

The Great Argentine Train Robbery

*The leading
currency board
advocate tells
a tale of
economic and
political chaos.*

BY STEVE H. HANKE

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 good 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 to give the country a confidence shock. Under the Convertibility Law, the peso and the U.S. dollar both legally circulated at a one-to-one 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 cover fully its peso liabilities.

With the passage of the Law of Public Emergency and Reform of the Exchange Rate Regime on January 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 what was a 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.

Was the convertibility system a currency board? Argentina's convertibility system is often referred to as a currency board system. That it was not. During its lifetime, the system lacked one or more of the defining features of an orthodox currency board. For example, last year the Banco Central de la

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Note: The author remarked that "in the Argentine context a floating peso has always meant a sinking peso." Since this article went to press, the peso-dollar rate has gone from 2.5 to 3.5.

República Argentina (BCRA) engaged in extensive discretionary monetary policy. The “pure” foreign reserves in the convertibility system fluctuated wildly from a high in February of 193 percent of its monetary liabilities to a low in December of 82 percent. If Argentina had employed an orthodox currency board, those reserves would have always been 100 percent of the system’s monetary liabilities.

Under the convertibility system, the BCRA also regulated banks and set their reserve ratios. It was un-

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officially a lender of last resort, though it retained a constructive ambiguity about its role that reduced moral hazard risk.

As evidence of the BCRA’s hyperactivity, one has only to look at the *Bulletin of Monetary and Fiscal Affairs* published quarterly by the BCRA. Each issue since April 1991 contained a long list of measures taken by the BCRA. If the BCRA had been operating as an orthodox currency board, these pages would have been blank.

Was the peso 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 full 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 percent ahead of exports during the same period in 2000. Considering that estimated real growth in world trade was only 0.9 percent 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.

There are other indicators that contradict the overvaluation story. For example, *The Economist* magazine’s Big Mac Index, which compares the price of McDonald’s hamburgers around the world, indicates that the peso, before its devaluation, was 2 percent undervalued. In 1999, the index had indicated that the peso was 3 percent overvalued and in 2000, it had indicated no overvaluation. Even so, from May 15, 1999 through February 2, 2002, *The Economist* contained twenty-six articles claiming that the economy was being dragged down by an overvalued peso. 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 percent of its so-called fundamental equilibrium real exchange rate.

Will the devaluation restart the economy? For better or for worse, devaluation is now a fact. The big question going forward is: Will it revive the economy? Let’s go through the arithmetic. The short-run price elasticity for Argentine exports is about -0.1. Therefore, to stimulate exports by one percent, the real value of the peso (adjusted for inflation) would have to depreciate by 10 percent. Exports in Argentina accounted for only 9 percent of GDP last year. Consequently, if the current devaluation of 60 percent (the floating peso is trading at about 2.5 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 6 percent. Under this optimistic scenario, the current level of devaluation would add little more than a half percent to GDP—a GDP that, thanks to the new exchange-rate regime, has collapsed.

And even though estimates of price elasticity cannot be treated with very high confidence, the short-run price elasticity for exports would have to be about ten times as great as its estimated value to offset the 5 percent officially-projected contraction in GDP this year. If the private sector's more pessimistic forecasts of Argentina's contraction in GDP for 2002 were used, the price elasticity would have to be even greater.

Why was Argentina's devaluation unique? Argentina's devaluation was unlike those in typical fiat monetary regimes because of the redemption pledge enshrined in the Convertibility Law. With its repeal, peso holders' claims on foreign reserves held at the central bank were revoked. Argentina's devaluation, then, represented more—much more—than a garden-variety devaluation. It was a great bank robbery. Foreign reserves equal to 17.8 billion dollars that were the property of peso holders were confiscated by the government.

That was just the beginning. In addition to taking the foreign reserves from people who held pesos, the government of Eduardo Duhalde has passed other laws and issued regulations to "pesofy" the economy (that is, convert dollar assets, liabilities, and prices into pesos, almost always at a rate that is not the market rate). These have annulled property rights and ignored the rule of law.

So, then, what caused Argentina's crisis? Argentina's economy went into recession in September 1998 in the aftermath of the Asian and Russian currency crises, which resulted in a general decline in flows of investment to emerging market economies. The Brazilian currency crisis of 1999 dealt the

*Argentina can do what Ecuador did
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economy another blow. Signs of recovery appeared in late 1999 and early 2000, but the incoming de la Rúa government choked the recovery by enacting large tax increases that took effect at the start of 2000. The government (and the IMF, which lent support to the government's program) thought the tax increases were necessary to reduce the budget deficit. Instead, tax collections fell. When Domingo Cavallo became minister of the economy in March 2001, he pushed through a financial transaction tax, which was increased in August to its current rate of 0.6 percent on bank debits and credits.

The tax increases put Argentina's tax rates well above comparable rates in the United States. The distortions created by Argentina's sky-high tax rates show up in the labor markets. For example, the tax wedge between gross labor costs and net wages

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is 42 percent, comparable to the largest wedges in Europe and almost double that of the United States. It is not surprising, therefore, that the unemployment rate is relatively high and the underground economy is so vibrant.

