ARGENTINA: CAVEAT LECTOR

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The discourse surrounding Argentina's recent travails has validated George Stigler's observation that "the quality of controversy is not only low but in fact declining…."[2] The anointed—to use Thomas Sowell's[3] expression—have become instant experts on Argentina. Indeed, they have built a flourishing cottage industry that has spun an Argentine story based on preemptive rhetoric and a disregard for factual evidence. The overriding lesson to be learned from the musings of these so-called experts and camp followers in the press is caveat lector.

Assertion 1—The anointed assert that Argentina employed a currency board from April 1, 1991 until January 6, 2002, and that it tied the hands of the central bank and caused Argentina to plunge into economic chaos.

To put an end to monetary mischief and rein in hyperinflation, Argentina established an unorthodox currency board system on April 1, 1991. Argentines called the system "convertibility," an uncommon term for an unusual system. 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.

Convertibility was not trouble-free, however. Indeed, its deviations from currency board orthodoxy allowed it to behave more like a central bank than a true currency board in many important respects.[4] Under currency board orthodoxy, a floor and a ceiling of 100 percent and 110 percent, respectively, are typically mandated for the foreign reserve cover of a board's monetary liabilities. Furthermore, a board's net domestic assets are frozen. Accordingly, an orthodox currency board has no latitude to sterilize foreign currency inflows or offset outflows and cannot engage in discretionary monetary policies. With the convertibility system, there was a floor under the foreign reserve cover, but no ceiling. Moreover, the central bank's net domestic assets were not frozen. Consequently, the convertibility system had the ability to sterilize inflows of foreign currency and offset outflows.

Argentina's central bank used the powers granted under convertibility liberally. Indeed, in virtually every month of convertibility's existence, the central bank sterilized or offset changes in its foreign reserves, and in most months after 1994, these powers were used aggressively. For example, foreign reserves fell by 12 billion dollars over the course of 2001, and 122 percent of those foreign reserve outflows were offset by increases in the central bank's net domestic assets. Contrary to the musings of most observers, the central bank under convertibility engaged in super-activist monetary policies, particularly after 1994. In that time period, the net domestic asset position of Argentina's central bank was over six times more volatile than that of Chile's central bank, which has an independent monetary policy and is operating under a floating exchange-rate regime.

In addition to a hyper-active monetary policy, the central bank under convertibility engaged in a wide range of other activities—including lender of last resort liquidity operations and the regulation of commercial banks' reserves—that are prohibited under currency board orthodoxy. Indeed, each quarter the central bank publishes a "Bulletin of Monetary and Fiscal Affairs," and each issue, from the inception of convertibility until its demise, contained a long list of measures that were taken by the central bank. If the central bank would have been operating as an orthodox currency board, these pages would have been blank.

And if these deviations were not bad enough, Argentina's former economic czar Domingo Cavallo announced on June 15, 2001 that, starting on June 19, 2001, Argentina would abandon its unified exchange rate of 1 peso for 1 dollar and replace it with a multiple exchange-rate regime.[5] With that, convertibility lost what little semblence it had to a currency board arrangement.

Lesson 1—The anointeds' attack on what they assert was an Argentine currency board is a case of mistaken identity. Currency boards are monetary arrangements that many anointed love to hate. With the collapse of convertibility—a system which originally had, at most, some currency board-like features—the anointed took license to lay the blame for Argentina's problems squarely at the feet of currency boards. If the anointed had bothered to read the Convertibility Law, the central bank's "Bulletin of Monetary and Fiscal Affairs" or the central bank's balance sheet, they would have concluded that convertibility was never an orthodox currency board.[6] Instead, convertibility was nothing more than a pegged exchange-rate regime that allowed a hyper-active central bank—forget tied hands, please—to engage in monetary policies that conflicted with its exchange-rate policies. And like most of these arrangements, it was fatally flawed and ultimately collapsed. A proper diagnosis of the convertibility system would have led any informed and objective observer to conclude that the rules of the game contained in the Convertibility Law of 1991 were flawed and that subsequent transgressions from currency board orthodoxy led to convertibility's eventual demise.[7] But who wants to let factual evidence get in the way of an opportunity to malign currency boards?

