ARGENTINA'S ECONOMIC MELTDOWN: CAUSES AND REMEDIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL MONETARY POLICY AND TRADE

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 6; MARCH 5, 2002

Printed for the use of the Committee on Financial Services

Serial No. 107–52

U.S. GOVERNMENT PRINTING OFFICE

77–785 PS WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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ARGENTINA'S ECONOMIC MELTDOWN: CAUSES AND REMEDIES

WEDNESDAY, FEBRUARY 6, 2002,

U.S. House of Representatives,
Subcommittee on International Monetary Policy and Trade,
Committee on Financial Services,
Washington, DC.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 2220, Rayburn House Office Building, Hon. Doug Bereuter, [chairman of the subcommittee], presiding.

Present: Chairman Bereuter: Representatives Toomey, Capito, Ferguson, Frank, C. Maloney of New York, Carson, Sherman and Sanders.

Chairman Bereuter. The hearing will come to order. I apologize for the cramped conditions of the room, but our major hearing room is under renovation at the moment. We'll follow the normal Committee rules with respect to the Ranking Member and this Member and limiting us to 5-minute opening statement and other Members who might appear 3 minutes. We have many conflicts, including some mandatory conferences going on right now.

In any case, the Subcommittee on International Monetary Policy and Trade meets today in open session to examine the financial crisis in Argentina, including the activities of the International Monetary Fund (IMF) within this country. The subcommittee will hear from the Under Secretary of the Department of the Treasury for International Affairs, Dr. John Taylor, on the subject of Argentina, as the Department of the Treasury is responsible for implementing U.S. policy toward the IMF.

The subcommittee has jurisdiction, of course, over international monetary policy generally and the United States' participation in the IMF, both of which are relevant to today's hearing. This is the first hearing under my Chairmanship of this subcommittee which addresses the activities of the IMF as it relates to a particular country. Last year, the subcommittee focused on the regional multilateral development institutions and the Export-Import Bank.

At the outset, I would like to convey to the subcommittee Members the sensitive nature of the political and economic situation in Argentina. For this reason, I would urge the Members to not focus on the internal workings of the Argentine government, but to instead focus on the Argentine policies which are relevant to any future IMF or U.S. assistance to the country.

Before introducing our distinguished witness, I would like to remark upon the overall fiscal situation in Argentina. At each subcommittee Member's desk, the following two products are found. The Congressional Research Service has provided, at my request, a chronology of events in Argentina and a recent CRS report on the Argentine financial crisis.

[The information referred to can be found on page 93 in the appendix.]

The focus of today's hearing is as follows:

1. Recent Argentine political and economic history.

2. The recent economic plan supported by the Argentine government on February 3, 2002.

3. The recent role of the IMF in Argentina.

4. The recommendations of the Meltzer Commission and its dissenting views as it relates to the IMF preconditionality criteria for Argentina; and five—and I'll do this by unanimous consent——

5. Extending my remarks, some of my own views about the IMF. Because of the limited time, I ask unanimous consent that I may extend my entire statement into the record.

Without objection, that will be the order.

First, in order to understand the current economic and political turmoil in Argentina, it's necessary to review recent Argentine history. In 1991, the Argentine government established a currency board to set the peso's value on a one-to-one peg with the U.S. dollar in order to curb hyperinflation. However, because the value of the dollar appreciated over the past 10 years, it became increasingly difficult for Argentina to export its products. As a result, in 1998, Argentina began to fall into a deep recession. At least that was part of the reason. By the end of 2001, Argentina had a total debt of approximately $132 billion.

Furthermore, on November 30, 2001, President de la Rua of Argentina imposed a $1,000 per month limitation on personal bank withdrawals. As a result of this restriction and other austerity changes in the Argentine government, violent protests broke out and President de la Rua was forced out of office on December 20 of last year. Over the next ten days, there were four different presidents of Argentina, including Mr. Eduardo Duhalde, who is currently in power.

When Mr. Duhalde took over as President, he implemented immediate economic reforms. He announced the end of the currency board with its peg to the dollar and his plan for the devaluation of the peso. President Duhalde implemented a dual exchange rate in which the peso was floated for financial transactions and fixed the ratio at a 1.4 pesos to the dollar for foreign trade and certain other transactions. He also continued the freeze of bank deposits in dollars over certain thresholds.

Second, on Sunday, February 3rd, 2002, the Argentine government came forth with a new economic plan, which would completely free float the local peso currency and loosen an unpopular freeze on bank accounts. This new economic plan was in part a response to the decision of the Argentine Supreme Court which declared the current freeze on bank deposits to be unconstitutional. To further illustrate the current political and economic instability in Argentina, their Congress is considering impeaching the judges who rendered the decision.

Furthermore, the Argentine government on February 3 announced it would turn all dollar debts into pesos at a rate of one-to-one. This change would help debtors pay back their loans since it will reduce the value of their debt substantially because the floating value of the local peso is at a volatile actual market rate of around two pesos per dollar. However, both the creditors and the banks will suffer losses because of the pesofication of debt. Furthermore, this economic plan also turns all dollar deposits into local pesos at a rate of 1.4 to the dollar. This devaluation of deposits has angered middle class demonstrators, of course, because of their loss in savings.

Argentina declared a bank and foreign exchange rate holiday on Monday and Tuesday of this week to prepare for the new economic measures. The effectiveness and political ramifications of these reforms remain an open question.

I ask unanimous consent, in order just to cover the background, that both the Ranking Member and I have 2 additional minutes of the normal Committee rules. Without objection. Thank you.

Moving on, third, it's important to note that Argentina has received extensive assistance from the IMF over the past years. For example, in March 2000, the IMF agreed to a 3-year, $7.2 billion arrangement with Argentina. Moreover, in January 2001, the IMF augmented its earlier agreement by pledging another $7 billion for it as part of a larger $40 billion assistance package which involves the Inter-American Development Bank, the World Bank, Spain, and private lenders. However, due to the fiscal instability in Argentina, the IMF withheld its $1.24 billion loan installment on December 5 of last year.

Fourth, the concept of preconditionality for IMF assistance was endorsed by the majority report of the Meltzer Commission—a controversial recommendation. I take particular interest in the Meltzer Commission, because I'm the father of that legislative language which ended up in an Omnibus Appropriations Act in 1979.

This Commission, which completed its work in March of 2000, was charged with studying the future of the IMF, the World Bank, and the regional multilateral development banks. I would encourage Members and their staff to review both the majority report and the dissenting views of the Meltzer Commission, as I find them very instructive regarding this controversial recommendation.

With respect to the preconditionality for IMF assistance, it appears from press reports that both the IMF and Secretary of the Treasury Paul O'Neill support some form of IMF preconditionality as it relates to Argentina. Examples of preconditionality include the free-floating of the local Argentine peso and the reduction of deficit spending. I do see, of course, merits of a country having a sound economic structure in place before receiving IMF assistance.

With that background information in mind, I'd like to introduce Dr. John Taylor, the Under Secretary of the Treasury for International Affairs, who will, I am sure, assist the subcommittee in examining these important issues. Dr. Taylor has a very distinguished academic and professional record. He received his undergraduate degree from Princeton University and his Ph.D. from Stanford University. He's taught economics at Columbia, Yale, Princeton and Stanford University. He has also directed the Monetary Policy Research Program at the Stanford Institute for Economic Policy Research. In addition to these academic positions, Dr. Taylor was a member of the President's Council of Economic Advisers during the Administration of President George Herbert Walker Bush. Moreover, he has also served in the private sector as an analyst for Alan Greenspan's Wall Street firm, Townsend-Greenspan, in the late 1970s and early 1980s.

Dr. Taylor, we welcome you to these hearings, your first appearance before a subcommittee. And before we move to you, I'd like to turn to the Ranking Member of the Minority, the gentleman from Vermont, Mr. Sanders, for 7 minutes if he'd care to use them.

[The prepared statement of Hon. Doug Bereuter can be found on page 80 in the appendix.]

Mr. SANDERS. Thank you, Mr. Chairman, and welcome, Dr. Taylor. I think we all know that Argentina today is in a major financial crisis. Unemployment is about 17 percent. The economy is in its fourth year of recession, and the country is now in the process of defaulting on its foreign debt.

I am sure that there is a lot of blame to be spread around regarding the Argentine financial crisis. Generally speaking, it is not our job to try to get involved in the internal financial crises of countries all over the world. My interest, and what I think is relevant to this subcommittee is that we are the international financial organizations subcommittee, which deals among other things with the IMF. So what interests me is what role the IMF may or may not have played in precipitating or expanding the crisis that exists in Argentina. And obviously there are a lot of differences of opinion about that.

Let me just quote, if I might, from an article that appeared in the *American Prospect* by Robert Kuttner, an economist from Massachusetts. And he says, and I quote: "Argentina followed the IMF model faithfully, more faithfully, than almost any other nation. Its economy was opened wide. Its peso was pegged to the dollar. For a few years this sparked an investment boom as foreigners bought most of the country's patrimony—its banks, phone companies, gas, water, electricity, railroads, airlines, airports, postal service, even its subways. As long as this money came in, there were enough dollars to keep plenty of pesos in circulation. But the dollar-to-peso peg led to an overvalued currency which killed Argentine exports, and once there was little more to sell off, the dollars ceased coming in, which pulled money out of local circulation. As Argentina tanked, the IMF's austerity program pushed the economy further into collapse."

There was another op ed that appeared in the *San Francisco Examiner* about 2 years ago, which indicated that about 2 years ago, Argentina signed a technical memorandum of understanding with the IMF which required Argentina to cut its budget, slice civil services salaries by 15 percent, and cut pensions by 13 percent. If Argentina followed this program, the IMF argued, their production would increase by 3.7 percent. Instead, production fell by 2.1 percent. It has now dropped off the charts.

In other words—and I won't go into great detail—while in general it is not our business to worry about the internal affairs of Argentina, Brazil, Colombia or any other country, what should interest us is that the role the IMF has played not only obviously in Argentina, but in countries around the world. And some of us for many years have had a great deal of concern about that.

So I, Mr. Chairman, would yield back the balance of my time. And Dr. Taylor, I would appreciate in your remarks if you might want to say a few words about the role of the IMF.

Chairman BEREUTER. Thank you very much, Mr. Sanders. I ask unanimous consent that the other Members now in attendance have 5 minutes instead of the usual 3 under Committee rules if they care to use it. And then for people coming in after this point, we'll revert to the normal 3 minutes if they wish to be heard.

The gentleman from Pennsylvania, Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. In the interest of hearing from Mr. Taylor sooner rather than later, I will yield back the balance of my time and wait to have a chance to ask some questions.

Chairman BEREUTER. Thank you, Mr. Toomey.

Mr. Frank, the gentleman from Massachusetts.

Mr. FRANK. Mr. Chairman, this is a very important hearing and I appreciate your having it and I appreciate Dr. Taylor being here. Obviously we've got a short-term crisis in terms of the violence that was aimed at us, and dealing with that violence is going to take a lot of our energies. But there is an ongoing fundamental public policy issue that we have to address of which this hearing is a part. And it is the question of how do you promote policies in the world that increase prosperity without so exacerbating inequality that social tensions reach the point where it interferes with progress?

We've got a worldwide consensus that capitalism is without question the best way to generate wealth. There was a few years ago a consensus that said in addition to a capitalist system, you needed to make that work by a very minimalist public sector approach. And that I think has been called into question by events. When Franklin Roosevelt became President, he made the decision to try to preserve the capitalist system. There were some hems and haws in how he ultimately decided to do that. But the notion was that we would have the capitalist system plus a Government role involving some regulation and some intervention to provide social equity.

Our challenge today is to try and duplicate that kind of approach on the global scale. Now it's extremely harder. You're not dealing with one sovereignty. But it's the same kind of intellectual problem. How do you give full rein to the capitalist system, which after all depends on inequality to work, if you do not have people unequally rewarded according to how hard they work, how smart they invest, how cunningly they anticipate public needs, and so forth? Then you don't get the wealth creation. What I believe and many others, and I think this was what Franklin Roosevelt argued, there is a point beyond which the inequality can become dysfunctional. That it can be more than is necessary to give the proper incentives. There is also a need for some forms of regulation.

A few years ago it seemed to me we were close to a consensus among policymakers that essentially all you needed to do was to remove the restrictions on capital and let capital find its most profitable niche anywhere in the world, and we would be, on the whole, better off. I think that that has been disproven by a good number of events. Clearly, the thrust of the New Deal was to say, yes, we want capital to be able to find its best area of return, but not without other factors being taken into account. Again, it's much harder to do that internationally.

Argentina for a while was an example of the success of a fairly unrestrained capitalism. And what we have seen now is that in the global economy, that is not enough. And this is the point we have to make—no matter what people think about the appropriate public policy, there is a reaction now within Argentina politically to people have perceived to be that fairly unrestrained capitalist model that may be going further than is reasonable. Certainly, it's going further than is reasonable in many people's minds. And you see these connections. This Administration has made a free trade agreement for the Americas a high priority. That's endangered in part by the political reaction you are seeing in Argentina.

So this, to me, is part of an ongoing effort to try to find a way to harmonize support for the capitalist system with attention to the kind of policy issues that Franklin Roosevelt successfully launched here in the United States. And unless we can come up with a better balance, I think we will continue to have these problems. I would just point out I was encouraged to see in the world economic forum in New York City, at least as it was reported to me—I wasn't there—the discussion was somewhat different and I would say more balanced than it had been before. There was more concern about the social aspect. And this is our challenge: How do you maintain globally a system in which capital is free to do its job of creating wealth, but not in a way that so exacerbates tensions and inequality either within countries or between countries where, ultimately, popular resistance will bring it down?

Chairman BEREUTER. Thank you, Mr. Frank.

The gentlelady from West Virginia, Ms. Capito.

Ms. CAPITO. Thank you. I don't have an opening statement.

Chairman BEREUTER. Thank you very much. For the information of the subcommittee and others interested, we will be holding the next round of hearings on the subject on March 5th. We will have private witnesses and perhaps other Administration testimony as well.

Dr. Taylor, Mr. Secretary, we welcome you, as I said, to the subcommittee for your first appearance here. Your entire statement will be made a part of the record. I am not imposing any time limits on your comments, your presentation, because I want you to deal with it as thoroughly as you feel comfortable. Thank you. You may proceed as you wish.

STATEMENT OF HON. JOHN TAYLOR, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Mr. TAYLOR. Thank you very much, Mr. Chairman, Mr. Sanders and other Members of the Committee for inviting me to this hearing on a very important topic—the economic situation in Argentina.

Let me first say that what's quite clear is that the people of Argentina are facing extremely difficult and trying times. And as President Bush has made very clear, Argentina is a close friend and a close ally, a country that we're interested in supporting. We want Argentina to succeed economically, become an engine of economic growth for its people and for the whole hemisphere.

In my written testimony, Mr. Chairman, which I would like to put in the record, I reviewed recent events in Argentina, a description of the IMF program and what U.S. policy has been not only regarding Argentina, Latin America, but emerging markets in general.

In my oral remarks here I'd like to focus on the events in Argentina itself. I think it's very useful to go back, as you did, Mr. Chairman, in your opening remarks, to the early 1990s when the government of Argentina took on a series of very important economic reforms. Perhaps most visible and effective is the one you referred to. That is, the conversion of monetary policy to what was formerly a highly inflationary policy leading to inflation of over 3,000 percent per year, so-called hyperinflation, changing that policy to a convertibility law, which not only pegged the peso one-to-one with the dollar, but limited the amount of money creation that the Central Bank could generate. That in itself was a major shift in policy.

There was also a move to fiscal policy which led to better control, if you like, to more fiscal discipline in the privatization program that Mr. Sanders referred to in his remarks. I also think it's important to note that there was removal of barriers to trade and international investment.

If you look at the effects of these reforms, I think there's no question that they were quite impressive and remarkable. Of course, the hyperinflation ended, to many people's amazement, very quickly, from over 3,000 percent to nearly zero in short order.

There was also an increase in economic growth from negligible amounts in the 1980s, near zero, slightly negative, to growth over 4 percent in the early 1990s and into the mid-1990s. Investment in exports grew remarkably rapidly during this period. That is, through the 1990s.

I think when you evaluate the impact of economic reforms, it's very important to pay attention to the response of these market-oriented reforms, as I've just indicated.

As I look at the situation, the policies began to change in the mid- to late 1990s. And also there were a series of external shocks that affected the economy. The thing that I focus on is that the government budget deficits began to increase quite noticeably, an indication of a waning of fiscal discipline if you like. That caused the debt to begin to rise more rapidly. It began to raise concerns about sustainability of the debt. Risk premium began to rise, and of course higher risk premium means higher interest rates, which in turn, tends to reduce economic growth.

This increase in debt itself was compounded by several other problems. One, a persistent deflation which continued into the late 1990s into 2000 and 2001; a depreciation of currencies that Argentina trades with, in particular countries in Europe and Brazil, which led to less competitiveness in the Argentine economy.

I think it's also important to note that expectations, persistent expectations of depreciation of the peso, even in the face of the convertibility law where the Currency Board created interest rates in Argentina higher than they would otherwise be. In particular, peso interest rates higher than dollar interest rates. That, in turn, tended to reduce economic growth, as anyone can see in any other country.

These difficulties of low growth, of growing debt, high interest rates, continued right through last year and culminated at the end of last year in the events which really brings us here today.

It became increasingly clear to the government of Argentina and to private participants in the markets, that efforts to adjust the budget were just not working. Economic growth was not increasing. And therefore, it became clear that the debt profile was becoming unsustainable to a greater degree over time. And that's why last fall the president of Argentina at that time, President de la Rua, decided that he would restructure the government debt to bring the debt burden down to more manageable levels. Very significant announcement at the time.

However, as that restructuring was underway, because there had been so few restructurings of sovereign debt over time, there's always a great deal of unpredictability over how it will proceed and delays. In any case, as that restructuring was proceeding, uncertainty about its impacts began to develop, in particular uncertain about its impacts on the banks which had held some of that debt. This uncertainty began to lead to large deposit withdrawals. People in Argentina would be withdrawing their deposits from the banks. And in order to stop these withdrawals, the de la Rua government decided to impose restrictions on those withdrawals from the banks.

Soon after these restrictions were imposed, we began to see the social and political protests which unfortunately turned violent, and President de la Rua then resigned.

If you think of where we are right now, it's clear the economic circumstances in Argentina have deteriorated since the imposition of these restrictions on deposit withdrawals. Right now there's a lack of a functioning payment system, which brings economic activity to a near halt. There's a shortage of liquidity because people are restricted in how much they can bring out of the banking system.

What we see now, however, is Argentina is beginning to find ways to remove these restrictions and to restore liquidity. It announced last Sunday the outlines of an economic plan to gradually remove the restrictions, to float the peso, which will allow the Central Bank to provide more liquidity. They've announced that the amount of liquidity provided will be limited to a certain amount, thereby constraining the inflationary forces that could otherwise be created by the provision of liquidity, and I think through these measures will effectively be freeing up the payment system so that economic activity can begin again.

The government of Argentina has just given the outlines of a broader plan with changes in the revenue sharing agreements with the provinces, changes in the tax system. And those changes also must be made if Argentina is to grow again. Economic growth is the most essential thing for the Argentine economy, for the people of Argentina. And I think we're encouraged that the steps have been taken. In fact, Secretary O'Neill just said earlier this week that he's very encouraged, and I certainly endorse this, that Argentina is beginning to take substantive steps to address these economic problems.

So I'd like to leave it at that, Mr. Chairman, in my opening remarks and take questions as you and the other Members see fit. Thank you very much.

[The prepared statement of Hon. John B. Taylor can be found on page 88 in the appendix.]

Chairman BEREUTER. I thank you very much, Secretary Taylor. We will now proceed under the 5-minute rule and perhaps we'll have an opportunity for a second round of questions too if we don't have many more Members attending.

We have such incredible levels of social and economic agitation today in Argentina that one has to wonder if the prescriptions that might be recommended by the IMF, whether or not they're the correct prescriptions, can be swallowed. And it certainly is a very difficult situation for the President and for the Congress and the other governmental institutions.

I'd like you to comment on three items if you could. One, to what extent do you think that the external factor of the Brazilian devaluation was a major factor in the problems that Argentina faces, especially in light of their membership in MERCOSUR with Uruguay?

Second, what do you have to say about the dollar-to-peso peg and the length of time in which it was put in place, given the accelerated value of the dollar? Hong Kong, of course, has a direct peg, too. And although people have tried to break it, they've not been successful. But then Hong Kong has fiscal discipline and more than $90 billion in reserves.

And finally, at least, I would like to start you down a path if you have time to talk about the recommendations of preconditionality for IMF assistance to a country as recommended by the Meltzer Commission, but strongly objected to by the minority opinion.

Mr. TAYLOR. Thank you very much, Mr. Chairman. With respect to your first question, the effects of the depreciation of the Brazilian currency, and for that matter, the depreciation of the euro relative to the dollar, I think these were certainly factors in preventing Argentina from growing more rapidly in the last 2 or 3 years. It is not the only factor.

Argentina is, at this point in time, not as open as one may think in the sense of the fraction of exports, the GDP is relatively low. It's not much different than the United States, in fact. It's not nearly as important for the overall economy as other small open economies in Latin America.

So I think it's important to look at other factors in addition to the depreciation of the real and the euro here. And to me, those are the higher interest rates generated by basically expectations of depreciation of the peso, which generated higher interest rates in Argentina.

And I think also these changes in policy which I referred to, basically a movement back away from reforms where the deficits were beginning to increase again and raising questions about debt sustainability, I think that policy shift maybe not so noticeable at the time, certainly not as noticeable as the remarkable change that occurred in the early 1990s, but a gradual shift away from those things, the fiscal discipline, the move toward privatization, and so forth. I think that also is an important part of the growth slowdown and negative growth.

Taxes have to be favorable for economic growth. The tax system in Argentina is not as favorable as it could be. So I would add all those other reasons to the depreciation itself.

With respect to the dollar-peso peg itself, I always say when I talk about this that that provided an enormous degree of stability to the Argentine economy because it ended the hyperinflation. In fact, it was a very popular law among Argentine people, because of the end of the hyperinflation which has very painful memories in most people's minds.

There's no exchange rate system, however, which works perfectly in all dimensions. And pegs, even very strong pegs, have the disadvantage of not allowing changes in the exchange rate. And sometimes it's better if those occur. I am of the view that if you have pegs, they should be as strong as possible. For example, the European Union effectively has pegs for the countries in that union. It's very strong and effective. Greece is joining the European Monetary Union, thereby pegging its currency in a more or less permanent way with the euro. Those are very strong, very credible, and don't have the difficulties of credibility that other kinds of pegs do. So the interest rates in Greece will converge very quickly to interest rates in the rest of Europe. That did not happen in Argentina. Interest rates in Argentina, the peso interest rates, were generally higher than dollar interest rates because of the possibility of depreciation or devaluation.

I think at this point in time, the Argentines have chosen to have a flexible exchange rate. They recognize that that means there will have to be other ways to contain inflation. And they have outlined a program whereby the Central Bank will limit its increase in money growth. And I think that's going to be very essential to keep inflation low, even without the convertibility law. What would be very pleasing I'm sure for the Argentine people and I know for economic growth if inflation ultimately can be at the very low levels that it was in the early 1990s after the end of the hyperinflation, and no different from levels in Chile, Brazil, which are coming down still, and for that matter, the United States.

The third question you raise about the preconditions. I think that is a very important issue. This Administration has emphasized prior actions or preconditions in many times, many programs already. Terminologies differ. I think the basic concept that you're referring to is that a country before it starts into a program takes actions which are in place and will not only make the likelihood of the program continuing greater, but will increase economic growth. And there was a program in Turkey that was developed during the course of last year, actually voted on early this week at the IMF. That program in many respects at Secretary O'Neill's urging, the U.S. Government's urging, contained I think more prior actions than many other programs. And that has been very accepted positive by the Turkish government, and they have made changes. For example, changes in the banking law, changes in privatization.

And I think the more we can have changes up front, the more we can limit the amount of conditions that have to be monitored as you go through time, I think the more effective the programs would be.

So the general concept of prior actions I think makes a lot of sense, and we'll be trying to work with the IMF to have as much of that as possible.

Chairman BEREUTER. Of course, Argentina was in the midst of a plan, so that's a little bit different than the application of preconditionality.

Mr. TAYLOR. Yes.

Chairman BEREUTER. But I'll come back to that later. I'd like to turn to the gentleman from Vermont, the Ranking Member, for his comments and questions.

Mr. SANDERS. Thank you, Mr. Chairman.

Dr. Taylor, I think it's no secret to you that many people in the developing world and some of us in the United States have the feeling that the IMF to a large degree represents the interests of large and powerful multinational corporations and does not serve the poorest people of the world well. A lot of people hold that feeling. I share that feeling.

I want to, if I can, combine three questions to you and see if you can respond to them. And it deals in fact with the role of the IMF in Argentina. The Argentine government pegged its currency to the dollar in 1991. Approximately how much money did the government borrow from the IMF, either directly or through packages arranged with the help of the IMF from that point on? So number one, first question is, what kind of economic relationships existed between the IMF and Argentina? And I start off with the assumption, which is no great secret, that the United States is the 2000 pound gorilla within the IMF. We have veto power, and that reflects back on the policies that our Government develops. That's question one.

Question two, it now seems to be recognized by the vast majority of economists that this decision of pegging the peso to the dollar was a fatal mistake and explains much of the recent meltdown. Should the IMF accept responsibility for this mistake since it supported the fixed exchange rate for years with tens of billions of dollars of loans? And then again, and obviously this was also before your time, and what about the role of the U.S. Treasury in urging the IMF forward on that policy?

Third, the IMF now claims, as I understand it, that it was against the fixed exchange rate regime all along. There is no written record of either the IMF or Treasury trying to persuade Argentina to abandon the peg. Can you think of any other country to which the IMF continued to loan and arrange loans for very large amounts of money to support a policy that the Fund thought was wrong and which if wrong could lead to economic disaster? In other words, they're saying now they made a mistake, but most of us when we look back on the IMF, the IMF doesn't lend money to countries who are not following their dictates. To clarify, we are not talking about a country missing its targets for the money supply or running a central government budget deficit bigger than what it committed to. In other words, the issue here is, to what degree should we hold responsible, understanding that the Argentines themselves of course deserve a great deal of the responsibility, but this Committee deals not with the internal workings of Argentina, but with the IMF and Treasury's role within the IMF.

So those are some of the questions that I would like to address to you and appreciate your response.

Mr. TAYLOR. OK. Thank you very much. The IMF programs that are currently actually in play, but they're in suspension if you like after December, really got started in March of 2000, the current program, if you like.

Mr. SANDERS. If I may interrupt you. The original programs go back a lot earlier.

Mr. TAYLOR. Yes. Many programs, there was loans. The loans were repaid back, and basically I can go through all the loans that were made and then paid back, but would you like me to——

Mr. SANDERS. Can we stay on the issue of the pegging of the dollar to the peso, which began in 1991? It's hard for me to believe that that was not supported, despite what the IMF may be saying today, by the IMF at that time. Could you comment on that?

Mr. TAYLOR. Right. There were programs at that time. The programs in the early 1990s, and there were loans made, loans paid back, loans made, loans paid back. And what I can do is get you the actual details of where all those stand exactly to the dollar amount if you'd like. But, there were certainly—there were programs that go back a long period of time with the IMF, IMF programs.

Mr. SANDERS. But, the simple question—and I would appreciate that if you could get it to me as soon as you could——

Mr. TAYLOR. Yes.

Mr. SANDERS. But, the question is, if I am the IMF and I'm going to lend you money, and I say I'm not going to lend you money for fun. I want you to follow my policies. One of the policies I want you to do is to peg the dollar to the peso. Now in 2002, it doesn't look like such a good idea. And then I said, well, actually, that wasn't my idea in the first place. What's the story?

Mr. TAYLOR. Well, I'm not sure where the changes of opinion you're hearing about are coming from. But let me just say, and try to answer your question in this way, the views about exchange rates, about pegs, about floating, about dollarization, about single currencies, amongst economists, amongst the private sector, evolve over time. And until the Asian financial crisis, there were many more pegs around the world than there are now. And I think partly as a result of that crisis, but partly as a result of other factors, there's been a move away from pegs of the kind that we've seen that are unsustainable.

But there's been a movement away in two directions. One direction is toward flexible exchange rates, as Brazil has recently undertaken, that Chile undertook before that. Mexico is following that kind of a policy. The movement away from pegged rates toward flexible rates. And those moves always require that the country adopt a monetary policy that focuses on keeping inflation low. So if you'll notice, each of those countries have some kind of an inflation-oriented price stability program associated with it.

The other move is toward, if you like, harder pegs. That's like dollarization is used in Ecuador. Greece joined in the European

Monetary Union. Pegs which are viewed as more sustainable, that don't have the threat of causing expectations of depreciation.

I think that movement is correct. And I believe either direction is correct away from this middle ground which has caused so much difficulty.

I think that the IMF, from what I understand from what I understand of their staff, is in agreement with that basic philosophy. That the pegs in the middle here have led to difficulties. And one other recent example of this is Turkey. Turkey's IMF program started with a peg and it fell apart in the middle, and now they're in a flexible system, and I think many people think that that's working better. That doesn't mean that dollarization or single currencies is a bad idea. On the contrary, in many respects it's a good idea. What it means is these pegs in the middle are bad.

So I really can't answer your questions about shifts in the IMF's view or saying that their view was different three weeks ago or four weeks ago from what it is now. I do know—I'll maybe finish my answer with this—that what the U.S. Government feels is that an exchange rate decision by a country is one that is very important to emphasize the country's ownership of that. Exchange rate systems involve history of the country, involve politics, really the inner workings of a country more so perhaps than many other policies, but certainly a policy where ownership is important.

So what we have said in our policy about exchange rates is that's a decision for the country. And in terms of which works, I think my view here about the ends of the spectrum are the ones that tend to work and the ones in the middle——

Mr. SANDERS. Can I ask one great big last question?

Chairman BEREUTER. I ask unanimous consent that the gentleman have an additional minute. Is there objection? Hearing none, the gentleman may proceed.

Mr. SANDERS. Thank you, Mr. Chairman.

In your view, what role did the IMF austerity program on Argentina have to bring about the current crisis?

Mr. TAYLOR. I think that the IMF has over this period of time tried to give recommendations to Argentina to get their economy growing again. I think there's many things an economy can do to increase growth. But to me, it's basically lower taxes, a more efficient tax system, if you like, tax reform.

Mr. SANDERS. You're not asking the question, sir. The austerity program imposed by the IMF in causing the current crisis. Austerity program meaning cutting budgets and so forth.

Mr. TAYLOR. I would not characterize the IMF's program that they worked out with Argentina as an austerity program.

Mr. SANDERS. There are some who would respectfully disagree with you on that point.

Mr. TAYLOR. Of course. I know that, sir. But it seems to me that what the IMF wanted to do was work with Argentina to find a way to get their economy stable. In fact, it was the Argentine government this year that decided to move toward the zero deficit law, which I think in the terms that you're talking about would be classified as quite austere.

Mr. SANDERS. I should think so.

Mr. TAYLOR. And they did that because they wanted to continue with the program and not begin to restructure their debt. That was the decision that they made in the summer. That turned out not to be sustainable, and they're off of that program. Now the new government announced I believe yesterday a program where there would be a deficit for the year 2002.

Mr. SANDERS. Thank you very much.

Chairman BEREUTER. Thank you, Mr. Sanders.

I want to call Members' attention to the CRS report before us, January 14th. On page 5, you'll see that the record of the IMF lending to Argentina traces back to 1986 and the repayment. Your staff may look at that to see if you agree with that. You may not have to send information. This is from the IMF website.

The gentleman from Pennsylvania, Mr. Toomey, is recognized.

Mr. TOOMEY. Thank you, Mr. Chairman. It seems to me what's vitally important for an economy is that there be a medium of exchange in which all players can have confidence. Borrowers, lenders, consumers, everybody can have confidence that the value will remain roughly constant and that there not be excessive inflation or deflation, and therefore a credible peg—and I think that's an important distinction that you made—can serve that goal very, very well. And there are examples, many, in which it does.

And in fact it strikes me that contrary to the notion that the peg was the cause of the economic problems, it seems to me this is a very clear example of where free market, classic or liberal economics were working extremely well. From the history, as I understand it, and correct me please if I'm wrong, but having established in the early 1990s a solid currency in which investors and borrowers and others could have confidence, imposing fiscal discipline on the part of the government, lowering trade barriers and privatizing government entities, generated tremendous economic growth and prosperity and income growth and job growth and trade and so on.

And in fact, it was when the government lost that discipline on the spending side and started incurring an unsustainable level of debt that the problems began to occur. Do you believe that the excessive level of government spending and therefore debt contributed more to the economic decline in Argentina than the fact that they chose to peg their currency to the dollar?

Mr. TAYLOR. Yes I do, Mr. Toomey. I think, just as you say, the changes made in the early 1990s had a great deal of success, and as long as they were continuing, things were working just fine. So I would point to the problem you just mentioned, is moving back from those reforms as a major factor.

It's not to say there weren't external shocks and changes in exchange rates or interest rates in the U.S. economy and other economies around the world. But I think you're pointing to the fundamental fact.

Mr. TOOMEY. My follow-up question is, by early 2000, do you recall approximately what was Argentina's debt as a percentage of its GDP?

Mr. TAYLOR. Approximately—you'll have to accept some round numbers—approximately 45 percent.

Mr. TOOMEY. And looking to grow significantly at the time?

Mr. TAYLOR. Yes.

Mr. TOOMEY. As opposed to the United States where we're somewhere in the low thirties as a percentage of GDP and as a percentage of GDP, not likely to grow terribly significantly?

Mr. TAYLOR. It has been falling remarkably.

Mr. TOOMEY. The United States has been falling remarkably?

Mr. TAYLOR. Yes.

Mr. TOOMEY. Argentina's been going up. My question really is, do you believe it was really prudent for the IMF to contribute to increasing this debt load, which it did, from March of 2000 adding, as I understand it, over $7 billion in debt? January of 2001, another $6 billion. August of 2001 another $8 billion. Increasing the debt which arguably was significantly contributing to the very problem while there was not systematic reforms that would bring back the discipline yet that had gotten the economic prosperity in the first place? In other words, was the IMF now contributing to the problem?

Mr. TAYLOR. Well, that's a very good question. The most recent augmentation of the IMF program occurred last August. And that was for a particular purpose which was actually to stem or to halt, curtail a run on the banks. Basically deposits were being withdrawn last summer at a pretty rapid rate. And so those funds were put in there for that purpose.

The IMF makes loans. That's the way their funds are distributed. So their support is always in the form of loans. So since that was for that particular purpose, I think it would not qualify as something that would cause the dangers you refer to.

The second part of that was a $3 billion loan which would be available if Argentina began to restructure its debt. So in other words, that loan was for the purpose of actually reducing overall loans. IMF loans are of course a much lower interest rate than Argentina has to pay in the market. And so that loan actually was used as a way, if they wanted to do it, to begin to restructure the debt and therefore reduce the debt.

However, I would say in general, your question raises some important issues. And that is, is it really correct when a country is in a high debt situation to provide loans? And the general thought about that is if you're convinced, if the IMF is convinced and the shareholders are convinced that those loans will, if you like, bridge to better times where you can see a decline in the level of debt compared to GDP, then we make sense. But, if it's just loaning to an increasingly high level of debt compared to GDP, then it doesn't make sense and it shouldn't be done. And I think that's where we have to insist on more. That we don't provide loans in those circumstances, because effectively those loans are bailing out the bondholders who at that point in time having received very high rates of return, shouldn't be bailed out.

Mr. TOOMEY. Thank you.

Chairman BEREUTER. Thank you very much. An important conclusion I think.

The gentleman from Massachusetts, Mr. Frank, is recognized for 5 minutes.

Mr. FRANK. Mr. Taylor, one of the problems I think we have is however they got into the fix, they're in it and here it seems to me there is this dilemma. The things that they need to do in Argentina to reduce the problem almost certainly will have unpleasant short-term effects on a large number of people in Argentina. And that's part of the dilemma. How do you get a democracy to do that? I mean, this is one of the things I think we have to deal with. It's a democracy, and we have a commitment in the U.S. which has been bipartisan. In fact, one of the encouraging things about Latin America is if you go back 30 years and compare it to today, democracy has clearly thrived, and it has clearly improved its standing.

