Argentina: Where To GoFrom Here?

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Argentina is currently undergoing its deepest economic, social, and political crisis ever. A combination of extremely harmful regulations have pushed the economy from a severe recession between 1998 and December 2001 to a tragic virtual standstill from December 2001 to date. The elements of current economic policy that are most directly responsible for the current situation are: (1) A set of financial restrictions that prohibit depositors to withdraw funds from their bank account—the so-called corralito. In practice, these restrictions imply that since December of 2001 Argentina has been operating without a banking sector. (2) Massive tariff and non-tariff barriers to international trade keep Argentina isolated from world markets with the exception of Brazil. (3) The extensive privatization process that took place during the 1990s was not accompanied by deregulation. As a result, privatizations simply turned state monopolies into private monopolies.

Elements (2) and (3) of the current policy mix are responsible for turning the 1998 recession from what should have been a V-shaped recession (that is, a short contraction and a quick recovery) into a banana-shaped recession (i.e., a long period of time between the downturn and the recovery). Element (1) is responsible for the economic catastrophe that has been taking place since the beginning of the year.

It is important to make clear from the outset that Argentina will not be able to get out of the current state of collapse unless the financial restrictions are completely removed. In addition, unless the economy opens itself to international trade and deregulates domestic markets, it will have a hard time resuming sustained growth.

It is important to realize that monetary policy is not at the heart of Argentina's current difficulties. In particular, all other things equal, a monetary reform that eliminates the peso in favor of dollarization or a new domestic currency, is likely to have very little effect, if any, in lifting Argentina out of its current situation.

Public Confidence

At this point public confidence in the financial sector is literally nil. Today banks operating in Argentina are receiving no fresh, voluntary deposits from the private sector. On the contrary, the reason why the financial restrictions have not been lifted is that the government, correctly, fears that lifting them would lead to a bank run.

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Similarly, the generalized public sentiment is that the social return of tax contributions is extremely low. As a consequence tax evasion is rampant, and tax collection is falling at alarming rates. In April of 2002 tax revenues fell by about 20 percent with respect to April 2001.

Financial Crises in Argentina and Other Emerging Market Economies

In the mid 1990s, Mexico and Korea, for instance, took a dip as a result of financial crises. But quickly thereafter—about one year—they resumed normal growth rates. A key difference with the Argentine case is that neither Mexico nor Korea imposed financial restrictions like those currently in effect in Argentina. In addition, neither Korea nor Mexico opted for debt default. Russia represents an example of a country that defaulted on external obligations but did not impose a freeze on deposits. In that country, the output effects of the financial crisis were not nearly as large as those observed in Argentina. It is then very likely that most of the decline in aggregate activity in Argentina since December of 2001 is due to the financial restrictions put in place in the last month of the De la Rua-Cavallo administration.

What Must Be Done?

At a minimum, the Argentine government should:

1. Lift the financial restrictions (corralito) immediately. (More on this below.)

2. Resume negotiations with domestic and foreign public-debt holders. These negotiations should end up in the determination of a reasonable rate of interest on existing public debt, say 8 percent.

3. Deregulate all markets, particularly the financial sector, communications, transportation, public utilities, and energy.

4. Open the economy to international trade in goods and financial assets. This involves lifting restrictions to capital movements, imposing a low and uniform tariff (of, say, 10 percent) on all imports, removing all non-tariff barriers and export taxes. Note that the suggested trade reform implies a departure from Mercosur. It is time to recognize that Mercosur has not delivered the desired results in terms of trade creation. Unilateral opening to trade and financial markets should be accompanied by an aggressive foreign affairs policy aimed at achieving reciprocity from the rest of the world.

5. Fight tax evasion. To this end, the government should set a uniform VAT tax rate and eliminate all exceptions. Lowering the VAT tax rate somewhat, say to 17 percent, may prove helpful in curbing tax evasion. The government should immediately terminate contracts with firms that hold the concession of services and fail to pay the corresponding fees. Examples include the postal service and airports.

6. Follow a simple and transparent monetary. (More on this below.)

7. Assistance plans to the needy should concentrate primarily on the population below 15 years of age, providing food, health care, and education.

