

Argentina's Fall From Grace

by Steve H. Hanke

When Argentina's economy melted down in January, everyone blamed their currency board system linking pesos to the dollar. Everyone was wrong.

Anyone attempting to make sense out of Argentina's fall from grace to economic and political chaos faces a real challenge. Most of the commentary has been, at best, confused and confusing. The road to economic health began on April 1, 1991, when Carlos Menem's government installed what was known locally as a "convertibility system" to rid Argentina of hyperinflation and give the country a confidence shock. Under the Convertibility Law, the peso and the U.S. dollar both legally circulated at a 1-to-1 exchange rate. The owner of a peso had a property right in a dollar and could freely exercise that right by converting a peso into a dollar. And that redemption pledge was credible because the central bank was required by law to hold foreign reserves to fully cover its peso liabilities.

With the passage of the Law of Public Emergency and Reform of the Exchange Rate Regime on Jan. 6, 2002, near-dictatorial powers were transferred to President Eduardo Duhalde and the convertibility system was swept into the dustbin. Consequently, the peso has been devalued and is now floating.

The confusing commentary about Argentina centers on its rather unusual monetary regime and the fact that, unlike the Argentine public, the chattering classes didn't approve of convertibility. In consequence, they have trotted out every half-truth or non-truth under the sun to bolster their claims that Argentina's problems resulted from its convertibility system.

This is nothing new. As Oskar Morgenstern stressed in his classic book, *On the Accuracy of Economic Observations*, wrongheaded arguments, distortions, and lies are common fare for the policy elite. For example, he recounts that:

When the Marshall Plan was being introduced, one of the

chief European figures in its administration (who shall remain nameless) told me, "We shall produce any statistic that we think will help us to get as much money out of the United States as we possibly can. Statistics which we do not have, but which we need to justify our demands, we will simply fabricate." These statistics "proving" the need for certain kinds of help, will go into the historical records of the period as true descriptions of the economic conditions of those times. They may even be used in econometric work! (p. 21)

Alas, much of what has been written about Argentina's convertibility system follows the script for the Marshall Plan. Central to the chattering classes' argument against convertibility was the claim that the peso was overvalued.

Supposedly, the peso's link to the strong U.S. dollar made the peso 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 eleven 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 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 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 ranked 22nd, about midway between the most expensive city, Tokyo, and the least expensive, 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

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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.

Doing the Math

Ignoring those facts, the chattering classes went on to claim that a devaluation was necessary to boost exports and economic growth. Does this claim hold water? 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) doesn't 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 a half percent to GDP — a GDP that, thanks to the new exchange-rate regime, has collapsed.

In addition to errors of commission, the commentary on Argentina is replete with errors of omission, too. I have yet to see mention of the fact that Argentina's real GDP growth rate during the decade of convertibility was more rapid than during any other decade in the 20th century. Never mind. That little fact would have ruined the story.

If not the convertibility system and the peso, then what?

Argentina's acute political and economic crises have resulted from an interrelated set of self-inflicted Argentine blunders.

Self-Inflicted Harm

In the 1990s, Argentina failed to carry out comprehensive free market reforms. Contrary to claims by Eduardo Duhalde, Argentina's new president, the neoliberal economic model was never more than partially implemented. The fiscal system is a mess and tax rates are sky-high. For example, the tax wedge between gross labor costs and net wages is a whopping 42%, comparable to the biggest wedges in socialist Europe and almost double that of the U.S. No wonder official unemployment has remained so high and the underground economy is so vibrant. In addition, over half the working-age population in some provinces is employed by the government. The Mussolini-style labor laws and the public health-care and social security systems remain unreformed and in need of modernization.

- In 1999, former president Menem failed to follow through on an experts' report that I co-authored with Kurt Schuler.* We had recommended the replacement of the peso with the dollar. Menem's failure left the peso vulnerable to meddling of the always unreliable Argentine politicians.

- In 1999, Argentina's voters elected a weak left-wing government. It was led by President Fernando de la Rúa. Although a decent man, he remained distant and removed from the economic realities of Argentina and was tone deaf to Argentina's politics.

- In 2000 and 2001, the de la Rúa government introduced three large tax increase packages on the recommendation of the International Monetary Fund. These pushed the top tax rates in Argentina to very high levels, much higher than those in the United States. Not surprisingly, these tax increase packages forced the economy to slow rapidly and

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total tax revenues collapsed. As a result, Argentina was unable to service its debt.

- In March, 2001, Domingo Cavallo was appointed Minister of the Economy. Cavallo's economic principles were subject to constant change and as fluid as the assets in a well-managed bank. This fact, combined with his hyperactivity, was a deadly cocktail.

- On April 25, 2001, President de la Rúa replaced the president of the central bank, Pedro Pou, with Roque Maccarone, a man who was inclined toward meddling with the rules governing the peso-dollar exchange rate.

- On June 19, 2001, Argentina introduced a multiple exchange-rate system. Under this setup, exports (excluding oil) took place with a devalued peso; imports with a reval-

*"A Monetary Constitution for Argentina: Rules for Dollarization." *Cato Journal*, v. 18, no. 3, pp. 405-19.

ued peso, and interest rates shot up. All other transactions take place at a peso-dollar rate of 1-to-1. This was the beginning of the end because Argentina abandoned the convertibility rules. Consequently, external drains of foreign reserves out of Argentina accelerated.