But how do we deal with that? I mean, this it seems to me is a major issue for policymakers. How do you get a democratic electorate to accept politically short-term pain? We have seen a succession of very obstreperous, and in some cases, as you point out, violent responses to things. Given what we would suggest Argentina do, do you see a problem in getting a democratic government to persuade its electorate to go for it?

Mr. TAYLOR. I think at this point in time the payment system needs to be freed up.

Mr. FRANK. What system? I'm sorry.

Mr. TAYLOR. The payment system in Argentina needs to be freed up. There needs to be at least a gradual removal of the freeze on deposits, and both of those things are going to be things that the Argentine people would like right now.

Mr. FRANK. Well, except you're saying gradual removal. They don't want a gradual removal. They want a quick removal. A gradual removal means a continuation for a while. It seems to me a gradual removal was not all that popular.

Mr. TAYLOR. At least it's an improvement from where it is. You mentioned in your question about frequently economic changes or reforms require pain in the short run in order to get the gain in the long run. And I think in this case there's a real opportunity to relieve the pain in the short run.

Mr. FRANK. You're coming in in the middle of the movie, and they were there for the whole movie. That is, yeah, once you've got the freeze, it is better not to gradually relax the freeze than to keep it going, but should they have had a freeze in the first place?

Mr. TAYLOR. Well, I think in the first place it would have been better and everyone agrees that they never got to the position where they needed the freeze.

Mr. FRANK. I agree. The best way to go on a diet is never to get fat in the first place. I understand that.

[Laughter.]

Mr. FRANK. But I don't think you make a lot of money selling that as a diet plan, except maybe on the internet where you can sell anything. But the question is, given where they are today—I think you're just ducking the question, frankly. I don't understand the point of that. Yes, it is better to have a gradual, from a political standpoint, it's better to have a gradual relaxation of the freeze than to have it forever. But the problem is, if you thought a freeze was necessary at all, yeah, it would have been better not to have needed a freeze. But do you think they needed a freeze? And if they did, how do you sustain that in the face of political unhappiness even if you're going to gradually relax it?

Mr. TAYLOR. Well, as I said in my opening remarks, they imposed the freeze because of this withdrawal of deposits. And in a reserve banking system in the currency regime they were in at that time, they couldn't have this continual withdrawal of funds. That's the reason they put it in.

Mr. FRANK. I understand that.

Mr. TAYLOR. You could say that, given that situation, they had to put the freeze in and——

Mr. FRANK. Well, you could say, you want to say. I mean, you could say a lot of things. What do you want to say?

Mr. TAYLOR. Well, I want to answer your question.

Mr. FRANK. OK. Then answer my question. My question is, do you think given where they were they had to put on the freeze, and if they did, how do you deal with the political resistance to something like a freeze which is unpopular?

Mr. TAYLOR. Dealing with the political resistance it seems to me is you want to emphasize to people the benefits of getting to a better system. And if there is in any case some pain in the short run, you want to emphasize to people that that is short run and there are going to be such good gains for you in the future that you should pay attention to those.

The other thing is you can find ways to relieve the pain in the short run. In many societies, the United States included, we have ways to help people who lose their job, who have no income, and that's——

Mr. FRANK. But those require government spending don't they? In the short term to help people who have lost their jobs?

Mr. TAYLOR. Well, certainly.

Mr. FRANK. And they would add to the deficit. But that's the dilemma that if believing that part of the problem was an increase in government spending, then alleviating the pain in the short term.

Let me turn to one other quickly. By the way, when you talk about the long-range gains, I know you're not a Keynesian. But Keynes' political advice I think was superb, regardless of what you think of his economic advice. But public reaction, as you know, when they are told about the long run, they say in the long run we'll all be dead. The public understands that and their tolerance for long-range gain over short-term pain it's I think hard to deal with.

Chairman BEREUTER. I ask unanimous consent the gentleman have another minute so he can get his last question in, without objection.

Mr. FRANK. I have just one regional issue. The banking sector, obviously, is heavily engaged. And it seems to me there's another dilemma. Yes, people who lend money know they're at risk. On the other hand, if the result is nobody wants to lend any money in the future, we also have a problem. Have you looked at what the impact might be on a couple of major American banking institutions? And obviously I don't want to see moral hazard, but I don't want to see the reactions of any kind of support there's a total withdrawal. How do we deal with that dilemma?

Mr. TAYLOR. Well, I think one of the biggest problems that have existed in these emerging markets in the last 3 or 4 years has been a decline in the flows going through them. If you look at a chart of emerging market——

Mr. FRANK. Decline in what? I'm sorry. You said a decline in what? I didn't hear the words.

Mr. TAYLOR. Decline in capital going through the emerging markets, into the emerging markets, capital flows, if you like. It's declined dramatically in the last 3 or 4 years. And what we've been trying to do is trying to reverse that, because those flows are really what's going to help developing economies, emerging market economies grow more rapidly.

So one of the ways you want to do that is to have a more sensible IMF policy, a more predictable policy with respect to debt sustainability.

So that's a fundamental——

Mr. FRANK. Is there a tension there between that and trying to totally eliminate moral hazard?

Mr. TAYLOR. I didn't hear the first part of your question.

Mr. FRANK. Is there a tension between that goal and totally eliminating any moral hazard?

Mr. TAYLOR. I actually think it's a win-win situation. If we reduce moral hazard, create better certainty, more certainty in the markets, more predictability, I think there will be more flows into these markets. The difficulty in these markets is too much uncertainty.

What's happened in the last year, which I think we need to recognize, is that the markets have showed much less of contagion from one country hitting another country, than existed several years ago. And there are many reasons for that. But it's a very important development, and I think a favorable development, which will keep people in these markets and in fact bring more people into them. I'm not sure if I answered the full part of your question.

Chairman BEREUTER. The gentleman's time has expired. We will be able to come back if the gentleman sticks with us.

The gentlelady from West Virginia, Ms. Capito, is recognized for 5 minutes.

Ms. CAPITO. My original first question was much along the lines of my colleague in that can you restore confidence with all the civil unrest and turnover in the presidents, and so forth. Can you stem the tide of civil unrest? But I'm curious to know as well the leadover effect on other countries in South America, and certainly their economies are intertwined and where you see the reforms that are trying to be taking place in Argentina or the political situation there playing out in the rest of the continent.

Mr. TAYLOR. Well, first, the fact that there has been less economic or financial contagion I think is important to note. And the emerging markets generally have—the spreads have gone down. It went up on 9/11, of course, but they've come down dramatically since then, surprisingly.

The political carryover, if you like, sometimes people call it political contagion, to answer your question on that, it seems to me that it needn't occur if we are very clear about what actually has happened and has happened in Argentina. One thing I've tried to do in my testimony is indicate that it's not economic reform, it's not market principles. It's not fiscal discipline. It's not low inflation that caused the problems in the Argentina, it was moving away from those principles.

So if anyone wants to draw lessons from that, that seems to me that should be the lesson. And that suggests that there shouldn't be a movement away from good economic policy that seemed to work in other countries. And I think what we need to do is communicate that based on the facts and based on the analysis.

To me, discussions about possible political contagion here are similar to all the discussions about globalization that have occurred over the last few years. People for various reasons arguing that reduction in trade barriers, market principles are really not beneficial to the world economy, and many people trying to argue that that's not the case. That free trade is a way to reduce poverty and improve people's welfare. And I think because of events like this, we may have to have a response that pertains in particular to Argentina, and in particular to other countries in Latin America. But the arguments are very much the same. And that is to show as much as we can the facts, the reality that market principles, free trade, growth-oriented policies are good for people.

Chairman BEREUTER. Next we'll go to the gentlelady from New York, Mrs. Maloney, Ms. Carson and Mr. Ferguson. The gentlelady from New York is recognized.

Mrs. MALONEY. What's going to happen next? We thought the IMF was going to give them a loan at $1.3 billion in December, and they have backed off from that. So what's next? We need the market reforms then they'll give them the loan? What's going to happen next? They obviously need help.

Mr. TAYLOR. That's true. The IMF in December, as part of its regular review of what was happening in Argentina, as in every program, judged that the fiscal targets in the program were not met and that on that basis did not give the next tranche, the next loan, the next installment, if you like. And so what's next is for Argentina to make the decisions, as they're beginning to do, to get their economy moving again so they can get into a program again.

So the next part is really playing out as it should in Buenos Aires and Argentina to take some decisions to improve growth in the Argentine economy.

Mrs. MALONEY. And what if they don't do that? What happens?

Mr. TAYLOR. Well, I very much hope that they do do that, and I don't want to think of any alternative. That's the alternative is to continue to have low growth and continue to have policies which are painful to people. There's a great opportunity to improve things, and I very much hope they——

Mrs. MALONEY. Why is there less contagion now? It used to be that something like this would happen and there was like just an international concern that it would destabilize more countries and really hurt individual investors and mutual funds and retirement plans.

Mr. TAYLOR. That's a very interesting question.

Mrs. MALONEY. Because I can remember Indonesia having similar problems, everyone—some of the Asian countries. But this one they're treating it very differently. So I'm wondering why you're thinking there's no contagion.

Mr. TAYLOR. Well, I think several things have happened. One is, there's much more analysis of what's going on in these markets than there was 3 years ago at the time you're referring to. So that investors themselves differentiate between countries' policies, good policies, bad policies. And they also differentiate between policies and external events that hit countries. And that's not just with respect to Argentina *vis-a-vis* other countries, it's with respect to all the markets.

I think that the U.S. and this Administration has tried to build on that change by commenting on it very early in our Administration, we commented on how contagion is changing. It's not automatic. It's more based on fundamentals. And in fact we were criticized quite a bit for that. But our purpose there was to communicate with the markets that we understood what was happening there and that our policies were going to reflect that. And I think that has helped to reduce the contagion as well by making our policies hopefully more predictable.

Mrs. MALONEY. What is the role of the international financial institutions in this? I know at one point they threatened to leave the country when they were going to structure the conversion to pesos really to a disadvantage to their accounts. What role will they play in this in helping to——

Mr. TAYLOR. Well, the international institutions have a role to play in emerging markets. I think their role can be improved in various ways, by greater transparencies and other things. But they do have an important role, not just the IMF, but the Inter-American Development Bank and the World Bank. And what they do, of course, not just with respect to Argentina, but with respect to other countries, is to provide loans.

That's what the IMF does, provide loans, to help bridge to better times, if you like. And I think they do that in the context of actions the countries take. So, for example, I just mentioned before, Turkey has taken some actions, on that basis they got loans hopefully to better times and things will improve and then the country can get off the IMF program and proceed with its policies independently.

Mrs. MALONEY. You mentioned earlier that they're not competitive in their exports, given their position as the third largest economy in South America, and that that's one of their problems. They're not able to generate their economy. Could you elaborate? What are they doing that—why aren't they competitive? Are their financial markets there controlling it too much, or what is happening? Running up the price? Or what's happening with their exports? They have a lot of things they could export. Why aren't they successful?

Mr. TAYLOR. I think the main reason for the lack of so-called competitiveness recently was the change in the currency in Brazil and Europe, which basically—there was a lot of trade particularly with Brazil, and the devaluation of the real.

Mrs. MALONEY. So it was really external actions?

Mr. TAYLOR. Yes. That's what that term means as I was using it. But it also means something internally about competition, and I think Argentina and many other countries could have ways to have their markets be more competitive. And ultimately, what's going to determine the degree of competitiveness for a country is how productive the country is. That is, how rapidly productivity increases. And that's a growth strategy, and that has to do with doing things, greater competition, less——

Mrs. MALONEY. Are they implementing a growth strategy?

Mr. TAYLOR. Well, I hope so. I hope so.

Mrs. MALONEY. I thought Mr. Toomey's comments earlier were interesting. I was in Argentina in the mid-1990s and we met, the International Relations Committee with then-President Menem, and it was being touted as the economy to watch, the growth economy in South America, and that pegging the peso to the dollar had been a smart move, and this was the whole talk internationally and in Argentina at the time. And then to see complete reversal. And you just say that's increased uncontrolled spending that happened?

Chairman BEREUTER. The time of the gentlelady has expired. The gentleman may respond.

Mr. TAYLOR. That was part of it. But I think the changes then were important. They had some very good effects. The problems now I think are not those changes, but moving away from those changes.

Chairman BEREUTER. The gentlelady from Indiana, Ms. Carson, is recognized.

Ms. CARSON. Mr. Chairman, I'd like to yield my time.

Chairman BEREUTER. The gentlelady may do that.

Mr. FRANK. Thank you.

Mr. Taylor, let me go back. Given the circumstances in which they were at the time, do you think the freeze was a good idea? The freeze on bank deposits.

Mr. TAYLOR. I think given that they were not going to make other changes at the time, yes. Other changes that could have been made.

Mr. FRANK. Like what?

Mr. TAYLOR. Well, they're of course now moving to a different exchange rate system. That would have been a possibility.

Mr. FRANK. But, I thought they had moved—hadn't they unpegged? They had unpegged, hadn't they, when they froze?

Mr. TAYLOR. They imposed the freeze before there was any move.

Mr. FRANK. OK. So you think if they had simply unpegged the peso and let it float?

Mr. TAYLOR. Well, as I was saying before, moving away from the peg toward solid dollarization or if you moved to a flexible——

Mr. FRANK. Would they then have not had to do a freeze? If they had done the right currency policy, do you think the freeze would have been unnecessary?

Mr. TAYLOR. I think so, yes.

Mr. FRANK. And which would that have been, in your judgment? What would have been the best policy?

Mr. TAYLOR. Well, as I indicated, you can either——

Mr. FRANK. Pick one. Are they equally good?

Mr. TAYLOR. It would depend on the circumstances at the time. But I'd say——

Mr. FRANK. This is not a hypothetical. This is like a real country. So we know the circumstances at the time. Argentina, 2001.

Mr. TAYLOR. Well, as I said before, and I believe this—I'm not dodging your question—that decision depends very much on what the country's history is like and their politics.

Mr. FRANK. But we know that.

Mr. TAYLOR. From an economic perspective.

Mr. FRANK. Yes, but we know that. Again, this is not a hypothetical, Mr. Taylor. It's a real country. Argentina in 2001. And what would have been your recommendation?

Chairman BEREUTER. I think the gentleman understands your point. We'll just let him respond.

Mr. FRANK. He's not responding.

Chairman BEREUTER. He may. Give him a chance.

Mr. TAYLOR. I at that point in time thought that dollarization would have been good for Argentina.

Mr. FRANK. I'm talking about—but couldn't dollarization, we're talking about last year when they had to get off dollarization.

Mr. TAYLOR. They were not in dollarization and they're not now. They're going in a different direction.

Mr. FRANK. You would have recommended that they move in 2001 to complete dollarization?

Mr. TAYLOR. I wasn't recommending that. Because, as I said, U.S. policy, it's for the country to choose. But, if you're asking my view——

Mr. FRANK. That would have been your view?

Mr. TAYLOR. That would have been my view.

Mr. FRANK. That leads to another question, though, which is what would the short-term social impact have been of dollarization, do you believe? Would there have been any greater one way or the other?

Mr. TAYLOR. First let me say the political side—I won't address that, because it depends very much on what the politics in the country is. But from the economic side, dollarization can have advantages to a country. It removes the threat——

Mr. FRANK. I'm sorry, Mr. Chairman, if this bothers you. But we're not talking about a country. We're talking about Argentina in 2001. And the problem again, because I want to get back to this, is that is there is this problem which I think you are enlightening too easily and this is what we have to really deal with. I understand your tendency is to say if they had done better in the first place, the problem wouldn't have arisen. I agree with that. But almost always we only deal with the problems that have arisen. There are a number of countries that have done good things. We don't have hearings about them. We don't have to make policy about them. We're in the grief business. That's what you do and that's what we do.

The question is, given that these mistakes were made by people there, how do you deal with it? Because you acknowledge, you agree with Mr. Toomey that excessive government spending and deficits are part of the problem. The problem, though, is that what you said could be done to alleviate the short-term pain adds to a deficit. So that's the complex of tough issues I think you have to deal with.

If you're going to take steps that are remedial, but increase short-term pain, how do you do that? Or is that then an appropriate role for international aid? Should we come in and help them with money to alleviate short-term pain if we're convinced that they are doing this as part of a program that's going to provide some long-term advantage?

Mr. TAYLOR. I think that's the way that the programs are frequently put together. As I was saying, a bridge to better times to give them some resources.

Mr. FRANK. But then let's go back to the Meltzer Commission, because they made it in a different context. Should they be grants instead of loans? One of the arguments of the Meltzer Commission that did seem to me to have some plausibility would be that we use loans too often for people who are in terrible trouble when we should be doing grants. But differing with them, is that I don't think they were ready to put the additional resources into that that I think that calls for.

But, should we have considered in a situation like Argentina if people are willing to adopt a policy that has long-term gain, short-term pain, should there be on our part and on the part of the international institutions a willingness to provide some money, perhaps through grants, to help them get over that?

Mr. TAYLOR. I think grants are an excellent way to proceed for very poor countries.

Mr. FRANK. So they're not Argentina?

Mr. TAYLOR. They're not Argentina.

Mr. FRANK. So you would not propose grants for Argentina?

Mr. TAYLOR. I think the loans are just fine for Argentina. The grants, however, for the poorest countries in the world——

Mr. FRANK. I realize we're not talking about the poorest countries. Thank you, Mr. Chairman.

Chairman BEREUTER. The time of the gentlelady which was extended to Mr. Frank has expired. The gentleman from New Jersey, Mr. Ferguson.

Mr. FERGUSON. Thank you, Mr. Chairman. I appreciate, Mr. Chairman, your holding this hearing and I thank the witness, Mr. Taylor for being here. I appreciate your understanding. I wasn't here the whole time. I didn't hear some of the other questioning. I have read some of your testimony, but my apologies in advance if some of this is duplicative.

Obviously the situation that we're dealing with Argentina is tragic in many ways. People there are experiencing very trying times. I appreciate what you have said and some of the principals that the Administration and the President laid out in terms of wanting to be friends and allies, to be there for our friends in their time of need.

But I think something you also said was to try to reduce the frequency of financial crises such as this in the future. And I think our reaction, and the actions that we take now in response to some of these crises and some of the actions taken by those in Argentina are gong to have a lot to do with avoiding these types of situations in the future, because not only do we want to make sure that this is a long-term and not simply a band-aid approach to helping Argentina during this time, but for their neighbors, for the rest of Latin American, and frankly, for the rest of the world are going to base their actions in some part looking at the reaction that we have to this situation.

I certainly don't want to take steps now to try and put a short-term solution on this situation and create additional long-term problems, and I'm sure you share this view. But that's kind of the mindset that I bring to this. And I certainly will not claim to be an expert on this situation. I certainly would not claim or pretend to know as much about the details of this situation as you do or perhaps as Mr. Frank does.

But I just have a couple of questions. What is your understanding of the measures taken by the Duhalde government against the United States companies that have invested billions of dollars in Argentina, such as folks in the electric and gas sector, the telecom sector, other sectors? What is your current assessment of the actions that have been taken?

Mr. TAYLOR. What we've tried to do in talking with various firms is to emphasize to the Argentine government that it's important to treat all investors fairly—foreign investors, investors within their own country. And we'll continue to do that.

They're now going through this process of changing from dollars to pesos. It's part of a reform program. And that entails changing valuations, basically devaluation. And they're doing that in a way that tries to address the fact that if you change a denomination of a loan or a deposit, it has big impacts on individuals. It's going to sometimes force people into bankruptcy or to other dire situations.

So they're looking for ways to smooth that out. And ultimately, people are going to have to make adjustments to that. And I think what we can do and we are doing is emphasizing to them is to do this in a way that is fair and predictable and sensible, and when we see they're not going in that direction, we comment on it.

And I think there's an important reason to do that in addition to the ones that you're indicating, and that is, that's how they're going to have foreign investment and growth in the future.

Mr. FERGUSON. How do you feel, though—I mean, we're talking about making sure that the actions that they're taking and the way that they are addressing the situation is fair and equitable. And I frankly have some concerns about what my understanding is the way that they're going about it. Do you share those concerns?

Mr. TAYLOR. We've received many phone calls from people that are concerned about it. And we've in turn expressed those concerns. They of course have received many concerns as well. And what I'd say is, they're now working on these concerns and trying to take them into account. They haven't finished. A program is being developed, and how the pesofication works is still being developed.

So, again, what I would like to do is to continue to work with them, work with the private sector to give suggestions about how to make it work. It's not finalized at this point in time.

Mr. FERGUSON. Are we having conversations? Is Treasury having conversations with IMF right now about the nature of trying to ensure some protection for U.S. investors in particular? I'm thinking of the energy sector in particular. I mean, are we——

Mr. TAYLOR. What we're having discussions with the private sector, with the government of Argentina, with the IMF is to argue that all investors should be treated fairly—foreign investors, U.S. investors, everyone else. So, yes, the answer to your question is yes, we are.

Mr. FERGUSON. Are we prepared to take actions with regard to that? I mean, are we prepared to insist that money being released to Argentina through the IMF is withheld until a fair process can be worked out or some agreements can be worked out? It's the estimation of a lot of folks that they're not going about it in a fair way.

Mr. TAYLOR. I'd say yes, that is a factor in any advice we would give to the IMF about this, certainly.

Mr. FERGUSON. Where would you put it on a scale? I mean, are we very high?

Mr. TAYLOR. Yes.

Mr. FERGUSON. Finally, what is your understanding of the protections provided to U.S. investors under the Bilateral Investment Treaty with Argentina? And I'm thinking specifically about your understanding of any recourse that may be available to these companies, to any of these investors, particularly when we're talking about actions tantamount to exappropriation.

Chairman BEREUTER. The time of the gentleman has expired. The gentleman may respond.

Mr. TAYLOR. I want to make sure that that doesn't happen and work toward that. And if it does, then I'll try to answer your question when it happens if that's OK. But certainly, as I say, we're working very hard on that. We recognize the importance of the Bilateral Investment Treaty. We have lawyers who are looking at it carefully and policy experts, and it is a concern. But at this point the contacts we have both in the private sector and in the government say that they're working on things right now. Your questions to me and my responses I hope are helpful as well in terms of indicating how important we think this is.

Mr. FERGUSON. Sure. I thank you, Mr. Chairman. I appreciate Mr. Taylor's testimony. And I would just reiterate that some of the concerns that I have—and you can see what I'm getting at through some of my questions—still exist, and I'd be happy to continue to work with you and as we have questions in the future, if you could continue to be as cooperative as you have today, that would be great. Thank you.

Chairman BEREUTER. As a matter of fact, we'll permit the Members, by unanimous consent, to submit questions to the Secretary for the Treasury to respond to for all Members.

I'd like to begin a second round and focus really on two things. First of all, I appreciated your response about the reason we haven't had, fortunately, the degree of contagion that we might have expected or that we saw in the Asian financial crisis.

I am highly critical of the IMF's activities with respect to Thailand and Korea. I think they prescribed medicine that wasn't appropriate and caused additional problems and plunged those two countries into difficulties, but neither one were fiscal basket cases and the IMF is accustomed to dealing with fiscal basket cases.

I liked Mr. Toomey's comments about the structural and microeconomic changes that have been made in Argentina. But fiscal irresponsibility, it seems to me, is part of the problem. And much of the problems that Argentina has in my judgment are self-inflicted. And if you take a look at the fiscal policies or irresponsibility of the provinces in particular, and of course the national subsidy to them, there have been several economists that have written about the extraordinary corruption and flagrant expenditures by the provinces, and they just got bigger and bigger.

Now hearing your comments about a middle type of peg which you think was not advantageous instead of a free-floating currency or a hard peg, do you think, if you know, the IMF loan extended in 1996, the IMF loan in 1996 and then extended in 1998, do you think the IMF gave a recommendation at that point about abandoning the type of dollar peg that they had in place?

Mr. TAYLOR. I just don't know the answer to that question.

Chairman BEREUTER. Do you think it would have been appropriate at that stage, or do you have an opinion on that?

Mr. TAYLOR. I really don't know the circumstances enough to answer it. My answer in general is the one I gave before, that there are these two sides which work well, and for a long time I've thought the one in the middle is questionable. And were I here at the time, I probably would have said that. But the circumstances are different.

Chairman BEREUTER. Thank you. We can go back and look at the speculation and what was the advice at the time, but of course we can't exactly find out because of lack of transparency.

The second point, I think Mr. Frank and perhaps another Member was headed this way. At least I want to convey the view that I think there are times when the patient is too weak to take the prescribed medicine, and that you need to try to restore some of the health of the patient. And Argentina is in that sick situation as Haiti was, for example, in the past, and the IMF imposed such a high degree of austerity measures that the political turmoil was just beyond their ability to cope with it.

So it seems to me that we have an opportunity to permit them to acquire more debt, or there's some sort of grant program, and then the question might be, is that grant program in the IMF or is it in the World Bank and a regional development bank, Inter-American Development Bank, in this instance. It's always easier, I think, if it was a part of the IMF rather than a coordination between IFIs. But they don't have that history, as far as I know.

So do you want to say something about this issue that, in fact, the austerity measures have to be tempered in certain cases with some assistance to the people that are out of work and to the other people that are in some degree of destituteness or problem?

Mr. TAYLOR. I think that's correct, Mr. Chairman. And the philosophy behind the IMF's engagement with countries is to support that view, I believe, in the sense of giving more breathing time, more room to make adjustments and therefore use resources to alleviate pain that might occur otherwise as Mr. Frank was indicating.

The other IFIs, the World Bank and the IDB, can give more direct loans for the social sector. And of course, in the very poor countries, not Argentina, but give grants, as we're arguing for that purpose. The IDB and the World Bank have already indicated in the case of Argentina the willingness to provide loans for the social sectors which could definitely alleviate some of the pain that you're referring to.

So I think it is really part of the nature of the assistance that they can give to countries. In the case of reforms, there's this area where the reforms may be difficult, may require some extra social service payments or extra aid to people who are harmed by it. And they can provide in those circumstances.

I think, just maybe add slightly to that, the concern that people sometimes have is that the loans and the support goes beyond that into more unsustainable things where there's nothing to bridge to, and then you get these series of problems that build up over time.

Chairman BEREUTER. The gentleman from Massachusetts.

Mr. FRANK. Thank you, Mr. Chairman. I'm going to pick up where you left off, because I think this is very important and I think we probably ought to acknowledge it. It's good that the international financial institutions are now doing this. Not too long ago they're doing the opposite. The IMF's response in situations like this, and this is one of the reasons it became controversial and many on this subcommittee were critical was in Asia and elsewhere in 1998, they were basically pressuring governments to do exactly the opposite; to cut back on those social measures which alleviate pain. And I think we should count that as a successful change in international public policy that the IMF now, and it's very good to hear you say that they have now reversed that and people understand that in the short term, some of these alleviation measures have to go forward.

As I said, again, unfortunately, if you go back in 1998 in Asia, they were prescribing exactly the wrong things. And I remember the specific prescriptions in Indonesia and Thailand and elsewhere that were exacerbating these kind of issues.

I was following very closely your debate—not your debate, your colloquy with Mr. Ferguson. Obviously people who lend should bear risk, but there are lot of tensions in this. One of the tensions is between telling all the foreign lenders that they're entirely on their own and don't come to me, and then saying, oh, by the way, it would be a good idea if you lent to those people. And I think if in fact we have a national policy of encouraging lending, then there is it seems to me some obligation to try and not bail them out completely, but to help. I do think this argues strongly for some form of international agreement dealing with what you do when you've got these kind of defaults.

But, let me ask from the Treasury standpoint, is there any concern—we've got a couple of large financial institutions. One of them is obviously the major one in the State that I represent, that have been heavily exposed there largely for good reasons. Is there any concern in the Department that their exposure could become a problem for us here domestically?

Mr. TAYLOR. Well, we've looked at the numbers, talked to them. They obviously are very concerned with what's happening, and relating to the discussion with Mr. Ferguson, communicating to us how they see it.

Mr. FRANK. There's another bankruptcy bill and——

Mr. TAYLOR. How they see it, and we listen and convey the concerns that we hear. But it's not something that is large enough to threaten their overall operations.

Mr. FRANK. OK. That's good to hear. But it does seem to me there's a public policy interest in their not being discouraged over and above there's no public policy interest in whether they make a profit or not. That's their deal.

Let me ask you one other set of questions. I know that the Administration had identified as a very high priority this free trade agreement with the Americas. It does seem to me that what's going on here is going to become more difficult there. In particular, what are the implications? I mean, clearly as you've said, one of the problems Argentina faced were the currency differences between Argentina and Brazil, the two large economies there, and the disparity in the value of the currencies have very significant impacts on trade. Does this mean that the currency question really has to be better dealt with as a prerequisite before you're going to get an agreement on an FTAA?

Mr. TAYLOR. I think the FTAA can work well with various currency arrangements, as long as you don't get to these ones that are unsustainable. And if you think about what's happening in much of Latin America, it is moving into exchange rate systems that are more lasting, and either through dollarization, as has occurred in Ecuador, or through the flexible system that Chile has used for quite a while, a dozen years. They were one of the first to start this inflation targeting type of system with the flexible exchange rates, and now Brazil and Mexico.

Mr. FRANK. The question, though, was——

Mr. TAYLOR. I think those all work quite well. When you think about——

Mr. FRANK. I understand that. My concern is this. Is there going to be a reluctance on the part of some of the countries further to open their economies to trade if they are worried that currency differences might have more of an impact?

Mr. TAYLOR. I hope not. But I think an example is NAFTA. We have I think a very successful North American Free Trade Agreement. We have a fluctuating exchange rate with both Canada and with Mexico. None of this has happened with those.

Mr. FRANK. Do you think that Brazil and Argentina and the others think of themselves analogously to Canada, the U.S. and Mexico in that regard? I mean, my sense is that the hope may be father to the conclusion here. And it does seem to me that the instability and difficulty exacerbated by different, not just different exchange rates, but different exchange rate mechanisms, and that's contributed to this. And let me just ask you very simply, if you polled in Argentina a year ago about a FTAA and you polled today, would you think it would be about the same or do you think there might be more resistance?

Mr. TAYLOR. Well, just guessing on my part, but I would say at least the same, maybe more favorable.

Mr. FRANK. You think the Argentine public is more favorable to an FTAA today?

Mr. TAYLOR. When I talk to my friends in Argentina, travel there, talk to them here, they are so positive about trade as a way to grow.

Mr. FRANK. Were any of your friends in Argentina out banging pots a couple of weeks ago?

[Laughter.]

Mr. FRANK. I mean, you know, there are friends and friends. Do you think that what's gone on is a good thing for the public support in Argentina for the FTAA?

Mr. TAYLOR. Well, I think the importance of FTAA is so important that we need to stress it further. In terms of what a particular person banging pots says, of course I don't know. But I think the genuine feeling is, is a recognition that more trade, in particular with the United States——

Mr. FRANK. Well, I envy you from your perspective your optimism. It must make life very cheerful. Thank you.

Chairman BEREUTER. Thank you. I think this is a question we may not want the Secretary to answer in open session.

Mr. FRANK. I seem to have come up with a lot of those.

[Laughter.]

Chairman BEREUTER. I think we need to conclude the hearing. But I do want to say that while I think that there are going to be a lot of attempts within Argentina to blame everybody else, including the United States, and perhaps there are problems with the IMF and the advice that they gave, perhaps there are, it's I think instructive to know that, unfortunately, Argentina, which was among the top ten countries in the world in per capita income at the turn of the 20th century, was one of the ten wealthiest countries in the world, a country that had relatively small amount of racial tension, a country that had a highly educated population for so long, has fallen to the problems that they have today for socioeconomic reasons or political reasons.

So I do think we have a responsibility to look at the IMF, but I hope that, while we can provide some assistance as necessary to people that are really hurting there, by our international financial institutions, the country and the people need to look at themselves in the mirror, too, and that's my own view I just would offer at this point for whatever it's worth. But a country so rich, one of three countries in the world that have the best agricultural soil, a country that hasn't really focused on exports to a substantial extent, focusing on internal markets for the most part as compared to their neighbors, well, you can only help people so much unless they're willing to help themselves. And that's sad.

I would ask unanimous consent before Mr. Frank leaves, the only Member, that subcommittee Members may be able to submit written questions to Dr. Taylor in the Treasury Department.

Dr. Taylor, thank you very much. I think it's been a very beneficial set of questions, and your testimony was very much appreciated and appropriate, in my judgment. And thank you very much.

Mr. TAYLOR. Thank you, Mr. Chairman.

Chairman BEREUTER. The hearing is adjourned.

[Whereupon, the hearing was adjourned.]

ARGENTINA'S ECONOMIC MELTDOWN: CAUSES AND REMEDIES,

TUESDAY, MARCH 5, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
MONETARY POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 1:33 p.m., in room 2128, Rayburn House Office Building, Hon. Doug Bereuter, [chairman of the subcommittee', presiding.

Present: Chairman Bereuter; Representatives Oxley, Shays, Sanders, Frank, and Sherman.

Chairman BEREUTER. The hearing will come to order.

Under the normal committee rules, we will permit the Ranking Minority Member and the Chairman 5 minutes, as well as the Chairman of the Full Committee, and others 3 minutes for opening statements.

I will begin by stating the subject of today's hearing. The Subcommittee on International Monetary Policy and Trade meets today in open session to continue its examination of the financial crisis in Argentina, including the activities of the IMF within this country.

The subcommittee will hear from a distinguished panel of private sector witnesses. Previously on February 6th, the subcommittee listened to the testimony from the Under Secretary of the Department of the Treasury for International Affairs, Dr. John Taylor, on the subject of Argentina.

Before introducing our distinguished witnesses at this second hearing on Argentina, I would like to remark upon the current fiscal situation in Argentina and call to the Members' attention that at your desk you have two updated products from the Congressional Research Service that are again provided, which I find instructive: A chronology of relevant events in Argentina; and a CRS Report on the Argentine Financial Crisis. When looking at these CRS reports, it is important to note that the events are changing in Argentina on an almost daily basis.

As we discussed at our first hearing in 1991, the Argentine government established a currency board to set the peso's value on a one-to-one peg with the U.S. dollar in order to curb hyperinflation. However, because the value of the U.S. dollar appreciated over the past 10 years, it became increasingly difficult for Argentina to export its products. In fact, by the end of 2001, Argentina defaulted on its total foreign debt of approximately $141 billion which resulted in an economic crisis that spiraled into deadly protests.

On February 3 of this year, the Argentine government declared that the local peso would free float and all dollar debts would be converted into pesos at a rate of one-to-one. Creditors and banks have suffered as a result of this pesofication of debt. Furthermore, this economic plan also turned all dollar deposits into the local peso at a rate of 1.4 to the dollar. This devaluation of deposits has angered middle class demonstrators because of their loss in savings.

Since this subcommittee's last hearing, the following main events in Argentina have occurred:

On February 11th, the Argentine peso was free floated, as I mentioned. As of March 2nd, the local peso was trading at 2.15 to the U.S. dollar.

Furthermore, on February 18th, unemployment in Argentina reached a high of 22 percent. In addition, petroleum workers began to protest a 20 percent energy export tax. Other protests continued as a result of the strict bank restrictions on withdrawals.

On March 1, the lower House of the Argentine Congress passed President Eduardo Duhalde's budget bill for 2002 which included a proposed reduction of spending by over 14 percent. This measure importantly eliminated the monthly minimum of $650 million in Federal grants to the provinces which has been draining the Federal budget. According to the most recent press reports, the upper House of the Argentine Congress has yet to act on President Duhalde's budget for 2002.

As far as the role of the IMF in Argentina goes, we can remember that they agreed to a 3-year, $7.2 billion arrangement with Argentina in March 2000. Moreover, in January 2001, the IMF augmented its earlier agreement by pledging another $7 billion to Argentina. However, the IMF withheld its $1.24 billion loan installment on December 5 of last year.

With regard to the recent budget for 2002 which passed the lower House of the Argentine Congress, as I mentioned, the IMF publicly welcomed this austerity measure that reduced the federal deficit and addressed the federal/provincial relationship. The IMF has said that it may send a negotiating team—in fact I am told they arrived today. In fact, they will be directed by a person accepting a newly created position of Director of Special Operations, who will lead an effort to focus on countries facing crisis situations.

