



Point of View | By Steve H. Hanke

# Received Ideas

**M**ILITARY HISTORY IS WRITTEN BY THE VICTORS. Economic history is written, to a degree, by central bankers. In both cases you have to take official accounts with a large dose of salt.

You thought you knew that the Duke of Wellington whipped Napoleon at the Battle of Waterloo. But according to the expert on Waterloo, Peter Hofschröer, Wellington's army of 68,000 men was locked in a bloody stalemate with Napoleon's force of 73,140 until late in the afternoon of June 18, 1815. That's when Field Marshall Blücher's 47,000 Prussian troops entered the field of battle and turned the tide.

The Iron Duke's official account has Prince Blücher failing to arrive until early evening and with only 8,000 troops. Somehow 39,000 Prussians simply vanished. As they say, the rest is history—history literally as written by Wellington.

Doctored accounts often gain wide circulation in the sphere of economics, too. In 2002 Argentina devalued the peso, defaulted on its debt and was engulfed in economic chaos. Why? Most commentators pointed their accusatory fingers at Argentina's monetary regime. For example, Paul Krugman repeatedly used his *New York Times* column to castigate the Argentinean convertibility system.

Krugman (and the rest of the herd) claimed that Argentina's monetary setup was governed by currency board rules. Accordingly, from April 1991 until Jan. 6, 2002, the central bank's hands were tied and domestic monetary policy was verboten. In addition, he claimed that the peso's one-to-one exchange rate with the dollar was overvalued, rendering Argentinean exports uncompetitive. Does this story hold water?

A currency board issues a domestic currency convertible into a foreign reserve currency at a fixed exchange rate. To ensure convertibility, it holds foreign reserves equal (or slightly greater) in value to its monetary liabilities. It therefore operates as an exchange house with a balance sheet that contains only foreign reserve assets and domestic monetary liabilities. Consequently the domestic money supply automatically fluctuates in a one-to-one correspondence with changes in a currency board's foreign reserves.

Unlike a currency board, Argentina's cen-



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tral bank could accumulate foreign reserves in excess of its monetary liabilities and could hold domestic assets. These features allowed it to engage in discretionary monetary policy and to break the link between changes in its foreign reserves and the domestic money supply.

During the period when the central bank operated under the convertibility law of 1991, it ag-

gressively used its discretionary powers. Indeed, it neutralized via open market operations 59% of the changes in its foreign reserves. In 2001 neutralization was dramatic. Foreign reserves fell by \$12 billion, but the central bank more than offset this dramatic decline by issuing peso liabilities and purchasing domestic assets.

The Argentinean monetary regime's reputation as a currency board represents a classic case of mistaken identity. The central bank's hands were anything but tied, allowing it to practice a hyperactive monetary policy. That was the system's fatal flaw.

The peso overvaluation/uncompetitiveness story also fails. If that story were true, exports would have been sluggish or declining during the 1991-2001 period. In fact the volume of exports was relatively robust when the peso was linked to the dollar. The average annual export growth rate (measured by volume) was a brisk 7.8%. After the devaluation export volumes have grown at only a 3% annual rate.

So much for received ideas. Where does all this leave us today? Argentina finally bounced off the bottom. In the last quarter of 2003 the real gross domestic product was 11.3% higher than in the same period in 2002. As a result of its recent growth spurt, Argentina's real GDP is now where it was at the end of 1996. Can sizzling growth be sustained?

To answer that question we have to go back to the devaluation of 2002. It was not a garden-variety devaluation. What made Argentina's monetary regime unique in the predevaluation period was its explicit redemption pledge. Each person who owned an Argentinean peso was guaranteed the right to convert a peso for a U.S. dollar. When the redemption pledge was revoked, the government confiscated \$17.8 billion of central bank reserves that had been the property of people who held pesos. Talk about a bank robbery!

As a result of that bank heist and the embrace of neopopulist policies, the rule of law in Argentina remains in shambles. Those who expect a sustained boom will, therefore, be disappointed. Argentina has a long way to go to make amends for its past sins. **F**



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