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INTELLECTUAL TYRANNY OF THE STATUS QUO FOLLOW-UP

Argentina's problems went far beyond the absence of a strict currency board: Comment on Schuler

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KURT SCHULER ARGUES MOST ECONOMISTS (MYSELF INCLUDED) failed to get the facts right. Schuler writes, “economists whose work in other areas I admire failed to do the research necessary for understanding Argentina’s situation accurately. As a result their analysis was faulty” (Schuler 2005, 235). This mischaracterization of Argentina’s economic situation led them to prescribe inappropriate policies, not the least recommending that Argentina end its tight link to the dollar.

According to Schuler:

- Talk of Argentina’s currency board was misleading since Argentina did not have a “true” currency board. Schuler’s preferred terms: a currency board-like system, or pseudo-currency board.
- Argentina did not have a trade deficit. Consequently, those who postulated such a deficit as a sign that the peso was overvalued were wrong.
- Argentina’s exports were growing, so it was inaccurate to talk of the burden an uncompetitive exchange rate placed on Argentina’s exports.

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- Argentina had the ability to dollarize in 2001 if it had so wanted.

Schuler thinks the right policy in late 2001 was “default and dollarize” and by failing to dollarize, Argentina increased the cost of its crisis.

I will address each of Schuler’s points in turn, and then lay out why I think his preferred solution, dollarization, would not have worked. Replacing pesos with dollars would not have changed the fact that Argentina’s government could not pay its debts or the fact that Argentina’s banks, by the end of 2001, lacked both liquidity and performing dollar-denominated assets. Dollarization would have made it even harder to achieve the adjustments in Argentina’s real exchange rates needed to reflect Argentina’s reduced ability to attract international capital, ensuring a continued recession. I also believe that the cost of Argentina’s crisis was greater than it needed to be, but largely because Argentina refused to devalue the peso and seek a restructuring of its debt more rapidly. There were many potential responses to Argentina’s crisis—Argentina (and the IMF) no more followed the policy course Nouriel Roubini and I have advocated than the policy course Kurt Schuler advocated (see Roubini and Setser 2004).

I doubt that many who, for the sake of simplicity, spoke of Argentina’s currency board (generally known as “convertibility” in Argentina) rather than the awkward “currency board-like arrangement” had major illusions about the nature of Argentina’s regime. Remember, Hong Kong’s currency board-like arrangement also falls short of Schuler’s strict standard—Hong Kong has more reserves than it needs, and it used those reserves to intervene to prop up the stock market in a big way back in 1998. It was widely known in policy circles that Argentina’s currency board-like arrangement allowed the central bank to hold dollar-denominated government of Argentina bonds as backing for a certain amount of the monetary base. Plus, as Schuler emphasizes, Argentina also held more reserves than required to back the monetary base—in part because a fraction of the banking system’s mandated dollar reserves were held in the central bank. That too was widely known; Argentina’s high levels of reserves and access to emergency liquidity through its contingent “repo” line with international banks were generally considered to be a key point in Argentina’s favor.

Any confusion about the nature of Argentina’s exchange rate regime, though, certainly disappeared over the course of 2001. The original architect of Argentina’s currency board arrangement, Domingo Cavallo, argued that he knew how to make the currency board more consistent with

growth, which in practice meant making it less of a currency board. Yet Argentina also insisted that its exchange rate arrangement was more than a “mere” peg. It consequently insisted on holding on to the one peso to one dollar parity even as the costs of that peg become more and more apparent.

Schuler’s charge that economists critical of Argentina’s peg did not pay sufficient attention to the ways “convertibility” differed from a pure currency board puts far too much emphasis on the ways in which Argentina’s peg differed from a currency board, and ignores the ways in which Argentina’s currency board-like arrangement required the same basic adjustments that a pure currency board would have required. So long as Argentina remained pegged to a (then rising) dollar, the only way Argentina’s real exchange rate could adjust was through falls in domestic prices.¹