Now, as for IMF preconditionality reform proposals as they relate to Argentina, I think it will be interesting to see the thoughts of the witnesses on the concept of preconditionality for IMF assistance as it relates to Argentina. This recommendation was endorsed by the majority report of the Meltzer Commission, whose Chairman, Dr. Alan Meltzer, is testifying today. I take particular interest in the Meltzer Commission as I am the original author of the legislative language, which created this 11-person bipartisan Commission through the fiscal year 1999 Omnibus Appropriations Act. This Commission, which completed its report in March of 2000, was charged with studying the future of the IMF, the World Bank, and the regional multilateral development institutions.

When Under Secretary Taylor testified before the subcommittee last month, he seemed to endorse the concept of preconditionality for IMF assistance as it relates to Argentina. Of course, there is merit in insisting a country have a sound economic structure in place before it receives IMF assistance. Yet, macroeconomic circumstances such as the political and economic repercussions on global stability also need to be taken into account on a case-by-case basis. A dissenting view of the Meltzer Commission, which was signed by Dr. Fred Bergsten, another of our panelists today, makes that point.

Let me say lastly that, with respect to the IMF, it is important to acknowledge that there has been substantial criticism of the IMF's past performance. I have a strong concern about the advice that the IMF initially gave to Thailand and Korea at the beginning of the Asian financial crisis. The fact is that IMF's demands of Thailand and Korea were counterproductive, in my judgment. It treated these countries like their "usual fiscal basket cases"and they were not fiscally troubled at the early stages of that crisis. Whether or not that treatment was the demand or recommendations of the U.S. Treasury Department in the Clinton Administration is not clear.

At the same time, we in Congress need to candidly admit, I believe, that if we did not have an IMF or an institution somewhat like it, perhaps a reformed one, we would have to create one. But, we also need to recognize that the U.S. Treasury has a very large role in influencing IMF policy and actions—some would say an inordinate amount of influence. And I take into account, of course, that we are the largest shareholder of the IMF.

I would like to turn, before I introduce the witnesses at the table, to the distinguished Ranking Member of the Subcommittee, the gentleman from Vermont, for comments that he might have.

[The prepared statement of Hon. Doug Bereuter can be found on page 106 in the appendix.]

Mr. SANDERS. Thank you, very much, Mr. Chairman, and thank you for holding this important hearing, and welcome to all of our guests for being with us today.

I look forward to the testimony of all of you. My understanding is Dr. Weisbrot has recently returned from Argentina. Is that correct? So we especially look forward to what you have to say about the current situation there.

I think we all know there is no debate that Argentina is in a major financial crisis. Unemployment is above 20 percent. The poverty rate is above 40 percent. The economy is in its fourth year of recession, and the country is now in the process of defaulting on its $142 billion foreign debt.

I am confident that there is a lot of blame to be spread around regarding the Argentine financial crisis. For example, corruption in the Argentine government is a major factor that has to be looked at.

But to place the blame for the crisis squarely in the laps of the Argentine government is, in my view, shortsighted and inaccurate.

We also have to take a look at the failed IMF austerity program, which I believe was a major contributor to Argentina's economic demise.

Let me just quote from a couple of op eds that recently appeared. Interestingly enough, one is from a progressive and one is from a conservative, and I think there are very legitimate, strong concerns about what the IMF has been doing for many years, including Argentina, from both the left and the right.

Robert Cutner is one of the editors of *American Prospect*, a progressive magazine. Quote: "Argentina followed the IMF model more faithfully than almost any other nation. Its economy was opened wide. Its peso was pegged to the dollar. For a few years this sparked an investment boom as foreigners bought most of the country's patrimony, its banks, phone companies, gas, water, electricity, railroads, airlines, airports, postal service, even its subways.

"As long as this money came in, there were enough dollars to keep plenty of pesos in circulation. But the dollar/peso peg led to an over-valued currency which killed Argentine exports. And once there was little more to sell off, the dollars ceased coming in, which pulled money out of local circulation.

"As Argentina tanked, the IMF's austerity program pushed the economy further into collapse."

And according to a recent op ed in the *Wall Street Journal*, not noted as a terribly progressive magazine, the IMF, and I quote: "austerity programs in Argentina contributed to the collapse of tax receipts, sky high interest rates to compensate for currency uncertainty, and investment standstill, deadly riots, and the fall of the government.

"The IMF's policy pattern is as clear in Argentina as in previous collapses around the globe. It gives countries bad economic advice, then lends heavily to them, allows them to waste the new funds, and watches as the government's popularity plummets.

"When the economic crisis is deep, the IMF blames the government and pulls the plug, knowing that it always gets paid first and in full. In Argentina, as elsewhere, the population and the private sector are left holding the bag. The result is a country more deeply impoverished than it would have been without IMF involvement."

Mr. Chairman, since its modest beginning 55 years ago, the IMF has grown to become the most powerful financial institution in the world. Amazingly enough, this secretive organization dominated by a few wealthy countries, has effective control over the economies of at least 50 developing nations.

This in itself is a problem of enormous concern for those of us who believe in democracy. But there is, I think, not only in developing countries, but throughout the world, a growing sense that the IMF is not doing the job it was established to do, and it has taken on new jobs it is not able to do.

I think the bureaucratic expression is "mission creep." The Argentine example is just the latest in a string of IMF failures in Asia, Africa, Russia, and many other parts of the globe.

I was just in Russia a couple of weeks ago and we met with government officials there. They said, "Well, you guys in the United States do not listen to your economic advisors. You send them to Russia. We listen to you, and thank you very much for the disaster that our economy is in. Keep them at home," is what they said. So I don't know.

I think many of us, for many years now, have been urging the IMF to stop prescribing one-size-fits-all austerity conditions that inevitably lead to economic stagnation and poverty.

I think all of us in a world in which so many hundreds of millions of people are living in dire poverty should be keenly sensitive to an institution which time, after time, after time tells some of the poorest countries on earth: Cut back on health care. Cut back on education. Cut back on food subsidies. That is a serious problem.

So I think there is a lot to be thought about in terms of the IMF role in Argentina and many other countries.

Mr. Chairman, thank you very much.

Chairman BEREUTER. Thank you, Mr. Sanders.

Now it is my pleasure to recognize the Chairman of the Financial Services Committee, the gentleman from Ohio, Mr. Oxley, for any comments he might like to make.

Mr. OXLEY. Thank you, Mr. Chairman. Thank you for the opportunity to participate in this hearing. Thank you for your leadership in this, and welcome to our distinguished panel.

We have seen over the past several months the third largest country in Latin America on the brink of both economic and social collapse. The situation in Argentina is tragic, but it is a good lens through which we can examine changes that may need to be made in the operation of the IMF.

Following last December's decision by the IMF to stop lending to Argentina, the government defaulted on its foreign debt and a succession of administrations attempted to govern the country. Some stability has returned and Argentina has begun to make the tough fiscal, money, and political decisions to begin the reform process.

Argentina is a valuable ally of the United States in South America, and I hope that they can get their economic house in order.

I am glad to see that the peso is now floating on the international market, and that the government has approved a budget that attempts to control spending. In particular, the reform made in the relationship between the provincial and federal government is key to reducing deficits and reigning in spending. However, there are parts of the economic reform package that are of concern. Specifically, the President of Argentina has announced a proposal to levy a tax on all companies that operate privatized businesses.

I question whether additional taxes should be levied on companies that are currently struggling in the midst of this crisis. Many of those companies are based in the United States, and additional taxation could force them to abandon projects that they are developing or maintaining in Argentina.

Additionally, a proposal that contracts in pesos, contracts negotiated in good faith, be paid in dollars, is troubling. By changing the terms of those agreements, Argentina casts doubts on the ability of U.S.-based companies to rely on assertions made by its government in the future.

I was encouraged by the Under Secretary Taylor's testimony last month that the Department of the Treasury was working to ensure that U.S. interests are being treated on a level playing field with other foreign interests. I trust those efforts are continuing.

As the largest shareholder in the IMF, the United States has the responsibility to ensure that the resources of that institution are being spent wisely.

I believe that the IMF must take a hard look at its lending policies and ensure it is not granting loans to countries simply because they are in need of financing.

The IMF must ensure that the money it distributes is making the greatest possible impact on improving the lives and economies of developing nations.

Last week, the Secretary of the Treasury outlined before this subcommittee efforts that the Bush Administration is pursuing to ensure that the IMF cultivates growth and productivity in the regions where it operates.

I agree with Secretary O'Neill that increased communications with the market, a narrowed focus, and a policy of not bailing out countries that do not pursue sound economic programs are key goals for the future operation of the IMF.

However, the IMF must also work with the recipient countries to ensure that they know what policies must be addressed prior to funding being cut off or being resumed. By establishing a blueprint of economic reforms for recipient countries to follow, the IMF will reduce the number of failures and encourage sound fiscal policies.

Finally, Mr. Chairman, the IMF has proposed a plan to encourage an orderly workout when there is a default by a borrower country. While this proposal is in the early stages, I am interested in the opinions of our witnesses as to whether such a proposal is needed and how it could be established.

I would like to welcome again our witnesses, and I look forward to a very lively and interesting debate. I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 109 in the appendix.]

Chairman BEREUTER. Thank you, Chairman Oxley.

Other Members are entitled to up to 3 minutes for opening statements. The gentleman from Massachusetts, Mr. Frank, is recognized.

Mr. FRANK. Thank you, Mr. Chairman.

I want to express my hope that the witnesses will talk, either today or at some future point, about one element of this that is problematic.

Mr. Sanders referred to it: The question of democracy. That is, it does seem to me we are too often in the position of advising countries to do things which no democratic society could easily do. Indeed, we are often telling them to do things that most of us would not vote for.

We are telling them to impose on their own people-restrictive policies, increases in sometimes a very regressive taxation, cutbacks in various levels of benefits, and I am struck at the absence of understanding of the way democracy can and should function.

I worry that in various cases—and it may be happening in Argentina. One of the things that troubles me about Argentina, in addition to the economic reality, are the comments I see reported in the press which are from people who have given up on democracy, who blame elections, who denigrate politicians, and that means they are denigrating the electoral process.

I think one of the defects in international economic policy all during the 20 years I have been watching it has been a failure to appreciate this democratic element. It is too often that people neglect the wisdom of John Maynard Keynes in the political field. Too often, obviously, people are told that they should accept this or that very distasteful, unpleasant, difficult public policy because in the long run they will be better off.

As you all know, as Keynes pointed out, in the long run we shall all be dead. That has a great deal of political wisdom. It is something that people in the particular situation understand.

So I would hope—and I must say, I do not see this sufficiently. As far as Argentina is concerned, I am interested to see what people have to say. It is a difficult situation. But I am struck that throughout the economic analysis that we get, too little is done to integrate our understanding of the democratic process into that.

That is not simply a theoretical flaw. I think we run the risk in various places and times of undermining democracy. I do not want people to associate democracy with austerity, with that kind of rigor, and as I said, I see some evidence just from what is reported that one of the victims so far in the Argentine crisis is the respect the Argentine people have for the democratic process, for the electoral process.

I would hope we would regard that as something also worth saving.

Thank you, Mr. Chairman.

Chairman BEREUTER. Thank you, Mr. Frank.

The gentleman from Connecticut, Mr. Shays, is recognized.

Mr. SHAYS. Thank you. I appreciate deeply that you are holding these hearings, Mr. Chairman. I cannot think of anything—well I can think of a number of things worse, but it is hard to imagine what it would be like to live in Argentina now and to think your life savings have disappeared, to not have a job, to not even know how you can begin to feed your family, with so many middle-class in that situation, a new experience for them.

I am also becoming more and more aware of how many countries around the world are dealing with debt service that is far above 50 percent. I think of 14 percent, 11 percent in the United States, and think of how we have found that a challenge. So I just am happy to be here, and grateful you are having this hearing, and I know we have expert witnesses and I thank them for their participation.

Chairman BEREUTER. Thank you, Mr. Shays. Without objection, all Members' opening statements will be made a part of the record. And to the extent that the witnesses have written statements, they will also be entered into the record in full.

I am pleased now to introduce the witnesses. They make a very distinguished panel with what we expect to be diverse views on Argentina and the Argentine-IMF relationship.

First we will receive testimony from Dr. Allan Meltzer. Dr. Meltzer is Professor of Political Economy and Public Policy at Carnegie Mellon University, and a former member of the President's Council of Economic Advisors. He is currently also a consultant to the World Bank.

Second, Dr. Fred Bergsten, the Director of the Institute for International Economics, will testify. Dr. Bergsten has been the Director of the IIE since its inception in 1981. He was an Assistant Secretary of the Treasury for International Affairs from 1977 to 1981.

Third, we will hear from Dr. Mike Weisbrot, the Codirector of the Center for Economic and Policy Research in Washington, DC. Dr. Weisbrot, who received his Ph.D. in economics from the University of Michigan, specializes in international economics with a particular emphasis on the role of the IMF. He is also an author of a weekly column on economic and policy issues that is distributed to the newspapers of the Knight-Reiter-Tribune Media Services.

Finally, Dr. Steve Hanke, a Professor of Applied Economics at the Johns Hopkins University in Baltimore, will testify. Dr. Hanke has advised many different foreign governments on currency reform and privatization. With respect to Argentina, he served as the advisor to the Minister of Economy at the Republic of Korea in 1995 and 1996. It is also important to note that Dr. Hanke is the President of Toronto Trust Argentina, which is an emerging Market Mutual Fund in Buenos Aires.

Gentlemen, again thank you for coming. Dr. Meltzer, we will hear from you. I would like to ask the panelists if they could restrict their comments to about 8 minutes, and you may proceed as you wish.

STATEMENT OF DR. ALLAN MELTZER, PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY

Dr. MELTZER. Thank you very much.

First I would like to say, Mr. Chairman, that I owe you a vote of thanks, and also I guess I bear some scars for your having created, or helping to create, the International Financial Institutions' Advisory Commission that in the usual way has been named after its chairman, me. So I thank you for that.

Argentina is now suffering from a deep and prolonged social and economic crisis. Its roots are political as well as economic. The political system seems unable to develop a coherent, consistent plan to solve or improve either Argentina's current position or its longer term structural problems.

The need for a plan or program to restore growth and output and employment without renewing inflation cannot have escaped the leadership. They have received this message from President Bush, Secretary O'Neill, the IMF, and others, including me, and Adam Lerrick when we were in Argentina talking to many of the people who are now in the government just before the new government formed.

Without a plan that begins to resolve current liquidity, financial, economic, and human problems, there cannot be a resolution of the crisis. Additional financial assistance from the international financial institutions, led by the IMF, cannot solve Argentina's problems unless Argentina adopts a coherent, consistent plan. This is the democratic solution that Mr. Frank discussed so fully a moment ago.

Argentina has three fundamental problems that brought it to its current deplorable position, with massive loss of wealth and increase in misery.

First, its debt could not continue to grow and be serviced by Argentina's economy and exports. Astute observers recognized publicly more than a year ago, and privately as early as 1999 in my experience, that Argentina's foreign currency denominated debt was unsustainable.

Second, Argentina's budget deficit increased its debt and undermined its monetary policy. The convertibility law tied the peso to the dollar and permitted unrestricted convertibility at a fixed exchange rate. This arrangement could not cope with an unsustainable debt on one side and an over-valued exchange rate on the other. The appreciation of the dollar and the depreciation of the Brazilian real made Argentina an unattractive place for investment and a costly place to buy.

For example, when we were there, Argentine apple growers and people with orchards said that the cost difference between their product and Brazil's was something on the order of 30 percent.

Third, Argentina made many reforms in the early 1990s, but it did not develop a budget policy, or pass a fiscal responsibility law that controlled provincial spending. And it did not remove some of the structural impediments to growth.

The current Argentine government has not proposed a coherent, consistent plan. Some of the actions that have been taken are piecemeal efforts to solve a particular problem without regard for the larger consequences. For example, the monetary authorities did not have enough dollars to convert peso deposits into dollars, as required by its monetary regime, so the government declared that all dollar deposits had to be converted into peso deposits at 1.4 pesos per dollar. This increased the potential money supply by about 30 percent, raising concerns about inflation. To assure the public that they would not lose from inflation, the government suggested indexing peso deposits to inflation. As inflation increased, the government or the central bank would print more money. This policy would lead to hyperinflation.

Argentine citizens have had such miserable monetary and economic experience for the past 50 years that they understand better than most the links between the central bank's printing press and inflation. Their response is to run from the peso before the inflation reduces the value of their money. This response further drives down the value of the peso, raising Argentine costs and prices. Unions, anticipating inflation, have asked for a 40 percent increase in wages.

The economy is collapsing. Construction activity in January was 44 percent below year-earlier levels. Because bank deposits were frozen, January's supermarket sales were 30 percent lower than the previous month. The unemployment rate is above 20 percent and rising as the economy sinks. The government announced that it does not have enough money to pay the wages of government workers. Meanwhile, it raised the incomes of those in the senior brackets of the civil service and in the government.

No one can fail to be concerned with and distressed by the fate of the Argentine public. People are fleeing the country. Lifetime savings are threatened, and bankruptcy and joblessness are high and rising. A decade after suffering the chaos that accompanied hyperinflation, people suffer from renewed economic collapse.

What can the IMF and other international institutions do? What should they do? The IMF has not ignored Argentina. In March 2000, it offered a $7.2 billion loan. In January 2001, when the sustainability of Argentina's debt was very much in doubt, it offered $7 billion more as part of a $20 billion official package. In August 2001, it advanced an additional $5 billion to prevent a banking and currency run. It should be clear to all that more money without policy changes did not work. The IMF announced new negotiations last week.

Would more money now help Argentina or its people? Until Argentina has a credible, coherent plan, the public has no reason to want to hold pesos. Giving money now would give the Argentine government money to support its exchange rate and its budget. That is another way of saying the holders of Argentine pesos would be able to get dollars on more favorable terms, and the Argentine government could maintain a larger budget deficit and avoid pressures to establish fiscal responsibility. This is not just conjecture. It is a description of what happened to much of the aid Argentina received in the last 2 years.

I favor assistance to Argentina once it has adopted a coherent, consistent plan. Such a plan is needed to ensure that money advanced to Argentina is not used to support an exchange rate peg or slide, to sustain budget deficits, or to permit creditors to avoid losses. That is how additional support would be used in the absence of a plan that the government adopts and implements.

In December 2001, Adam Lerrick and I discussed these issues with members of the Argentine government, and with those who were then in the opposition but are now in government. There were seven problems that have to be addressed. Some are interrelated.

First, external debt has to be reduced to a sustainable level. The debt is now in default. It has to be renegotiated. It cannot be renegotiated until there is some kind of coherent, consistent plan that allows the creditors to get some judgment about what they are likely to get.

Second, Argentina needs a credible exchange rate regime to replace the present blocked exchange system of currency controls.

Third, no exchange rate regime can remain credible or be sustained unless the monetary system produces low inflation or stable prices. The government must make the central bank independent and adopt a rule that prevents the central bank from printing money to finance the budget deficit.

Fourth, a stable fiscal regime, with budgets close to balance sustains credibility of the monetary system and exchange rate stability. The fiscal system should also encourage efficient use of resources to increase living standards, and the government should adopt the fiscal responsibility law applicable at all levels of government. Many of Argentina's fiscal problems, as many of you have pointed out, result from excessive spending by the provinces financed by the central government.

Fifth, adjustment of the Argentine monetary and exchange rate system should avoid asset and liability mismatch. Argentina's current government has wiped out the capital in the banking system and crippled the payment system.

Sixth, any policy today must convey unpleasant news. It should also convey some good news by reducing the 21 percent value-added tax as much as possible to stimulate private spending and to shift spending from the informal to organized markets.

Seventh, there is a pressing need for liquidity. Adam Lerrick and I proposed a way to reconcile an increase in liquidity and spending with safety and soundness of the financial system. The government adopted a version of this proposal.

The Argentine crisis affects not just the IMF, it poses a challenge for the World Bank with 8 to 10 percent of its outstanding loans to Argentina, and the Inter-American Development Bank, with 20 percent of its loans to Argentina. An Argentine default on these debts would severely impact the capital of these institutions. The lesson from this problem should not be to send more money; it should be to reform these financial institutions.

In summary, I support the IMF's current program. It is a major step forward from the open-handed bailouts of the 1990s. The new policy is exceedingly painful for Argentina because the government has failed to make adjustments and reforms necessary for growth. Financial support is wasted when the economic structure is unsound. I urge the Members of this subcommittee to support the important steps toward reform that Secretary O'Neill and Managing Director Koehler have underway. I urge them to continue with their effort to reward performance and to insist that promises must be kept.

Thank you.

[The prepared statement of Dr. Allan H. Meltzer can be found on page 111 in the appendix.]

Chairman BEREUTER. Thank you, Dr. Meltzer.

We will now hear from Dr. C. Fred Bergsten, Director of the Institute for International Economics. You may proceed as you wish with 8 minutes.

STATEMENT OF DR. C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Dr. BERGSTEN. Thank you very much, Mr. Chairman.

I largely agree with the analysis and presentation that Dr. Meltzer has just put forward. So in my remarks I would like to focus on the relationship between what has happened in Argentina and the role of the International Monetary Fund and what implications the Argentine developments have for the functioning of the international monetary system and, likewise, what changes or reforms in the monetary system have meant for the effects of the Argentine situation outside Argentina itself.

Let me first talk about the interaction between Argentina's travails and the functioning of the International Monetary Fund. I think the IMF is in severe danger of whipsawing itself over Argentina.

The problem for a very long time was not that the IMF was too tough on Argentina, but rather that the IMF was much too soft on Argentina.

All during the period of Argentina's boom in the late 1990s, the IMF did not insist that Argentina tighten its fiscal policy and develop the kind of responsible underlying measures that would have sustained its boom.

There was no pressure on fiscal policy during that period. There was tolerance of a currency board arrangement that was bound to become unsustainable and lead to a crisis.

The IMF, in short, tolerated unsustainable debt and exchange rate situations over an extended period of time. Then, with its two large rescue packages in 2000, and particularly in the summer of 2001, the IMF threw huge financial packages into the support of unsustainable policies.

In short, the IMF was much too soft. Indeed, when the IMF went to its second rescue package in August of last year, it seemed to be gambling for redemption. When its first package did not save the day, it went for a bigger second package, just like we sometimes say private banks facing bankruptcy try to gamble for redemption. It is almost like the IMF was doing the same thing.

The IMF then was viewed as too harsh once the situation exploded and the crisis hit. But I want to underline that it was too soft for much too long. And only belatedly did it begin to suggest the kind of policy changes that are needed.

My fear, however—and this echos something that Mr. Frank said a moment ago—is that the IMF might now become too harsh. If it sits back too long, if it fails to accept a responsible program that is the best the Argentines can do within the context of their democracy, as Mr. Frank mentioned, then it will become too harsh, will fail to help the Argentines recover from their own circumstance, and will further discredit the IMF.

In other words, if the IMF goes from being too soft to too harsh, it will be just like the private commercial banks who lend too much when a country is booming, and then back out when the country is hurting and make the situation worse by increasing the gyrations on both sides of the seesaw.

That, I think, is the problem that faces the IMF now. Dr. Meltzer is, of course, right that there has to be a solid program that gives a prospect of recovery. But if the IMF, the U.S., and everybody else insist on that program being too harsh after they have failed to insist that Argentina tighten its belt back when it could have done so without huge costs, they will make the situation worse and it will implode further.

My second point is that the U.S. Administration, much as I hate to say it, has performed even worse because they already have whipsawed themselves.

They came into office indicating that they would not support, quote: "big bailout rescues of emerging-market economies," yet they did it. They supported rescues for Argentina, which have clearly turned out to be unsustainable, as I and others and Dr. Meltzer per his testimony, were saying as long as 2 years ago.

They did the same thing in Turkey. They have already whipsawed themselves by saying they would not go for big unsustainable rescue packages, then going ahead and doing it. They have gotten the worst of all worlds. Their credibility has suffered.

They too have to get back on track in the same way as I suggested the IMF has to.

Now having thrown some brickbats, let me note that the good news is that the Argentine situation has generated much less contagion now than we would have expected in recent years.

And I think the really good news is it is because of some basic improvements in the functioning of the international monetary system, the kind of reform that many of us have called for over the years.

In fact, I would note not only has there been very little negative contagion, there has actually been some positive contagion.

The Mexicans, for example, will tell you that they have gotten capital inflow as a result of money moving out of Argentina.

One reason the Mexican peso has been the only currency in the world stronger than the U.S. dollar over the last couple of years is because money moving out of other emerging markets has moved into Mexico.

As the Mexicans have performed well, their policies have been strong, they have been linked to our own strong economy, they have gotten positive contagion.

The reason there has been much less negative contagion is of course partly because the Argentine crisis had been anticipated for a long time. But so was Thailand in 1997. So, to a large extent, was Mexico in 1994. So that is not the sole explanation.

I think the key differences are changes in the functioning of the international monetary system indicating there have been improvements in the architecture.

First of all, markets are learning to differentiate among different countries. It is not like in 1997 when everybody ran for the exits from all Asian countries when Thailand had its crisis.

That differentiation has been helped by the increased transparency of the system, the increased requirements for data submissions, the greater knowledge and sophistication of appraising the individual countries, which that have come with the attention paid to the international financial architecture over the last few years, fueled by things like the Meltzer Commission and other efforts to pursue improved performance.

Second, many of the other emerging markets, especially in Latin America, have strengthened their domestic banking systems. Their reforms are not yet complete by any means, but they have strengthened their system extensively in response to the call for such reforms dating back to at least 1997.

The creation of the Basel core principles that year really began to put the pressure on individual emerging markets to strengthen financial systems.

The weakness of those systems was of course a common cause of all the crises in the mid-1990s from Mexico through East Asia. And the strengthening of those systems is one reason we have less contagion today.

Third, and I think probably most important, is the nearly universal adoption now of floating exchange rates—not free floats but managed floats. Indeed, how to manage the floats is now one of the most important reform issues. However, practically every developing country has now moved away from the currency pegs of the past is whether it was a currency board, an adjustable peg, or whatever else, to floating rates which provide important buffers against crises, particularly buffers against contagion from crises in the neighborhood as in Latin America now, and that helps mightily to avoid contagion.

So the really good news is the lack of contagion at least so far in the traditional economic sense.

I share some of Mr. Frank's concerns about political contagion. That depends on how fast Argentina resolves its situation and how effective and responsive the outside world is in supporting them.

Finally, since I was the leader of the minority of the Meltzer Commission, as you mentioned, Mr. Chairman, I cannot fail to note that, at least in my judgment, the Argentine situation reveals the shortcoming of Dr. Meltzer's majority's recommendations for prequalification for IMF programs.

You will recall that those prequalifications focused almost solely on domestic financial systems. As I go back and read what the majority wrote, under its proposals Argentina would have qualified fully for IMF aid when the crisis broke.

Indeed, as I suggested in my original comments and criticism at the time, the Meltzer majority proposal would have underwritten the profligate fiscal policy of Argentina by authorizing IMF credits without any effort to correct it because the majority said that they do not believe in conditionality. We do not believe in going after countries. If they have got their financial system in order, then go ahead and lend.

It seems to me that what has happened in Argentina clearly indicates the mistake that would have resulted. I am therefore pleased that the recommendations of the majority were not accepted. I think the Argentine case suggests the wisdom of that outcome.

Chairman BEREUTER. Thank you, Mr. Bergsten.

Next we will hear from Dr. Mark Weisbrot, Codirector, Center for Economic and Policy Research. You may proceed as you wish, Doctor.

STATEMENT OF DR. MARK WEISBROT, CO-DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH

Dr. WEISBROT. Thank you, Mr. Chairman. I am going to go straight to these five points in my prepared remarks, because I hope we can actually look at some of the numbers having to do with what people have been saying about Argentina's fiscal situation over the last few years.

So the first point is that the IMF must acknowledge that it played a large role in causing the current crisis of Argentina's economy. This is much more than setting the historical record straight. It is necessary to prevent the Fund from causing further damage. For example, Argentina has been in recession for nearly 4 years. During this time, the Fund has supported, with lending and political encouragement, fiscal tightening of the central government budget. This is something that economists in the United States would never recommend for our own economy during a recession, and it has undoubtedly worsened and/or prolonged the downturn in Argentina.

The Fund has also contributed enormously to the crisis by arranging tens of billions of dollars of loans to support the convertibility plan, which was clearly not a viable exchange rate regime. The result was an insurmountable debt burden, which ended in default last December. As shown below in the appendixes attached hereto, it is this debt trap, not overspending by the government—and I have to emphasize this—it was the debt trap that caused the crisis.

Basically, the interest payments of the Argentine government increased consistently without the government increasing its primary spending, beginning with the Fed's decision to raise interest rates in 1994 and then on through the Mexican peso crisis and the Asian financial crisis, and the Russian and the Brazilian devaluation. That is explained in the appendix.

But we should come back to that, because it is very important to get the causes of this straight and not pretend, as so much of the press and popular discussion does, that this is a crisis caused by the overspending by the Argentine government.

Second, the IMF, the World Bank, and the Inter-American Development Bank and other official creditors should declare a moratorium on Argentina's debt service payments until the economy has recovered from the recession and achieved solid growth for at least a year. I think this is the very minimum these institutions can do to avoid worsening the crisis. Since the Fund presently functions as the leader of official, and often private, creditors, its decision—and therefore the decision of the U.S. Treasury Department—to declare a moratorium on debt service would help remove much of the uncertainty that now hangs over Argentina's financial future. Furthermore, the Fund could persuade private creditors to observe a similar moratorium.

An official moratorium on debt service is extremely important, because this is the biggest cloud that hangs over the Argentine economy. The government has been running a primary budget surplus, and the economy has a trade surplus. This is very important, because it means that there is no "adjustment" of the economy, usually referred to as structural adjustment, which is necessary if debt service payments are suspended.

Further adjustment along the lines historically pursued by the IMF would likely only prolong the recession.

Third, the IMF and U.S. Treasury should not try to impose austerity conditions on Argentina, and they should not take advantage of the crisis to impose other conditions for opportunistic or ideological reasons.

By dragging out the negotiations of the government of Argentina insisting on unnecessary austerity, the Fund is adding to the uncertainty that undermines economic recovery. And I spoke with Argentine businessmen who told me that Spanish banks want to open lines of credit to Argentine companies in spite of the default, but they are waiting for the IMF to reach agreement with the government.

This is just one example of how this creditors' cartel, which is headed by the IMF, can impair economic recovery in a time of crisis.

And I want to get back to this, too, because this is really relevant to the question raised by Congressman Frank—I hope we can pursue this—of democracy, which is the most serious, or very serious political problem here.

During the Asian financial crisis, the Fund imposed more than 140 conditions on Indonesia as part of the loan package. As a result, the Fund's main impact was to get the government to guarantee private loans, rather than to promote economic recovery. More than 4 years later, Indonesia still has not reached its pre-crisis level of GDP. It would be a tragedy if the IMF led a similar so-called "bailout" in Argentina.

Fourth, the first priority of any economic program must be to revive spending and production and pull the economy out of the depression. I emphasize this because many people have pointed to this, all the long-standing problems, corruption, the deep distrust of politicians, lack of confidence in the banking system as the root causes of the crisis.

But these problems may exist, but it is not necessary or sufficient to cure them in order to get the economy going. And we can talk more about that if there is time.

Finally, the most important question, I think, facing us right here is the IMF should state publicly what it is demanding from the Argentine government. The complete lack of transparency in the negotiations between the IMF and the government of Argentina invites abuse and corruption, and thwarts democracy in Argentina.

This is something, if they cannot put forward what they are demanding, I do not see why economists and journalists and so many people just say, "Well, the IMF is demanding a sound program, a responsible program." Clearly they have gotten it wrong. They got it wrong for the last 9 years in Argentina. They got it wrong in Brazil when they poured tens of billions of dollars into the Brazilian government and saddled them with debt to maintain a fixed exchange rate that was not viable there, and the economy recovered only after the currency collapse.

They got it wrong in Russia a couple of years ago.

So clearly, they are not necessarily the best judge of what is a sustainable plan. If we allow them to determine in secret what the government of Argentina's policy is, we are inviting serious trouble.

Now just to return to the question of the provincial spending which has been raised—and that is the latest thing that people are pointing to—I think we should understand that the provincial spending did not contribute to Argentina's crisis.

There was overspending in the provinces, and it did rise very rapidly in the last couple of years, but it was not absorbed by the central government.

So, for those who were loaning money to the provinces, it is the same as if they were loaning money to California or Illinois in the United States where the Federal Government does not guarantee their debt. Those lenders did not have to loan to them, and we should not allow the Fund or anyone else to just point to the provinces as a problem, or the source of the problem, because the central government of Argentina did not increase its revenue sharing with the provinces while they were increasing their spending.

So this really was a problem of a debt trap. Argentina had a debt that was barely payable going into 1994, and they were hit by a series of external shocks. And I know Mr. Bergsten says, well, they should have cut more out of the budget. They cut 2 percent. According to the IMF, they cut 2 percent in fiscal 2000. That is the equivalent of $200 billion in the United States being cut from our budget in a deep, deep recession.

How much more could they have cut? We could get rid of our $450 billion current account deficit in the United States, if we wanted to, by going through another Great Depression, but that is not how it is going to happen, right? The dollar is eventually going to fall, and that is how it is going to be reduced, probably gradually.

That could not happen in Argentina because they fixed their currency to the U.S. dollar. So you see this was a major set of mistakes that destroyed the Argentine economy, and it is unfair and counterproductive, I think, to try and blame it on the Argentine government's spending as though there were some kind of fiscal policy that might have saved this economy from the disaster that it is facing today.

Thank you.

[The prepared statement of Dr. Mark Weisbrot can be found on page 118 in the appendix.]

Chairman BEREUTER. Thank you very much. You finished in only one second over. Good timing.

Next we will hear, finally, from Dr. Steve Hanke. Dr. Hanke is a Professor at Johns Hopkins University, and President of Toronto Trust Argentina. You may proceed as you wish.

STATEMENT OF DR. STEVE H. HANKE, PROFESSOR, JOHNS HOPKINS UNIVERSITY; PRESIDENT, TORONTO TRUST ARGENTINA

Dr. HANKE. Thank you, Mr. Chairman.

I have prepared some remarks that I would request be put in the record, and I will make just a few comments here particularly motivated by your opening statement as well as some of the statements that your colleagues made.

It is very difficult to make any sense, really, out of this whole Argentine mess: what happened, how to diagnose it, as well as prescribe what should be done.

I think most of the commentary is confused and very confusing. I would commend the current issue of *The Economist Magazine*. They have one of the leaders on Argentina and then a several-page analysis of Latin America. It contains everything but the kitchen sink. If you can make any sense out of it, you can go to the top of the class, I think. And this is just typical of what you have to contend with when you are trying to grapple with the problems.

One example of this, by the way, Mr. Chairman, you mentioned what I call the overvaluation story. Some of my co-panelists have also alluded to it. Argentina tied the peso to the dollar in 1991. The dollar appreciated, was very strong; the peso became overvalued, the economy became uncompetitive.

The problem is, the story just does not hold water. It is an interesting story. It has been repeated ad nauseam. But to be uncompetitive, your exports have to be weak and declining.

Ever since 1991, in each full year, with the exception of 1999, exports have grown in Argentina. And in fact, in the first 11 months of last year exports increased by 3.2 percent. Last year, world trade only went up 9/10ths of 1 percent in the world.

So the relative performance of Argentina on exports has been very good. In fact, if the economy would have been growing at the rate exports have been growing, that debt service burden probably would not have overwhelmed them in the end.

So you can cut the overvaluation story a number of different ways. If you want to get, shall we say, more scientific, we can use the Big MAC Index, and the Big MAC Index said in 1999 that the peso was overvalued by 3 percent. In 2000, it was not overvalued or undervalued. In 2001, it was undervalued by 2 percent.

But, that did not stop *The Economist Magazine* from producing 26 major articles in that timeframe in which they claimed that the overvalued peso was making the economy uncompetitive and dragging the economy down in Argentina.

So, those are the kinds of issues, and we have a long list, that we really have to get through if we are going to analyze Argentina.

What made Argentina unique, I think, has really been missed. That is, their monetary setup really was unique. The U.S. dollar was legal. The peso was legal. They circulated in a bi-monetary system at a 1-to-1 exchange rate. That was one part of it.

