

Argentina Should Dollarize, Pronto

BY GABRIELA CALDERÓN DE BURGOS AND DANIEL RAISBECK

For the first time since 1991, Argentina suffers from annual inflation rates above 100 percent. It is thus no surprise that out-of-control price rises will be the defining issue in October's presidential election. According to a poll published in March by Universidad de San Andrés, 92 percent of Argentines are "totally dissatisfied" with the current handling of the economy.¹ Meanwhile, a majority of voters from both major political groupings—the governing Frente de Todos, a leftist Peronist coalition, and Juntos por el Cambio, the main center right opposition—said inflation is the country's worst problem (by 59 and 67 percent, respectively).²

Under former president Mauricio Macri, the founder of Juntos por el Cambio whose presidential term lasted from 2015 to 2019, average inflation levels doubled from around 27 to 54 percent.³ After a brief reprieve, inflation has more than doubled under Alberto Fernández, the current Peronist president, from 42 percent in 2020 to the current rate of 114.2 percent.⁴ Argentina is also reeling from a related debt crisis. In 2018, as the Argentine peso slid against the dollar,

Macri turned to the International Monetary Fund (IMF) for a \$57 billion loan, the largest in the fund's history.⁵ In 2020, Fernández's government failed to pay \$500 million in interest payments and reached a deal with creditors to restructure \$65 billion in debt.⁶

After these tremendous economic shocks, both coalitions are struggling to convince an electorate eager to vote with its pockets on August 13, the date of the mandatory primaries. Significantly, 29 percent of Argentines now believe that the country should dollarize.⁷ In other words, nearly a third of citizens think that the best remedy against the country's chronic bouts of inflation is to deprive Argentine politicians and functionaries of the ability to print any money at all. The only presidential candidate proposing to dollarize the economy is Javier Milei, a free-market economist who, as of July, was polling at 19 percent.⁸ Milei's critics denounce him as a demagogue with an arsenal of questionable antics, including the frequent use of profanity, but he is the one prominent politician in Argentina with a credible proposal to bring inflation under control.



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ARGENTINA'S CONVERTIBILITY SYSTEM OF THE 1990S

As the debate over adopting the dollar gathers steam, some critics have tried to delegitimize dollarization by pointing to Argentina's convertibility system in the 1990s, which pegged the peso to the U.S. dollar and caused the inflation rate to drop from over 2,600 percent in 1989–1990 to less than 1 percent in 1998.⁹ Nonetheless, as Johns Hopkins University economist Steve Hanke explains, the convertibility system had major design flaws.

It allowed the central bank to sterilize foreign currency inflows and neutralize outflows, since there was no limit “on the amount of foreign assets held at the central bank relative to the central bank's monetary liabilities.”¹⁰ The central bank was also allowed to “hold and alter the level of domestic assets on its balance sheet.” Hence, it carried out a discretionary—and often aggressive—monetary policy.¹¹ Argentina's central bank, moreover, maintained the ability to act as a lender of last resort and regulated reserve requirements for commercial banks. Eventually, the convertibility system came under a dual currency regime (with different official exchange rates for imports and exports).¹² In 2001, speculators smelled blood, and the peso lost parity with the dollar in currency markets. In January 2002, Argentina carried out a chaotic exit from its fixed exchange rate.

As Hanke has argued, “Argentina's convertibility system operated more like a central bank than a currency board in many important respects,” mainly through its ability to act as a lender of last resort and to carry out discretionary monetary policy.¹³ By contrast, an orthodox currency board exchanges the domestic currency it issues for an anchor currency at a fixed rate of exchange and without “discretionary monetary powers,” and it cannot engage “in the fiduciary issue of money.”¹⁴ Stripped of any ability to issue credit or act as a lender of last resort, an orthodox currency board engages in purely passive and automatic operations. It “holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold” as reserves, whose levels “are set by law and are equal to 100%, or slightly more, of its monetary liabilities.”¹⁵ Neither commercial bank deposits nor any type of financial asset can serve as convertibility and foreign reserve cover requirements.¹⁶

Since a currency board implements a fixed exchange rate policy but carries out no monetary policy, it acts like a strait-jacket on the local monetary authorities. The alternative of official dollarization, whereby a country grants a foreign currency legal tender status,¹⁷ is the equivalent of a hangman's noose: it mothballs the central bank and fully does away with the local currency.¹⁸ This type of hard dollar regime is exactly what Argentina needs now.