- On June 25, 2001, a law was put into effect in which the peso's anchor would switch from the dollar to a basket of 50% euros and 50% dollars once the euro reached parity with the dollar. This constituted another breach of the Convertibility Law and gave rise to further external drains of foreign reserves.

- In November 2001, Domingo Cavallo engineered a local debt swap in which domestic financial institutions, including banks and private pension funds, were forced to provide credit to the government. This destroyed billions of dollars worth of assets at these institutions and also replaced liquid tradable assets with illiquid, non-tradable assets.

- In early December, 2001, Argentina imposed an interest rate ceiling on interest paid in pesos. Consequently, bank runs and internal drains of deposits out of Argentina's banks accelerated. Then, in an attempt to slow the external and internal drains in Argentina's money and banking system, exchange controls were imposed. These totally abrogated the property rights people had been granted under the Convertibility Law. Argentines viewed this as theft and went to the streets.

- On Dec. 26, 2001, interim President Adolfo Rodríguez Saá proposed the issuance of a parallel currency, the Argentino. Whenever Argentina has found itself in a tight pinch in the past, it has resorted to the printing of more fiat paper money. Since these experiments have always ended badly, the public responded by rioting and the Argentino never saw the light of day.

- On Jan. 6, 2002, Duhalde scrapped the Convertibility Law and devalued the peso, which is now floating. In addition, the government is in the process of "pesofying" the economy.

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Argentina's Devaluation Was Like No Other

What set it apart is that it involved what Frédéric Bastiat termed legal plunder. The Convertibility Law gave a peso holder the right to freely convert a peso into a U.S. dollar. Argentina's redemption pledge was credible because the central bank was required by law to hold foreign reserves to fully cover its peso liabilities. This right of redemption made the convertibility system unique and distinguished it from typical fiat money systems.

Accordingly, with the repeal of the Convertibility Law, the redemption pledge was thrown to the winds and the peso holders' claims on foreign reserves held at the central bank were revoked. Consequently, Argentina's devaluation represents a great bank robbery, one in which the rights to 17.8 billion U.S. dollars in foreign reserves were abolished by the government. For the Duhalde government, that was just the beginning. Indeed, the government has passed a string of new laws that trample on property rights, make a mockery of the rule of law, and are worthy of the Bolsheviks.

Much of this centers on the pesofication of the economy.

Embraced by the Duhalde government, this policy was first articulated by Ricardo Hausmann, a Harvard professor and former chief economist of the Inter-American Development Bank, in the Oct. 30, 2001 issue of London's *Financial Times*. The *Financial Times* leader of Oct. 30 dutifully endorsed pesofication, as did most of the chattering classes that reside in Washington, D.C. Prior to his pesofication manifesto, Hausmann had been one of the strongest advocates of dollarization.*

Pesofication has dealt a series of blows to the property rights of Argentines:

- Dollar reserves held by commercial banks were seized by the central bank and converted into pesos at 1.40 pesos per dollar. As of Feb. 1, dollar reserves held by commercial banks plus dollar vault cash was U.S.\$5.4 billion. At two pesos per dollar, the windfall loss for commercial banks and the corresponding windfall gain for the central bank is roughly U.S.\$1.6 billion.

- All bank loans originally made in dollars will be converted into pesos at 1 peso per dollar, generating a windfall gain for borrowers of dollars and a corresponding windfall loss for lenders. As of Feb. 1, the last business day before the

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new measures were announced, dollar loans were U.S.\$45.8 billion. At two pesos per dollar, the windfall gain for borrowers and the corresponding loss for banks is thus about U.S.\$23 billion.

- All bank deposits originally made in dollars will be converted into pesos at 1.40 pesos per dollar, generating windfall losses for depositors and windfall gains for banks. As of Feb. 1, dollar deposits were U.S.\$39.8 billion. At two pesos per dollar, the windfall loss for depositors and the corresponding windfall gain for banks is thus about U.S.\$12 billion. Overall, then, banks suffer a windfall loss of about U.S.\$1.6 billion + U.S.\$23 billion - U.S.\$12 billion = U.S.\$12.6 billion. (The capital of all privately owned banks, which constitute roughly three-quarters of the banking system, is U.S.\$12 billion.)

- Under privatization agreements with private utilities, many of which are foreign-owned, utility rates were denominated in dollars and indexed to the U.S. inflation rate. These agreements have been redenominated in pesos at 1 peso per dollar. The contract nullification costs, as yet to be calculated, will run into the billions of dollars.

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*I am reminded of George Orwell's 1984, in which the world was divided into three countries at war with one another. Oceania was in alliance with Europa against Eastasia. An orator from Oceania was haranguing the crowds, reviling Eastasia and praising Europa. Then a message was delivered from the central office; the alliances have changed! And without hesitation or change of inflection, the Oceania orator simply substituted the new ally for the old enemy. So it was with Hausmann's switch from dollarization to pesofication.