The other part that made it unique is that the peso holders had property rights in U.S. dollar reserves held in safekeeping by law by the central bank. Those were the two aspects that really made the system unique.

This means that the devaluation is not a normal devaluation in Argentina. It was a totally unique devaluation. It was not Brazil. It was not Russia. It was not Southeast Asia. What made Argentina's devaluation atypical was that the peso holders had property rights in those dollars that were backing—100 percent—the pesos that were outstanding.

And when you did away with the convertibility system, you did away with those property rights to the tune of $17.8 billion. And, Mr. Frank, this is the issue of the rule of law and why you do not have any respect for the politicians in Argentina. They have sticky fingers and a long history of sticky fingers. So when you did away, through the devaluation, you really confiscated $17.8 billion worth of property.

But of course, then we have gone on with pesofication of the economy. That has also rapped the rule of law on the fingers and created this governance problem and democracy problem.

To have democracy, Mr. Frank, you have to have the rule of law. And of course, they do not have this in Argentina now. With the pesofication, what do you have?

Loans were pesofied. This meant the banks lost $23 billion. Deposits were pesofied. This meant that depositors lost $12 billion and banks gained, of course, $12 billion.

And also in the middle of the night, the central bank sent out armored cars and confiscated, seized, $1.6 billion in federal reserve notes in the banks.

In addition to that, you have had many contracts that have involved U.S. citizens and U.S. corporations that have been torn up in the process of pesofication.

Now as far as the IMF's role, let me just quickly go through that.

From 1990 to 1994, GDP grew on a per capita basis by an amazing 72.8 percent. This is when they put the convertibility system in and did some of the big privatizations. The IMF had virtually nothing to do with that.

Post-the Mexican peso crisis in December of 1994, the IMF became very involved, and reforms, in effect, stopped in Argentina.

In 1999, President Menem wanted to dollarize the economy and fix the currency problem once and for all. The IMF poured cold water on that.

In 2000, de la Rúa came in, and the IMF, in the middle of a slump, encouraged three very large tax increases. And these tax increases put Argentina in a very unusual situation with a large and mounting tax wedge the difference between gross labor costs and net wages. In other words, this is how much labor gets taxed: 42 percent. There is only one country in Europe where the tax wedge is higher—that is France at about 43 percent. This is almost double the tax wedge in the United States.

Then you wonder why unemployment is so high and the underground economy is so vibrant.

Then in 2001, as the situation went out of control, the IMF essentially turned a blind eye to the whole thing. The meddling with the convertibility system, the further tax increases in the middle of a recession, and meddling with a monetary system that had the effect of tightening monetary conditions. So you tighten monetary conditions and increase taxes in the middle of a recession.

So what shall we do?

Many people think that the move toward floating has been a good thing and they heap praise on it. I do not think we are going to see the peso floating on a sea of tranquility. We have had a long history of sinking pesos.

I think, in closing, it is very interesting that, thanks to Congressman Frank, Under Secretary Taylor finally fessed up that the best thing they should have done—and what they should have done in early December—was to dollarize the economy to give it a positive confidence shock.

I think it is too bad that these things were not articulated by the Administration in a clearer game plan that could have been somewhat helpful in the situation in early December, but in any case, what they should do is dollarize the economy, point number one.

And point number two, the U.S. Government should respect U.S. laws. If you look at Title 22, various provisions in the U.S. Code, it states that if property is seized or contracts are nullified in a foreign country involving U.S. citizens or U.S. corporations, U.S. foreign aid should not be forthcoming and the President should instruct the executive directors of the IMF, World Bank, and Inter-American Development Bank to vote no for any disbursements from those organizations to the country involved in trampling on the rule of law and property rights.

Thank you.

I know I went over, Mr. Chairman, but I will shorten it up in the Q&A session.

[The prepared statement of Dr. Steve H. Hanke can be found on page 129 in the appendix.]

Chairman BEREUTER. That's all right.

The three of you went over equally. Actually, we could probably stand back and just let you throw verbal arguments at each other, but I am going to recognize Chairman Oxley for 5 minutes, and the 5-minute rule will proceed in the normal fashion.

Mr. OXLEY. Thank you, Mr. Chairman. I appreciate that.

It is tempting to follow that advice and just have a jump-ball here among our distinguished panelists, and we may get to that if I have time.

Let me ask you, Secretary O'Neill was here last week, Thursday, and testified regarding contagion. He basically pointed out that in his estimation contagion is simply a man-made phenomenon and that he saw little if any contagion with other countries because of the Argentina crisis.

I am wondering if our panelists agree with that assessment from Secretary O'Neill? Or is it perhaps too early in the game to make that kind of a statement?

Let's try Dr. Meltzer and then move on down.

Dr. MELTZER. Well, sir, it has been a very interesting experience, because not only, as Fred Bergsten has said, has Mexico received an inflow of capital, but Peru went to the capital markets and was able to borrow at 9 percent interest for 10 years. It is the first time they have been in the capital markets in 70 years. They did that after the Argentine crisis, just 2 weeks ago.

Brazil has been cutting its interest rates. In all the countries in that neighborhood, for example Chile, most of those countries have not had a problem. And the reason for that, I believe, goes to the fundamental part of what contagion is about.

Contagion was big in Asia because there were many countries that had similar problems, or appeared to have similar problems. It is just like the experience we are having right now.

People look at Enron and say it has a bad balance sheet. They then go to look at all the other companies that have bad balance sheets.

When they looked in Latin America, they saw that most of the other countries did not suffer from the Argentine problem, and that is why they left them alone. And, in fact, in many cases they received more capital, or they have been able to borrow in the capital markets. So no contagion.

Mr. OXLEY. OK. I knew Enron would come in here somehow.

Dr. Bergsten.

Dr. BERGSTEN. As I said in my testimony, I agree with Secretary O'Neill on this one. I think there are three basic reasons why there has not been contagion in this case.

First, the markets do differentiate better, partly because of greater transparency in the markets, and better information in them.

Second, because the countries in Latin America in particular have strengthened their banking and financial systems so they do not have the same underlying structural difficulties that was the case even 5 or 6 years ago.

And third, the move to floating exchange rates, which does provide a very important buffer.

There was one other important reason for the contagion in Asia, and it was certainly man-made. It was the role of the Japanese banks. It is still not widely known that the Japanese banks were the major source of contagion in Asia. When the Thai crisis hit and weakened the already weakening balance sheets of the Japanese banks, they then pulled their loans out of other countries in the region—out of Indonesia, out of Malaysia, out of Taiwan, out of Korea.

The contagion from the withdrawal of Japanese bank funds went right around the horn of the region and was an important factor in the contagion. Fortunately, we do not have that now, for the reasons I indicated, and I think that is likely to continue. I do not think it is a transitory phenomenon.

Dr. WEISBROT. Well, you might actually get agreement here. If you put all the economists end to end around the world, they are never supposed to reach a conclusion. But I think on this one there is basic agreement.

The only thing I would add about the—and I think O'Neill was right about this, too—is if you look at the contagion from Asia to Russia and then Brazil in the 1998-1999 crisis—well, it actually started in August of 1997—that was really the profound irrationality in the financial markets.

The part that Fred just described that's different: That is the Japanese banks pulling out their loans. But, investors pulling their money out of Brazil after the Russian devaluation is more of just an irrational phenomenon where they looked around and they said, "Well, where is the next emerging market that other investors might think is in trouble?" even if there was no solid economic basis for that.

So, that kind of thing is really fundamentally irrational. It is part of the functioning of financial markets. It could happen again, but it does not look like it is happening here now.

Dr. HANKE. I think one reason that we have not realized a lot of contagion from Argentina is their unique currency board like convertibility system. It is an extremely tough system that, in fact, surprise, did not fail.

They had 100 percent reserves covering the monetary liabilities of their monetary authority at the end of the day when they threw in the towel.

Usually when we have contagion motivated by an exchange rate crisis, what happens? The central bank loses all of its reserves. It cannot defend the exchange rate anymore. And the thing blows up. This was the Asian case. This was the Russian case. This was Brazil, and so forth.

If we want to really eliminate the possibility of contagion being motivated by foreign exchange rate problems, we should dollarize these emerging market economies. We should not be floating. Floating is not the way to go.

If we look at Argentina, they had a central bank. It was established in 1935. The peso has depreciated against the dollar by a factor of 6 trillion since 1935. They have had one crisis after another with the only decade of exception being the decade of convertibility.

So, if you think that a floating exchange rate is going to solve your problem, I think you are whistling in the wind, given the Argentine case. You can anticipate all kinds of problems and chaos, and ultimately, I think, official dollarization will see the light of day.

We know everyone prefers dollars in Argentina, and you have a lot of unofficial dollarization, and will see more of that. I think ultimately when they really hit the wall they will go to official dollarization.

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman BEREUTER. Thank you, Mr. Oxley. I say to the Chairman and all Members that since the House is not going to be voting until 6:30, we will not be interrupted. That is the positive side. So we can proceed with the second round of 5-minute questions, if that is the desire. I think it is probably desirable.

The downside, of course, for witnesses' information and for the audience, is that we do not have many Members back yet until 6:30.

The gentleman from Vermont is recognized under the 5-minute rule.

Mr. SANDERS. Thank you, Mr. Chairman.

I do not claim to be an expert on Argentina, but I find this discussion to be extremely curious. In Nicaragua today, which is a small Central American country, unemployment, I think at last I heard, was 60 or 70 percent. Nobody really cares anymore. Left-wing government is gone. The *New York Times* does not care. It doesn't matter. People go hungry. It's OK.

I suspect that the situation economically in Guatemala, El Salvador, total disaster. Who cares? Doesn't matter. Poor countries.

Suddenly there is great concern about Argentina. And I detect a bit of arrogance on the part of some people. Some people suggest Argentina is a bad country. They do not respect the rule of law.

Well, all of us believe in the rule of law. But that is what they do. And yet, billions of dollars have been invested in that country by very, very smart people—by U.S. corporations, by banks, by all these people, in a country that does not respect the rule of law.

So what interests me, first of all, is why all this interest in Argentina? Are you guys worried about the children in Argentina today who are hungry? Are you worried about the educational system, which is collapsing? Are you worried about the health care system in Argentina? Are you really worried about the people in Argentina? Or maybe, just maybe, is there something else involved in here?

I think Dr. Hanke was perhaps most up front about this when he talked about how the IMF should perhaps not fund countries which do not respect the rule of law and are doing terrible things to American corporations.

So, are we here because we are interested in protecting the investment of American corporations? Or are we concerned about the people of Argentina?

Now again, I do not claim to be an expert on Argentina. I am aware that there has been massive corruption in that country, as well as other countries around the world. So what? So what? Why do American taxpayers or American citizens stay up nights worrying about that? That is their business.

But, I detect that all of this interest in Argentina really has to do with something else. Not the people of Argentina, but corporate investments and the need to protect those investments.

Now in that regard, I note that an article, March 2nd, Knight-Reiter Tribune News Service, quote: "After more than 18 hours of debate, the lower house in Argentina passed and sent to the senate a budget that slashes spending by 14 percent compared to 2001 levels."

Now, my guess is that will mean less health care, less education, less affordable food, and other basic necessities of life.

Question to all of you: What is the reason for concern about Argentina? Is it the people of Argentina? Or is it American corporate investments in Argentina and the dangers that they are incurring?

And second of all, in your economic judgment, if a country in the midst of a major depression cuts spending, unlike what we do when we have a recession, how will that impact on the poorest people in that country?

Let me start off with Dr. Weisbrot and then go to the others, please.

Chairman BEREUTER. Try to answer the gentleman's questions, both of them, but we need to be relatively brief.

Dr. WEISBROT. Sure.

Chairman BEREUTER. For all of you. I understand.

Dr. WEISBROT. Obviously, we are concerned about the people of Argentina. I have written recently about Nicaragua and the situation there as well. They are the only country in Latin America whose income per person is lower than it was 40 years ago.

There are also a lot of failed policies promoted by the IMF and the Bank in that country. These policies had something to do with its decline.

When I was there, I spoke with a doctor who is running a health clinic in the neighborhood of Matanza, which is about 26 kilometers outside downtown Buenos Aires, and he told us that the malnutrition rate among children there was about 30 percent. The infant mortality rate was about 35 per 1000, which is very high.

He said everything was getting worse because hospitals were running out of supplies. It is a very severe crisis. It is affecting the poor, and I think it is horrible that the government is cutting their hospital budgets.

I have not focused on the human side at this hearing, because I think the economic side is what people here need most to understand, because it is because of the widespread misunderstanding that our government is supporting, and, in fact, the IMF is pressuring, the government of Argentina right now to make those budget cuts.

I feel that is wrong from an economic point of view, and it is terrible in its impact on the people there.

Mr. SANDERS. Thank you.

Dr. Meltzer, in a country in which children are suffering from malnutrition and their economy is collapsing, is it your economic judgment that they should cut back on subsidies for food, health care, and education?

Dr. MELTZER. I think those are questions that are best left to the government of Argentina.

Mr. SANDERS. Really?

Dr. MELTZER. Yes.

Mr. SANDERS. But, what we are talking about here is the power of the IMF over that country. Can that country make decisions independently anymore?

Dr. MELTZER. In fact, that's, I believe, what we have been fighting for, is to give those countries—put them in the position where the IMF does not dictate to them, where the World Bank does not dictate to them, but where they choose their own policies.

I want to say that in response to your question, I do not share the dichotomy that you have set up. I do not think that there is a conflict between American corporations and local people.

American corporations in most places are one group among many foreign corporations. There are many, many Spanish corporations, and indeed, many more Spanish dollars invested in Argentina than American dollars invested in Argentina.

What was the Argentine government's first response? It was to put a tax on the foreign corporations in order to pay for the mistake, in my opinion, that they made in adjusting the banking system. That was a mistake. They blew a hole in the banking system, and then they said, "Well, we will just make up that money by taxing oil companies."

Now, you may think that is a good idea. Let me just say the immediate reaction of the Spanish government was, "we are going to protect our corporate citizens." So they went to Argentina and they negotiated that down, and that left a hole in the banking system.

Mr. SANDERS. No, no. I am not saying whether it was a good—it does not sound to me like good economic policy, but the point is——

Dr. MELTZER. It wasn't good any kind of policy. It was a stupid thing to do.

Mr. SANDERS. Let's assume that if you were an advisor to the Argentine government you say "this is a stupid thing to do." What does this have to do with the average middle-class taxpayer in the United States that the Argentine government does stupid things?

Dr. MELTZER. Let me answer it this way. I think that there is a human problem, and I talked about that human problem in my testimony. I think that we have tried hard, and, in fact, even though Fred Bergsten and I disagreed on many things about the so-called Meltzer Commission Report, one of the things we agreed on very much was on the use of grants in place of loans so that we could help people in poor countries, and the President's program has been to push that.

So, I am not against humanitarian aid. I am for humanitarian aid. But in the case of Argentina, we have provinces where 50 percent of the population in the province works for the government.

If you go to an Argentine office, you see obvious signs of overmanning. Just lots of people standing around doing nothing. There is room to cut some of those budgets.

Their tax rates are very high.

Mr. SANDERS. If I could——

Dr. MELTZER. So it is possible to make major fiscal changes without cutting education. That is a democratic decision of the Argentine government.

Mr. SANDERS. Here is my point, and then I will——

Chairman BEREUTER. Just a brief comment, Mr. Sanders, and then we will come back to you.

Mr. SANDERS. Everything you are saying may well be right. So they have a bad government.

Dr. MELTZER. Yes.

Mr. SANDERS. What does this have to do with what the IMF does and whether we punish them or not?

Dr. MELTZER. Well, there are two ways you can go on this, as you and I both understand, Mr. Sanders.

You can say let's give them the money and help them, and allow them to continue to do the things that they do; or take away the money and get them to do some sensible things which will make it better in the future for both the children and the grandchildren of those people.

And people, you and I, can disagree about where the line between those two things are without necessarily disagreeing that both of those cases exist.

Mr. SANDERS. Thank you.

Chairman BEREUTER. We can come back to that if you would like, Mr. Sanders.

I would like to move to Mr. Frank who Mr. Shays is willing to let go ahead of him.

Mr. FRANK. I appreciate it, Mr. Shays.

Chairman BEREUTER. The gentleman is recognized.

Mr. FRANK. I have an ambassadorial appointment I have to meet, and so I apologize, too, because I would have liked to have stayed.

When we talk about cutting back and everything, one of the things—could I ask, some of you are more expert in Argentina than others, and maybe I am missing something—is Argentina under any significant danger of attack?

Does anybody know of any physical enemies menacing Argentina?

Mr. BERGSTEN. Mr. Frank, Argentina is sometimes characterized as a dagger aimed at the heart of Antarctica.

Mr. FRANK. Yes, well——

Mr. BERGSTEN. It has no national security threat whatsoever.

Mr. FRANK. That reinforces my view that we should amend the First Amendment and ban the use of metaphors in the discussion of foreign policy.

[Laughter.]

Dr. MELTZER. Yes. But in fact, they have cut back considerably on their military.

Mr. FRANK. Have they cut back on the military?

Dr. MELTZER. Considerably under both the Menem government and——

Mr. FRANK. But, one of the things that bothers me is when I look historically at the outside advice that is given, rarely are military expenditures among the items that other governments and the international financial institutions tell them to cut back. I think that is an indication of the kind of bias. People are told to cut back on other things.

We have many of these poor nations, it seems to me, overarmed, overairplaned, over-a-whole-bunch-of-things, and in the list of items that we are told, I can look at the IMF's list of things in the past and we're hoping to change these, and the military is rarely on the list to be cut back.

Dr. Hanke, do you want to comment?

Dr. HANKE. Yes. I was going to remark that President Menem and President Pinochet sorted out the last real potential conflict that they had on the border with Chile and Argentina in 1989.

Mr. FRANK. Well I——

Dr. HANKE. But at any rate, this gets back actually to your point. You can almost answer your own question. You raised the issue about democracy in your opening statement, and isn't this democracy at work? This is the whole problem with foreign aid. If you give them money, you know what happens.

Mr. FRANK. No, Dr. Hanke, I do not follow that at all. Your restatement of my point I do not recognize. I do not understand how the problem——

Dr. HANKE. Well I——

Mr. FRANK. Excuse me, but it is particularly my turn to say what I said.

I must say, you did seem, to me, disturbed, at least my sense of your reaction was that you were somewhat unhappy with my discussion of democracy——

Dr. HANKE. I agreed with it.

Mr. FRANK. As I was with your definition of it, and I will get to that in a second. But, I do not understand how, if you give them foreign aid, you know what is going to happen. That just does not follow.

In fact, what I am objecting to has been an excessively interventionist position by the international financial institutions and others in which they were told to make changes that I thought were unsustainable, both in terms of raising taxes, and cutting various kinds of spending.

I was struck, because when you responded you seemed to me to define democracy down to basically observing the sanctity of contracts. Now I am all for that. And given John Locke, obviously contract law has a great providence in democratic theory. But you seem to me to restrict it almost only to that, and particularly you said that, well, no wonder there was all this distaste for democracy in Argentina given the way they devalued, and so forth.

But, in fact, we went through three presidents before they got to devaluation. I mean the rioting and the troubles, it was not until Duhalde was in, which was two resignations already, or three, before he became president.

So, I did want you to elaborate on your view. It seemed to me you were attributing the lack of respect for politicians there largely to the failure to recognize the sanctity of contract, and things like economic inequities and people feeling they did not have enough to eat, or unemployment being too high did not seem to count.

Dr. HANKE. Well, those issues do count. I think what you have to do to put the—I was not looking at it in a narrow context—if you go back to the Federalist Papers and look at those, for example, or particularly Hamilton's view on the rule of law, it is really broad-gauged. And so I would put my remarks about the rule of law, governance, and democracy in the context of the Federalist Papers, I believe.

Mr. FRANK. Well, OK, then I would——

Dr. HANKE. Broaden it out——

Mr. FRANK. OK, I would say that I think that is not sufficiently broad today. The people who wrote the Federalist Papers and the Constitution were very smart guys for their time, but I think they had an insufficient understanding of the importance in a modern capitalist society of a more positive role for government.

And I must say, I did kind of detect—let me ask one question, if I could. It is one of the dilemmas I have. Yes, I understand we have got debts that are contracted. They cannot all be paid.

And there has been a lot of focus on the problem of moral hazard of encouraging people to lend improvidently, and I think that is something we have to deal with. But this seems to me one of those dilemmas, because if we are too harsh here, what is the impact on a flow in the future?

How do you deal with the problem of reducing moral hazard without getting to the point where you discourage people from lending in risky situations?

Let me say, if I could have 30 seconds, Mr. Chairman, I see that analogy domestically. Sometimes my colleagues and I object to people who engage domestically in predatory lending, and lending to people who will be too much in debt.

Then the next day we are upset because of red-lining. And if you never do any predatory lending, you will probably get involved in red-lining. Or at least if you do not lend to people who are shaky.

What about that dilemma? How do we deal with the problem of moral hazard without discouraging people in the future in the private sector? I assume we want them to continue to make loans.

Start with Dr. Meltzer.

Dr. MELTZER. Yes. That is a subject I have thought about a lot, because we have proposed various kinds of preconditions. So, one of the ways to deal with that problem is to try to get countries to reform.

We believe that the incentive system, which would occur with preconditions including, of course, one of the preconditions to correct something that Fred said, was that there be fiscal rectitude in a country, or fiscal stability in the country, which Argentina did not have.

So it wouldn't——

Mr. FRANK. Fiscal rectitude. Now we have got from the Federalist Papers to Dickens. You have got to find another word other than fiscal rectitude.

Dr. MELTZER. Whatever. You use the word. But we will both know what we mean.

Let me just say that the bulk of the money that comes to countries comes from the capital markets. Something like 15 to 20 times as much as from the international institutions.

If a country adopts solid policies like Mexico, like Brazil now, like Chile, then they get large amounts of money on much better terms because they are a better country from the standpoint of the lender.

So, the way we deal with the moral hazard problem is, one, we put the responsibility, the onus, on developing the incentive to do that on the country. We want them to choose the set of policies. That was the whole purpose of precondition, that they would choose the policy.

We would not get a laundry list from the IMF about things that countries should do, that maybe they would do and maybe they would not do, and most of the time did not do. What we would get was that the minister of finance of the country would go to his parliament and say "we're going to do this because it is going to be good for our country."

Second, we would get—one of the preconditions was—we are going to have foreign banks in the country. Now we have seen in Brazil, in Argentina, and elsewhere, that that really works quite well.

Third, we want to do something which says let's get less of the money out of the short-term capital market, which is the way the system worked before, and let's get it into long-term lending and private capital flows. That is, foreign direct investment.

Those are ways we reduce moral hazard.

Mr. FRANK. That last point, in particular, is very interesting to me. If you could give us something in writing as to how we could do that.

The last thing is the volatility, getting it into longer term would be a very good thing.

Any of the others?

Dr. MELTZER. I will write to you.

[The reply from Dr. Meltzer can be found on page 115 in the appendix.]

Dr. BERGSTEN. Yes. I would just like to add, I think the moral hazard problem is vastly overstated. It is one of my least worries. This was one of the debates between us on the Meltzer Commission.

There is virtually no empirical evidence that moral hazard has been a source of any of the crises of the recent periods.

If you want to do something about it, one way is to limit the magnitude of IMF support programs. A concern has been that countries, and particularly lenders, will lend excessively, build up excessive risk, because of the fear of an IMF bailout.

Therefore, one remedy is to roll back the size of IMF rescues to the normal kind of quota arrangements, rather than the excessively large packages in the recent past.

A second issue that has now come up is private sector involvement. Mr. Oxley mentioned the IMF proposal for more orderly debt workouts. I happen to support that, not every line in the Krueger proposal, but I think it is the right way to go. I think it does need to be worked out.

The main fear about that is that it will limit the flow of private capital in the future as creditors fear that they might get stuck in a workout position.

I actually think it will work the other way around: A more orderly, regularized procedure will lead to a steadier and probably more proper level of flow, reducing somewhat the huge seesaw—the excessive lending in good days, excessive pullouts on bad days—that I mentioned in my opening statement.

Chairman BEREUTER. Your time has expired. Well, go ahead, but make it a quick one.

Mr. FRANK. Well, I just wanted to listen to what Dr. Hanke said. I have to leave, but I would be glad to hear it in writing.

Dr. HANKE. Related to your moral hazard point——

Chairman BEREUTER. Use your mike.

Mr. FRANK. Microphone.

Dr. HANKE. Related to your moral hazard point, I think it is important that the U.S. enforce and follow its own laws, and that gets back to the U.S. Code Title 22.

If foreign governments engage in activities in which contracts are nullified and property is seized, it is fairly obvious to me, if you look at the Code it should be triggered. And I think that would help reduce moral hazard problems.

Mr. FRANK. I would just add on that, if we got uniform enforcement with the things we have put into the various IFI replenishments about labor rights, and poverty and human rights, maybe I could buy that as a package. But I would not want to see selective enforcement.

Dr. WEISBROT. Could I respond? It is a really good point, I think, and I think first of all the balance now is tipped very overwhelmingly toward bailing out, in terms of the tradeoff, bailing out reckless international creditors. And that is what happened in the Asian crisis, for example, as the Fund basically coerced the governments of Indonesia and South Korea and the others to absorb the debt of the foreign lenders.

I think that is where transparency really comes in. If we could know right now what the IMF is demanding from the Argentine government, for example, we might find out what most of the people that I talk to there believe: that there are some bad things happening involving the guaranteeing of foreign lenders.

Now in terms of striking a balance, capital controls have been shown to be helpful. Chile, for example, used capital controls very effectively and it did increase the time, the average time of investment.

Mr. FRANK. It would be the short-term problem.

Dr. WEISBROT.And finally, we also should have some perspective on what is really being provided to countries when foreign lenders are loaning at 19 and 20 and 25 percent, which has been the average returned in the last year or two. Is there any investment in those countries that is producing a return higher than that?

In other words, is there a net gain to those countries?

I would say in many cases there is not. This is just a speculative bubble of some sort, and it is really a drain on those economies.

Mr. FRANK. But, not forced on them. I mean we do have——

Dr. WEISBROT. No, No, I'm just saying that it is not something——

Mr. FRANK. They make the decisions.

Dr. WEISBROT. We have to worry about if that kind of lending does not continue at its present rate.

Chairman BEREUTER. Dr. Bergsten, very briefly. I want to get to Mr. Shays.

Dr. BERGSTEN. Dr. Weisbrot has twice said that the IMF's demands on Argentina should be made public and I want to pick up Mr. Frank's point about democracy. That is one of the worst ideas I have ever heard because then any proposal they made would have to be rejected by any Argentine government. No democratic government could accept the dictate of the IMF no matter how reasonable it was.

So you cannot make it public.

Chairman BEREUTER. Mr. Sanders.

Mr. SANDERS. That is rather an amazing statement.

Chairman BEREUTER. You will have Mr. Sanders' attention here shortly.

[Laughter.]

Chairman BEREUTER. The gentleman from Connecticut, Mr. Shays, is recognized for equal time. You will probably get about 8 or 9 minutes.

Mr. SHAYS. Well, given that I am going to stay to the end, I do not really care. Thank you.

I am doing a lot of wrestling, because I was grown up by strict parents who say you make obligations, you abide by them. And I happen to, unlike Mr. Sanders, I do not think you can repeal the law of gravity.

By that I mean there are just some basic economic principles that come into play. What I would first like to know is, I do not know what the debt service to their entire budget is, the percent of their entire budget is debt service. What is it?

Dr. WEISBROT. I have that.

Mr. SHAYS. Mas e menos.

Dr. WEISBROT. The percent of their current spending is debt service as a——

Mr. SHAYS. Yes, yes.

Dr. WEISBROT. Let's see. I think it was——

Dr. MELTZER. They pay about an 11 percent average interest rate on about $130 billion worth of debt, and——

Mr. SHAYS. And you are going to make me figure it out. All I want to know——

Dr. MELTZER. Well, I am just trying to do it in my head.

Mr. SHAYS. Why don't you do it in your head and then tell me the answer?

[Laughter.]

Dr. WEISBROT. I can't give you an exact number. I mean all—what I can tell you is that——

Mr. SHAYS. No, I don't even want an exact number.

Dr. WEISBROT. Yes, yes.

Mr. SHAYS. This dialogue means nothing if it was 10 percent of their overall budget. If it——

Dr. MELTZER. It is about 15 percent, maybe.

Mr. SHAYS. Fifty?

Dr. MELTZER. Fifteen, twenty maybe.

Dr. WEISBROT. Yes, that sounds about right.

Mr. SHAYS. That's all?

Dr. MELTZER. Yes, but that is not their problem. The problem, briefly, is it is not the amount of interest payments they have to make, it is those interest payments compared, not to their budget, but to the amount of exports, because the debts are all dollar or euro denominated, and they have to import.

Their problem was that they exported about 8 percent of their GDP, 9 percent of their GDP, and their debt service was something like——

Mr. SHAYS. You know, you've got to talk a little bit slower for me, because——

Dr. MELTZER. They exported 8 to 9 percent of their GDP. That is where they earned the dollars. And they had to pay something like 5 percent of their GDP to service the debt. All right? So that left them very little room for other things.

Dr. WEISBROT. It was even more than that. I mean, it got up to 8 or 9—it got up to the full level of export earnings. So, it basically became impossible for them to pay off their debt.

Dr. MELTZER. Yes. The heart of their problem was not that their debt was so big relative to their economy or relative to their GDP, it was that they did not export a lot, and their exports were going up, but not very rapidly, and they did not have any room to import. Because they had to pay debt service.

Mr. SHAYS. And would you say that the condition in Argentina is a crisis? Catastrophic? Desperate? How would you define it?

Dr. MELTZER. Terrible.

Mr. SHAYS. Terrible doesn't do it for me.

Dr. MELTZER. Just desperate.

Dr. WEISBROT. It is a very desperate situation.

Dr. BERGSTEN. All three of what you just said.

Mr. SHAYS. Yes, that's kind of what I think.

Dr. BERGSTEN. All of the above, yes.

Dr. WEISBROT. It is a severe depression.

Mr. SHAYS. I mean, from the stories I am getting, people who have had assets have seen them wiped out, if they are financial. What I am hearing is that they literally go to the bank and are only able to take out $150 a week.

Dr. MELTZER. That is because of the banking rule. I mean, that is the rule they imposed on themselves.

Mr. SHAYS. And that, basically, there has just been extraordinary capital flight, and that people who have called Argentina their country for generations and generations are leaving.

Dr. MELTZER. Yes. So they are losing not only their money, but their hope.

Mr. SHAYS. They have lost their hope, it appears.

Dr. MELTZER. Yes.

Mr. SHAYS. So, and then I get kind of pulled over to where Barney is, because it just seems to me like the regular rules do not apply.

Yes, sir?

Dr. HANKE. I think that is the point. There are no rules of the game. The whole structure of property rights and the rule of law has completely collapsed.

Now, to show you how catastrophic the situation is, normally, if you have bank runs what happens? People go to the bank and they draw the money they have in the bank out of the bank.

Well, during the bank runs in Argentina, they were running their safety deposit boxes. And the reason they were running their safety deposit boxes is they did not trust the crooks in the government to keep their fingers out of the safety deposit boxes.

So, that is the level you are getting at. And I can tell you, if they continue with this lack of rule of law, no respect for property rights, a floating exchange rate, you are not going to have banks in Argentina for 10 or 20 years. They have had a long history of this.

This is not the first time around for them. Who would put money in an Argentine bank, given what has happened to them in the last 2 or 3 months? There is just no way.

Dr. BERGSTEN. Could I compound your ambivalence in another way? Because, I too have a lot of sympathy for what Barney said. But here is the problem:

Argentina does have to get its fiscal house in order. Your parents were right. Because unless they do, they will fall back into hyperinflation.

The people who lose the most from hyperinflation are the poorest. It is the poorest people that Bernie cares about, and Barney cares about, who will be the victims if Argentina relapses to the hyperinflation of a decade ago.

The fiscal problem is an important part of that and unfortunately, you have to include interest payments. You cannot just say the primary budget is in surplus. Correct, but irrelevant.

So, they have to do fiscal tightening. The question is then: How do they do fiscal tightening?

One huge problem in Argentina is they do not have a tax revenue. They cannot collect taxes. There has been a history of that. So they have to tighten up on the revenue side.

But on the expenditure side, the question is: Do you worry about the safety nets? Or do you go after other things like military spending? You should cut that further. There is absolutely no doubt about it.

But the basic point is that there does have to be fiscal tightening. I pointed out in my statement it should have been done 5, 6, 7 years ago when Argentina was booming. It had this wonderful record we all talked about.

Mr. SHAYS. I am just going to say, to show my ignorance, which I seem to do at hearings, but I learn from it. I do not even know why it even matters if what we are talking about is their ability to export.

Dr. WEISBROT. Could I respond to that? Because I disagree completely. I don't think any country should cut back on spending during a deep depression.

You know there were people who recommended that during our Great Depression, too, and they turned out to be overruled.

Mr. SHAYS. I am going to come back around——

Dr. WEISBROT. I think it's they have a debt problem. That is why I kept emphasizing that at the beginning. Because the IMF kept pouring, piling more and more, arranging more and more loans for them to support the convertibility system as it was falling apart, they ended up with a debt that is completely unpayable. And because interest rates kept rising and they were tightening their budget. They were cutting. As I said, the IMF recognized they cut 2 percent of GDP out of spending in 2000. This is big.

Mr. SHAYS. OK.

Dr. WEISBROT. This contracts your economy.

Mr. SHAYS. My time has run out. I am going to come back for round two. But I am just going to say, the law of gravity works both ways. And if Argentina does not have the capacity, then it ain't gonna get paid.

And so, round two, I will look forward to round two.

Dr. BERGSTEN. Could I just put one fact on the table, because it is very important. The debt-to-GDP ratio in Argentina rose from 23 percent in 1993 to 50 percent last year.

There was a huge increase in budget deficits and deficit spending over this time. They then cut $2 billion out. It was much too late. They should not have done it in the face of a recession. They should have done it earlier.

They got into a position that was untenable, which had to be cut, or else the hyperinflation risk is there.

Dr. WEISBROT. See, that's very misleading. That is very misleading——

Dr. BERGSTEN. All of which was compounded by——

Dr. WEISBROT. You're saying the debt was increased, but it wasn't because of spending by the government. It was because their interest rates and interest payments exploded. Those kept rising. But the government itself was cutting its spending on goods and services——

Dr. BERGSTEN. Well, all this——

Dr. WEISBROT.——And on salaries, and everything else. So they were caught in a debt trap, and the debt was piled on them. What you call being too lenient was actually a curse. It was a terrible thing what the international lenders did to them. They kept piling more debt on them, and that is what happened to them. And the interest rates kept going up——

Mr. SHAYS. Mr. Chairman, you are in charge.

Dr. WEISBROT. Because nobody believed that the currency was going to hold.

[The gavel is heard.]

Dr. WEISBROT. But that was not a spending problem.

Chairman BEREUTER. I want you to go.

Dr. BERGSTEN. The problem was with Hanke and his currency board because that added integrally to what you are talking about. Absolutely right.

[Simultaneous speakers.]

Chairman BEREUTER. The Chairman has not had any time yet, and I am about to take it. I am going to throw out three pieces of red meat here, one of which is the currency board.

Several, or two of you at least, mentioned what we have to be concerned about now after too permissive a policy—I will use that term, you did not use it, I have forgotten what you used—on the part of the IMF.

Now the problem is that we may be too harsh. The IMF may be too harsh. I would like to ask you if they are to have a coherent, consistent economic plan, what will be the indication that it is too harsh?

Second question: Dr. Weisbrot specifically, you said something to the effect that the austerity programs do not work in Argentina because of the particular circumstances. But I would ask you this question: Without such a program, won't Argentina continue to run deficits and never escape from the debt burden it currently carries?

And third: Two or three of you must have something substantial to say about currency boards that Dr. Hanke has discussed. If not, I would be surprised, because I thought there was a major element of controversy between at least some of you.

So, having used only less than a minute to ask my three questions, I would just like to see who wants to tackle any one of those.

Dr. Weisbrot, you are first. I mentioned you by name.