CRITICS OF DOLLARIZATION

Predictably, the Argentine left has decried any dollarization initiative. According to economist and pundit Pablo Anino, dollarization is a “Trojan horse against the working class.”¹⁹ A standard left-wing critique is that the loss of seigniorage, the price paid to a currency's issuer, would be a ruinous, national humiliation. “Dollarization,” Anino writes, “would hand over [Argentina's] seigniorage to the Federal Reserve. It is the dream of American imperialism come true: for the dollar to take strides as an international currency.”²⁰

In a similar vein, Daniel Scioli, a leading Peronist and former presidential candidate, claims that dollarization would deal an unacceptable blow to Argentina's monetary sovereignty.²¹ This is an intriguing defense of the system that has caused triple-digit inflation, interest rates to rise above 80 percent, and levels of currency devaluation against the U.S. dollar that reached 50 percent in 2018 alone.²²

Far more interesting is the resistance that dollarization has faced on the center right and even within classical liberal or libertarian circles. José Luis Espert, a free-market economist who became a congressman in 2021, has publicly opposed the measure.²³ Dollarization, Espert claims, would be a leap in the dark because, as he previously argued in 1999, it would leave little room for macroeconomic policy measures, such as lowering domestic demand with devaluation shocks.²⁴ This is merely the technocratic case for the old notion of monetary sovereignty.

WHY DOLLARIZATION WORKS

Whether on the right or the left, the monetary sovereignists miss the essential point behind dollarization, which is to protect ordinary people's purchasing power from the excesses of chronically profligate politicians and often

subservient—or simply incompetent—central bankers. It should come as no surprise, in fact, that, along with semi-dollarized Peru,²⁵ Latin America's three fully dollarized countries—Panama, Ecuador, and El Salvador—have had the region's lowest inflation levels during the past 20 years (and for much longer in the case of Panama).

Despite the United States experiencing the highest inflation rates in four decades, Latin America's dollarized trio—all of whose per capita gross domestic product (GDP) growth surpassed that of Argentina during the past 20 years—did not see double-digit inflation levels in the aftermath of the COVID-19 pandemic.²⁶ It turns out that if you prevent the local ruling class from printing money indiscriminately, positive results begin to emerge. As Hanke has noted, dollarization is equivalent to instituting the rule of law in the monetary sphere.²⁷

Official dollarization is no guarantee of economic growth or sound fiscal management. In El Salvador, which officially dollarized in 2001 under former finance minister Manuel Hinds, successive governments tripled the national debt between 2003 and 2018.²⁸ As Hinds argues, however, were it not for the dollar, Salvadoran governments would have been tempted to monetize the debt à la Argentina.²⁹

Instead, even the left-wing Farabundo Martí National Liberation Front, a former Marxist guerrilla group that won the 2009 and 2014 presidential elections, had to backtrack on its pledge to restore the Salvadoran colón.³⁰ The dollar had proved too popular among a population that benefited from far lower inflation and interest rates—4–5 percent lower according to a study by the IMF—as well as longer loan periods than in the bygone era of monetary sovereignty.³¹ For the same reasons, Rafael Correa, the left-wing strongman and ally of Hugo Chávez who governed Ecuador between 2007 and 2017, failed in his attempt to get rid of the dollar as the country's official currency.³²

Nor does dollarization imply, as the sovereigntists claim, a country's surrender of its monetary policy to the United States. As economist Juan Luis Moreno-Villalaz argued in the *Cato Journal* in 1999, Panama's banks, which have been integrated to the global financial system after a series of liberalization measures in the 1970s, allocate their resources inside or outside the country without major restrictions, adjusting their liquidity according to the local demand for credit or money. Hence, changes in the money

supply—which arise from the interplay between local factors and the specific conditions of global credit markets—and not the Federal Reserve, determine Panama's monetary policy. Fed policy affects Panama only to the same extent that it does the rest of the world.³³

THE SEIGNIORAGE RED HERRING

Regarding seigniorage, Hinds tells us that, for dollarized countries, the “loss” involved “is much smaller than normally assumed.”³⁴ He likens it to an insurance premium paid for protection against the higher risks of maintaining a local currency. According to economist Nicolás Cachanosky, Argentina's inflation has made its seigniorage low or even negative, in which case governments resort to inflationary measures, increasing the debt, or raising taxes.³⁵