The Corralito: Why It Survives And How To Lift It

Duhalde's Misperception and the IMF's Disorientation

In arguing against lifting the financial restrictions that are depriving Argentina of a banking system, President Duhalde claims that the corralito is like a time bomb, which, if not deactivated slowly, can explode with harmful consequences. President Duhalde does not seem to realize that the bomb already exploded back in December of 2001. Because banks operating in Argentina are unable to conduct financial intermediation, the current situation is worse than one in which some (or most) of the banks go bankrupt with the rest operating normally, the situation so feared by President Duhalde.

A similar misunderstanding is evident from the IMF. In the past six months, this institution has placed at the highest priority, not the lifting of the corralito, but the passing of reforms to the economic subversion and bankruptcy laws. This ununderstandable misplaced emphasis has been particularly damaging for the people of Argentina because the government, under the perception that an IMF aid package is indispensable to get out of the crisis, has been placing all of its energies into ensuring the passage of the above-mentioned reforms in Congress.

It is clear that a first step in lifting the corralito is that the government and the IMF become convinced that it must go. This might entail calling for immediate general elections in Argentina and an evaluation of Ms. Krueger's ability to design conditionality packages that ameliorate rather than deepen the pain of crises in emerging economies.

Lifting The Corralito

The financial restrictions imposed in December of 2001 by the De La Rua-Cavallo administration represented a severe violation of property rights. Shortly afterward, the Duhalde-Remes Lenivov administration greatly aggravated the situation by instituting an asymmetric pesoification of loans and deposits. In practice, this measure amounted to massive de facto expropriations of bank deposits and transfers of wealth to banks and borrowers. This situation is impossible to undue. Thus, there is no such thing as a clean or fair way out of the corralito. But clearly the financial restrictions must be removed. To this end, the government should

1. Gradually but quickly increase the withdrawal limit. Initially from the current 1,200 pesos per moth to 3,000 pesos per month. The next moth to 6,000 pesos. The nest to 9,000, and so forth. This limits should apply to funds deposited in any type of accounts (sight deposits, time deposits, saving accounts, etc.)

2. Depositors should be compensated for foregone interest on deposits trapped in the corralito. All deposits should be indexed by the consumer price index starting at

the time of the implementation of the corralito and until the moment the deposit is liberated. In addition, an interest rate of, say, 8 percent should be applied to interest-bearing deposits.

3. The government should pay to banks 0.4 pesos per peso withdrawn from a frozen account. This transfer compensates banks for the costs imposed by the asymmetric pesoization of loans and deposits.

4. The above transfers from the government to banks should be materialized via money creation, without concern for its effect on the peso/dollar exchange rate.

5. Banks that fail to meet withdrawals should be subject to bankruptcy procedures as dictated by the legal code.

6. The government should encourage the mergers, fusions, and absorptions among banks.

Alternative Monetary Regimes

Before considering the issue of what monetary regime is most likely to work for Argentina, it is important to stress that if conditions for sustained growth and fiscal solvency are not met, then no monetary regime is going to deliver a stable nominal anchor.

Is the Argentine Peso Viable?

What makes the value of a currency stable is not its name or history. Rather, it is the outlook that the government can offer for fiscal and financial conditions. Thus, the Argentine peso may or may not regain the status of a low-inflation currency depending on the economic policies to be adopted by the Argentine government.

Back to the Currency Board?

In principle, given the necessary conditions that guarantee stable growth and sound fiscal stability, there is no fundamental contraindication to a currency board. If this option were to be taken, the exchange rate should be set at a value consistent with a reasonable relation between high-power money measured in dollars and foreign reserves held at the central bank. This corresponds to an exchange rate of about 3 pesos to the dollar.

However, a move to a currency board would entail going against the trend. Most countries in the world have moved over the past decade to more flexible exchange-rate regimes. There are very few cases of fixed exchange rate regimes in place. In today's highly volatile world capital markets, having an exceptional exchange rate arrangement might generate unnecessary sources of instability. In addition, in the past few years a growing body of academic and nonacademic research has suggested that fixed exchange rate regimes might be more conducive to financial crises.