Dr. WEISBROT. If I could take the second one first, because you addressed that to me, you said without austerity won't they continue to run deficits?

This is in the appendix to my testimony. You can see the actual numbers. No, they will not, if they have a moratorium on interest payments, which I think is the least they can do to a country that has reached this crisis at least partly because the Fund encouraged and arranged this borrowing to support an inviable exchange rate regime.

Chairman BEREUTER. Dr. Weisbrot, aren't you concerned at all about the message that sends to other countries?

Dr. WEISBROT. No, I think this is an important thing. First, it sends a message that these institutions are finally for the first time in decades going to take responsibility for their actions.

They were wrong. They made a mistake. And I think most of all—OK, Steve won't agree, necessarily—but everyone else will probably agree that this was wrong, everyone here on this panel, everyone else, and so why shouldn't there be a—we're not even asking for a cancellation here. We are just saying roll over it, restructure it, and the Fund has already agreed to postpone $936 million interest debt service payment for a year.

They need to just say this, and then they can—because what is the alternative? The alternative is to keep cutting the spending of the government during a recession and push it further into depression, and hurt the people who are hurting the most.

Chairman BEREUTER. Dr. Meltzer.

Dr. WEISBROT. This is, to me, completely unreasonable and the alternative of a moratorium is very minimal.

They don't have an overspending problem. They have a debt servicing problem from the past. And this has been true since 1993.

Chairman BEREUTER. I will see if Dr. Meltzer agrees, or perhaps he has another——

Dr. MELTZER. I want to answer your hard question. I will answer the currency board question in a moment.

You asked how do you know when the austerity is too tough. The answer to that question, my answer to that question, the answer of the majority of the Commission was, you put the problem back into the country.

You do not have a bunch of rules sent down from the IMF. You say to the country, "come with your coherent, consistent plan and if it is a good plan, we will support it. But you decide. It is your country and you have to sell, just as you would have to sell here, you have to sell the idea to your constituents that this is the plan that is going to work for your country"; that they have to make some sacrifices now, cut some tax rates, and that would at least—because the tax rates are so high that 40-, 50 percent or more of the transactions take place outside the market economy with no taxes collected.

Chairman BEREUTER. I guess the government policies were being tested rather demonstrably on the streets.

Dr. MELTZER. Right, so those were the bad policies. So do it in a political way. It is a democratic country, and let the people decide through their representatives what it is that they can stand to have.

That is why the Commission majority, one of the problems, get rid of conditionality; put the burden back within the country. All right? Let them decide.

Second, on the currency board very briefly, the currency board is a form of fixed exchange rate. Fixed exchange rates work well. Floating exchange rates work well. They all work well if you have good policies. None of them work well if you do not have good policies.

So my answer is: It was not the currency board that was the source of the problem. It was the combination of the currency board and the policies.

Now, in Argentina, they also had the appreciation of the dollar and the depreciation of the Brazilian real, which made the currency board difficult to sustain. But, they did also add a policy which made their debt unsustainable and threatened their currency board.

Chairman BEREUTER. Was the fact that the four economies had become increasingly more integrated a problem so that when Brazil had its change in currency, this had a greater impact on Argentina?

Dr. MELTZER. Yes, but Argentina only exports about 8 percent of its GDP. So it is not a big integration with the world. It was integrated in the world in another sense in that it depended upon capital flows to build its economy, and those disappeared. That is one of the ways in which the currency board got threatened.

Chairman BEREUTER. Thank you.

Dr. Bergsten, you would like to comment on any of the subjects? And then I will move to Dr. Hanke.

Dr. BERGSTEN. Yes. I, of course, agree that almost always you do not want to cut budgets in a recession. I yield to very few people in having hammered Japan, and even Europe in recent months and years for doing exactly that and making their situation worse.

Chairman BEREUTER. So that would apply to the construction program of highways in this country, too, during a recession, right?

Dr. BERGSTEN. And I certainly agree that the U.S. erred in the 1930s when it cut the budget in the face of the Depression.

However, in none of those cases did the country face a risk of hyperinflation.

Argentina is different from all those cases, because with its history, with its psychology, with its lack of a solid financial underpinning—and there I agree with Hanke—they do face a risk of return to hyperinflation.

Avoiding that requires, first and foremost, a new and sensible and efficient monetary policy. And I think there is some hope that they are headed in that direction. They ought to adopt inflation targeting. They have got a good man now to run the central bank like Brazil did.

But in addition, they have to have a fiscal policy that spends within their means. You do not do it overnight. You do it in ways that protect the safety net, not make it worse. But they do have to bring their fiscal policy back into order.

Let me just say very quickly, we did a major study on currency boards 5 years ago. It went through every case of currency boards that had existed to that time. What it shows is there are two cases where currency boards do make sense. One is in very small, very open economies that essentially do not have autonomy over their exchange rate or monetary policy anyway. The second is in countries that desperately need some kind of external anchor to get rid of hyperinflation. That was the Argentine case.

The problem is that it inherently produces an overvaluation in the currency if left in place over time. You must have an exit strategy to get out of it. Argentina did not. That was the problem. Not being, to put it mildly, a small, open economy, it was not a case for a long-term currency board.

Chairman BEREUTER. Do all of you agree with Dr. Weisbrot's comments earlier that the federal contributions to the provinces did not go up, therefore that was not an increase?

That is contrary to some op ed pieces that have been written, and factually, I do not know which is correct. Do all of you agree with his assessment that on this revenue sharing program it did not go up? Even though they may have been prolifigate in the way they were spending it in the provinces, it was not something that continued to go up?

Is that correct as far as all of you know?

Dr. MELTZER. I don't know.

Dr. BERGSTEN. But I'm not sure it's relevant, because the issue as I mentioned is that the debt/GDP ratio, just to take that commonly used measure, went from 23 percent in 1993 to 50 percent a year ago. it was a huge explosion of domestic, as well as foreign debt.

That included revenue sharing with the provinces. Cuts had to be made somewhere. I am with Mr. Sanders. I do not want to cut the safety net. I would much rather cut the transfers to the provinces for road spending, and so forth, and so forth.

So that, I think, is a very important part of the package. You cannot ignore that, whether it went up or down.

Chairman BEREUTER. I am well beyond my time, too, but if we can take maybe one minute for Dr. Hanke who deserves to speak, and then we will go to Mr. Sanders.

Dr. HANKE. I agree with Dr. Meltzer about letting the country come up with their own game plan.

The problem is, I remain quite skeptical about these possibilities with the current government. They have only had one clear idea. That is, to destroy the convertibility system, to pesofy the economy and get the dollar completely out of the picture officially and unofficially——

Chairman BEREUTER. "They" meaning the IMF?

Dr. HANKE. No, I am talking about the government. So you have to have these policies homegrown. There is no successful reform or economic prosperity program, Mr. Sanders, that has ever been rammed down somebody's throat. These are homegrown. You can go right across the border. There has never been one that has been imposed from the outside.

So, it has to come from the inside. My problem is, the current government completely is on a one-track rampage, getting rid of the dollar. Therefore, they have no ideas about how to go forward.

All their effort has been essentially how to destroy the convertibility system, how to pesofy the economy, and they are left holding an empty bag. They have no idea of what to do, and they are not going to come up with any coherent game plan.

Chairman BEREUTER. We are going to go to Mr. Sanders now, and we will do an 8-minute round for the two of us, or anybody else that arrives.

Mr. SANDERS. What I find interesting about this discussion is I keep thinking the issue is not currency conversation or peso/dollar peg, it is a lot deeper than that.

There have been some statements that Dr. Bergsten and Dr. Hanke have made that disturbed me a lot.

Dr. Bergsten said, basically, if I got it right, if the people knew the truth in Argentina about the IMF agreement with the government, essentially they would be panicked. There would be an uprising. Is that what you said?

Dr. BERGSTEN. No. You totally misunderstand me.

I said that any program that the IMF or an external force published would have to be rejected by the Argentine government——

Dr. MELTZER. In advance.

Dr. BERGSTEN.——In advance, whether it was the perfect——

Mr. SANDERS. Why?

Dr. BERGSTEN. If it was a program——

Mr. SANDERS. Why?

Dr. BERGSTEN. Because, it would be imposed by the foreigners. If you——

Mr. SANDERS. Well, first of all——

Dr. BERGSTEN. ——Designed the program——

Mr. SANDERS. First of all—hold on. Hold on.

Dr. BERGSTEN.——They would reject your program.

Mr. SANDERS. I am asking the questions. Two points.

If that is the case, if you are saying that the average person in Argentina did not want a program imposed by foreigners, then you have got a problem in the first place. Why are foreigners imposing a program on the people? If they do not want to be—that is the first thing.

But, second of all, implicit, the program that the IMF usually imposes works disastrously for the average people. All right? So the truth is, people in Argentina are saying, "Let me see. We're being dominated by big money interests from abroad, and their prescription for us will raise unemployment, lower wages, cut health care and education. Hmmm."

You know what, if I were one of those people, I would say: "Yeah, I don't want that program either."

Now the conclusion is, therefore, we can continue to do this thing in secret so that the people do not know it, or maybe we say this type of negotiation is not good and we should not be doing it.

That is exactly what the issue is.

Dr. MELTZER. But, that is not what is happening.

Mr. SANDERS. Let me finish.

Dr. MELTZER. That is not what is happening.

Mr. SANDERS. Hold on one second. Let me ask Dr. Hanke, who is very concerned about contract law and making sure the governments respect the agreements that they sign, and I think that is fair enough. That is fair enough.

But, American corporate interests have invested billions in Indonesia, and Suharto's corrupt, illegal, undemocratic regime. Now, am I correct in understanding—so we get the record clear, and I want to be blunt on this; I do not want to be rude—you basically represent, as President of which bank?

Dr. HANKE. Toronto Trust Argentina.

Mr. SANDERS. You represent, correct me if I am wrong, people who invest in Argentina? Is that correct?

Dr. HANKE. No. That is an Argentine Mutual Fund.

Mr. SANDERS. OK.

Dr. HANKE. Now back to your question about is anyone——

Mr. SANDERS. Who do you represent in that capacity?

Dr. HANKE. Just a minute.

Mr. SANDERS. No. I'm asking you a question. Wait a minute, you. Who do you represent?

Dr. HANKE. Argentine citizens. Foreigners cannot invest. It is an Argentine Mutual Fund. All our employees are Argentines. All the investors are Argentines.

Mr. SANDERS. OK. Thank you.

Dr. HANKE. Now that gets back to your question, though, about who is concerned about the people. I lose a lot of sleep, I have lost a lot of sleep worrying about people, OK, with a small "p". Our clients are all Argentines. All are families of people who work for me. We have maintained our group. No one has been let loose. We do not want to let anyone loose. They are good people and have been with us for a long time.

So, I do worry about people on that scale, Congressman, but on the larger scale, I worry about the well-being of Argentines when you have a situation where in dollar terms, the GDP per capita has been cut more than 50 percent in Argentina.

They have gone from the highest GDP in Latin America to something that will come in lower than Chile. And I, probably unlike you, think that as the tide goes up, all the boats come up. This is consistent with the work of David Dollar over at the World Bank.

The poor benefit when prosperity is booming.

Mr. SANDERS. OK, but the issue here is: Are we really discussing how the United States and the IMF can improve the standard of living of people in Argentina and other developing countries? Or are we primarily concerned about how we protect the investments of the wealthy and large multi-national corporations?

Now, Dr. Hanke, a moment ago you talked about the rule of law and respect for the rule of law. That is a fair point. I certainly agree with that.

I would point out that the United States today protects the interests of companies that invest in China. Does China respect the rule of law? Billions of dollars were invested in the Suharto dictatorship. Pinochet of Chile, who was recently indicted as a war criminal, is a violator of very fundamental human rights.

The United States Government supported American companies that were investing in there. We invested in apartheid South Africa. Saudi Arabia, we have very close business ties with Saudi Arabia. Are those countries which respect the rule of law for their own people?

Dr. Hanke?

Dr. HANKE. Well, the question is, without making too broad a generalization, I think the standard should be uniform, and that is what the U.S. Code requires in Title 22 that I was referring to.

Mr. SANDERS. I understand.

Dr. HANKE. So, that is all I have to say.

Mr. SANDERS. But, do those countries that I mentioned, does China respect the rule of law? Does Saudi Arabia respect the rule of law?

Dr. HANKE. According to all the studies that have been done, the ranking is rather low in those places and that is why economic growth has generally been lower in countries that have a lower respect for the rule of law and property rights.

Mr. SANDERS. Well actually, China's rate of growth has been pretty good.

Dr. HANKE. China has been an outlier in those studies. But generally, and they are statistically robust, the stronger the rule of law, the stronger private property rights, the more rapid the rate of growth, the higher the level of prosperity.

Mr. SANDERS. But the United States Government has supported many, many countries who do not respect the rule of law. I happen to have real problems with that. I don't want to say I have problems with that, but the recent Administrations apparently do not.

Dr. HANKE. Back to your point, though, about the IMF, getting back so we are on the same wavelength here for a moment, I indicated that in the big boom years of 1990 through 1994 in Argentina, the IMF had virtually nothing to do. They had nothing to do with setting up the currency board, economic policy, and so forth.

The Argentines did it. They had a boom. After the Mexican devaluation in December of 1994, the IMF got in there big time with a lot of policy advice and money and screwed the thing up. And it has been a bloody disaster ever since.

Recently, if the IMF has not given the lead, it has turned a blind eye. So either way you look at it, all these policy errors have either come from Washington, DC, or Washington, DC. has looked the other way when it has been convenient and let them go ahead blundering away with bad policy.

Mr. SANDERS. So your conclusion is perhaps that we should leave them to run their own government, and if people want to invest in it that is fine.

Dr. HANKE. That's right. That's why I say I think we're on the same wavelength on this particular issue.

Dr. MELTZER. May I make a very brief statement?

Mr. SANDERS. Sure.

Dr. MELTZER. I think the IMF is in the process of transition to a system. They are not sending a lot of messages, and they are not sending a lot of conditions down to Argentina. They are sending a message which says come with a plan that is coherent.

The people you should be aiming at, if I may say so, are the World Bank. They are the ones that are down there to do structural reforms. They are the ones that are supposed to be concerned about poverty alleviation. They have a miserable record.

I mean, Congress, the U.S. Congress when it passes the next IDA appropriation, should ask for a performance audit by an independent agency of how the development banks do. Because they have many, many programs and their success rate is awful.

Dr. WEISBROT. Can I say something, too, on this because I really think that if the IMF really wants to let Argentina decide, then they should state publicly what they are asking of the government, and not just say a sustainable plan.

I am kind of shocked sometimes how many people are willing to accept from them, to accept when it is reported in the press that the IMF is holding out for a sustainable plan. Well, what is a sustainable plan?

They did not have a sustainable plan the last few years that the IMF supported them. The IMF has clearly supported many plans that were not sustainable and ended in disaster.

So, why should we just have a blind trust? We question Members of Congress. We question our President. Why should the IMF be taken completely at its word?

I do not accept Fred's idea that the people of Argentina are so blindly nationalistic and irrational that they will reject any proposal from the IMF. If the IMF proposed a moratorium on debt payments for the next 4 years. And in fact they did, right? They proposed——

Mr. SANDERS. Dr. Bergsten, can you respond to that, please?

Dr. WEISBROT.——A moratorium on the first——

Mr. SANDERS. Let him respond to that.

Dr. WEISBROT.——Billion dollars in those loans. The people——

Mr. SANDERS. Dr. Weisbrot, let him respond to that, please.

Dr. BERGSTEN. Sure. I don't mean to single out Argentina. The United States, including its Congress, would reject any dictate to its economic policy from abroad.

Mr. SANDERS. So? Fine.

Dr. BERGSTEN. Therefore, if you are serious about trying to get a better program in Argentina and get a constructive role for the IMF. The last thing you want is for the IMF to publicly say what it is it wants from Argentina.

Mr. SANDERS. You are saying what I said you said. Then it should be kept secret, hidden from the people because the people would reject it?

Dr. BERGSTEN. No. I didn't say——

Mr. SANDERS. Until it is adopted.

Dr. BERGSTEN. No. It shouldn't be kept secret.

Mr. SANDERS. I'm sorry?

Dr. MELTZER. Until it's adopted.

Dr. BERGSTEN. No, no, no. It shouldn't be kept secret until it's adopted either. The IMF should not just publish it and say here is what you must do. That is obviously the opposite of domestic ownership, which we all want.

However, the IMF now publishes on its website all the letters of intent. They leak to the public in every country they negotiate with when it is being negotiated.

There is no secret. It is well known to people.

Dr. WEISBROT. We do not know what they are demanding right now. That is the big problem.

Dr. BERGSTEN. They are not demanding any specifics right now.

Dr. WEISBROT. Oh, come on. How much you want to bet that budget cut had something to do with what they were pressuring the government to do, that 14 percent they cut out of their budget?

Chairman BEREUTER. A little interchange is good, but we also have a recorder here who is probably struggling. We have a disagreement right there, Mr. Sanders, you may have noticed, between——

Dr. MELTZER. More than one.

Chairman BEREUTER. Do you want to resolve it?

Mr. SANDERS. I don't think we can resolve it. Let me finish.

Dr. HANKE. Mr. Chairman, on that point, you see the Administration, neither the Administration nor the IMF has laid out what the general—not the detail of the game plan, but what the general coherent game plan might be. So there has been, I would say, very little direction from Washington, DC. in general.

Now that might be fine, because as I indicated earlier, if you try these top-down approaches you are not going to be able to force something down somebody's throat.

That said, the IMF has been involved. Dr. Krueger did indicate that it was not feasible to dollarize the economy, for example, on the 11th of January, she said this when they were still going through the process trying to figure out what they were going to do.

Dr. BERGSTEN. And she's right.

Dr. HANKE. She is completely wrong, and I have written about this on several occasions in *The Financial Times*. But at any rate, that is not my point, Fred.

My point is that she did intervene. She made a public statement about something that is very sensitive in Argentina. And that is, what kind of currency regime they are going to have going forward.

So maybe that was not some official big blueprint that was laid out in a comprehensive way. It was something that was in the headlines of all the papers in Buenos Aires and had a huge impact on the direction things were taking, and the dynamics down there.

So the idea that the IMF is not intervening, is not saying anything, is just nonsense. It is not true.

Dr. WEISBROT. They are just hiding the things that they do not want people to know about. They are announcing the things——

Dr. HANKE. They selectively take their shots when they want to. And they have an enormous influence, because I can tell you even in the last Administration when Larry Summers was at Treasury in February of 1999, President Menem wanted to dollarize the economy, had proposed it.

Well, it was a little bit ambiguous, but if you read what Summers said, it was technically correct and carefully stated. The headlines the next day in Buenos Aires? "Summers Against

Dollarization." And that almost deep-sixed the thing completely right there. Just a series of headlines.

So, these things are all quite important, and I think we have to be very careful.

Dr. MELTZER. It is my understanding that the IMF is giving no direction to the Argentine government. It is asking the Argentine government to come with a coherent, consistent plan.

When I was in Buenos Aires and talked to people who are now in the government, I presented them with a plan very much like what I have in the paper that I prepared for this subcommittee. But we told them, over and over again, "this is our plan. You have to develop your plan. Here are the problems you have to solve. It is up to you to come up with solutions that are satisfactory within your democratic arrangements."

That is what the IMF—that is the position, as I understand it, that the IMF has taken. They have taken the position of saying that certain things would not be acceptable to them.

For example, a dual exchange rate. A dual exchange rate is a source of corruption. It would be a very bad policy for Argentina.

Now, they did not say you cannot have a dual exchange rate; they said we cannot support a dual exchange rate.

Dr. WEISBROT. Which means they would not get the loan if they didn't get——

Dr. MELTZER. That seems to me to be a perfectly sensible thing to do. Just as any lender has a right to say "we think that your policy is bad and we are not going to lend you money. But we are not going to tell you you cannot do it."

The IMF is taking the position, that kind of position. That seems to me to be a far step forward from where they were 5 years ago, or 3 years ago, where they came in with a blueprint for the country, which often did not work, and that had many, many conditions on it that had nothing to do with the crisis.

Dr. WEISBROT. I agree with Allan that this is a step forward. I mean, it is not like the list of 140 conditions that they gave to Indonesia. But there's still—and that is fine. That is progress.

But, it is still a major problem that they are making demands on this government that are secret and may well hurt the economy very much.

Now, if I could just address the one economic issue I think of importance that we missed, which Fred raised, on the hyperinflation. That was his argument that, even though we would never cut our budget in a depression, that Argentina should.

This is a serious argument. I take that very seriously because hyperinflation is a real danger. But the question is: Do they really need to slash their budget in a depression in order to avoid hyperinflation?

That is a question—that is why I think this discussion should be out in the open and it should not be done secretly and pressured secretly, because that is a tough question. I don't think they have to. And I think if you look at the last two situations like this of devaluations in Brazil and Russia, in both of those cases the Fund said very clearly "you cannot let the currency fall in the first place. You will get hyperinflation."

That was their only reason for supporting these fixed exchange rates to the abyss. And, in fact, they turned out to be wrong. In both of those cases, inflation was very mild and manageable.

Now, I am not saying that is guaranteed here. But one of the problems is, one of the biggest threats of hyperinflation comes if people do not want to hold the peso. And the more the IMF drags out this process, the more likely that risk increases.

Chairman BEREUTER. I would like to thank you, Mr. Sanders.

I would like to finish with three questions that I think might be easy to answer, although there may be disagreement among you.

First of all, Dr. Meltzer, I think you made reference to a liquidity proposal. I do not know if you have that available to us, but if you do I would appreciate knowing more about it. It does not have to be stated at this point, but I would like to see that, if that is possible.

Dr. MELTZER. I would be glad to.

Chairman BEREUTER. Thank you.

Dr. MELTZER. I have it here, and I will leave it with you at the end of the hearing.

[The information supplied can be found on page 117 in the appendix.]

Chairman BEREUTER. Thank you very much.

Dr. Bergsten, I will start with you on this one, and perhaps others of you have an opinion. I would think Dr. Hanke would.

The U.S. and Argentina have a Bilateral Investment Agreement. In your opinion, was this agreement violated when the Argentine government declared that contracts that had been negotiated to be paid in dollars are now to be paid in pesos?

Dr. BERGSTEN. I actually do not have a strong opinion on that.

Chairman BEREUTER. OK.

Dr. BERGSTEN. I have asked my staff, who know about the issue, to research it. We are doing that. If I could send you a note on it in a couple of days, I would like to.

Chairman BEREUTER. All right.

Dr. BERGSTEN. I think it is a very serious question, but I am not sure legally what the implication is.

Chairman BEREUTER. Dr. Hanke, my guess is you do.

Dr. HANKE. I think that they have violated, yes.

Chairman BEREUTER. Other opinions on that question, if you have them formed at this point?

Dr. Meltzer.

Dr. MELTZER. It is a sovereign right.

Chairman BEREUTER. It is a sovereign right to change them, therefore it is not a violation of contract.

Dr. MELTZER. Everyone who lends in those circumstances—it is a violation of the contract, but everyone who enters into those contracts understands that they are entering into it with a sovereign and a sovereign has the power to change the contract after the fact.

Dr. WEISBROT. I agree with that also. I mean it is a change of currency regime. There is nothing they could do.

Chairman BEREUTER. It is not good for future investment climates, at least.

Dr. MELTZER. Indeed, it isn't.

Chairman BEREUTER. The *Washington Post* op ed today noted that a consensus is emerging that the current government after two months in office cannot put together and execute the necessary reforms.

[The article referred to can be found on page 158 in the appendix.]

Is that too pessimistic? Or do you have an opinion you want to share, any of you?

Dr. WEISBROT. Yes, I think that is overwhelmingly too pessimistic. Again, the government is—I want to emphasize this—they are not facing the structural problem that other countries have often faced. They are not overspending except for interest payments. That is the only overspending by the government.

That is not always the case in crisis situations. They also do not have a balance of payments problem, which is another problem that would be much harder to reverse and would take much longer.

So they really only need—I mean, the main thing they need now is to not have to pay these interest payments on the debt until their economy recovers. So that is very different from many of the other crises that you can point to.

Obviously the Asian crisis had different causes, but this is not as much a systemic problem as it is being made out to be. And if I can offer just a slightly——

Chairman BEREUTER. But they do reference the current government. And of course——

Dr. WEISBROT. What——

Chairman BEREUTER. The question is whether or not the current government can do this.

Dr. WEISBROT. Well, they could, but again they would need——

Chairman BEREUTER. And all——

Dr. WEISBROT. They would need some kind of relief from their debt service payments to do it.

Chairman BEREUTER. Ultimately of course——

Dr. WEISBROT. And that's exactly what the Fund does not want to provide.

Chairman BEREUTER. Ultimately, of course, some government will have a plan that is acceptable. It might take a long time.

Dr. BERGSTEN. I might just say that I share the view that it is too pessimistic to write off the current government. They have done some good things, like the deal with the provinces. We will see if it holds. But that is a step in the right direction.

Hanke had his horror list of things they have done, but they faced an untenable situation. They came into the midst of a crisis. They had no money to pay all these debts. How could they not violate contracts? So they had to make some changes.

I think it is too soon to say whether they will be able to pull out of it, but I certainly would not write them off at this point.

Chairman BEREUTER. Our staff is going to have a very interesting and difficult time trying to develop a consensus on this. At least we have not had a dull panel. We've had lots of interaction and lots of disputes.

Dr. MELTZER. May I say to that last question, I am very pessimistic. I am pessimistic not because I think the situation is untenable or unresolvable, but it isn't certainly going to be easy to resolve.

I am pessimistic because most of the moves that have been made by the current government have, many of them have been in the wrong direction. That is, there is a strong tendency, having met with these people and talked to them, there is a strong tendency to want to blame foreigners and to try to extract the solution from the foreigners.

That was the purpose of the tax on oil companies. That was the purpose for the new tax. They came back from Washington. They didn't get the $20 billion they wanted. So they immediately put a tax on foreign corporations.

I mean, that is their view of how to operate. I think with that mindset, it is going to be very difficult for them to come with a package that is going to work.

It is not entirely difficult, nor is it easy to come with such a package, but it is not going to be easy if you start with a mindset that says we are going to try to get the foreigners to pay. And the main question that we get from Argentine radio, television, newspapers, is: Why doesn't the IMF just give us the money?

That mindset has to change.

Chairman BEREUTER. I guess that is what we did the last two times, meaning the IMF.

Dr. MELTZER. Thank goodness we are making some progress with the IMF.

Dr. WEISBROT. I think it is reasonable, because the oil exporters do get a windfall from the devaluation. I don't see anything unreasonable about taxing that.

Chairman BEREUTER. Dr. Hanke, you are going to have the last word on this series of questions.

Dr. HANKE. I remain quite pessimistic about the possibilities of the Duhalde government coming up with something, because what they have to do—it has nothing to do with, I think, these things Mark has been talking about, macro economics and everything. You need a massive confidence shock in a system.

And, Fred, yes there was something they could have done in the middle of the crisis. They could have done what Ecuador did in early 2000, when they dollarized the economy, gave it a huge confidence shock.

They were in the same kind of mess exactly in Ecuador as Argentina. What do you have today? Ecuador is the fastest growing economy in Latin America. The unemployment rate has come down from about 15 percent to 9 percent. 30-day deposit rates have come down from 60 percent to about 3.5 percent.

A complete turnaround in the thing.

So, you have got to come up with something that gives a big confidence shock to the system, and this will be virtually impossible for a government that has ignored the rule of law, destroyed property rights, torn up contracts until there's no tomorrow.

I see virtually no hope that they can pull any rabbit out of the hat at this point in the game, given their initial behavior.

Chairman BEREUTER. Thank you. This panel has been very patient and is very much appreciated. We have let a lot of discussion go on among you, and I think that is appropriate given the sharply different opinions on a few subjects.

Mr. Sherman has just arrived from California, no doubt, and I would say we will put a statement of yours in the record, and if you have a question or two for the record you would like to make in a minute or two, why, you will have the last word.

Mr. SHERMAN. Why, thank you, Mr. Chairman.

My heart goes out to the Argentine people, but I would like to address my questions to how this affects the United States. Let's say Argentina simply renounced all its debt to all agencies of the United States Government and any agency in which we have an interest.

How much does the U.S. Government lose? Does anybody have an answer?

Dr. BERGSTEN. I don't know the amounts.

Mr. SHERMAN. Can it be $10 billion? $50 billion? Does anybody have a guess?

Dr. BERGSTEN. They would be a tiny share of any——

Dr. WEISBROT. It is nothing that big.

Dr. BERGSTEN. It is a tiny share of any denominator you care to put in there. The Eximbank undoubtedly has some outstanding credits.

Mr. SHERMAN. Let me——

Dr. BERGSTEN. The international loans——

Mr. SHERMAN. I have a limited amount of time.

Dr. BERGSTEN. The loans from international agencies are about $40 billion, and the U.S. share is about a quarter of that.

Mr. SHERMAN. So it would be over $10 billion, then?

Dr. BERGSTEN. Somewhere in that range.

Mr. SHERMAN. And what shocks me, and what I hope that this will be a case study of, is why so many agencies are so anxious to loan money to foreign governments that are obviously bad credit risks, but do not want to loan to small businesses, at least in my district, if not in Nebraska, as well. And the way that the too-big-to-fail bailout system, you know, when a bank loses money on a loan to a small business in my district, we don't have hearings here as to how to bail them out.

And the tendency of our Government to insulate banks from moral hazard when they ship tens of billions of dollars overseas leads to some very bad lending decisions. And perhaps the Argentine people have a right to be angry that we loaned—that our financial institutions, or first world financial institutions, made loans to them that were far beyond their ability to repay.

Dr. MELTZER. I think we have made a big improvement. I think the Commission that I headed pushed in the direction that you are talking about. I think we have made substantial progress, because for the first time now we have seen Ecuador, Pakistan, Ukraine, and Argentina where the lenders take a loss.

I think one of the big, big improvements that has come in the last year has been that lenders who lend to sovereign countries now understand a lot more about risk than they did before because the IMF has not been there to bail them out, as they have over the last 25 years.

I think that is a great step forward that is going ultimately to make a much improved international capital market.

Dr. BERGSTEN. Yes, I agree with that. Note that there are huge losses that private lenders and investors are now taking in Argentina. So it is not a bailout to put it mildly.

Mr. SHERMAN. Thank you, Mr. Chairman.

Dr. MELTZER. I mean, they are going to get 20 or 30 cents on the dollar.

Dr. WEISBROT. I agree with that, as well. But I do think that there is still a lot of negotiation taking place, and we do not know how much of those bad loans they are going to force the Argentine government to absorb.

Chairman BEREUTER. Thank you very much, gentlemen. I very much appreciate it. I have not had a chance to talk to all of you ahead of time, but I will come down there and meet Dr. Meltzer, who I have not met yet.

The hearing is adjourned.

[Whereupon, at 3:55 p.m., the hearing was adjourned.]

A P P E N D I X

February 6, 2002

Opening Statement
Argentina Hearing
February 6, 2002
The Honorable Doug Bereuter
Chairman
Subcommittee on International Monetary Policy and Trade

The Subcommittee on International Monetary Policy and Trade meets today in open session to examine the financial crisis in Argentina, including the activities of the International Monetary Fund (IMF) within this country. The Subcommittee will hear from the Undersecretary of the Department of Treasury for International Affairs, Dr. John Taylor, on the subject of Argentina, as the Department of Treasury is responsible for implementing U.S. policy towards the IMF.

The Subcommittee on International Monetary Policy and Trade has jurisdiction over international monetary policy generally and the United States participation in the IMF - - both of which are relevant to today's hearing. This is the first hearing, under my chairmanship of this Subcommittee, which addresses the activities of the IMF as it relates to a particular country. Last year, this Subcommittee focused on the regional multilateral development institutions and the Export-Import Bank.

At the outset, I would like to convey to the Subcommittee Members the sensitive nature of the political and economic situation in Argentina. For this reason, I would urge the Members to not focus on the internal workings of the Argentine government. But, to instead focus on the Argentine policies which are relevant to any future IMF or U.S. assistance to the country.

Before introducing our distinguished witness from the Department of the Treasury, I would like to remark upon the overall fiscal situation in Argentina. At each Subcommittee member's desk, the following two products from the Congressional Research Service (CRS) are provided, which I find very instructive: a chronology of relevant events in Argentina and a recent CRS Report on the Argentine Financial Crisis.

The focus of today's hearing is as follows:

1. recent Argentine political and economic history;

2. the recent economic plan supported by the Argentine Government on February 3, 2002;

3. the recent role of the IMF in Argentina;

4. the recommendations of the Meltzer Commission and its dissenting views as it relates to IMF preconditionality criteria for Argentina; and

5. my general views on the IMF.

First, in order to understand the current economic and political turmoil in Argentina, it is necessary to review recent Argentine history. In 1991, the Argentine Government established a currency board to set the peso's value on a one-to-one peg with the U.S. dollar in order to curb hyperinflation. However, because the value of the U.S. dollar appreciated over the past ten years, it became increasingly difficult for Argentina to export its products. As a result, in 1998, Argentina began its fall into a deep recession. By the end of 2001, Argentina had a total debt of approximately $132 billion.

Furthermore, on November 30, 2001, President de la Rua of Argentina imposed a $1,000 per month limitation on personal bank withdrawals. As a result of this restriction and other austerity changes by the Argentine Government, violent protests broke out and President de la Rua was forced out of office on December 20, 2001. Over the next ten days, there were four different presidents of Argentina, including Mr. Eduardo Duhalde who is currently in power.

When Mr. Duhalde took over as President, he implemented immediate economic reforms. He announced the end of the currency board with its peg to the dollar and his plan for the devaluation of the peso. President Duhalde implemented a dual exchange rate in which the peso was floated for financial transactions, and fixed at a rate of 1.4 pesos to the dollar for foreign trade and certain other transactions. He also continued the freeze of bank deposits in dollars over certain thresholds.

Second, on Sunday, February 3, 2002, the Argentine Government came forth with a new economic plan, which would completely free float the local peso currency and loosen an unpopular freeze on bank accounts. This new economic plan was in part a response to a decision from the Argentine Supreme Court which declared the current freeze on bank deposits to be unconstitutional. To further illustrate the current political and economic instability in Argentina, their Congress is considering impeaching the judges who rendered this decision.

Furthermore, the Argentine Government on February 3rd announced that it would turn all dollar debts into pesos at a rate of one-to-one. This change should help debtors pay back their loans since it will reduce the value of their debt substantially because the floating value of the local peso is at a volatile actual market rate of around two pesos to the dollar. However, both the creditors and the banks will suffer loses because of the pesofication of debt. Furthermore, this economic plan also turns all dollar deposits into the local peso at a rate of 1.4 to the dollar. This devaluation of deposits has angered middle class demonstrators because of their loss in savings.

Argentina declared a bank and foreign exchange rate holiday on Monday and Tuesday of this week to prepare for the new economic measures. The effectiveness and political ramifications of these reforms still remains an open question.

Moving on, third -- it is important to note that Argentina has received extensive assistance from the IMF over the past few years. For example, in March 2000, the IMF agreed to a three-year $7.2 billion arrangement with Argentina. Moreover, in January 2001, the IMF augmented its earlier agreement by pledging another $7 billion as part of a larger $40 billion assistance package which involves the Inter-American Development Bank, the World Bank, Spain, and private lenders. However, due to the fiscal instability in Argentina, the IMF withheld its $1.24 billion loan installment on December 5, 2001.

Fourth, the concept of preconditionality for IMF assistance was endorsed by the majority report of the Meltzer Commission -- a controversial recommendation. I take particular interest in the Meltzer Commission as I am the author of the legislative language, which created this 11-person bipartisan Commission through the FY99 Omnibus Appropriations Act. This Commission, which completed its report in March of 2000, was charged with studying the future of the IMF, the World Bank, and the regional multilateral development institutions. I would encourage the Members and their staff to review both the majority report and the dissenting views of the Meltzer Commission, as I find them very instructive regarding this controversial recommendation.

With respect to the concept of preconditionality for IMF assistance, it appears from press reports that both the IMF and Secretary of the Treasury Paul O'Neill support some form of IMF preconditionality as it relates to Argentina. Examples of preconditionality include the free-floating of the local Argentine peso and the reduction of deficit spending. I do see the merit of a country having a sound economic structure in place before it receives IMF assistance.