Schuler’s argument also ignores the fact that in 2001, Argentine policy makers, backed by leading Argentine economists, consistently sought to find ways to avoid implementing the monetary tightening implied by even a pseudo-currency board, let alone the more draconian tightening implied by a true currency board. After two years of recession and slow deflation, Argentina did not want more recession or more deflation—so it is not a surprise that Argentina’s policy makers spent the first half of 2001 trying to find ways to defer further adjustment.² One example: Argentina’s end-of-2000-IMF program was designed to provide the financing Argentina needed to implement a pause in Argentina’s fiscal consolidation in order to provide more room for growth (Independent Evaluation Office 2004). Inflows from the IMF also meant that Argentina would not have to dip into its reserves to finance private capital outflows, and thus helped Argentina maintain a less strict monetary policy than otherwise would have been the case. Another example: After missing its first quarter fiscal targets, Argentina opted for Domingo Cavallo, who promised that he knew how to make the currency board arrangement more consistent with growth, rather

¹ As external inflows first fell and then turned into massive outflows, Argentina’s pseudo-currency board still required monetary tightening. Base money fell substantially in 2000 and 2001. A pure currency board would have implied an even more draconian monetary tightening, particularly in 2001, as base money would have had to fall in line with Argentina’s reserves. The likely results would have been even faster falls in domestic prices, more rapid real exchange rate adjustment through deflation, and even larger falls in output than Argentina.

² Mussa (2002, 5) noted: “They [the policies that ultimately led to the crisis] were the policies desired and implemented by the Argentine government. In general, the Fund supported these policies . . . but the Fund did not press the Argentine government to adopt policies that it did not willingly choose to implement.”

than Ricardo Lopez-Murphy, who promised more fiscal austerity. Cavallo's program for growth effectively amounted to a program for loosening convertibility's constraints while formally preserving the peg. Bank regulation would be changed to generate a de facto monetary loosening, and a combination of import tariffs and export subsidies would generate a "fiscal" devaluation.³ He also announced his intention to shift from a pure dollar peg to a joint euro/dollar peg. A final example: faced with a bank run in the summer of 2001, Argentina sought, and obtained, an immediate \$5 billion cash infusion from the IMF to allow Argentina's central bank to act as a lender of last resort. John Taylor, the Treasury Under Secretary, strongly backed this operation (Blustein 2005)—even though a domestic "lender of last-resort" is incompatible with Schuler's pure currency board.

Even after all these options had been tried and failed, Argentina still refused to accept the draconian monetary tightening that would have been implied by a pure currency board. As revenues shrunk in line with Argentina's shrinking economy, Argentina's provinces started to pay people with script—funny money—rather than cut salaries to match falling revenue (among others, IMF 2003a). That basically amounted to printing money—again, the opposite of what a strict currency board required.

Schuler's points on trade are also misleading. He looks at average export growth rates from 1991 through 2001. There is no doubt that Argentina's trade boomed in the first years of currency board, driven by economic recovery created by the end of hyperinflation, successful debt restructurings in both Argentina and Brazil, and a relatively weak dollar. In 1995, though, the dollar started to appreciate and in early 1999, the game changed completely. Brazil was forced to abandon its peg to the dollar and the dollar started to appreciate substantially against the euro. The result was a substantial appreciation of the peso's real value, a real appreciation that shows up whether one looks at the CPI-based real exchange rate or the PPI real exchange rate (see IMF 2003b).

In the face of this appreciation, Argentina's exports—measured by export volumes—really were stagnant. Schuler's own volume index shows an average increase in volumes of only 2 percent between 1999 and 2001;

³ Specifically, Cavallo reduced the reserve requirements imposed on Argentina's banks to free up more funds for new lending. By allowing (or forcing) the banks to hold a high-yielding dollar denominated bond issued by the government as part of their reserves, Cavallo obtained additional financing for the government, and a capital inflow that boosted Argentina's reserves. (The banks ran down their international dollar deposits in New York to buy this bond). The combination of tariffs and export subsidies generated a "fiscal" devaluation of 8 percent. See Hausmann and Velasco 2002 and Mussa 2002.

IMF data shows an average volume increase of over 7 percent for all emerging and developing economies over the same period. In nominal terms, Argentina's exports did even worse—a rally in commodity prices in 2000 did prompt large increase in the dollar value of Argentina's exports that year, but that rally came after a large fall in prices in 1999. Argentina's 2001 exports—\$26.5 billion—were no larger than they were in 1998—\$26.4 billion. In the mean time, Argentina's external debt has increased from \$147.6 billion to \$166.3 billion and interest payments on that debt increased by \$5.3 billion to \$8.2 billion. Nothing suggested the trend would change: interest payments were set to keep on rising, and Argentina's export growth would be constrained by its link to the dollar.