Assertion 2—The anointed assert that the peso's one-to-one link with the dollar under convertibility left the peso overvalued, rendering Argentina uncompetitive and causing a prolonged economic slump.

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 during convertibility 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.[8] Considering that estimated real growth in world trade was only 0.9% in 2001, 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 2000 and 2001, Argentina would not have experienced a recession.

In an attempt to bolster claims of 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 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 basket of 111 goods and services, weighted by typical consumer habits - 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 those taxi rides that were allegedly so expensive cost about 8% less than in Rio de Janeiro.[9]

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 skepticism, 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.[10]

Lesson 2—Unfounded claims by the anointed take on a life of their own. Even though the overvalued peso story doesn't hold water, there is a moral to the story: If you are "politically correct," being factually incorrect doesn't matter.

Assertion 3—The anointeds' solution to the alleged problems created by assertions 1 and 2 was a devaluation of the peso a pesofication of the economy. According to the anointed, that quick fix would do the trick.

Needless to say, the quick fix has resulted in little more than a river of tears. President Duhalde chose to abandon the convertibility system by decree on January 6, 2002, pesofy the economy and bank balance sheets asymmetrically, and eventually float the peso on February 12, 2002. It is important to stress that the Duhalde devaluation was more than a garden-variety devaluation because convertibility's redemption pledge—the government's legal obligation to redeem 1 peso for 1 dollar—was broken. Even though the Argentine courts subsequently ruled (September 2002) that the pesofication of the economy and devaluation were illegal, a confiscation of peso holders' property ($17.8 billion) occurred in January 2002, and economic chaos ensued.

Exports, which were supposedly being held back by convertibility's "overvalued" peso, have declined by 7 percent during the first six months of 2002 compared to the same period last year. The 70 percent devaluation clearly hasn't worked its much-advertised magic.

Prior to the suspension of internal convertibility (the so-called '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 most robust in Latin America. 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 their savings disappear as the peso-dollar exchange rate has depreciated roughly 70 percent since the beginning of the year. The impact of these 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 banking system remains under considerable stress. The following table shows statistics of the Argentine financial system as of August 30. All the key figures have deteriorated since the convertibility system was abandoned. Bank deposits, which amounted to roughly $70 billion in dollar terms in mid-November 2001, now stand at 66.3 billion pesos, or $18.31 billion in dollar terms at current exchange rates. Bank reserves (technically known as liquidity requirements) have fallen from 12.7 to 8.6 billion pesos (or $12.7 to $2.4 billion in dollar terms, or a fall from 18.1 to 13.0 percent of deposits).

The decline in bank deposits and reserves has put pressure on the banks to reduce their lending. Loans, which peaked at $77.8 billion in dollar terms in December 2000, now stand at 69.2 billion pesos, or $19.1 billion in dollar terms. As a result of this decline, interest rates are very high. The overnight interest rate was 39.1 percent per annum at the end of August, and the prime rate was a stiflingly high 90.5 percent at the same time.

Table: Key Statistics of the Argentine Financial System, August 30, 2002

Central bank (BCRA)—amounts in billions of pesos

Assets		*Liabilities*	
"Pure" foreign reserves	32.949	Peso notes and coins held by public*	13.270
Argentine government bonds	NA**	Peso notes and coins held by banks*	1.646
Reserves against government deposits	.324	Peso deposits of customers*	6.367
Rediscounts to banks	16.971	Dollar deposits of customers*	.189
Net of repurchase agreements*	4.131	Government deposits	.324

*Items comprising monetary base (liability items – asset items = 17.341 billion pesos).
Foreign reserve coverage of monetary base = 52.5% (Foreign reserves converted at August 30 exchange rate of 3.62; this coverage ratio implies dollarization would be possible at an exchange rate of 1.91 pesos per dollar).
**Data on Argentine government bonds ends on February 11, 2002. On that date the value of bonds held by the BCRA was 8.721 billion.