However, I also believe that macroeconomic circumstances such as the political and economic repercussions on global stability also need to be taken into account on a case-by case basis by the IMF. A dissenting view of the Meltzer Commission, which Mr. Fred Bergsten of the Institute for International Economics signed, among others, makes this same point. If certain prequalification criteria would have been applied to the 1997 Asian financial crisis (such as with Thailand and Korea), this global contagion may have in fact been worse. As a result of these concerns, I am interested in having Undersecretary Taylor address any degree of regional or global contagion that the Argentine financial crisis might cause or has caused.

Lastly, I would like to offer a few candid remarks on the IMF. A great many in Congress have lost confidence in the IMF. I certainly believe its advice has been both faulty and very dangerous in some instances. Regrettably, I believe that the IMF and the Treasury Department in the last Administration was unwilling to face up to some of its errors and misjudgments in which they exercised a heavy hand. The first step in the process of reform is to face up to recent failures of the IMF and to what I believe has at times been a very serious misuse of its resources. The IMF has been unwilling to do this. The fact is that there were counterproductive IMF policies employed in the early stages of the Asian financial crisis in both Thailand and Korea, treating them like the usual fiscal basketcases which initially they were not. There were also massively wrong-headed loans to Russia, which might better be labeled "Yeltsin loans," and which will be shown, over time, to be part of one of the biggest blunders of the late 20th Century.

At the same time, we, in Congress, need to candidly admit that if we didn't have the IMF or an institution like it, we would have to create one. But we also need to recognize, in reality, that U.S. Treasury has a very large role in greatly influencing and, in reality, practically dictating important IMF policy. The U.S. is, of course, the largest shareholder in the IMF with its 17.16% voting share.

With this background information in mind, I would like to introduce Dr. John Taylor, the Undersecretary of the Treasury for International Affairs, who will, I am sure, assist the Subcommittee in examining these important issues. Dr. Taylor has a very distinguished academic and professional record. He received his undergraduate degree from Princeton University and his Ph.D from Stanford University. He has taught Economics at Columbia, Yale, Princeton, and Stanford Universities. Dr. Taylor also directed the Monetary Policy Research Program at the Stanford Institute for Economic Policy Research. In addition to these academic positions, Dr. Taylor was a member of the President's Council of Economic Advisers during the Administration of President George Herbert Walker Bush. Moreover, he also served in the private sector as an analyst for Alan Greenspan's Wall Street Firm, Townsend-Greenspan, in the later 1970's and early 1980's, where he studied world commodity markets. Dr. Taylor was sworn into his current position as Undersecretary last year.

Dr. Taylor, we welcome you to this hearing. Without objection, your written statement will be included in its entirety into the record. Before your testimony, I turn to the distinguished Ranking Member of this Subcommittee from Vermont (Mr. Sanders) for any comments that he may have.

Opening Statement—*Prepared, not delivered*

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on International Monetary Policy and Trade

"Argentina's Economic Collapse – Causes and Remedies"

February 4, 2002

I would like to welcome Undersecretary John Taylor to the Committee, this being his first opportunity to testify before our panel. I would also like to thank Chairman Bereuter for holding this important hearing on the economic crisis facing Argentina. As the third largest economy in Latin America and a close ally of the United States, Argentina is of great concern to all of the Members of this Committee. A strong Argentina is critical to Latin America and to U.S. interests in this region.

We have been witnessing economic, political and social turmoil in Argentina over the past several months with no definite end in sight. The International Monetary Fund has refused to continue to supply Argentina with financial assistance until a comprehensive and viable economic policy is developed and implemented. This comes after nearly twenty years of IMF involvement in Argentina and over $22 billion in economic aid sent to help finance its economy.

Economic reform is long overdue in Argentina. I am pleased that the government plans to depart from the dual exchange rate and will soon float the peso on the open market. However, I am concerned with some of the other proposals that the Argentine government has proposed in recent days. First, the conversion of dollar deposits and dollar debts to pesos unfairly devalues accounts of individuals and companies that have relied on assurances by the government that their money will be protected. Some economists estimate that this policy could cost the banking industry alone nearly $14 billion. Additionally, early comments by the government that Argentina may move away from free market reforms toward an isolationist approach will not bring Argentina out of its financial constraints; rather, it will prolong the economic hardship by restricting foreign investment and the free flow of capital to this region. I hope that Argentina continues on its reform path and maintains the commitment to fostering free markets.

The Administration stated early last year that it would not continue to support the approval of loans through the IMF to countries that did not undertake meaningful reforms. I applaud that decision. However, in the past year we saw the approval of a $40 billion aid package to Argentina, to which the IMF contributed $7 billion without evidence of critical economic reforms. I am interested in gaining some insight into the Administration's policy on IMF assistance, and when assistance will and will not be provided. I strongly support the Administration's efforts not to provide loans to countries that refuse to adopt sound fiscal policies and believe that we must develop conditions that must be in place prior to aid being approved, I would like to see more predictability in the implementation of this policy. Predictability is critical for the markets, the creditors, and the countries involved.

As the situation in Argentina changes daily, I understand the sensitivity of the situation for both the government and the IMF. I look forward to hearing your views on the current state of affairs and what you think are the key reforms that must be made to bring Argentina back from economic collapse. Thank you again, Mr. Chairman.

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Opening Statement
HON. JOHN J. LaFALCE
Subcommittee on International Monetary Policy & Trade
Hearing on Argentina
10:00 a.m., February 6, 2002

Welcome, Dr. Taylor. It is a pleasure to see you again. The situation in Argentina appears not to have improved significantly since last December when we met in my office. I recall that your assessment of Argentina at that time was frank and direct, and I look forward to your comments today.

For the most part, I am not interested in finger-pointing in terms of laying blame for the crisis in Argentina on the International Monetary Fund or the U.S. Treasury. I think this has been a crisis largely of Argentina's making. Certainly, Argentina suffered from some bad luck in terms of external economic shocks. Nonetheless, much of what went wrong there was the result of bad policy decisions within Argentina.

That said, I am troubled by one aspect of the crisis that does trace back to the role of the IMF and perhaps our Treasury Department. Argentina's decision to maintain their currency board until late last year has to been seen, in retrospect, as a colossal failure. Yet, we didn't even need the benefit of retrospection on this point. When people talk about the slow-motion train wreck in Argentina last year, it is the currency board that they are referring to. That is, observers knew for many, many months that the currency board had become unsustainable, and Argentina's continued efforts to maintain it were drawing the country closer and closer to a financial collapse.

Yet, there is little evidence that the IMF saw fit to urge the Argentine government to abandon the currency board. In fact, Fund officials themselves have suggested that it is the Fund's policy to accept whatever currency arrangement a member country chooses for itself. So presumably, if Argentina had decided to peg the peso to the price of Enron stock, the Fund would have been ok with that.

I am interested in your views, Dr. Taylor, on this particular aspect of the crisis, and where Treasury and the Fund were in terms of offering critical assessments of the currency board over the past 12 to 18 months. It seems to me that Fund officials have not been shy since last December in pointing to the problems with the dual exchange rate system that was adopted as an interim measure in Argentina. This criticism was justified in my view; clearly, the dual rate system was not a good idea, and it is a good sign that the Duhalde government has decided to abandon it. But criticism of the dual rate stands in stark contrast to the lack of similar criticism of the currency board during the previous two years.

Let me briefly comment on next steps in Argentina. Just as this was a crisis largely of Argentina's making, I also believe that much of the hard work toward getting the Argentine economy and financial system back on track will be Argentina's responsibility. At the same time, I believe the United States and the international institutions have an important role to play in supporting reform efforts there.

Resumption of IMF loan support will be critical in the coming months. But more than that, I believe an aid package through the World Bank and the Inter-American Development Bank will be essential to restoring political and social stability in Argentina. As the IMF's own research suggests, financial crises often fall hardest on a country's most vulnerable social groups. In Argentina's case, fiscal reform will be necessary to resolve debt payment problems; but fiscal austerity should not come at the expense of a strong social safety net. The World Bank and IDB can be very useful in this regard, and I look forward to supporting these efforts in the months ahead.

RON PAUL
14TH DISTRICT, TEXAS
FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEES:
VICE CHAIRMAN
OVERSIGHT AND INVESTIGATIONS
CAPITAL MARKETS, INSURANCE, AND GOVERNMENT-SPONSORED ENTERPRISES
DOMESTIC MONETARY POLICY, TECHNOLOGY, AND ECONOMIC GROWTH
INTERNATIONAL RELATIONS COMMITTEE
SUBCOMMITTEES:
INTERNATIONAL OPERATIONS AND HUMAN RIGHTS
WESTERN HEMISPHERE

Congress of the United States
House of Representatives
Washington, DC 20515–4314

203 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225–2831
312 SOUTH MAIN
SUITE 228
VICTORIA, TX 77901
(361) 576–1231
200 WEST 2ND STREET
SUITE 210
FREEPORT, TX 77541
(979) 230–0000

Ron Paul

Statement of Ron Paul

Mr. Chairman, the recent economic difficulties in Argentina provide many valuable lessons for policy makers, both in America and in the rest of the world. Unfortunately, early signals indicate that many are drawing the wrong lesson from this crisis.

In the last several months, all too many commentators and policy makers have pointed the finger of blame for Argentina's economic crisis at deregulation, free markets, and free trade. The logical conclusion of this analysis is that Argentina should embrace protectionism, increased welfare spending, regulation, and maybe even return to the days when all major industry was nationalized. However, those familiar with the economic history of the twentieth century will find this analysis shocking -- after all, if state control of the economy was the path to prosperity, then Cuba and North Korea would be the world's richest countries and leading economies!

In fact, Mr. Chairman, Argentina does not represent an exception to the laws of economics. Rather, Argentina's economic collapse is but one more example of the folly of government intervention in the economy done to benefit powerful special interests at the expense of the Argentine people and the American taxpayer. The primary means by which the federal government forced the American taxpayer to underwrite the destruction of the Argentine economy is the International Monetary Fund (IMF), which enjoys a $37 billion line of credit provided by American taxpayers.

Despite clear signs over the past several years that the Argentine economy was in serious trouble, the IMF continued pouring taxpayer-subsidized loans with an incredibly low interest rate of 2.6% into the country. In 2001, as Argentina's fiscal position steadily deteriorated, the IMF funneled over 8 billion dollars to the Argentine government!

According to our colleague, Congressman Jim Saxton, Chairman of the Joint Economic Committee, this "continued lending over many years sustained and subsidized a bankrupt Argentine economic policy, whose collapse is now all the more serious. The IMF's generous subsidized bailouts lead to moral hazard problems, and enable shaky governments to pressure the IMF for even more funding or risk disaster."

Argentina is just the latest example of the folly of IMF policies. Only three years ago the world economy was rocked by an IMF-created disaster in Asia. The IMF regularly puts the taxpayer on the hook for the mistakes of the big banks. Oftentimes, Mr. Chairman, IMF funds end up in the hands of corrupt dictators who use the taxpayer-provided largesse to prop up their regimes by rewarding their supporters and depriving their opponents of access to capital.

If not corrupt, most IMF borrowers are governments of countries with little economic productivity. Either way, most recipient nations end up with huge debts that they cannot service, which only adds to their poverty and instability. IMF money ultimately corrupts those countries it purports to help, by keeping afloat reckless political institutions that destroy their own economies.

IMF policies are ultimately based on a flawed philosophy that says the best means of creating economic prosperity is through government-to-government transfers. Such programs cannot produce growth, because they take capital out of private hands, where it can be allocated to its most productive use as determined by the choices of consumers in the market, and place it in the hands of politicians. Placing economic resources in the hands of politicians and bureaucrats inevitably results in inefficiencies, shortages, and an economic crisis, as even the best intentioned politicians cannot know the most efficient use of resources.

In addition, Mr. Chairman, the IMF violates basic constitutional and moral principles. The federal government has no Constitutional authority to fund international institutions such as the IMF and it is simply immoral to take money form hard-working Americas to support the economic schemes of politically-powerful special interests and third-world dictators.

The only constituency for the IMF are the huge multinational banks and corporations. Big banks used IMF fund -- taxpayer funds -- to bail themselves out from billions in losses after the Asian financial crisis. Big corporations obtain lucrative contracts for a wide variety of construction projects funded with IMF loans. It's a familiar game in Washington, with corporate welfare disguised as compassion for the poor.

Mr. Chairman, the damage inflicted by the IMF on Argentina is immense and inexcusable. This is yet further proof that the IMF was a bad idea from the very beginning -- economically, constitutionally, and morally. However, perhaps some good can come out of this debacle if it causes Congress to at last rethink America's foolish participation in the IMF. This is why I will soon be introducing legislation to withdraw America from the IMF. I hope my colleagues will join me in working to protect the the American taxpayer from underwriting the destruction of countries like Argentina, by working with me to end America's support for the IMF.

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

Embargoed for Release at 10:00 AM
February 6, 2002

Contact Tony Fratto
202-622-2960.

STATEMENT OF JOHN B. TAYLOR
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL MONETARY POLICY AND TRADE
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

February 6, 2002

Thank you Chairman Bereuter, Ranking Member Sanders and members of the Subcommittee for inviting me to participate in this hearing on the current economic situation in Argentina.

The people of Argentina are facing extremely trying times. Throughout this difficult period, President Bush has made it clear that Argentina is an important friend and ally of the United States of America. We want our allies to be strong leaders of free democracies and free markets. Argentina should be an engine of economic growth in our hemisphere. It is important that Argentina succeeds.

In order to understand the current situation in Argentina, I think it is helpful to begin by reviewing some of the key economic developments in Argentina during the last decade.

The Economy of Argentina in the 1990s

In the early 1990s, the government of Argentina undertook a series of important reforms in economic policy, including monetary policy, fiscal policy, structural policy, and international trade policy. Perhaps most dramatic and immediately noticeable was the change in monetary policy. A highly inflationary monetary policy was replaced by a new "convertibility law," which pegged the peso one-to-one with the dollar and largely prevented the central bank from financing the government's budget deficit by printing money. Fiscal policy was also brought into better control with a decline in deficits. On the structural side, a comprehensive privatization program was implemented through which a number of inefficient state-owned enterprises were privatized. Moreover, barriers to international trade and investment were reduced and Argentina's financial sector was opened to foreign investors.

These market-oriented reforms produced very impressive results. Hyperinflation—which had risen to over 3000 percent—was brought to a quick end by the convertibility law. Economic growth turned around sharply: after falling during the 1980s, real GDP began growing at over 4 percent per year. Investment and exports grew particularly rapidly. The sharp increase in economic growth was even more remarkable given the very rapid disinflation that was occurring at the same time.

However, starting in the late 1990s there were a number of policy setbacks and external shocks which sharply reduced economic growth in Argentina and ultimately led to the financial crises in 2000-2001 and the current halt to economic activity.

First, government budget deficits began to increase, an indication that fiscal discipline had begun to wane. Government spending at the federal and provincial level increased faster than tax revenues. These deficits could not be financed by money creation because of the convertibility law. Instead, they were financed by borrowing in both the domestic and the international capital markets; however, as the government's debt began to rise and raise questions about sustainability of the debt, risk premia rose and increased interest rates. Eventually the higher interest rates put additional pressure on the budget deficit and held back economic growth.

Second, the low inflation of the early-to-mid 1990s turned into persistent deflation which also had negative effects on economic growth. In addition, the currencies of Argentina's major trading partners in Europe and Brazil depreciated relative to the dollar, and therefore relative to the Argentine peso. This effective appreciation of the peso led to a deterioration in Argentina's competitiveness which, along with the higher interest rates, further held back economic growth.

Third, persistent expectations of depreciation of the peso caused interest rates on peso loans to be higher than dollar interest rates. Whenever policy actions were taken that raised questions about central bank independence or about the convertibility law, market expectations of depreciation increased causing domestic interest rates to rise further.

As low economic growth persisted into 2000, concerns began to grow that a vicious cycle of low tax revenues and continued government spending increases would lead to rising interest rates, which would further slow the economy. Following the political turmoil in October 2000 when Vice President Alvarez resigned, Argentina's borrowing costs soared and rolling over government debt became more and more difficult. Renewed plans to reduce the budget deficit brought interest rates down temporarily, but by February 2001 it was clear that further actions needed to take place. The Argentine government introduced a number of policy changes and finally decided to create a rule – the zero deficit law – in the summer of 2001 to try to provide confidence about the government's seriousness in getting its fiscal house in order.

Eventually, however, it became clear that these changes to the budget were not working. Many market participants considered the government's economic plan to be unsustainable, and interest rates on government debt began to increase sharply. By November, it was apparent that the government's debt would have to be restructured and, indeed, President de la Rua took the step of announcing that such a restructuring would take place.

As the restructuring effort was underway, the uncertainty about its impact on the banking system led to increasingly large deposit withdrawals from banks and international reserves began to fall. In order to stop the withdrawals and the decline in reserves, the government imposed severe restrictions on such withdrawals in December. Soon after the restrictions were imposed, social and political protests turned violent, leading to the resignation of President de la Rua and his Ministers.

Economic circumstances in Argentina deteriorated after the imposition of the restrictions on deposit withdrawals. The lack of a functioning payments system led to a virtual halt of much economic activity. The shortage of liquidity is hindering economic growth and underlies much of the social frustration. The Duhalde government, which took over in January, is in the process of gradually removing these restrictions and at the same time moving to a flexible exchange rate system.

It is of course up to the government of Argentina to work out the details of a set of economic policies that will increase economic growth in a sustainable way. Indeed, it has begun to lay out the broad outlines of such a policy strategy in the last few days, and, as Secretary O'Neill said on Monday, we are encouraged that the Argentine Government is taking substantive steps to address its economic problems. In terms of economic policy, the government must still develop a growth-oriented tax system and a lasting budget arrangement with the provinces that is based on realistic assumptions about available sources of non-inflationary financing. The central bank must establish a transparent, rules-based monetary regime that will keep inflation from rising as the convertibility law did in the 1990s. The government must begin discussions to restructure its debt. And banks must be recapitalized so that lending to the private sector can resume, which in turn will strengthen growth, investment, and job creation.

Summary of IMF Programs

During the period of time discussed above, the government of Argentina had several programs with the International Monetary Fund (IMF). In March 2000, Argentina obtained a $7.4 billion IMF program. The Argentine government treated the program as "precautionary," meaning that the government did not intend to draw upon it. However, starting in the summer of 2000, the growing concern in financial markets was that the persistent Argentine recession was setting up the potential for a financial crisis.

In December 2000, Argentina drew on $2 billion from its IMF program, and the next month the IMF approved an additional $6.3 billion for Argentina's program, bringing the total program size to $13.7 billion. As a condition for the January package, the Argentine government agreed to a series of structural measures in the area of fiscal, pension and health care reforms to help develop a sustainable fiscal position in the medium-term and to build investor confidence.

In August 2001, the IMF provided Argentina with a further augmentation of $8 billion. Of this amount, $5 billion was to bolster reserves in the central bank to counter a substantial fall in deposits during the summer. The remaining $3 billion could be used to support a voluntary, market-based debt operation and thereby begin to address Argentina's debt sustainability problem. However, when tax revenues continued to fall short and the government failed to reach an agreement on transfers to the provinces, it became increasingly clear that the government was not going to be able to meet its fiscal targets and had no other sources of financing. This fueled concerns about the government's ability to service its debt, particularly to domestic banks, and eventually prompted an accelerated run on the banking system.

In December, IMF staff determined that Argentina was not going to make its fiscal targets for the fourth quarter that were agreed upon in August and that its program was no longer sustainable. Thus, the IMF could not complete its review and consequently did not disburse a loan tranche in December 2001.

U.S. Policy

Since the Bush Administration took office, we have remained in close engagement with the IMF, the G-7, and other leaders in the region about the financial and political problems that Argentina faces. Moreover, we have and will remain fully engaged with Argentina -- our neighbor, friend, and strong ally. As President Bush has stated and Secretary O'Neill has reiterated, once Argentina has designed a sustainable economic program, we are prepared to support it through the international financial institutions.

Our engagement with the International Monetary Fund and the government of Argentina during the last year should be viewed in the context of our overall approach to emerging markets. During the last four years the flows of capital to the emerging markets have declined sharply, and it has been the intent of the Bush Administration to reverse this trend by reducing the frequency of financial crises of the kind that we have seen in Argentina.

Of course the ideal would be to prevent crises such as the one in Argentina from occurring. This requires not only early detection of policies or of external shocks that could cause crises, but also the resolve to take actions to reverse such policies or counter such shocks. The Bush Administration has encouraged the IMF to strengthen its capacity to detect potential troubles on the horizon, and to be willing to warn countries that are heading down a dangerous path to take appropriate action. Effective communication with markets is also key. And the IMF can be more effective and credible in undertaking these tasks if it focuses on issues that are central to its expertise – notably strengthening monetary, fiscal, exchange rate, financial sector, and debt management policies. In the last decade, the IMF became too involved in matters outside of these core areas.

I hope the emerging market asset class grows much more in the future as the rates of economic growth in developing and emerging market countries rise. But we have to recognize that official sector resources cannot possibly grow at such a high rate that we can continue with very large official finance packages to deal with emerging market debt crises as in recent years.

There will inevitably be limitations on the use of official sector resources. Moreover, in order to reduce bailouts of private investors it is necessary to limit the use of official resources, especially in cases where debt sustainability is in question. We must therefore gradually move in the direction of less reliance on large official finance packages.

An important change has been occurring in emerging markets and we have encouraged this change as part of our approach to emerging markets. Investors are increasingly differentiating between countries and markets based on fundamental economic assessments -- judgments that are facilitated by better information. This differentiation is reducing contagion from one country to another, as exemplified most recently by the relative stability in other emerging markets over the past few months despite the crisis in Argentina. Emphasis on the risk of contagion by the official sector in the past led to the expectation on the part of investors and emerging market governments that the official sector would bail them out. That encouraged excessive risk-taking and gave rise to the very conditions that made financial crises more likely. Changing this mindset has been an important priority, and, I think, an area where we have made some progress.

One important challenge that remains is to explore options to promote more orderly sovereign debt restructurings. The official sector should not encourage countries to default on their debts, but we recognize that restructuring can and will happen in certain cases. At the moment, there is a great deal of uncertainty about the process involved in such restructurings. It is important to find a way such that when a sovereign debt restructuring occurs, it does so in a more orderly manner that treats debtors and creditors fairly and reduces the scope for arbitrary, unpredictable official action.

Thank you again for this opportunity to speak with you. I look forward to hearing your views and answering your questions.

Order Code RS21130
January 31, 2002

CRS Report for Congress

The Argentine Financial Crisis: A Chronology of Events

J. F. Hornbeck
Specialist in International Trade and Finance
Foreign Affairs, Defense, and Trade Division

Summary

Argentina's current crisis resulted from a confluence of events, some external to Argentina's policy process, others directly related to its political and economic choices. Although it is not easy to discern at what specific point in time Argentina's economic situation turned into a crisis, it is clear that by early 2001, political, economic and social events had taken a significant turn for the worse. The following is a summary of these events from before Argentina's adoption of the currency board in 1991 to developments in early 2002. This report will be updated periodically.

Chronology of Events[1]

1980s	Argentina suffers through an extended period of economic instability including the Latin American debt crisis and hyperinflation.
1989	Peronist candidate Carlos Menem is elected President of Argentina and appoints Domingo Cavallo as Minister of Economy. Together they enact a major structural adjustment program including tax reform, privatization, trade liberalization, deregulation, and adoption of a currency board.
April 1, 1991	Argentina's Congress enacts the Convertibility Law, which legally adopts the currency board guaranteeing the convertibility of peso currency to dollars at a one-to-one fixed rate and limiting the printing of pesos only to an amount necessary to purchase dollars in the foreign exchange market. Effectively, each peso in circulation is backed by a U.S. dollar and monetary policy is forcibly constrained to uphold that promise.

[1] The events compiled here are drawn from standard news sources and from documents on the web page of the International Monetary Fund (IMF) at: [http://www.imf.org/].

1991-94	Argentina enjoys strong economic growth and the currency board is considered highly successful.
1995	Following Mexico's December 1994 peso devaluation, capital flows out of emerging markets. Argentina's GDP declines by 2.8%.
May 1995	President Menem is reelected President after convincing Congress to change electoral laws that prohibit a second term.
1995-1999	The U.S. dollar experiences a prolonged period of real appreciation, resulting in similar appreciation of the Argentine peso relative to its trading partners.
1996-1997	Renewed period of Argentine economic growth (5.5% in 1996, 8.1% in 1997), but current account deficit and debt measures worsen.
July 1997	East Asian financial crisis begins.
1998	Financial crisis moves to Russia and then Brazil. Argentina enters prolonged recession in third quarter (still in effect) and unemployment begins to rise.

1999

January	Brazil, facing its own financial crisis, devalues its currency, hurting Argentine exports, 30% of which were traded with Brazil.
September	The Argentine Congress passes the Fiscal Responsibility Law, committing to large reductions in both federal and provincial government spending.
October 24	Fernando de la Rua of the Radical Civic Union (UCR), the opposition coalition candidate, running on a platform to end corruption (under Menem) and the recession, defeats Peronist candidate Eduardo Duhalde for President.
December 10	De la Rua is inaugurated President of Argentina and shortly thereafter seeks assistance from the IMF.

2000

March 10	The IMF agrees to three-year $7.2 billion stand-by arrangement with Argentina conditioned on a strict fiscal adjustment and the assumption of 3.5% GDP growth in 2000 (actual growth was 0.5%).
May 29	The government announces $1 billion in budget cuts in hopes that fiscal responsibility will bring renewed confidence to economy.

September 15	The IMF concludes an Article IV Consultation, the required annual comprehensive review of member country economies.
October 6	Vice President Carlos Alvarez resigns over de la Rua's decision not to replace two cabinet members linked to a recent Senate bribery scandal.
December 18	The de la Rua government announces a $40 billion multilateral assistance package organized by IMF (see below).

2001

January 12	Argentina's continued poor economic performance prompts the IMF to augment the March 10, 2000 agreement by $7.0 billion as part of a $40 billion assistance package involving the Inter-American Development Bank, the World Bank, Spain, and private lenders. The agreement assumes GDP will grow at a rate of 2.5% in 2001 (versus actual decline of 5.0%).
March 19	Domingo Cavallo, Minister of Economy under Menem and architect of the currency board ten years earlier, replaces Ricardo Lopez Murphy, who resigns as Minister of Economy.
June 16-17	The de la Rua government announces a $29.5 billion voluntary debt restructuring in which short-term debt is exchanged for new debt with longer maturities and higher interest rates.
June 19	The peso exchange rate for merchandise trade is priced at a 50/50 dollar-euro peg, effectively allowing a 7% devaluation for foreign trade in hopes of improving Argentina's international competitiveness. Many analysts raise concern over the effects on the credibility of the convertibility regime.
July 10	Cavallo announces a plan to balance budget, but the markets react negatively, expressing lack of confidence.
July 19	Unions call a nationwide strike to protest government austerity plan.
July 29	The Argentine Congress passes "Zero Deficit Law," requiring a balanced budget by the fourth quarter of 2001.
September 7	Based on Argentina's commitment to implement the "Zero Deficit Law" immediately, the IMF augments its March 10, 2000 agreement for a second time, increasing lending commitment by another $7.2 billion.
October	The use of provincial bonds as "scrip" to pay public salaries becomes more widespread as federal revenue transfers decline.
October 14	The opposition Peronist Party wins control of both chambers of Congress in mid-term elections.

November 6	Argentina conducts a second debt swap, exchanging $60 billion of bonds with an average interest rate of 11-12% for extended maturity notes carrying only 7% interest rate. International bond rating agencies consider it an effective default.
November 30	A run on the banks begins, with central bank reserves falling by $2 billion in one day. President de la Rua imposes $1,000 per month limitation on personal bank withdrawals.
December 1	Protests begin over bank withdrawal limitations.
December 5	The IMF withholds $1.24 billion loan installment, citing Argentina's repeated inability to meet fiscal targets.
December 7	Argentina announces it can no longer guarantee payment on foreign debt.
December 13	The government announces that the unemployment rate reaches near record high of 18%. Unions call nationwide strike.
December 14	Supermarket looting begins.
December 19	Rioting spreads to major cities over deep budget cuts. The government declares a state of siege. Minister of Economy Domingo Cavallo resigns.
December 20	President de la Rua resigns in the wake of continued rioting, leaving 28 people dead.
December 21	Congress accepts President de la Rua's resignation. Senate President Ramon Puerta is named provisional president for 48 hours.
December 23	Congress appoints San Luis Governor Adolfo Rodriguez Saa as interim president until elections can be held in March 2002.
December 26	The liquidity standards for banks are relaxed. Rodriguez Saa announces a new economic plan based on: 1) suspension of payments on public debt; 2) new jobs creation program; and 3) creation of new currency (the *Argentino*) to begin circulating in January 2002 and not to be convertible to the U.S. dollar.
December 30	President Rodriguez Saa resigns after continued rioting and loss of party support. Senate leader Puerta resigns to avoid second appointment as interim president. No immediate successor emerges to take over the Presidency.
December 31	The Argentine Congress selects Peronist Senator Eduardo Duhalde to complete December 2003 Presidential term.

2002

January 1	Senator Duhalde sworn in as President. He blames Argentina's economic problems on the free-market system and vows to change economic course. Except for debt moratorium, new economic policies are unclear.
January 6	After the Argentine Congress passes necessary legislation, President Duhalde announces the end of the currency board and a plan to devalue the peso by 29% (to 1.4 to the dollar) for major foreign commercial transactions, with a floating rate for all other transactions. Other elements of economic plan include: converting all debts up to $100,000 to pesos (passing on devaluation cost to creditors); capital and bank account controls; a new tax on oil to compensate creditors for the losses that will ensue; renegotiating public debt, and a balanced budget.
January 10	Government announces it will "guarantee" dollar deposits, but to curtail bank runs, the $1,000 (1,500 peso) limit on monthly withdrawals is maintained and all checking and savings accounts with balances exceeding $10,000 and $3,000, respectively, will be converted to certificates of deposit and remain frozen for at least one year. Smaller deposits have the option of earlier withdrawal by moving to peso denominated accounts at the 1.4 exchange rate.
January 11	The government extends the bank holiday two extra days, while the foreign currency market opens for first time in three weeks. The peso falls immediately to 1.7 per dollar.
January 15	The peso falls as low as 2.05 to the dollar in active trading.
January 16	The IMF approves request for one-year extension on $936 million payment due January 17, keeping Argentina from falling into arrears.
January 17	The government announces that dollar denominated loans exceeding $100,000 will be converted to pesos at 1.4 for fixed rate, deepening the balance sheet mismatch of banks.
January 19-20	Duhalde reverses his decision to guarantee dollar deposits, which will be converted to pesos at some undefined devalued exchange rate.
January 23	The Argentine Senate passes bankruptcy law that would use capital controls to restrict payment of foreign private debt payments through December 2003.
January 28-29	Foreign Minister Carlos Ruckauf visits with Bush Cabinet members to appeal for political and financial support (including IMF assistance) as protests continue in Argentina.
January 30	IMF team meets with Argentine officials, who declare intention to adopt a floating exchange rate in near future. Argentina's Chamber of Deputies

passes controversial bankruptcy law, stripping it of the Senate provision prohibiting foreign debt payments, but other capital controls remain in effect. It retains language allowing conversion of dollar denominated debt below $100,000 to pesos at 1-to-1 rate (benefitting debtors) and suspending creditor action on loan debt defaults for 180 days.

Order Code RS21072
Updated January 14, 2002

CRS Report for Congress

Received through the CRS Web

The Financial Crisis in Argentina

J. F. Hornbeck
Specialist in International Trade and Finance
Foreign Affairs, Defense, and Trade Division

Summary

On January 1, 2002, Peronist Senator Eduardo Duhalde was chosen by the Argentine Congress, after a series of interim presidents, to complete the December 2003 Presidential term of Fernando de la Rua. De la Rua resigned ten days earlier following three weeks of violent protests against the country's failed attempts to reverse its prolonged economic crisis. From 1991 until 2002, Argentina had a monetary system based on a currency board. Although it tamed the country's hyperinflation, it eventually contributed to serious macroeconomic imbalances and the current crisis. The new economic plan is centered on abandoning the currency board and the peso's one-to-one peg with the U.S. dollar, as Argentina moves to a dual exchange rate regime. Restoring Argentina's credibility in the world markets will be as tough as the adjustments needed to address recession, massive debt, and the devaluation. This report will be updated.

Following the resignation of Argentina's President Fernando de la Rua and a succession of failed interim appointments in the aftermath of widespread violent protests over failed economic policies, the Argentine Congress selected Eduardo Duhalde on January 1, 2002 as the new President to finish de la Rua's December 2003 term. As Peronist Party leader, and a former Vice President (under Menem) and Governor of Buenos Aires Province, Duhalde has been a vocal critic of Argentina's market-based reforms. His new economic plan calls for abandoning the currency board and one-to-one peg with the U.S. dollar in favor of a dual exchange rate system based on a highly devalued currency. Other twists include the conversion of much dollar debt to pesos, capital controls, a sharp budgetary contraction, and restructuring of massive foreign debt, all of which portend a lengthy and difficult adjustment period ahead.

Background to the Crisis

The seeds of Argentina's financial and political crisis were planted with adoption of its currency board in 1991, a strategy conceived to fight hyperinflation by putting in place a system that ideally was to have curtailed long-term undisciplined monetary and fiscal governance. Prior to 1991, Argentina had a history of economic and political turmoil that was accentuated in the 1980s by the Latin American debt crisis and repeated failed attempts to establish a credible and effective stabilization program. The election of Peronist candidate Carlos Menem to President in 1990 (and his selection of Domingo

Cavallo as Minister of Economy) inaugurated a period of major structural adjustment including tax reform, privatization, trade liberalization, deregulation, and adoption of the currency board.[1] Congress approved the currency board with passage of the Convertibility Law, which legally guaranteed the convertibility of peso currency to dollars at a one-to-one fixed rate and which limited the printing of additional currency only to an amount necessary to purchase dollars in the foreign exchange market. Effectively, each peso in circulation was backed by a U.S. dollar and monetary policy was forcibly constrained to uphold that promise. By tying its currency and monetary policy to the United States, Argentina was able to achieve its goal of a similarly low inflation rate.

In addition to the monetary restriction, the currency board also required a fiscal constraint because a government deficit would have to be fully covered by debt rather than by printing money (monetized).[2] Therefore, the currency board raised hopes for a credible economic stabilization based on a compulsory monetary restraint and implied fiscal responsibility, both long absent in Argentina. The currency board operated well in the early 1990s. Stabilization brought low inflation and interest rates, attracted new investment, and so spurred economic growth. But its success hinged on continuing strong economic growth and disciplined macroeconomic policies, particularly if it were to weather the inevitable external shock. Three major "areas of vulnerability" were identified from the outset: the fiscal deficit, which had to be tamed to ensure financial stability in support of the currency board; a real (inflation-adjusted) appreciation of the peso, which would lead to international competitiveness (current account) problems; and the high level of external debt, which if unchecked would leave Argentina vulnerable to the vagaries of external capital.[3]

Economic Challenges

Despite these concerns being well known, Argentina struggled to address them. Sustainable economic growth under Argentina's convertibility regime required reducing the fiscal deficit. This was no small task given weak tax compliance, recession-induced revenue shortfalls, and overspending by provincial and national governments. Deficit-induced debt was a key vulnerability, as may be seen in **table 1**. Except for 1999, the consolidated *primary* fiscal balance, which excludes interest payments, was positive after 1996, reflecting Argentina's attempts to control discretionary spending. However, the *overall* balance, with interest, produced a sizable deficit. The difference between the two shows that between 1996 and 2001, interest payments alone ranged from 2.5% to over 5% of GDP. The foreign component of debt was equally dismal, as seen by the external debt service ratio rising from 30.2% in 1995 to 84.4% in 2001. Argentina's finances were spinning out of control. Continued support from the International Monetary Fund (IMF) and other creditors was done with the assumption that Argentina's economy would resume

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[1] More on the reforms of this time can be found in Wise, Carol. Argentina's Currency Board: The Ties That Bind? In: Wise, Carol and Riordan Roett, eds. *Exchange Rate Politics in Latin America.* Washington, D.C. The Brookings Institution. 2000. pp. 96-99.

