar-denominated notes (Hanke 2003).

Critics, however, have dismissed dollarization as a viable alternative. Willett (2002: 59) argues that the “debate over dollarization was like a discussion about alternative types of cosmetic surgery while the disfigured accident victim was bleeding to death.” Anne Krueger of the IMF, when asked about the dollarization option for Argentina at a press briefing on January 11, 2002, responded, “Well, my understanding at the moment is that [dollarization] is technically unfeasible. So I don’t think the authorities are thinking about it; I don’t think we are thinking about it” (Krueger 2002). The IMF crushed the possibility of dollarization with its bureaucratic weight and made a sham of its declared policy to foster local ownership of economic policies.

Yet, the facts did not support the IMF’s position. On January 10, 2002, the central bank had “pure” foreign reserves equal to \$14.75 billion and 3.93 billion pesos in overdrafts and rediscounts to banks that were fully collateralized by publicly traded securities assessed at market value. Unless the central bank was cooking the books—or the IMF knows something that we don’t—those two categories of assets

would have been more than adequate to cover the central bank's 17.92 billion in outstanding peso liabilities at the one peso–one dollar exchange rate, making dollarization a feasible option (Hanke 2002b, 2002c).

Conclusion

The Argentine crisis was not caused by the failure of a currency board, but by its absence. Currency board critics attacked a straw man. What Argentina needs is stable money and limited government; those goals can best be achieved through dollarization coupled with free banking, protection of property rights, and fiscal accountability.

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