It is impossible to argue away the weakness in Argentina's export performance after 1998. Global trade was booming in 1999 and 2000, propelled by strong demand growth in the dot-com US economy. Most emerging economies benefited from surging exports—and surging export volumes. Not Argentina. As Ted Truman has emphasized (see the commentary on Hausmann and Velasco 2002), Argentina's exports grew more slowly than any other emerging market in the second half of the 1990s—a period that coincides with the dollar's broad appreciation from its 1995 lows.

Schuler is right that Argentina's trade deficit peaked in 1998, and Argentina's deficit shrank in 1999 and turned to a small surplus in 2000. An economic contraction led imports to fall substantially. Schuler is wrong though to argue that the absence of a trade deficit is sufficient to prove that Argentina's exchange rate was not really that overvalued—at the end of his paper, he even suggests “calculations based . . . on wholesale or producer prices . . . would show that in 2000 and 2001 the real exchange rate was perhaps undervalued” (Schuler 2005, 261). For a country with as large an external debt as Argentina, the absence of a trade deficit is not sufficient to provide external sustainability. Large (and growing) interest payments implied relatively large ongoing current account deficits even if Argentina's trade was in rough balance. In 2000, interest payments were 30 percent of Argentina's exports revenues—far more than any other emerging economy.⁴ Since the real interest rate on Argentina's external debt far exceeded the real growth rate of Argentina's economy, Argentina needed to run a significant trade-and-transfers surplus in order to stabilize its external debt to GDP ratio. Perry and Serven's (2003) calculation, which shows a

⁴ Hausmann and Velasco (2002, 33). External debt service was a bit over 20 percent of Brazil's export revenues, and well under 20 percent for all other emerging economies.

large real overvaluation of the peso, takes into account the fact that a country with rising external debt needs a real depreciation over time to free up export revenues to service its external debt.

Argentina consequently faced two obstacles to external sustainability even after a deep recession had eliminated its trade deficit. First, Argentina either needed ongoing inflows of capital from abroad to finance its current account deficit (along with the ability to refinance maturing debt) or its economy needed to shrink to reduce imports to the point where Argentina could finance interest payments on its external debt out of a substantial trade surplus. The fact that Argentina's exports were such a small share of Argentina's economy made such an adjustment particularly difficult. Generating a 3 percent of GDP trade surplus off a 9 percent of GDP export base implied imports of only 6 percent of Argentina's GDP. Second, even with ongoing market access, keeping Argentina's debt to GDP ratio from exploding required both a trade surplus (though not as large a trade surplus as would be the case if all interest payments had to be financed out of export revenues) and the resumption of growth. Yet the resumption of growth, at Argentina's 2000 real exchange rate, would have pushed Argentina's trade back into a trade deficit.

Argentina was caught in a trap. Improving its trade balance in the short-run (barring a huge increase commodity prices) required squeezing imports. Argentina's peg, even in a pseudo-currency board, implied that (real) depreciation of the peso could only come through domestic deflation. Deflation implied an economic contraction. The political tensions associated with the need to cut government spending to match falling revenues made creditors reluctant to extend Argentina the ongoing financing it needed on any but the most onerous terms. Those onerous terms hindered growth, and led Argentina's interest payments to soar (interest payments on government debt doubled between 1997 and 2001). Hausmann and Velasco (2002, 4) put it well: "In this sense, Argentina's financial crisis [was] a growth crisis: if income keeps dropping, at some point debts become impossible to pay."

Schuler's solution: dollarize and default on the debt. Schuler is right to note that Argentina had enough gross reserves to replace all pesos in circulation right until the end—though some of those reserves were borrowed from the IMF.⁵ Indeed, the fact that Argentina still had

⁵ Net reserves fell from \$21.9 billion at the end of 2000 to \$0.4 billion. Argentina's banks also ran down their external assets, helping to finance the massive outflow of capital from Argentina. Remember, Argentina still ran a current account deficit in 2001, so all these

substantial gross reserves was one reason why Lavanga's economic team was able to stabilize the peso after Argentina's default even without additional support from the IMF.

The fact that dollarization was technically possible, however, though does not mean dollarization late in 2001 (or for that matter in 1999) was a good idea, or that it would have solved Argentina's problems. Schuler and other proponents assert dollarization would have generated a surge in confidence, particularly a surge in confidence in the banking system, which would have saved Argentina. Capital flight would have stopped—even in the face of a default on the government's debt.