Emilio Ocampo, another Argentine economist, notes that Ecuador's lost seigniorage revenues have been equivalent on average to 0.2 percent of its annual GDP. He calculates that if Argentina were to dollarize, the annual seigniorage sacrificed would be within the range of 0.6 and 0.8 percent of GDP.³⁶ This is not a high price to pay to control the chronic and costly illness of inflation. In fact, the cost could be more than compensated if Argentina replaced its current stagflation—the country's GDP did not grow between 2010 and 2021³⁷—with even meager economic growth. Ocampo writes that despite having a fiscally extravagant left-wing government during most of the 2010s, Ecuador's GDP per capita since 2010 “has grown at a rate that exceeds that of Argentina by 1 percent per year.”³⁸

Nevertheless, the seigniorage versus dollarization dichotomy is a false dilemma. In its orthodox form, a currency board generates seigniorage “from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities.”³⁹ Thus, a country can keep the benefits of seigniorage and those of dollarization if it opts for an orthodox currency board. However, a currency board can be reversed far more easily than official dollarization.⁴⁰ Also, dollarization leaves no currency in the hands of the central bank, nor does it depend on a promise from the local political class to abide by a certain set of rules. Hence, in light of Argentina's tumultuous financial history, it would be far more prudent in our opinion to grant the U.S. dollar legal tender.

THE LIQUIDITY NOTE TIME BOMB

The most thoughtful critique of official dollarization in Argentina is that of Roberto Cachanosky. A classical liberal economist who argued in favor of dollarization as recently as 2019,⁴¹ Cachanosky maintains that it is not feasible to dollarize now due to the \$30 billion that the central bank owes to private banks, which in turn are in debt to their depositors.⁴² The debt consists mainly of short-term bonds or liquidity notes (LELIQs, or *letras de liquidez*) with a maximum maturity of 28 days in most cases and an automatic rollover mechanism. The central bank issues LELIQs to mop up pesos from the market in an attempt to revive domestic demand for the local currency. Despite their constant escalation, nominal LELIQ interest rates—the current rate is 97 percent, versus 38 percent in early January 2022—have not kept up with what is now triple-digit inflation.⁴³ The effective rate, on the other hand, stands at an astronomical 155 percent per annum.⁴⁴

The central bank has only been able to pay for such drastic interest rate hikes by expanding the monetary base aggressively, thus boosting inflation further. Since higher inflation leads to greater demand for hard currency, the use of LELIQs as a means to strengthen the peso has become counterproductive. As such, the LELIQ experience provides yet another argument in favor of dollarization, not against it.

For investors, one motivation to buy LELIQs has been the alluring opportunity to carry trade, the practice in which one borrows at a lower interest rate in one currency to invest at higher rates in another. As the *Financial Times*'s Benedict Mander noted in 2017, a craze for the carry trade arose in Argentina after Mauricio Macri liberated capital flows early in his term.⁴⁵ The mix of high inflation, policies to strengthen the local currency, and a floating exchange rate attracted foreign funds into Argentina's local debt instruments; at the time, these were the bills of exchange known as LEBACs (Letras del Banco Central). The carry trade bonanza, Mander wrote, left Argentina "exposed should circumstances change, either at home or abroad." The shock came in 2018, when the peso lost 50 percent of its value against the dollar. LEBACs were no longer issued after December 2018. According to one calculation, the LEBAC carry trade left an overall dollar loss of 13 percent in its three-year existence.⁴⁶ Investors learned the hard way about the inherent fragility of the carry trade strategy, which leaves the creditor exposed to a wipe out with an exchange rate crisis.

In its current state, LELIQ debt is a fiscal time bomb. Writing in March 2023, Javier Blanco, a financial journalist at Argentina's *La Nación* newspaper, states that the total amount of LELIQ debt (ARS\$12 trillion) was more than twice as large as the monetary base (ARS\$5.07 trillion), with its growth gathering enough pace to double every five months. Since March 2022, the total amount of LELIQ debt had increased by 147 percent, thus outpacing inflation.⁴⁷ Economist Ramiro Castiñeira adds that Argentina's central bank had no assets with which to pay the interests on its liabilities, likening its continuous monetization of LELIQ debt to a Ponzi scheme. Those further down the pyramid, Castiñeira argues, receive ever growing amounts of inflation.⁴⁸

Since the dollar straitjacket would prevent the central bank from printing money to pay short-term bond interest, several analysts maintain that dollarization would force a default in LELIQ debt payment. Since the central bank has insufficient assets with which to meet its obligations to commercial banks, a full-on banking crisis could ensue. However, Argentina would face the same scenario if the central bank simply stopped monetizing its debt, which is what it should do to create long-term macroeconomic certainty.