[2] See: CRS Report RL31169, *Argentina: Economic Problems and Solutions*, by Gail Makinen.

[3] Dornbusch, Rudiger. Progress Report on Argentina. In: Dornbusch, Rudiger and Sebastian Edwards. *Reform, Recovery, and Growth: Latin America and the Middle East.* Chicago, University of Chicago Press. 1995. pp. 224-29.

growth at very high rates, the excessive optimism of which became increasingly clear as Argentina entered a recession in mid-1998 that has stretched into 2002.

Table 1. Argentina: Selected Economic and Financial Indicators

	1995	1996	1997	1998	1999	2000	2001*
GDP Growth (%)	-2.8	5.5	8.1	3.8	-3.4	-0.5	-1.4
Inflation - CPI (%)	3.4	0.0	0.6	0.9	-1.2	-0.9	-0.6
Unemployment Rate (%)	16.4	17.2	13.1	14.3	14.2	15.0	18.4
Consolidated Overall Fiscal Balance (% GDP)**	-2.3	-3.2	-2.1	-2.1	-4.2	-3.6	-3.7
Consolidated Primary Fiscal Balance (% GDP)***	-0.4	-1.1	0.3	0.5	-0.8	0.5	1.5
Current Acct. Bal.(% GDP)	-2.0	-2.4	-4.2	-4.8	-4.2	-3.2	-2.9
Debt Service ratio (%)#	30.2	39.3	50.0	57.5	75.8	76.6	84.4
Terms of Trade Change	0.3	7.8	-1.2	-5.5	-5.9	10.4	-0.6

* = estimate. Sources: IMF web site http://www.imf.org
** Consolidated budget includes federal and provincial government budgets, trust funds, and capitalization of interest. *** Primary balance does not include interest payments.
# Interest and principal repayments on external debt as a percent of exports of goods and services.

A peso appreciation issue also arose. It began with Argentina's relatively higher inflation rate compared to the United States, but became a serious issue when the U.S. dollar appreciated from 1995 to 1999, meaning that the Argentine peso also appreciated relative to currencies of its trading partners. Argentine exports became less competitive, and imports a bargain, as seen in the deteriorating current account deficit. Argentina's competitiveness was further eroded by the Brazilian devaluation in January 1999, diminished terms of trade due to falling commodity prices, and rising interest rates. By the late 1990s, the real appreciation of the peso, budget deficit, and growing external debt, combined with inhospitable external factors such as rising interest rates, financial crises abroad, and finally the global downturn in 2001 all served to compromise Argentina's current account, budget deficit, and debt position (see **Table 1**).

Argentina's policy decisions were also critical to its economic undoing. Two factors bear elaboration. First, details of the consolidated fiscal deficit show that budget deficits plagued both national and provincial governments, eventually undermining credibility in the country's overall fiscal policy (and by extension the convertibility regime).[4] Second, Argentine exports became extremely dependent on the Brazilian market after creation of Mercosur (Mercado Comun del Sur–Southern Common Market) in 1991. From 1991 to 1998, Argentine exports to Brazil grew nearly four times as fast as to the rest of the world, with Brazil eventually having 30% of the Argentine export market. Brazil's financial crisis and sudden abandonment of its pegged exchange rate in early 1999 exposed this vulnerability and caused Argentine export revenues from Brazil to plunge by 28%, compromising its ability to service its debt, balance its budget, and meet the macroeconomic constraints needed to support the currency board.

[4] See: Wise, Carol and Manuel Pastor. From Poster Child to Basket Case. *Foreign Affairs*, November/December 2001, p. 6.

By 2000, with the recession in its second year, Argentina faced a major adjustment problem, creating a policy conundrum that was centered in the inherent constraints of the currency board. In countries with flexible exchange rates, a persistent current account deficit that is not financed by capital inflows would force the exchange rate lower, correcting any currency overvaluation, improving competitiveness, and hence, restoring balance. Given that Argentina's nominal exchange rate could not move, its only option was to allow dollars to leave the country, thereby reducing the money supply, and causing domestic prices to fall (a de facto policy of deflation).[5] This could take years to restore competitiveness to a new growth equilibrium and hence the severe social cost to such a policy, Argentina's deepening recession and high unemployment. The constraints of the currency board kept Argentina from fighting its lingering recession with either a strong fiscal stimulus or expansionary monetary policy, as the United States did in 2001. In fact, the consensus policy recommendation was to do just the opposite and tighten its fiscal position to address concerns over its mounting debt and overall fiscal credibility. In short, Argentina had no way to address both problems of debt and economic growth simultaneously and still maintain its currency board.

Unable to address basic economic problems, President de la Rua, again guided by Minister of Economy Domingo Cavallo, opted for increasingly novel and desperate measures to meet pressing short-term financial commitments to shore up the convertibility regime. In June 2001, $29.5 billion of short-term debt was exchanged for new debt with longer maturities and higher interest rates. It was assumed that the return of strong economic growth would allow Argentina to cover the higher debt service. Argentina then engineered an effective 7% devaluation of the peso for foreign trading, in hopes of improving Argentina's competitiveness, presumably without compromising the currency board, which many observers doubted.

As liquidity became tighter, both the federal and provincial governments began using their bonds as a form of script to pay public salaries, which effectively circulated as currency in the economy, further undermining the monetary system. Argentina's last hope for financial recovery rested on the debt swap announced in November 2001. The federal government had some $132 billion dollars in debt ($95 billion in bonds). The proposal called for $60 billion of bonds to be refinanced as a tax-receipt guaranteed loan, lowering the average interest rate from between 11-12% to 7% and extending the maturity of the notes by three years. The expected $4 billion in savings was to be used for a fiscal stimulus. The savings proved to be much lower and all the above measures taken together did not allow Argentina to meet the fiscal targets promised in its IMF program. This finally led to the IMF refusal to extend a $1.3 billion draw scheduled for December 2001.

The November debt swap also strained credibility with private international lenders, who labeled it a "distressed exchange" and treated it effectively as a default. In December 2001, Argentina found itself cut off from international financial markets, both public (official) and private. As confidence in the peso waned, there was a flight to dollars and international reserves fell by over $4 billion in November. President de la Rua responded with a decree limiting individual cash withdrawals to $1,000 per month, setting off the violent protests that culminated in his resignation on December 20. Following a

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[5] Makinen, *Argentina: Economic Problems and Solutions*, p. 3

succession of unsupported interim presidents, the Argentine Congress turned to Eduardo Duhalde at the new year to be the next President.

The Role of IMF

Argentine attempts to deal with its financial difficulties included an ongoing relationship with the IMF. As **Table 2** suggests, Argentina is no stranger to the IMF. Since the Latin American debt crisis in the 1980s, Argentina has tapped the IMF repeatedly, and in general, for increasingly large amounts of money. Argentina's current IMF stand-by arrangement was requested shortly after the President de la Rua took office in December 1999. The IMF approved a three-year agreement on March 10, 2000 for $7.2 billion (SDR 5.4 billion), replacing the extended arrangement in place since February 4, 1998. The credit was conditioned on a strict adjustment in fiscal balance based on the Fiscal Responsibility Law passed by the Argentine Congress in September 1999. Included was a reduction in transfers to provincial governments and their commitment to engage in budget cutting with the federal government as part of a broader revenue sharing reform effort. The arrangement also assumed that Argentina's economy would grow by 3.5% in 2000, and 4% in later years, which clearly did not happen.

Table 2. Argentina: History of IMF Lending
(in millions of SDRs*)

Date of Arrangement	Date of Expiration	Facility	Amount Agreed	Amount Drawn	Amount** Outstanding
Dec. 28, 1984	June 30, 1986	Stand-by	1,182.5	1,182.5	0
July 23, 1987	Sept. 30, 1988	Stand-by	947.5	616.5	0
Nov. 10, 1989	March 31, 1991	Stand-by	736.0	506.0	0
July 29, 1991	March 30, 1992	Extended	780.0	438.8	0
March 31, 1992	March 30, 1996	Stand-by	4,020.3	4,020.3	1,318.1
April 12, 1996	Jan. 11, 1998	Stand-by	720.0	613.0	133.8
Feb. 4, 1998	March 10, 2000	Extended	2,080.0	0	0
March 10, 2000 Jan. 12, 2001 Sept 7, 2001	March 9, 2003 Jan. 11, 2002 March 9, 2003	Stand-by (of which SRF#)	16,936.8 6,086.6	9,756.3 5,875.0	9,756.3 5,875.0
Total			27,403.1	17,133.4	11,208.2

Source: IMF website: http://www.imf.org. * The Special Drawing Right (SDR) is the unit of account at the IMF, its value is based on a basket of currencies and fluctuates over time. As of December 28, 2001 it was equal to approximately $1.26. ** Amount to be repaid as of November 30, 2001. # Supplemental Reserve Facility provides funds at higher rates and shorter maturities to countries that have experienced a sudden loss of market confidence, but have corrective reform measures in place.

Argentina's continued poor economic performance prompted the IMF to augment the original agreement on January 12, 2001 by $7.0 billion (SDR 5.2 billion). This was part of a larger package that included $5.0 billion in loan commitments from the Inter-American Development Bank (IDB) and the World Bank, $1.0 billion from Spain, and voluntary refinancing from the private sector of $20 billion. The IMF advanced these funds with an expectation that the Argentine economy would grow by 2.5% in 2001, which also proved unattainable, leading to a third augmentation of $7.4 billion (SDR 5.6 billion) on September 7, 2001. This increase was also based on promises of strong fiscal reform as passed by the "Zero Deficit Law" on July 29, 2001, and continued efforts at revenue sharing reform with the provinces. Despite IMF funding, it became increasingly clear that the high cost of debt combined with recession and doubt over Argentina's ability to make needed adjustments was leading the country to default, or worse.

Outlook

President Duhalde has been given broad emergency powers by the congress to keep Argentina's financial crisis from mushrooming into economic collapse. He is attempting to restore Argentina to financial competitiveness and credibility by abandoning the currency board and the peso's 1-to-1 peg with the dollar in favor of a dual exchange rate system. When foreign exchange markets opened on January 11 for the first time in three weeks, the peso traded at a 29% managed devaluation, or 1.4 to the dollar, for most foreign commerce and finance transactions. Individual transactions were subject to a market set rate, with the peso falling some 40% to 1.7 to the dollar. Dollar denominated bank loans up to $100,000 will be converted to pesos at the 1-to-1 rate, passing on the cost of devaluation from debtors to creditors (mostly banks). Also, to "guarantee" dollar deposits, but curtail bank runs, the $1,000 (1,500 peso) limit on monthly withdrawals has been maintained and all checking and savings accounts with balances exceeding $10,000 and $3,000, respectively, will be converted to certificates of deposit and remain frozen for at least one year. Smaller deposits have the option of earlier withdrawal by moving to peso denominated accounts at the 1.4 exchange rate. Duhalde must also restructure Argentina's massive foreign debt and is attempting to negotiate a $15-20 billion assistance package with the IMF, which has yet to garner support from the United States or the Fund. Fiscal tightening is the other cornerstone to Argentina's financial credibility, another difficult proposition that has yet to be explained.

The new program faces many challenges. The dual exchange rate is not supported abroad and managed devaluations historically have proven difficult to maintain, with the market rate tending the "overshoot" the fixed rate, as already seen. Also, should high inflation resume, much of the benefit of devaluation would be lost. Passing the cost of the devaluation on to the banks risks their collapse given the mismatch between dollar assets and liabilities. The plan calls for some type of tax, loan, or other financial support from the oil industry to help finance the banking sectors losses, but even if feasible, which is questionable, this too simply shifts the burden of devaluation from one sector of the economy to another, both heavily controlled by foreign interests. Capital controls (freezing bank accounts) stifle economic activity, discourage new investment from entering the country, and further erode confidence in the banking system, causing long bank lines and continued social unrest.

As for the IMF, its policies are again under scrutiny. Reports that the Fund had concerns that the Argentine program was inherently unworkable have emerged. Yet, the IMF continued to support the economic program citing grandiose expectations of economic growth and Argentine promises of a balanced budget. Argentina's nearly four-year recession, however, should have raised questions regarding the sustainability of its currency board, and whether the IMF might have done something to encourage other solutions or Argentina's earlier exit from its convertibility plan earlier, when the costs would have been much lower.

APPENDIX

March 5, 2002

Opening Statement
Argentina Hearing
March 5, 2002
The Honorable Doug Bereuter
Chairman
Subcommittee on International Monetary Policy and Trade

The Subcommittee on International Monetary Policy and Trade meets today in open session to continue its examination into the financial crisis in Argentina, including the activities of the International Monetary Fund (IMF) within this country. The Subcommittee will hear from a distinguished panel of private sector witnesses. Previously on February 6th, the Subcommittee listened to testimony from the Undersecretary of the Department of Treasury for International Affairs, Dr. John Taylor, on the subject of Argentina.

Before introducing our distinguished witnesses at this second hearing on Argentina, I would like to remark upon the current fiscal situation in Argentina. At each Subcommittee member's desk, the following two updated products from the Congressional Research Service (CRS) are again provided, which I find very instructive: a chronology of relevant events in Argentina and a CRS Report on the Argentine Financial Crisis. When looking at these CRS reports, it is important to note that events are changing in Argentina on an almost daily basis.

Today, I would like to focus on a few remarks on the following subjects:

1. recent changes in the Argentina fiscal situation;
2. the role of the IMF in Argentina;
3. the IMF preconditionality reform proposal as it relates to Argentina; and
4. my general views on the IMF.

1. **Recent changes in the Argentina fiscal situation**

As we discussed at our first hearing, in 1991, the Argentine Government established a currency board to set the peso's value on a one-to-one peg with the U.S. dollar in order to curb hyperinflation. However, because the value of the U.S. dollar appreciated over the past ten years, it became increasingly difficult for Argentina to export its products. In fact, by the end of 2001, Argentina defaulted on its total foreign debt of approximately $141 billion which resulted in an economic crisis that spiraled into deadly protests.

On February 3, 2002, the Argentine Government declared that the local peso would free float and all dollar debts would be converted into pesos at a rate of one-to-one. Creditors and banks have suffered as a result of this pesofication of debt. Furthermore, this economic plan also turned all dollar deposits into the local peso at a rate of 1.4 to the dollar. This devaluation of deposits has angered middle class demonstrators because of their loss in savings.

Since this Subcommittee's last hearing on February 6th, the following main events in Argentina have occurred. On February 11th, the Argentine peso was free floated on the foreign exchange markets. As of March 2nd, the local peso was trading at 2.15 to the U.S. dollar.

Furthermore, on February 18th, unemployment in Argentina reached a high of 22%. In addition, petroleum workers began to protest a 20% energy export tax. Other protests continued as a result of the strict bank restrictions on withdrawals.

On March 1st, the lower House of the Argentine Congress passed President Eduardo Duhalde's budget bill for 2002 which included a proposed reduction of spending by over 14%. This measure importantly eliminated the monthly minimum of $650 million in Federal grants to the provinces which has been draining the Federal budget. According to the most recent press reports, the upper House of the Argentine Congress has yet to act on President Duhalde's budget for 2002.

2. The role of the IMF in Argentina

In March 2000, the IMF agreed to a three-year $7.2 billion arrangement with Argentina. Moreover, in January 2001, the IMF augmented its earlier agreement by pledging another $7 billion to Argentina. However, the IMF withheld its $1.24 billion loan installment on December 5, 2001.

With regard to the recent budget for 2002, which passed the lower House of the Argentine Congress, the IMF publicly welcomed this austerity measure that reduced the Federal deficit and addressed the Federal/Province relationship. The IMF has said that it may send a negotiating team to Argentina as early as this week. In fact, the IMF negotiating team will be directed by a person accepting a newly created position, of Director of Special Operations, who will lead an effort to focus on countries facing crisis situations.

3. The IMF preconditionality reform proposal as it relates to Argentina

I am very interested in the thoughts of the witnesses on the concept of preconditionality for IMF assistance as it relates to Argentina. This recommendation was endorsed by the majority report of the Meltzer Commission, whose chairman, Dr. Alan Meltzer, is testifying today. I take particular interest in the Meltzer Commission as I am the original author of the legislative language, which created this 11-person bipartisan Commission through the FY99 Omnibus Appropriations Act. This Commission, which completed its report in March of 2000, was charged with studying the future of the IMF, the World Bank, and the regional multilateral development institutions.

When Undersecretary Taylor testified before this Subcommittee last month, he seemed to endorse the concept of preconditionality for IMF assistance as it relates to Argentina. Of course there is merit in insisting a country have a sound economic structure in place before it receives IMF assistance. Yet, macroeconomic circumstances such as the political and economic repercussions on global stability also need to be taken into account on a case-by case basis by the IMF. A dissenting view of the Meltzer Commission, which was signed by Dr. Fred Bergsten, among others, makes this same point. Dr. Bergsten is also testifying today.

4. My general views on the IMF

Lastly, with respect to the IMF, it is important to acknowledge that there has been substantial criticism of the IMF's past performance. I have a strong concern about the advice that the IMF initially gave to Thailand and Korea at the beginning of the Asian financial crisis. The fact is that IMF demands of Thailand and Korea were counterproductive. It treated these countries like their "usual fiscal basket-cases" -- which initially they were not. Whether that treatment was the demand or recommendation of the Department of the Treasury in the Clinton Administration is not clear.

At the same time, we, in Congress, need to candidly admit that if we didn't have the IMF or an institution like it, we would have to create one. But we also need to recognize that U.S. Treasury has a very large role in influencing IMF policy and actions -- some would say an inordinate amount of influence. (The U.S. is, of course, the largest shareholder in the IMF with its 17.16% voting share.)

To assist the Subcommittee in examining these issues, I am pleased that we have the opportunity to hear from our distinguished panel of witnesses with their diverse views on Argentina. First, we will receive testimony from Dr. Allan Meltzer. Dr. Meltzer is a professor of political economy and public policy at Carnegie Mellon University and a former member of the President's Council of Economic Advisors. He currently is also a consultant to the World Bank. Again as I mentioned earlier, he was the Chairman of the Meltzer Commission.

Second, Dr. Fred Bergsten, the Director of the Institute for International Economics (IIE), will testify. Dr. Bergsten has been the Director of the IIE since its inception in 1981. Furthermore, he was the Assistant Secretary of the Treasury for International Affairs from 1977-1981. Dr. Bergsten received his Masters and Ph.D. degrees from the Fletcher School of Law and Diplomacy. As stated earlier, Dr. Bergsten was also a member of the Meltzer Commission.

Third, we will hear from Dr. Mark Weisbrot, the Co-Director of the Center for Economic and Policy Research in Washington, DC. Dr. Weisbrot, who received his Ph.D in Economics from the University of Michigan, specializes in international economics with a particular emphasis on the role of the IMF. Dr. Weisbrot is the author of a weekly column on economic and policy issues that is distributed to newspapers by the Knight-Ridder/Tribune Media Services.

Finally, Dr. Steve Hanke, a Professor of Applied Economics at The Johns Hopkins University in Baltimore, will testify.

Dr. Hanke has advised many different foreign governments on currency reform and privatization. With respect to Argentina, he served as the Adviser to the Minister of Economy at the Republic of Argentina in 1995 and 1996. It is also important to note that Dr. Hanke is the President of Toronto Trust Argentina, which is an emerging market mutual fund in Buenos Aires.

Before the testimony of the witnesses, I turn to the distinguished Ranking Member of this Subcommittee from Vermont (Mr. Sanders) for any comments that he may have.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

March 5, 2002

Argentina's Financial Crisis – Causes and Solutions. Subcommittee on International Monetary Policy and Trade

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I want to take this opportunity to thank Chairman Bereuter for holding this second hearing on the crisis in Argentina and the role of the IMF. We have seen over the past several months the third largest country in Latin America on the brink of both economic and social collapse. The situation in Argentina is tragic, but it is a good lens through which we can examine changes that may need to be made in the operation of the International Monetary Fund.

Following last December's decision by the IMF to stop lending to Argentina, the government defaulted on its foreign debt and a succession of administrations attempted to restore economic order to the country. Some stability has returned, and Argentina has begun to make the tough fiscal, monetary and political necessary to implement reform. Argentina is a valuable ally of the United States in South America and I hope that they can get their economic house in order. The peso is now floating on the international market and that the government has approved a budget that attempts to control spending. In particular, recently enacted reform in the relationship between the provincial and federal governments is critical to reducing deficits and reigning in spending. However, there are parts of the economic reform package that are of concern. Specifically, the President of Argentina has announced a proposal to levy a one time tax on all private utility and energy companies to support social programs by the hardest hit by the crisis. Some question whether additional taxes should be levied on companies that are currently struggling in the midst of this crisis. Many of those companies are based in the United States, and additional taxation could force them to abandon projects they are developing or maintaining in Argentina. Additionally, a proposal to pay for contracts in pesos, which were negotiated in good faith to be paid in dollars, is troubling. By changing the terms of those agreements, Argentina casts doubts on the ability of U.S. based companies to rely on assertions made by its government in the future. I was encouraged by Under Secretary Taylor's testimony last month that the Department of Treasury is working to ensure that U.S. interests are being treated on a level playing field with other foreign interests. I trust those efforts are continuing.

As the largest shareholder in the IMF, the United States has the responsibility to ensure that the resources of that institution are being used wisely. I believe that the IMF must take a hard look at its lending policies and ensure it is granting loans to countries that have sound economic policies. The IMF must ensure that the financing it extends is making the greatest possible impact on improving the lives and economies of developing nations. Last week, before this Committee, the Secretary of the Treasury outlined the efforts the Bush Administration is pursuing to ensure that the IMF cultivates growth and productivity in the regions where it operates. I agree with Secretary O'Neill that increased transparency in the international marketplace, a narrowed focus on the IMF's core mission, and a policy of not bailing out countries that do not pursue sound economic programs are key goals for the future operation of the IMF. However, the IMF must also work with recipient countries to ensure that they know what problems must be addressed prior to funding being cut off or being resumed.

Finally, the IMF has proposed a plan to encourage an orderly workout with creditors when sovereign debt is unsustainable. While this proposal is in the early stages, I am interested in the opinions of our witnesses as to whether such a proposal is needed and if so, how it could be established.

I would like to welcome our witnesses, and look forward to hearing from this panel on issues relating to the IMF and Argentina. I look forward to a lively discussion from all angles of the ideological spectrum. Thank you again, Chairman Bereuter.

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Argentina and the IMF

by Allan H. Meltzer
The Allan H. Meltzer University Professor of Political Economy, Carnegie Mellon University and Visiting Scholar, American Enterprise Institute

Argentina is now suffering from a deep and prolonged social and economic crisis. Its roots are political as well as economic. The political system seems unable to develop a coherent, consistent plan to solve or improve either Argentina's current position or its longer-term structural problems.

The need for a plan or program to restore growth in output and employment without renewing inflation cannot have escaped the leadership. They have received this message from President Bush, Secretary O'Neill, the IMF and others, including me. Without a plan that begins to resolve the current liquidity, financial, economic and human problems, there cannot be a resolution of the crisis. Additional financial assistance from the international financial institutions, led by the IMF, cannot solve Argentina's problems unless Argentina adopts a coherent, consistent plan.

Argentina had three fundamental problems that brought it to its current, deplorable position with massive loss of wealth and increase in misery. First, its debt could not continue to grow and be serviced by Argentina's economy and exports. Astute observers recognized publicly more than a year ago (and privately as early as 1999) that Argentina's foreign currency denominated debt was unsustainable. Second, Argentina's budget deficit increased its debt and undermined its monetary policy. The convertibility law tied the peso to the dollar and permitted unrestricted convertibility at a fixed exchange rate. This arrangement could not cope with an unsustainable debt on one side and an overvalued exchange rate on the other. The appreciation of the dollar and the depreciation of the Brazilian real made Argentina an unattractive place for investment and a costly place to buy. Third, Argentina made many reforms in the early 1990s, but it did not develop a budget policy or pass a fiscal responsibility law that controlled provincial spending. And it did not remove some of the structural impediments to growth.

The current Argentine government has not proposed a coherent, consistent plan. Some of the actions it has taken are piecemeal efforts to solve a particular problem without regard for the larger consequences. For example, the monetary authorities did not have enough dollars to convert peso deposits into dollars, as required by its monetary regime, so the government decreed that all dollar deposits had to be converted into peso deposits at 1.4 pesos per dollar. This increased the potential money supply by about 30%, raising concerns about inflation. To assure the public that they would not lose from inflation, the government suggested indexing peso deposits to inflation. As inflation increased, the government or the central bank would print more money.

This policy would lead to hyperinflation. Argentine citizens have had such miserable monetary and economic experience for the past fifty years that they understand better than most the links between the central bank's printing press and inflation. Their response is to run from the peso before the inflation reduces the value of their money. This response further drives down the value of the peso, raising Argentine costs and prices. Unions, anticipating inflation, have asked for a 40% increase in wages.

The economy is collapsing. Construction activity in January was 44% below year earlier levels. Because bank deposits were frozen, January supermarket sales were 30% lower than December. The unemployment rate is above 20% and rising as the economy sinks. The government announced that it does not have enough money to pay the wages of government workers.

No one can fail to be concerned with and distressed by the fate of the Argentine public. People are fleeing the country. Lifetime savings are threatened, and bankruptcy and joblessness are high and rising. A decade after suffering the chaos that accompanied hyperinflation, people suffer from renewed economic collapse.

What can the IMF and other international institutions do? What should they do? The IMF has not ignored Argentina. In March 2000 it offered a $7.2 billion loan. In January 2001, when the sustainability of Argentina's debt was very much in doubt, it offered $7 billion more as part of a $20 billion official package. In August 2001, it advanced an additional $5 billion to prevent a banking and currency run. It should be clear to all that more money without policy changes did not work. The IMF announced new negotiations last week.

Would more money now help Argentina or its people? Until Argentina has a credible, coherent plan, the public has no reason to want to hold pesos. Giving money now would give the Argentine government money to support its exchange rate and its budget. That's another way of saying that holders of Argentine pesos would be able to get dollars on more favorable terms and the Argentine government could maintain a larger budget deficit and avoid pressures to establish fiscal responsibility. This is not just conjecture. It is a description of what happened to much of the aid Argentine received in the last two years.

I favor assistance to Argentina once it has adopted a coherent, consistent plan. Such a plan is needed to ensure that the money advanced to Argentina is not used to support an exchange rate peg or slide, to sustain budget deficits, or to permit creditors to avoid losses. That's how additional support would be used in the absence of a plan that the government adopts and implements.

In December 2001, Adam Lerrick and I discussed these issues with members of the Argentine government and with those who were then in opposition but are now in government. There are seven problems that have to be addressed. Some are interrelated.

(1) External debt has to be reduced to a sustainable level. The debt is now in default. It has to be renegotiated.

(2) Argentina needs a credible exchange rate regime to replace the present blocked exchange system of currency controls.

(3) No exchange rate regime can remain credible or be sustained unless the monetary system produces low inflation or stable prices. The government must make the central bank independent and adopt a rule that prevents the central bank from printing money to finance the budget deficit.

(4) A stable fiscal regime, with budgets close to balance sustains credibility of the monetary system and exchange rate stability. The fiscal system should also encourage efficient use of resources to increase living standards, and the government should adopt a fiscal responsibility law applicable at all levels of government. Many of Argentina's fiscal problems result from excessive spending by the provinces financed by the central government.

(5) Adjustment of the Argentine monetary and exchange rate system should avoid asset and liability mismatch. Argentina's current government has wiped out the capital in the banking system and crippled the payments system.

(6) Any policy today must convey unpleasant news. It should also convey some good news by reducing the 21% value added tax as much as possible to stimulate private spending and to shift spending from informal to organized markets.

(7) There is a pressing need for liquidity. Adam Lerrick and I proposed a way to reconcile an increase in liquidity and spending with safety and soundness of the financial system. The government adopted a version of this proposal.

The Argentine crisis affects not just the IMF. It poses a challenge for the World Bank, with 8 to 10% of its outstanding loans to Argentina, and the Inter-American Development Bank, with 20% of its loans to Argentina. An Argentine default on these debts would severely impact the capital of these institutions. The lesson from this problem should not be to send more money. It should be to reform these financial institutions.

In summary, I support the IMF's current program. It is a major step forward from the open-handed bailouts of the 1990s. The new policy is exceedingly painful for Argentina because the government has failed to make adjustments and reforms necessary for growth. Financial support is wasted when the economic structure is unsound. I urge members of this committee to support the important steps toward reform that Secretary O'Neill and Managing Director Koehler have underway. I urge them to continue with their effort to reward performance and to insist that promises must be kept.

Carnegie Mellon

Graduate School of Industrial Administration
William Larimer Mellon, Founder
Carnegie Mellon University
Pittsburgh, Pennsylvania 15213-3890

(412) 268-2262
Fax: 412 268 6830
am05@andrew.cmu.edu

Allan H. Meltzer
The Allan H. Meltzer
University Professor of Political Economy
Gailliot and Scaife Families, donors

March 29, 2002

Congressman Barney Frank
2210 Rayburn HOB
Washington, D.C. 20515-2104

Dear Barney:

At the hearing on Tuesday, March 5, 2002 you asked me to expand in writing on my comment about making international financial systmes safer and sounder. I touch on some of these issues in the testimony I gave the following day at the Joint Economic Committee hearing on the Meltzer Commission after 2 years.

The recent troubles of Argentina, and the losses experienced by lenders to Argentina, have begun to change the international financial system. Lenders now understand that if they make risky loans, they will not be bailed out, so they are apt to suffer losses. If this message sinks in, they will become more prudent in their lending. Pricing of Argentine debt in the capital markets certainly shows a greater awareness of the costs lenders incur when they make imprudent loans.

It is too early to say whether Argentina will make the additional reforms that are necessary to renegotiate its debt and improve its credit standing. But the message from defaults in Ecuador, Pakistan, Ukraine, and now Argentina has certainly not been lost on other debtor countries. They have greater incentive to reform. Those reforms must reduce the use of short-term loans and replace them with longer-term capital.

In the Meltzer Commission report, we proposed four or five preconditions to bring that about. These included prudent fiscal policies, missing in Argentina, and opening of the banking system to allow foreign banks to compete in the local markets. Experience in Brazil and Argentina shows that these reforms were helpful. They prevented a serious run on the Brazilian banking system. Even in Argentina, the foreign banks remained solid and strong until the government began to interfere directly with the banks' balance sheets.

This standard, allowing foreign banks to be in local markets, has been accepted by the WTO and endorsed by 60 or 70 countries. Among the other reforms advocated by the Meltzer Commission that are essential preconditions for improved market performance, greater transparency is certainly one of the more important. The Commission advocated that countries must announce promptly the amount and time distribution of its obligations to foreign creditors,

I attach great importance to the preconditions. Countries that adopt and maintain the preconditions will attract more capital from the market at lower interest rates. Countries that fail to adopt the preconditions will attract less capital and will pay higher interest rates. This alone should give the incentives to adopt sound, prudent policies that are in their interest. If we can avoid bailouts, and insist upon preconditions being met, we can develop a safer, sounder financial system. More capital will come in the form of foreign direct investment and less in the form of short-term bank loans.

I have discussed some of these issues a bit in my testimony before the Joint Economic Committee. I have enclosed a copy.

Needless to say, I will be happy to discuss these issues more fully at a time of mutual convenience.

Sincerely,

Allan H. Meltzer

encl.

[This is a response to a request by Congressman Frank at the hearing on March 5. You may wish to include this into the record.]

FINANCIAL TIMES January 24, 2002

A solution for Argentina

1/24/02

Adam Lerrick and **Allan Meltzer** suggest an alternative to printing pesos as a way of solving the country's liquidity problems

PERSONAL VIEW

The printing presses of Argentina's central bank are being readied this week to roll out new pesos. But in what amounts and to what end? There is no magic number that will restore cash to the economy without triggering inflation.

The list of economic demands that citizens require of their governments is short, simple and non-negotiable. They want jobs. They want free access to the fruits of their labour. And they want money that retains its value. The ire in the streets of Argentina proves once again that regimes that fail to deliver these basics do not survive.

Fernando de La Rúa's government was ousted when people were denied access to their own bank accounts and the chain of cash payments that accounted for half of the economy and provided the social safety net for the poor was broken. Adolfo Rodriguez Saa's brief presidential tenure ended when rumors of a new currency revived memories of the 5,000 per cent hyperinflation of 1990-91.

Freezing deposits to prevent a bank run has been a classic Latin American response in times of crisis. In such cash-dependent economies, the economy quickly grinds to a halt. In Argentina, tax revenue has fallen 30 per cent in the past year and wages in the informal sector have collapsed 50 per cent in just one month.

The classic Latin American antidote to this liquidity starvation has been a huge infusion of new money; its sequel is hyperinflation. Anticipation can become as forceful as fact. Agricultural producers, the dominant force in Argentine exports, are now hoarding their harvest for fear of being paid in plummeting pesos.

Unless families soon have money to put food on their tables, policymakers will not be given the chance to stabilise the economy and to promote growth. The restrictions on the use of deposits and wages, which Eduardo Duhalde, president, has called a "ticking time bomb", must be undone. But without a run on banks and without inflation.

There is a solution. It can be found right within the banking structure as it stands. It permits full economic activity while the financial sector is temporarily frozen. It is compatible with any exchange rate regime: fixed, floating or dollarisation. It can be introduced quickly and seamlessly reversed into a traditional monetary system. It is neither a much-feared new government currency nor a flood of fresh pesos. Rather, it would provide an interim means of payment that would circulate but leave bank reserves and the money supply untouched.

Just as warehouse receipts for commodities are traded without moving the grain from the silo or the gold from the vault, a mechanism can be created whereby individuals use receipts representing bank deposits for everyday transactions without moving cash from the banking system.

Commercial banks would issue deposit receipts in standard denominations of 2, 5, 10, 20, 50 and 100 pesos. These would be unconditional obligations of the issuing bank and represent a direct 1:1 claim on bank demand deposits. To speed public acceptance, the deposit receipt would adopt the format of a widely understood instrument – a certified or bank cheque – but issued in bearer form and without fee. The public should not pay to access its own money. Cheques, credit and debit cards and direct deposits would continue to circulate. Deposit receipts can perform all the functions of money. The government can declare them legal tender. Taxes and wages can be paid. Cheques can be cashed in a bank. Savings account balances can be exchanged. Loans can be made and repaid. Even those without bank accounts can use this new means of payment.

To prevent a run from weak to strong banks, the government should underwrite a guarantee of deposits until the sector is recapitalised. Receipts of all banks would then have the same market value, regardless of bank credit risk. However, deposit receipts would trade in the markets to reflect the currency risk between pesos and US dollars.

By transforming bank deposits into the equivalent of readily available cash, the entire current and savings account deposit base again becomes money. Liquidity is immediate but inflation is contained Because the maximum level of deposit receipts is limited to the amount of existing deposits, no new money is created. A drain on bank reserves is precluded. When deposit balances are exchanged for deposit receipts, nothing leaves the system. In contrast to printing new money, the government does not profit because deposit receipts cannot be used to finance fiscal expenditures.

Although vital in the short term, this new liquidity mechanism would make a graceful and unnoticed exit. Once confidence returns and restrictions on cash withdrawals are phased out, deposit receipts would lose their relevance. Until the next time. Or the next place.

The writers are, respectively, director and chairman of the Gailliot Centre for Public Policy at Carnegie Mellon University

www.ft.com/argentina

Testimony by Mark Weisbrot[1] before the
Subcommittee on International Monetary Policy and Trade
Committee on Financial Services
U.S. House of Representatives

Hearing on the State of Argentine Economic Crisis and the Role of the International Monetary Fund

Tuesday, March 5, 2002, 1:30 pm
Room 2128, Rayburn House Office Building

[1] Mark Weisbrot is co-Director of the Center for Economic and Policy Research in Washington, DC.

I would like to thank the committee, and Chairman Bereuter, for the opportunity to testify today on these matters of vital interest to the United States and the world. The Argentine economy is now suffering the worst economic crisis in its history, with unemployment of more than 22 percent, and there is no sign of recovery. It is essential that we understand, and change, the role of our own government -- including the US Treasury Department, which has the overwhelmingly dominant voice within the International Monetary Fund (IMF) -- so that Washington does not continue to worsen an already desperate economic situation which threatens to degenerate into political chaos.