Flexible Exchange Rate Regimes

For the reasons given above, it might be more sensible for Argentina to continue operating under a flexible exchange rate regime. It is important to note that the term 'flexible exchange rate regime' is void of content without a concrete specification of monetary policy. Back in January of 2002, the Remes Lenicov-Blejer tandem announced a monetary target for 2002, which implied an increase in the money base of about 20 percent. Above all, Argentina needs a simple and clear monetary rule. Such rule should leave enough room to allow relative prices to adjust smoothly over the business cycle without inducing costly deflationary pressures. What specific policy is adopted is not crucial. A policy that meets he above criteria is a monetary target consisting in expanding the monetary base at, say, 8 percent per year. All increases in the supply of money should be carried out through open market purchases of government debt. Assuming long-run output growth of about 4 percent, this policy would be associated with an annual inflation rate of about 4 percent. This underlying inflation can accommodate real appreciations of up to 12 percent per annum without declines in nominal prices. But other monetary policy alternatives, such as a transparent inflation targeting mechanism, can be equally effective.

Is Dollarization a Good Commitment Mechanism to Monetary Discipline?

The reason why many observers favor dollarization is its assumed ability to tie the hands of governments too weak to resist the temptation of the printing press. However, the question of commitment could also be turned around: Is it not naive to believe that a chronically indisciplined government would alter its behavior merely because of a change in currency? Would such a government not simply get rid of dollarization at the first strong desire to inflate? Alternatively, would a government that has solved its fundamental fiscal problems not be as prepared to stick to dollarization as to any other low-inflation monetary policy, particularly if the alternative policies yield higher welfare? Clearly, these are issues that have yet to be explored, both empirically and theoretically.

A natural and potentially fertile ground for understanding the nature of government commitment to dollarization is monetary and fiscal behavior at the provincial level. To a large extent, a national currency is to a province what the U.S. dollar is to a dollarized country. In developing countries, the emergence of provincial money is not a rare phenomenon. For example, because the Argentine peso is legal tender in Argentina, its provinces can be considered "pesoized" economies. However, over the past two decades, most provincial governments in Argentina have introduced local currencies. A case in point is the issuance of the CECOR in the province of Córdoba. In the mid 1990s, after having been hit hard by the Tequila effect, the government of Córdoba–the second most important province from an economic point of view after the province of Buenos Aires—was in financial dire straits. Having failed to meet wage payments for a number of months, the provincial government was facing an economic crisis of major proportions that was threatening to degenerate into social chaos. As a way to circumvent its serious liquidity crunch, the government of Córdoba decided to pay wages and other current financial obligations with a provincial bond called

CECOR explictly issued for this purpose.[1] As soon as the CECOR was introduced, it began to play the quintessential role of money: medium of exchange. The CECOR rapidly assumed money's other two classical functions of store of value and unit of account.

By putting the CECOR in circulation, the government of Córdoba was in effect abandoning a monetary arrangement that featured the peso as the only medium of exchange. A number of important lessons can be learned from the CECOR episode: (i) Deviating from dollarization is likely to occur at a point at which not only the government but also the public perceives the regime shift as beneficial. In Córdoba, the CECOR introduced much needed liquidity in the midst of an unprecedented credit crisis; (ii) Governments can reintroduce domestic currencies almost effortlessly and clearly do not need to create a central bank first. The most likely scenario is that the Treasury department will simply print low-denomination government bonds and use them to pay for current government expenditures. Thus, all that is needed is a printing press and some government obligations; (iii) A 'domestic' currency can circulate even if the foreign currency maintains its status as legal tender. Indeed, during its existence, the CECOR was Córdoba's primary medium of exchange.

But perhaps the most important lesson that can be learned from experiences like the CECOR in Córdoba is that the superiority of adopting a foreign currency over other conventional monetary arrangements as a commitment mechanism should not be taken for granted.

[1] CECORs (Certificados de Cancelación de Obligaciones de la Provincia de Córdoba) were issued as two-year bearer bonds denominated in pesos paying an annual interest rate of 12 percent. CECORs were issued in denominations as low as five pesos, which is the equivalent of five U.S. dollars.