Financial institutions—amounts in billions of pesos

Assets		*Liabilities*	
Loans to private sector in pesos	64.376	Dollar deposits	1.013
Loans to private sector in dollars	4.861	Peso deposits	65.271
Peso vault cash***	1.646		
Dollar vault cash***	.396		
Peso deposits at central bank***	6.367		
Dollar deposits at central bank***	.189		

***Items comprising bank reserves (8.598 billion pesos).
Ratio of bank reserves to deposits = 13.0%.

Interest rates

Overnight interbank rate	39.1%
Prime rate	90.5%

Note Some assets and liabilities are unlisted, hence assets may not equal liabilities.
From Banco Central de la República Argentina, *Boletín Estadístico del Banco Central de la República Argentina*, available at www.bcra.gov.ar.

The confiscation of private property and the collapse of the banking system and ensuing credit crunch have decimated the economy. Indeed, industrial production has fallen by 15.5 percent during the first eight months of 2002, and consumer confidence is at an all-time low.

Lesson 3—When offering advice, do no harm, please. And if things don't go according to plan, at least have the courage to acknowledge it. Alas, as Thomas Sowell recounts in excruciating detail, the teflon prophets typically commit both vices. The deafening silence of the anointed following their Argentine follies is par for the course.

Assertion 4—Dollarization—the liquidation of the central bank and replacement of the peso with the dollar—was a solution embraced by extremists and was not feasible.

The use of a word like "extremists" to characterize a man and his position—an old rhetorical trick often employed by the anointed—is used less to describe a position than to dispose of it. Indeed, the purpose is to put views—like dollarization—outside the range of normal discourse.

And for good measure, you can deep six an option by simply stating that it's not technically feasible. This is what the IMF, and especially its first managing director Anne Krueger did. When asked about the dollarization option for Argentina at a press briefing on January 11, 2002, Krueger 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." With that statement, the IMF dismissed the possibility of dollarization. This meddling in the internal affairs of Argentina also made a sham of the IMF's campaign to foster local ownership of economic policies.[11]

If that was not bad enough, the facts did not support the IMF's position. On January 10 the central bank had "pure" foreign reserves equal to $14.75 billion and 3.93 billion pesos in overdrafts and rediscounts to banks which 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 a one peso –one dollar exchange rate.[12]

The case for dollarization is stronger today than ever. Unofficially, Argentina has a bimonetary financial system in which the dollar circulates alongside the peso and the value of the dollars in circulation is 5.8 times larger than the peso monetary base at the current exchange rate of 3.6 pesos per dollar. Given the current foreign reserves at the central bank, the peso could be liquidated at an exchange rate of 1.91 pesos per dollar and the economy could be dollarized. This, combined with off-shore banking, could give Argentina the confidence shock it so desperately needs. Argentina has never had a stable central bank-issued currency.[13] Indeed, since the central bank was established in 1935, the peso has depreciated against the dollar by a factor of 10.86 trillion. Consequently, Argentines do not trust the peso. To eliminate the possibility of more Argentine monetary mischief and restore confidence, the central bank should be liquidated and its power to issue currency should be repealed.

Lesson 4—The IMF's patina of technical competence is often thin. And contrary to its public pronouncements, the IMF's mantra of local ownership for economic policies is a sham.

Endnotes

[1] Remarks presented at the Cato Institute's 20th Annual Monetary Conference, New York, October 17, 2002. Steve H. Hanke is a Professor of Applied Economics at the Johns Hopkins University in Baltimore and a Senior Fellow at the Cato Institute in Washington.

[2] George J. Stigler, *The Citizen and the State: Essays on Regulation*. Chicago: University of Chicago Press, 1975, p.3.

[3] Thomas Sowell, *The Vision of the Anointed: Self-Congratulation as a Basis for Social Policy*. New York: Basic Books, 1995. Sowell's thesis is that the anointed represent a class of elites, or thinking people, who, in fact, do little thinking about substance, consider evidence to be irrelevant and are skilled in rhetoric. With the rise of mass media, mass politics and massive government, these articulate teflon prophets drive the debates and have an undue influence on the course of policies.