That possibility cannot be totally ruled out. Robert Rubin (Rubin and Weisberg 2003) likes to emphasize that there are no certainties in life, or in finance. But it hardly seems the most likely possibility. Argentina's core problems—an overvalued currency that stifled export growth after 1998, a banking system that lacked dollar liquidity, and insufficient access to external financing to cover interest and principal payments on Argentina's external debt—would have remained. Further economic contraction was needed to bring about the deflation needed to generate the real exchange rate adjustment. Defaulting on the government's debt alone would not have eliminated all external payments—private companies also had significant external debts.

Moreover, default was hardly likely to restore confidence in Argentina's banks, or to stop capital flight. That in many ways is the nub of the problem. Dollarization would have taken all (or almost all) of the central bank's gross reserves. The banks themselves lacked dollar liquidity at the end of 2001, so any further run on the banks would have forced a bank holiday. Proponents of dollarization claim that depositors with dollar deposits would have no reason to run. But depositors worry about more than currency risk. Dollars deposited in Argentine banks ultimately were claims on the banks' assets, and those assets did not look particularly good at the end of 2001. Dollar-denominated loans to Argentina's government made up a substantial share of the bank's assets. And in the face of a continued economic contraction, it is safe to assume that a rising share of

outflows had to be financed out of existing external assets. The argument that peso deposits fell faster than dollar deposits in 2001 is a red herring. Had Argentine depositors been concerned solely by a depreciation, they could have protected their wealth by shifting from domestic peso deposits to domestic dollar deposits. So long as Argentina maintained a peg, what mattered was the overall fall in domestic deposits – since money leaving the banking system moved abroad and was a drain on either Argentina's reserves or the banks' foreign assets.

the banks' dollar denominated loans to private companies also would have failed to perform (Gelpern 2004; IMF 2004; Lagos 2002).

Actually, there would have been one potential way to avoid a comprehensive bank holiday: The head offices of the major international banks could have provided big credit lines to their local subsidiaries. The locally owned banks would have closed, but such a credit line could have allowed the subsidiaries of international banks to remain open. However, convincing the head offices to put up that kind of credit line would have been difficult—after all, they would have been increasing their exposure to a country that in Schuler's scenario would have just defaulted on most of its external debt. Moreover, they would be lending to a country with a still overvalued exchange that was in the midst of a deep contraction. Political risk was rising—a grand gesture like dollarization would not have led the world's big banks to ignore Argentina's remaining problems.

Schuler puts too much emphasis on the ways in which Argentina's monetary arrangement differed from a pure currency board, and too little emphasis on the fact that the basic mechanism for real exchange rate adjustment in Argentina's currency board-like arrangement was no different than in a pure currency board. Barring a miraculous increase in confidence, a pure currency board implied a more significant tightening of monetary conditions, faster deflation and a stronger economic contraction. Schuler's analysis of Argentina's trade fails to look carefully at the major real appreciation that occurred in 1999, and ignores the fact that Argentina's rising external debt and soaring interest payments implied that a significant trade surplus was needed to stabilize Argentina's external debt to exports ratio. Last-second dollarization—particularly in a context where the banks lacked both liquidity and performing assets (IMF, 2004)—was unlikely to generate a magic restoration of confidence. That is all the more the case if dollarization was combined with default. Nor would dollarization have eliminated the need for deflationary real adjustment. Ecuador, it should be remembered, dollarized after defaulting on its government debt, after freezing much of its banking system and after a substantial devaluation.

Argentina's mistake was not its refusal to dollarize, but rather its unwillingness to devalue and initiate a restructuring before it had depleted both its own reserves and its the capacity to borrow additional reserves from the IMF. Had it moved earlier it would have been in a better position to limit the impact of the devaluation and default on the domestic banking system. Debt restructurings are inherently disruptive. But an earlier restructuring combined with IMF lending to help “soften the blow” might have reduced the disruption. Argentina would have had a greater capacity both to intervene

in the currency market to try to limit the overshooting of the peso, and to backstop the banking system during the restructuring process (see Roubini and Setser 2004 and Blustein 2005 for details). An agreed program of fiscal adjustment might have helped Argentina reach agreement with its creditors more rapidly. Such a policy course carried with it significant risks—there truly were no good options available to Argentina in 2001. But it also just might have produced a smaller cumulative loss in output.

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