Nicolás Cachanosky and Ocampo argue that dollarization provides the only way to solve the LELIQ problem and thus possibly avoid or at least mitigate a banking crisis without assuming new debt. They propose to swap the central bank's assets for bonds in a foreign jurisdiction, depositing said bonds in a new trust with the ability to issue asset-backed commercial paper with short-term maturities.⁴⁹ The trust, which would be supported by an underwriting backstop facility (in which money center banks provide a backstop or secondary source of funds, in exchange for a fee if used, to complement the funding available initially and thus meet the total funding requirement), would swap LELIQs for dollar-denominated commercial paper, which would be paid off with proceeds from the trust's assets until the entirety of LELIQ debt is liquidated.⁵⁰ As an alternative, financing the central bank's liabilities would involve yet another large multilateral loan, presumably from the IMF.

According to economist Iván Carrino, the underlying issue is not the method through which the central bank's liabilities can be restructured or financed to rescue creditors but rather the need to implement a series of macroeconomic measures that can provide confidence in the country, bring

down interest rates, and thus allow the debt to be paid off in an orderly fashion. Dollarization would go a long way toward creating such confidence.

After all, the Argentine state must pay its obligations regardless of its official currency. As for commercial banks' assets and liabilities, they would remain the same after dollarization—save for the new unit of account—in terms of their current value in U.S. dollars.⁵¹ Adopting the dollar, on the other hand, would introduce much-needed hard budget constraints even if strict fiscal rules would still be necessary to rein in deficit spending.⁵² Together, dollarization and a regime of budget discipline would lower interest rates and limit the future size of the debt.

THE MATTER OF RESERVES

Roberto Cachanosky further argues that Argentina currently holds insufficient reserves to dollarize.⁵³ These objections, however, stem from the mistaken assumption that there are certain conditions that a country must meet before it can install a currency board or a dollarized system. As Hanke writes, “a currency board requires no preconditions for monetary reform and can be installed rapidly. Government finances, state-owned enterprises, and trade need not be already reformed for a currency board to begin to issue currency.”⁵⁴ The same applies to official dollarization.

Regarding reserves, it is only Argentina's central bank that lacks dollars. Argentine citizens and companies, on the other hand, hold plenty of hard currency even if, in a logical attempt to shield themselves from the country's frequent bank runs, they do so either under their mattresses or in other jurisdictions. According to Argentina's National Institute of Statistics and Census, at the end of 2022, Argentines held over \$246 billion in foreign bank accounts, safe deposit boxes, and mostly undeclared cash.⁵⁵ The amount exceeds 50 percent of Argentina's GDP in current dollars for 2021 (\$487 billion).⁵⁶

If Argentina were to dollarize—or even announce much-needed reforms, such as the end of price and currency controls—it would be reasonable to expect a sizable portion of the hard currency held abroad to return to the country. This was the case in Ecuador after the bank runs of the late 1990s. With the mere announcement of dollarization in January 2000, there was an immediate increase in deposits even though the beleaguered banks were offering negative interest rates.⁵⁷

In Argentina, the \$9 billion of reserves needed to dollarize are not a significant obstacle given Argentina's GDP, Ocampo argues. He adds that dollarizing physical pesos need not be a measure implemented overnight but rather over a period of several months, during which time both currencies would circulate.⁵⁸

IMPLEMENTATION WILL BE KEY

To be clear, Roberto Cachanosky does not support maintaining the Argentine peso but rather getting rid of its legal tender and allowing a free competition among currencies. The practical effects of full monetary freedom in Argentina, however, would be the widespread adoption of the U.S. dollar, which already thrives in the black market. Under either scenario—simply ending the peso's legal tender or formally declaring the dollar Argentina's official currency—the country would be able to overcome inflation. With the right set of supply-side policies, Argentina can also return to economic growth.

Argentina's next government should dollarize while taking seriously the technical challenges that dollarization presents. As José Piñera, a former minister of labor in Chile, remarked in reference to his own country, radical reform requires conservative execution.⁵⁹ Regardless of which party wins the presidency in 2023, dollarization should continue to be at the forefront of the political debate.

NOTES

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