[4] For an early diagnosis of convertibility's deviations from currency board orthodoxy and the problems that might (and did) ensue, see Steve H. Hanke, Lars Jonung, and Kurt Schuler, *Russian Currency and Finance: A Currency Board Approach to Reform*, London: Routledge, 1993, pp. 72-6.

[5] In addition to a hyper-active central bank, Argentina, during most of 2001, had a hyper-active economic czar, Domingo Cavallo. With his appointment on March 20, 2001, the peso risk premium jumped 50 basis points and was ratcheted up with each of his meddling activities throughout his tenure in the De la Rúa administration. These significant upward ratchets in the peso risk premium began on April 25, 2001, when Cavallo began his attack on convertibility by putting Pedro Pou under fire as Governor of the central bank, and continued with forced debt swaps (property confiscations), the imposition of a multiple exchange-rate regime, the passage of legislation that would have eventually changed the peso's anchor from the dollar to a euro-dollar basket and the prohibition on internal convertibility. Indeed, Cavallo's regular refrains about the beauty of a floating exchange rate, as well as the specific actions mentioned above, all had the effect of pushing up the peso's risk premium. The ensuing higher interest rates, of course, eventually smashed confidence and threw Argentina's debt dynamics over the top, forcing a debt default on December 23, 2001. Never mind. As one of the anointed, Cavallo is still referred to in some circles as a "brilliant finance minister." See Mark Falcoff, "Argentina Gropes for Answers," *Latin American Outlook*, Washington: American Enterprise Institute for Public Policy Research, September 2002, p. 1.

[6] I have never encountered an anointed professional economist who has read a currency board law (or the Convertibility Law). Ignorance is, apparently, bliss. Moreover, unlike Sir John Hicks—a Nobelist and high priest of economic theory—the anointed have obviously never bothered to get their hands dirty with Argentina's central bank balance sheet. For more on Sir John's respect for balance sheets, see Arjo Klamer, "An Accountant Among Economists: Conversations with Sir John Hicks," *Journal of Economic Perspectives*, 3(4), 1989, pp. 167-180.

[7] It is worth noting that F. A. Hayek concluded in 1932 that the anointed followed the same pattern in their writings about the breakdown of the gold standard: "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. In order to understand what actually happened, therefore, a brief consideration of the origin and significance of these new ideas is necessary." See F. A. Hayek, "The Fate of the Gold Standard," in Stephen Kresge (ed.). *The Collected Works of F. A. Hayek, Vol. V: Good Money Part I: The New World*. Chicago: The University of Chicago Press, p. 153. Much as with an orthodox currency board, Hayek stressed that under a classical gold standard, the money supply should vary in a one-to-one correspondence with changes in a central bank's net foreign reserves. For Hayek, as well as advocates of currency boards, sterilization of foreign currency inflows or the offset of outflows is a crime.

[8] Tom Darin Liskey, "Argentina Final Oct.Trade Surplus $605M Vs. $587M Prelim," Dow Jones News Service newswire, December 7, 2001.

[9] Union Bank of Switzerland, *Prices and Earnings Around the Globe*, Zurich: UBS Switzerland, 2000, p. 6, 19.

[10] Kalin Hristov, "FEER and Currency Boards: Evidence From the 90's," unpublished manuscript, Bulgarian National Bank, presented at the Centre for Central Banking Studies (Bank of England) Conference on Exchange Rates, November 26, 2001, p. 25.

[11] See James M. Boughton and Alex Mourmouras, Is Policy Ownership an Operational Concept? IMF Working Paper 02/72, April 2002.

[12] See Steve H. Hanke, "Questions the IMF is obliged to answer." *Financial Times*, January 17, 2002 and Steve H. Hanke, "Questions remain unanswered." *Financial Times*, February 6, 2002.

[13] See Gerardo della Paolera and Alan M. Taylor, *Straining at the Anchor: The Argentine Currency Board and the Search for Macroeconomic Stability, 1880-1935*. Chicago: University of Chicago Press, 2001.