If that wasn't bad enough, Domingo Cavallo meddled with convertibility. In April, he announced that the peso's anchor would eventually change from the dollar to a basket of 50 percent dollars—50 percent euros, and in June he announced a preferential exchange rate for exports. These changes moved convertibility further from currency board orthodoxy and caused interest rates to skyrocket. Deviations from currency board orthodoxy cause problems—big problems.

In the middle of a nasty slump, the de la Rúa government increased tax rates on three occasions. It also meddled with the convertibility system, which tightened monetary conditions. Not surprisingly, these actions proved to be a deadly cocktail.

What Should the U.S. Role Be in Argentina? The Duhalde government's measures, especially those connected with the exchange rate and the banking system, have drawn praise from many observers as steps in the right direction. The observers are wrong. They ignore the fact that the government's program amounts to destruction of the rule of law. The government has changed the terms of some contracts between private parties, suspended the validity of other contracts, and seized wealth from some members of the public to redistribute to other members or to itself.

The Duhalde government has so disrupted rights to private property that these rights hardly exist. The government's measures are disastrous for Argentina's future. Without a reversal of most of the measures, Argentina will remain for years to come what it has been for more than half a century: a once-rich country that has stagnated while other countries, once poorer, have surged ahead of it.

Observers who have praised the government's measures have also somehow failed to notice that a depreciating peso is massively unpopular. Since central banking was established in Argentina in 1935, the peso has depreciated against the dollar by a factor of approximately 7,500,000,000,000. In the Argentine

context, a floating peso has always meant a sinking peso. The convertibility system, though imperfect, was the cornerstone of Argentina's economic growth in the 1990's. Now that the cornerstone has been removed, much of the structure has already crumbled.

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The chattering classes 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.

ment, since it would have carried considerable weight. Although the United States is not responsible for Argentina's economic problems, it is in our national interest for the Treasury Department to offer advice that would promote economic growth and political stability in Argentina. The result of the Treasury's hesitant attitude about recommending dollarization has been that Argentina is now asking the IMF and other international financial institutions for billions of dollars in new loans. Since the United States is the largest provider of funds to those organizations, if they lend to Argentina at their customary below-market rates, U.S. taxpayers will in effect be paying for the Treasury's hesitation. This leads me to my two recommendations for U.S. policy towards Argentina.

First, recommend dollarization. As a purely technical matter, dollarization is always feasible at some exchange rate, and as Ecuador's experience of dollarization in 2000 indicates, it is feasible even when established in the midst of political and economic chaos. The question in Argentina's case is what exchange rate is appropriate now and, if dollarization is not adopted soon, how to determine the exchange rate that would be appropriate should a future government decide to dollarize. Dollarization remains desirable because the prospects are poor for making the peso into a stable currency that people will want to use without coercion. People trust the dollar; they do not trust the peso.

It may no longer be possible to return to an exchange rate of one peso per dollar, but Argentina can do what Ecuador did when it dollarized in 2000: establish a uniform exchange rate for converting local currency into dollars and apply it to all assets and liabilities denominated in local currency. This rate should not be determined mechanically, by simply looking at what exchange rate would be necessary to make the central bank's dollar assets cover its peso monetary liabilities. The confidence that dollarization would inspire might enable dollarization to occur at an exchange rate considerably more favorable for the Argentine public than a mechanical calculation indicates.

My second recommendation is that the Treasury respect laws that Congress has passed, which establish the wise principle that Americans as taxpayers should not support a government that robs Americans as investors. A number of provisions of Title 22 of the U.S. Code state that the President shall deny foreign aid to governments that seize the property of or nullify contracts with U.S. citizens or corporations. These provisions also state that the President shall instruct U.S. executive directors at international financial institutions to vote against loans (except humanitarian aid loans) for such governments unless the governments have, within a specified period, provided compensation for the property taken or submitted claims for compensation to arbitration in accord with international law.

In my view, the actions Argentina has taken should clearly trigger U.S. opposition to loans by international financial institutions to which the United States belongs. In testimony to the Joint Economic Committee on February 14, 2002, Dr. Taylor indicated that Argentina's actions have not triggered the provisions of Title 22 because Argentina has treated all foreign investors equally. That is not the standard the provisions refer to, however; rather, the provisions are supposed to be triggered by specified violations of property rights that affect Americans whether or not other foreign investors have suffered similar violations. Americans as taxpayers supporting a government that has robbed them as investors in Argentina will send a terrible signal.

To promote prosperity, secure private property rights are essential. To turn a blind eye to the massive violations of property rights in Argentina would not only harm U.S. investors; it would reinforce longstanding tendencies that have made Argentina a problem-prone country for most of its history. Without well-defined, secure property rights, people cannot plan for the future. Consequently, there is little incentive to invest, to create jobs, to innovate—in short, to do all the things to produce the economic growth Argentina's people desperately need. U.S. laws should be upheld and the United States should vote against aid for Argentina from the IMF and other institutions until Argentina reverses its seizures of property or provides compensation for them. Promoting the security of property rights is not simply in the interest of U.S. and other foreign investors; it is in the interest of the Argentine people. ♦