From February 11-15, I met with Argentine businessmen, bankers, economists, trade union officials, members of the Argentine Congress, and non-governmental organizations. The recommendations that follow reflect what they told me, as well as the research carried out by the Center for Economic and Policy Research.

1. The IMF must acknowledge that it played a large role in causing the current crisis of Argentina's economy. This is much more than setting the historical record straight: it is necessary to prevent the Fund from causing further damage. For example, Argentina has been in recession for nearly four years. During this time, the Fund has supported, with lending and political encouragement, fiscal tightening of the central government budget. This is something that economists in the United States would never recommend for our own economy during a recession, and it has undoubtedly worsened and/or prolonged Argentina's downturn.

The Fund also contributed enormously to the crisis by arranging tens of billions of dollars of loans to support the convertibility plan, which was clearly not a viable exchange rate regime. The result was an insurmountable debt burden, which ended in default last December. As shown below (see appendix), it is this debt trap -- not overspending by the government -- that caused the crisis.

In other words, the central government of Argentina has run primary budget surpluses (excluding interest rates) every year since 1993. But its debt service burden kept growing -- not because of spending increases, but because of rising interest rates and therefore debt. These increasing interest rates were a result of external shocks, beginning with the Fed's increase of US short-term rates from 3 to 6 percent (February 1994 - February 1995). The Mexican peso crisis (December 1994), the Asian economic crisis (beginning August 1997), the Russian (October 1998) and then the Brazilian devaluation (January 1999) all added to investors' doubts about the fixed exchange rate, and therefore to Argentina's foreign debt service and debt.

Yet the Fund, together with the other multilateral lenders that follow its lead, continued to add to Argentina's debt, even after it became clear that it could never be repaid. Argentina's currency -- under the fixed exchange rate regime -- also became overvalued, hurting its domestic industry and adding to unemployment and slowing growth. This was not a matter of being "over-indulgent," as is it often portrayed -- it was a case of lending to support as set of bad policies that eventually brought the economy to ruin.

2. The IMF, World Bank, Inter-American Development Bank, and other official creditors should declare a moratorium on Argentina's debt service payments until the economy has recovered from the recession and achieved solid growth for at least a year. This is the very minimum that these institutions can do to avoid worsening the crisis. Since the Fund presently functions as the leader of official (and often private) creditors, its decision -- and therefore the decision of the US Treasury department -- to declare a moratorium on debt service would help remove much of the uncertainty that now hangs over Argentina's financial future. Furthermore, the Fund could persuade private creditors to observe a similar moratorium. During this time, negotiations for a write-off of debt, and rescheduling of debt that will be paid, could proceed. As noted below, the multilateral lenders increased their lending from $15 to $33 billion, from December 1995 to September 2001, as private sources dried up. This was a bad gamble on their part, to support a non-viable policy (the fixed exchange rate regime). The official creditors should be prepared to write off debt that was incurred as a result of their own, easily preventable, errors.

An official moratorium on debt service is extremely important, because that is the biggest cloud that hangs over the Argentine economy. Unlike other economic crises, this one does not involve an economy that is living beyond its means: there is neither a domestic (central government) spending imbalance, nor a (foreign) balance of payments problem. The government has been running a primary budget surplus, and the economy has a trade surplus. In other words, there is no "adjustment" that is necessary, if debt service payments are suspended. Further "adjustment" along the lines historically pursued by the IMF would likely only prolong the recession.

3. The IMF (and US Treasury) should not try to impose austerity conditions on Argentina, and they should not take advantage of the crisis to impose other conditions for opportunistic or ideological reasons.

There is evidence that the IMF is continuing to push for budget cuts, despite the deepening recession. In fact, late last year it reported approvingly that Argentina had reduced its structural budget deficit by percent of GDP -- the equivalent of a $200 billion tax increase in the United States -- in the middle of a severe recession. The Fund should not be trying to squeeze the Argentine government so as to get a better deal for foreign creditors. These lenders knew they were taking a risk, and received very high interest rates as a risk premium -- more than 20 or even 30 percent in the last year and a half before default. Furthermore, by dragging out negotiations with the government of Argentina, and insisting on unnecessary austerity, the Fund is adding the uncertainty that undermines economic recovery.

I spoke with Argentine businessmen who told me that Spanish banks want to open lines of credit to Argentine companies, but they are waiting for the IMF to reach agreement with the government. This is but one example of how this creditors' cartel, headed by the IMF, can impair economic recovery in a time of crisis.

During the Asian financial crisis, the Fund imposed more than 140 conditions on Indonesia as part of a loan package. As a result, the Fund's main impact was to get the government to guarantee private loans, rather than promote economic recovery. More than four years later Indonesia still has not reached its pre-crisis level of GDP. It would be a tragedy if the IMF led a similar "bailout" in Argentina.

4. The first priority of any economic program must be to revive spending and production, and pull the economy out of the depression. Many people have pointed to a host of long-standing problems -- corruption, the deep distrust of politicians, lack of confidence in the banking system, etc. -- as the "root causes" of the crisis. Unfortunately, it is convenient for those who contributed to the crisis to pretend that it is all the result of deeply rooted, intractable problems in Argentine society and governing institutions. While many of these problems exist, it is neither necessary nor sufficient to cure them, in order to jump-start the economy.

The functioning of the financial system must be restored, in the wake of the default, at least to the point where producers can get credit to purchase necessary inputs, including imports. The "corralito" -- the freezing of deposits in the banking system -- will have to be gradually lifted. The "peso-ification" of the economy must succeed to the point where people are willing to hold pesos, with a relatively stable exchange rate.

These are urgent priorities for the economy, and there are even more urgent needs for the rapidly growing population of poor people, who are in need of health care, employment, and in many cases even food. Any economic recovery program should target those most in need, and the government may have to play a leading role in stimulating demand until the confidence of both private investors and consumers is restored. Here it is especially important that the IMF and Treasury do not prevent such measures for ideological reasons, or for the purpose of getting earlier or larger repayments of the foreign debt.

5. The IMF should state publicly what it is demanding from the Argentine government. The complete lack of transparency in the negotiations between the IMF and government of Argentina invites abuse and corruption, and thwarts democracy in Argentina. Since the IMF's approval is presently a prerequisite for most other lending, the Fund has enormous power, especially in a crisis situation. If the IMF wants the government to cut its spending or raises taxes during the recession, it should say so. If the Fund wants a better deal for the foreign banks in terms of how much they will absorb the costs of devaluation, this should also be public information. There is no legitimate reason to keep these demands secret, other than to hide the process of decision-making from the public.

Appendix

What Happened to Argentina?

By Mark Weisbrot and Dean Baker

January 31, 2002

INTRODUCTION

On December 20, President Fernando de la Rua of Argentina resigned, after weeks of rioting and looting that had left 27 people dead. Within 14 days the government was officially in default on its international debt, the largest default of a national government in recent memory.

As reported in the United States and the international press, the story was one of a profligate government that could not contain its spending, and make the necessary "hard choices" to build confidence among investors and lenders, including official creditors led by the International Monetary Fund. Indeed, the Fund precipitated the final crisis by refusing to disburse a scheduled $1.3 billion loan on December 5, 2001, because of "Argentina's inability to meet the targets under the zero deficit law."[2]

As millions understand it, Argentina's credit card was cut off because it ran up too big of a tab and couldn't pay its bills. But the official numbers tell a very different story. It is the story of debt, inherited from the past, that was perhaps manageable until—through no fault of the debtor—interest rates on the country's borrowing increased. Higher interest payments, not increased spending, led to higher deficits. Growing deficits in turn created doubts about the overvalued exchange rate, which pushed interest rates still higher, creating larger deficits, in a hopeless spiral that ended in default and devaluation.

As will be seen below, policy failures played a role in Argentina's economic collapse. The most important mistake was the fixed exchange rate, which tied the Argentine peso to the US dollar. But the immediate cause of Argentina's crisis was a series of external shocks that were beyond its control, beginning with the US Federal Reserve Board's decision to raise interest rates in February of 1994. The effect of each of these shocks was much worse than it otherwise would have been, because of the fixed exchange rate. But the commonly believed story that the government could not accept a sufficient dose of the painful medicine of austerity, or spent its way into a hole, is not supported by the data.

[2] IMF spokesman Thomas Dawson, December 20, 2001, press briefing (at www.imf.org).

FISCAL POLICY

Table 1 shows the Argentine government's revenues, spending, and interest payments for the years 1993-2000. If one looks only at the total budget balance, the numbers generally reported in the press, it looks as though there is a significant loosening of fiscal policy during this period. The budget goes from a surplus of $2.7 billion pesos[3] (1.2 percent of GDP) in 1993 to a deficit of $6.8 billion (2.4 percent of GDP) in 2000. This is a significant change in the government's fiscal position, although it is worth emphasizing that a deficit of 2.4 percent of GDP, the largest in this period[4], is still relatively modest for a nation in a deep recession, with more than 16 percent unemployment. For comparison, the United States ran a budget deficit amounting to 4.7 percent of our economy (or GDP) coming out of the last recession; 1983, at the end of a more serious downturn, the deficit was 6 percent of GDP.[5]

Nonetheless, even this modest deficit, and the shift from surplus at the beginning of the period, does not accurately represent the government's fiscal policy. To see this we must look at the primary balance—that is, the government's spending other than interest payments, subtracted from revenues. This appears in Table 1. The primary balance moves from a surplus of $5.6 billion (2.4 percent of GDP) in 1993 to $2.9 billion (about 1.0 percent of GDP) in 2000, a very modest deterioration.

Furthermore, none of this deterioration occurred on the spending side. Government spending, excluding interest, was essentially flat over the period. It was 19.1 percent of GDP in 1993, and 18.9 percent of GDP in 2000, despite the severe recession of the later years, as shown in figure 1. All of the deterioration occurred on the revenue side, as tax collections fell off during the recession, a normal and economically desirable development.

In light of this path of spending, it is difficult to argue that Argentina's government contributed to the economic crisis through overspending. Nor it is likely that, even if it were politically possible, the government could have averted the default and devaluation through further fiscal tightening throughout the recession.

[3] All numbers in the text are in current pesos unless otherwise noted; during this period, the peso also exchanged at the rate of one peso = one US dollar.
[4] The deficit of $4.7 billion in 1999 would have been $7.3 billion without income from privatization that year. However, there was still a primary surplus ($876 million) for that year. Revenues from privatization do not grossly alter the primary account balance (see below) for other years.
[5] The IMF noted that Argentina's austerity measures in fiscal 2000 were equal to 2 percent of GDP, the equivalent of a $200 billion reduction in the deficit in the United States ("Article IV Consultation and First Review," December, 2000, p 17)

Interest Payments

As can be seen from Table 1, it was increasing interest payments on the debt that drove the government's budget from surplus to deficit. Interest payments rose from $2.5 billion in 1991 to $9.5 billion in 2000, or from 1.2 to 3.4 percent of GDP (see Figure 2). This by itself is a significant drain on the economy, since almost all of these payments are in foreign currency, and most of the money goes out of the country. But in the context of Argentina's fixed (and then overvalued) exchange rate, the effect of these rising interest rates is much more damaging to the economy. The budget deficit caused by these increasing interest payments increased uncertainty in financial markets about the viability of the exchange rate. Such uncertainty drives interest rates even higher. The government's attempts to eliminate the deficit, by cutting primary spending during a recession, worsens the economic situation: first by directly reducing demand, and also by causing political instability and uncertainty, which fed fears of devaluation and/or default.

It must be emphasized that the whole downward spiral that led to Argentina's economic collapse occurred without any new borrowing by the government to finance primary (non-interest-payment) spending. In other words, the increased interest rates, and consequent increasing interest payments and debt, resulted from a combination of external shocks, and the dynamics of the fixed exchange rate system itself.

The long slide began when the US Federal Reserve Board began a series of interest rate hikes in February of 1994, which would double US short-term rates (from 3 to 6 percent) over the next year. Argentina was hit immediately with the first rate increase, because of the uncertainty it created in emerging financial markets. Thus the cost of the government's borrowing, simply to roll over past debt, increased by both the Fed's 3 percentage points, as well as the increasing spread between Argentine government bonds and US Treasuries of the same maturity.

The situation worsened drastically with the devaluation of the Mexican peso in December of 1994.[6] Within weeks, the Argentine banking system lost 18 percent of its deposits. The economy, which had grown at an average annual rate of 8 percent from the second half of 1990 to the second half of 1994, fell into a steep recession. Gross Domestic Product contracted by 7.6 percent from the last quarter of 1994 to the first quarter of 1996. As can be seen in Table 1, the government's interest burden increased by more than 50% from 1994 to 1996. There was a massive capital outflow and shrinkage of foreign exchange reserves.

Recovery began in the second half of 1996, and capital inflows, both public and private, resumed. But it was not long before the economy was hit with the Asian financial crisis, which began with the slide of the Thai baht in August of 1997. This sent Argentina's risk premium and cost of borrowing up again. Throughout this whole period, at least since the Fed's interest rate

[6] This was also at least partly triggered by the Fed's interest rate hikes, which attracted tens of billions of dollars away from Mexican bonds to the US.

hikes of 1994, the Argentine peso also became increasingly overvalued—since it was tied to the US dollar, which also became overvalued (leading to rapidly expanding US current account deficits).

The overvalued peso damaged the economy by further undermining confidence in the exchange rate regime, and also by worsening the current account, especially in services. It is worth noting that Argentina's increased interest payments from 1993-2000 also showed up in the current account, leading to deficits there as well. For example, in 1998, the current account deficit peaked at $14.6 billion, or 4.9 percent of GDP; over half of this deficit was due to interest payments.

The Asian economic crisis spread first to Russia and then to Brazil, where it led to the collapse of the Brazilian *real* in January of 1999. By this time the collapse of Argentina's fixed exchange rate was inevitable, and it was only a matter of how long it would take, and how much more the economy would be sacrificed in order to avoid devaluation and/or default. The economy lapsed into recession in the second half of 1998 and never recovered. Repeated attempts to restore confidence in the overvalued peso through spending cuts, and loans arranged through the IMF—including a $40 billion dollar loan package in December of 2000—could not reverse the downward spiral. In 2001 there were accelerating withdrawals from the banking system, leading to riots, political crisis, the collapse of the government, default, and devaluation.

Conclusion

This paper has focused narrowly on certain macroeconomic aspects of Argentina's economic collapse, in order to correct a widespread misunderstanding of its causes. There are other structural and economic changes in the 1980s and 1990s that critics have cited as contributing to Argentina's problems.[7] But even within this narrow focus of this paper, there are certain conclusions that may be drawn.

Many will undoubtedly infer that the main problem was the fixed exchange rate, and that fixed exchange rates are inherently flawed. Argentina's experience certainly makes a strong case for this argument. The Argentine economy's extreme vulnerability to the Fed's interest rate hikes in 1994 is a classic reason for not choosing a fixed exchange rate, and leaving so much of the economy in the hands of a foreign central bank.

It is also worth noting that the other shocks to Argentina's economy during this period came from the global financial system, and were not directly connected to any real factors in Argentina's economy. This is true of the "tequila effect" of the Mexican peso crisis, and perhaps even more strikingly, the transmission of the Asian financial crisis to Russia, and then Brazil and

[7] Among those often mentioned are: the rapid acceleration of trade liberalization and undermining of domestic industry, high unemployment even during the (1990-94) period of rapid growth, the wholesale privatization of state enterprises (sometimes involving corruption or other problems), and capital flight (which was mentioned briefly in this paper).

Argentina. In these instances investors responded to a particular crisis by fleeing emerging markets generally, often simply because they assumed other investors would do the same. Argentina's fixed exchange rate made all of these shocks much worse, because it made adjustment difficult or impossible, and attempts to maintain the exchange rate ended up sacrificing the economy. But Argentina's experience—including the considerable amount of capital flight during this period—does raise questions about the functioning of international capital markets without controls at the national level. It raises the question of how much any country would want to put itself at the mercy of such volatile international markets.

The role of the IMF and international lending agencies is also important here. The Fund supported the fixed exchange rate policy[8] all the way into the abyss, absorbing, together with other official creditors, an increasing share of Argentina's burgeoning debt. From December of 1995 to September 2001, these institutions' Argentine debt more than doubled, from $15 billion to $33 billion dollars. Throughout the period, the Fund insisted that more fiscal tightening was the key to restoring confidence and economic recovery. But it is clear that no amount of budget cutting, or tax increases, could have saved Argentina from the inevitable default and devaluation. And as noted above, the austerity policies almost certainly hurt the economy.

This should be kept in mind as new agreements are negotiated amid renewed calls for budget austerity. Although the fixed exchange rate is gone, austerity is no more likely to help Argentina's economic recovery now than it did in the past. And the government will need to cancel enough debt so that it never falls into the situation that it faced in recent years, in which rising interest rates and payments produce a debilitating debt spiral from which there is no escape.

[8] Fund officials now claim that they were against the fixed exchange rate policy in Argentina from the beginning, but supported it at the behest of the Argentine government. It is worth noting that the IMF supported, with massive loan packages as well as monetary and fiscal tightening, overvalued exchange rates in both Russia and Brazil in 1998. In both cases the Fund's argument was that devaluation would lead to uncontrolled inflation. But both currencies collapsed, the inflationary effect was controlled and temporary, and both economies responded positively to the devaluation—with Russia registering its highest growth (8.3 percent [real] in 2000) in 20 years.

Table One

Argentina, National Government Spending and Revenues (1993-2000)

In millions of current pesos

	YEAR							
	1993	1994	1995	1996	1997	1998	1999	2000
Total Revenue	**50,726.5**	**51,078.2**	**50,293.6**	**47,668.9**	**55,376.7**	**56,726.1**	**58,455.4**	**56,570.5**
Total Spending	**47,996.0**	**51,364.3**	**51,666.9**	**52,933.3**	**59,653.3**	**60,799.6**	**63,223.8**	**63,362.1**
- Total Spending as % of GDP	20.29%	19.95%	20.07%	19.45%	20.37%	20.34%	22.30%	22.29%
- Interest Payments (included in Total Spending)	2,914.0	3,150.3	4,083.5	4,607.9	5,745.0	6,660.3	8,223.6	9,656.0
- Interest Payments as % of GDP	1.23%	1.22%	1.58%	1.69%	1.96%	2.23%	2.90%	3.40%
Deficit or Surplus (Revenue-Spending)	**2,730.5**	**-285.9**	**-1,373.3**	**-5,264.4**	**-4,276.6**	**-4,073.5**	**-4,768.4**	**-6,791.6**
Primary Spending (excluding interest)	**45,082.0**	**48,214.0**	**47,583.4**	**48,325.4**	**53,908.3**	**54,139.3**	**55,000.2**	**53,706.1**
Primary Surplus or Deficit	**5,644.5**	**2,864.2**	**2,710.2**	**-656.5**	**1,468.4**	**2,586.8**	**3,455.2**	**2,864.4**
Primary Spending as % of GDP	**19.06%**	**20.29%**	**18.44%**	**17.76%**	**18.41%**	**18.11%**	**19.40%**	**18.90%**

Source: *Secretaría de Hacienda. Ministerio de Economía, Argentina*

GDP at Current Prices

In millions of current pesos

	1993	1994	1995	1996	1997	1998	1999 (*)	2000 (*)
GDP Market Prices	**236,504.98**	**257,439.96**	**258,031.89**	**272,149.76**	**292,858.88**	**298,948.36**	**283,523.02**	**284,203.74**

(*) Estimates

Source: *Dirección Nacional de Cuentas Nacionales, Argentina*

Figure One

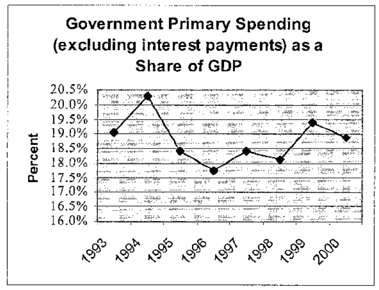
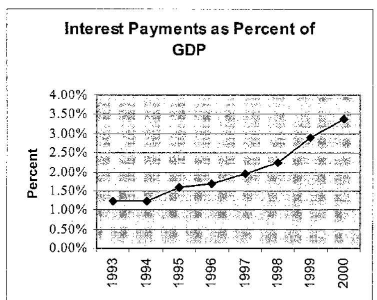


Figure Two



Testimony

U.S. House of Representatives
Committee on Financial Services

Subcommittee on International Monetary Policy and Trade

5 March 2002

Steve H. Hanke
Professor of Applied Economics
The Johns Hopkins University
Baltimore, Maryland 21218
and
President
Toronto Trust Argentina
Buenos Aires, Argentina

(410) 516-7183
hanke@jhu.edu

Mr. Chairman, thank you for this opportunity to express my views on the causes of and cures for Argentina's current political-economic crisis. I first became seriously interested in economic reform in Argentina shortly after meeting Argentina's newly elected President, Carlos Menem, in 1989. At that time, I concluded that, while stability might not be everything, everything was nothing without stability. To achieve stability, a cure for Argentina's endemic inflation and unstable money was required. In consultation with some members of Argentina's Congress, I developed a blueprint for monetary stability during 1990 with a fellow economist, Kurt Schuler. In 1991, our proposal for an orthodox currency board was published (*Banco Central o Caja de Conversión?* Buenos Aires: Fundación República). In 1994, I became President of Toronto Trust Argentina (TTA), a Buenos Aires-based domestic mutual fund that can invest in stock and bonds. TTA has had a good record. Indeed, in 1996, Micropal, a company that rates investment funds, ranked TTA as the best-performing emerging market mutual fund in the world. In 2000, S&P/Micropal ranked TTA third out of the 169 funds monitored in Latin America for the 1997-2000 period.

During 1995-96, I was an advisor to the Minister of Economy, Domingo Cavallo. In 1999, shortly after president Carlos Menem suggested dollarization for Argentina, Kurt Schuler and I wrote a paper explaining how to achieve that goal, step by step. I presented the paper to president Menem in February ("A Dollarization Blueprint for Argentina," *Friedberg's Commodity and Currency Comments Experts' Report*, Toronto: Friedberg Commodity Management, Inc., February 1, 1999, available at http://www.cato.org/pubs/wtpapers/dollar.pdf). In December 2001, I updated the case for dollarization in two papers, gave talks about dollarization in Argentina and presented my new proposal to Carlos Menem on December 6, 2001 ("Argentine Endgame: Couple Dollarization with Free Banking," Cato Institute Foreign Policy Briefing No. 67, December 4, 2001 http://www.cato.org/pubs/fpbriefs/fpb-067es.html ; "How to Dollarize in Argentina Now," with Kurt

Schuler, December 20, 2001, updated January 2, 2002, http://www.cato.org/pubs/papers/schuler-hanke011231.pdf).

All this is simply intended to inform you that I have been interested and involved in Argentine affairs for over a decade, and to indicate what the nature of that involvement has been.

What Went Wrong in Argentina?

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 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 give the country a confidence shock. Under the Convertibility Law, the peso and the U.S. dollar both circulated legally 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. 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 January 6, 2002, near-dictatorial powers were conferred upon President Eduardo Duhalde and the convertibility system was swept into the dustbin. The peso was floated and is currently worth less than half of its former value.

The confusing commentary about Argentina centers on its rather unusual monetary regime, which although popular with the Argentine public, was not well understood by most economists, many currency speculators, or the International Monetary Fund.

Because the convertibility system was not well understood, it has been blamed for a number of Argentina's ills that either had little to do with convertibility or simply did not exist. The convertibility system was the linchpin for a decade of stable prices and a solid export and economic growth performance. The price level at the end of 2001 was about where it was in 1994. Exports grew each full year of the convertibility system, with the exception of 1999. And the real GDP growth rate during the decade of convertibility was greater than any other decade since World War II.

Was Argentina's monetary system an orthodox currency board? Argentina's monetary system from April 1, 1991 to January 6, 2002 was known locally as convertibility. It was an unusual name for an unusual system. The convertibility system was not an orthodox currency board. Rather, it was a currency board-like system: a mixture of currency board and central banking features. In writings dating back to 1991, I proposed that Argentina establish an orthodox currency board and criticized convertibility as an unstable, mixed system.

The three defining features of an orthodox currency board are:

- a fixed exchange rate with its anchor currency,
- unrestricted convertibility into and out of the anchor currency at the fixed rate, and

- net reserves of 100 percent or slightly more of the board's monetary liabilities, held in foreign assets only.

Together, these three features imply that an orthodox currency board is a narrowly focused, rule-bound institution. In particular, an orthodox currency board lacks the power to conduct sterilized intervention, does not lend to the government, does not regulate commercial banks, and does not act as an official or unofficial lender of last resort.

The convertibility system lacked one or more of the defining features of an orthodox currency board throughout its lifetime. Last year, when the convertibility system began encountering severe problems, the government fiddled with the exchange rate and restricted convertibility. Throughout the lifetime of the convertibility system, the Banco Central de la República Argentina (BCRA)—note that it was never officially renamed a currency board—held extensive domestic assets in addition to its foreign assets. The BCRA was initially allowed to hold true foreign reserves of as little as 66-2/3 percent of its monetary liabilities. It was allowed to hold the difference between its true foreign reserves and 100 percent in the form of Argentine government bonds denominated in foreign currency, valued at market prices. Later, the minimum ratio was raised to 90 percent, although the BCRA was allowed to breach that floor temporarily, which it did on a number of occasions, most recently from July 25 to September 7, 2001 and from December 12, 2001 until the convertibility system ended on January 6, 2002.

The BCRA was never subject to any *maximum* ratio of foreign reserves. In contrast, if an orthodox currency board holds reserves beyond 100 percent of its monetary liabilities, the purpose is to merely provide a small cushion to prevent reserves from falling below 100 percent. Many currency boards have held supplementary reserves of 5 or 10 percent to guard against losses, but they have not used their supplementary reserves to conduct discretionary monetary policy and have remitted to their owners all surpluses beyond what was necessary to maintain the core and supplementary reserves. Over the course of 2001, the BCRA had a ratio of true foreign reserves to monetary liabilities that varied from a high of 193 percent on February 23 to a low of 82 percent at year-end. The BCRA gained foreign reserves through the IMF loan of September 7. It lost foreign reserves by lending to commercial banks and indirectly supporting the market for government bonds, since government bonds were used as collateral for many loans.

The holding of domestic assets and the varying of the ratio of foreign reserves to monetary liabilities meant that the BCRA engaged extensively in a discretionary policy of sterilized intervention, which an orthodox currency board does not do. The problem with sterilized intervention is that it forces a monetary authority to attempt to hit simultaneously two possibly incompatible targets—an exchange-rate target and a money-supply target. The convertibility system thus eventually encountered the problem common to all pegged exchange rates: which target to hit when the two came into conflict. Argentina chose the money-supply target, which involved giving up the exchange-rate target.

Under the convertibility system the BCRA also retained the power to regulate banks, such as by setting reserve ratios. It was unofficially 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 to only 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.

In a 1993 book, *Russian Currency and Finance*, which I co-authored with Lars Jonung and Kurt Schuler, we predicted that Argentina's monetary system would eventually behave more like a typical central bank than an orthodox currency board. After a longer delay than we ever expected, we were proved correct.

Moral: An unorthodox, currency board-like system is an internally contradictory mixture of currency board and central banking elements. An orthodox currency board system is internally consistent and therefore does not encounter the same problems.

Was the original convertibility system in effect until January 6? The original convertibility system began to crack in April 2001, when Domingo Cavallo, who had been recently appointed minister of the economy, sent a bill to Argentina's Congress to change the peso's anchor from the dollar to a 50-50 basket of the dollar and the euro. As economy minister in 1991, when the convertibility system was established, Cavallo had considered but rejected a similar idea. Also in April, Pedro Pou, the independent-minded president of the central bank who preferred dollarization to devaluation, was ousted on a pretext in favor of the more pliable Roque Maccarone.

By June the original convertibility system was definitively finished. Congress approved changing the exchange rate link if and when the euro ever appreciated to one per dollar. More importantly, Cavallo announced a preferential exchange rate for exports—a dual exchange rate. This was contrary both to the intent of the original convertibility system and of an orthodox currency board. Cavallo's measures showed that the government was quite willing to tamper with the convertibility system. In previous episodes when confidence in the peso declined, the government had responded, sometimes after an agonizing delay, by reaffirming the link to the dollar and the commitment to a single exchange rate. By removing the cornerstones of the convertibility system, Cavallo left the edifice shaky.

By meddling with the convertibility system, Cavallo tightened monetary conditions. Indeed, peso interest rates shot up and remained at punishingly high levels until peso interest rate caps were imposed in December 2001.

In December 2001 the government imposed a freeze on bank deposits. It was the last straw. Angry Argentines remembered how high inflation during similar freezes in 1982 (engineered by Cavallo) and 1989 had robbed them of the real value of their savings. Cavallo and president Fernando de la Rúa resigned in the face of widespread protests.

There was another way out: official dollarization, which would have eliminated questions about confidence in the peso by eliminating the peso itself. Unfortunately, a lack of resolve by the Argentine government and a lack of support from the U.S. government prevented this economically beneficial, but politically somewhat difficult, option from being implemented either when president Menem first proposed it in 1999 or subsequently. Instead, Argentina temporized and eventually suffered both a currency crisis and a political crisis.

Moral: When a currency board-like system faces a crisis caused by lack of confidence in the currency, a "hard" exit, for example via dollarization, is preferable to the "soft" exits of devaluation or floating.

Was the peso overvalued? Many people assert that the crux of the Argentine crisis was an overvalued peso. Supposedly, the peso's link to the strong US 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 of the convertibility system except 1999, when Brazil, its largest trading partner, suffered a currency crisis. Exports during the first 11 months of 2001 were 3.2 percent ahead of 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.

In an attempt to bolster claims that the peso was highly overvalued under the convertibility system, 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 were allegedly so expensive cost about 8 percent less than in Rio de Janeiro.

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 (Kalin Hristov, "FEER and Currency Boards: Evidence from the 90's," unpublished manuscript, Bulgarian National Bank, presented at the Centre for Central Banking Studies (Bank of England) Conference on Exchange Rates, November 26, 2001, p. 25).

Moral: Look carefully at the evidence before claiming that a currency is overvalued.

Will the devaluation restart the economy? For better or 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. So, to stimulate exports by 1 percent, the real value of the peso (adjusted for inflation) would have to depreciate by 10 percent. Exports in Argentina only accounted for 9 percent of GDP last year. Consequently, if the current devaluation of 50 percent (the floating peso is trading at about 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 percent. 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. 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 you use private-sector forecasts of the Argentina's contraction in GDP for 2002 (which are much more pessimistic and realistic than the official estimate), the elasticity would have to be even greater.

Moral: When considering a regime shift, use the back of an envelope and make a few calculations.

Why was Argentina's devaluation unique? The Convertibility Law gave a peso holder the right to convert a peso into a US dollar. That redemption pledge was made credible because the central bank was required by law to hold foreign reserves to fully cover its peso liabilities. It was this redemption pledge that made the convertibility set up unique and distinguished it from the typical fiat money system.

With the repeal of the Convertibility Law, the redemption pledge was thrown to the wind and the 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. The Congress acquiesced in the government's actions by approving the Law of Public Emergency and Reform of the Exchange Rate Regime on January 6, 2002. The law transfers extraordinary powers to the president and allows him to, in effect, rule by decree for two years (when his term is scheduled to end).

Moral: In a country that fails to adhere to the rule of law, the domestic currency should be replaced with a foreign currency produced in a country that embraces 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 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. Although the tax rate may appear low, it is not.

The tax increases added to the already heavy tax burden Argentines bear if they are part of the legal economy. Tax evasion is high in Argentina because the tax savings from going into the underground economy are huge. The value-added tax is 21 percent; social security and medical care taxes are 31.9 percent; and the top income tax rate of 35 percent starts at 102,300 pesos—currently about 50,000 dollars. Compare these with US state sales taxes of 0-9 percent (there is no federal tax); Social Security and Medicare taxes of 15.3 percent; and a top federal tax rate of 38.6 percent starting at about 300,000 dollars (plus state taxes of 0-11 percent). Unlike Argentina, the United States does not tax bank credits and debits at all.

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

It is also not surprising that tax revenue fell as higher tax rates aggravated the recession. Falling tax revenue made the government's debt more precarious. Particularly after Domingo Cavallo's changes to the convertibility system, concern about the consequences of a debt default spilled over into the currency market. Forward rates reflected an expected devaluation of the peso, and interest rates in pesos shot up to 40-60 percent. Concern about the consequences of a default also spilled over into the banking system, reflected by withdrawals of deposits and interest rates in dollars of 20-30 percent. (Most bank deposits and loans were, in fact, in dollars rather than pesos.) People feared that the government would not let the default remain compartmentalized as a problem of government finance, but would make it spill over into the rest of the economy.

Again, dollarization would have helped contain the problem, by depriving the government of a national currency as a tool for devaluation and inflation. Dollarization would not have guaranteed success—no monetary system can—but it would have improved the chances for success. It still would help today.

Moral: During a recession, avoid raising tax rates and don't "tighten" monetary conditions by meddling with monetary institutions.

<u>The IMF's Role in Argentina's Crisis</u>

During the boom years, 1990-94, when Argentina's per capita GDP measured in dollars grew by 72.8 percent, the IMF played a minor role in Argentina's economic affairs. Argentina implemented the convertibility system without the IMF's aid or advice. Following the Mexican devaluation of December 1994, Argentina suffered a crisis of investor confidence, which it overcame by enacting policies that included a reaffirmation of its commitment to an exchange rate of 1 peso per dollar. The IMF lent Argentina funds to support these policies, and ever since has been heavily involved in Argentina. Unfortunately, the IMF threw cold water on President Menem's dollarization proposal in early 1999. As a result, Argentina was forced to forego a much-needed positive confidence shock. When Fernando de la Rúa became president in December 1999, things went from bad to worse. His administration's new economic plan, approved by the IMF, was supposed to lower interest rates and produce a boom by raising taxes, which was meant to reduce the government's deficit. Its timing was awful. World interest rates in December 1999 were on the rise, so Argentina's rates also rose and the economy slumped further into recession. Argentina was headed for a crisis of confidence, one that would plunge the economy into a deeper recession and cause debt-servicing problems. The rest is history, almost.

From there the de la Rúa administration would commit a steady stream of policy errors that would undermine the successful reforms of the early 1990s: stable money and sound banking. And during this period, the IMF stood by silently and at the same time extended more credit to Argentina.

Then, during the early days of the Duhalde government, the IMF again threw cold water on the dollarization idea. When asked about dollarization for Argentina during a press briefing on January 11, Anne Krueger, first deputy managing director of the IMF, said: "Well, my understanding at the moment is that [dollarization] is technically unfeasible. So I don't think the authorities are thinking about it; I don't think we are thinking about it."

Dr. Krueger's statement implies that the BCRA did not have enough foreign reserves to liquidate its peso monetary liabilities and dollarize the economy. According to the BCRA's balance sheet of January 10, this was not the case, however. The BCRA's peso monetary liabilities were 17.92 billion pesos and its "pure" foreign reserves in US dollars were $14.75 billion. In addition, the BCRA had 14.96 billion pesos of domestic assets valued at market prices that could be sold to acquire U.S. dollars. Consequently, at the time Dr. Krueger made her statement, it would have been feasible for Argentina to dollarize at an exchange rate of 1 peso to 1 U.S. dollar, the rate in force under the Convertibility Law.

This, of course, leads to a number of questions. Was Dr. Krueger misinformed? Or does the IMF know something that the rest of us don't know? In short, does the BCRA have an "Enron problem"? Either way, the IMF does not look good.

If that were the end of the IMF-Argentina story it would be bad enough. But there is more. While Dr. Krueger's remarks about dollarization were quite specific, the IMF's mantra has been a vague stipulation that the Duhalde government must produce a comprehensive and sustainable economic program. The IMF has not been forthcoming publicly about what such a program might look like, so it is hard for outside analysts to evaluate whether the IMF's advice is even in the right ballpark. In contrast, I have proposed a detailed set of monetary, banking, and tax policies that I believe would bolster confidence in Argentina's economy and set it on the road to a sustainable recovery (http://www.cato.org/pubs/papers/schuler-hanke011231.pdf). Such policies include dollarization, significant reductions in tax rates, and fiscal reforms to enhance transparency.

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 neglect that the government's program amounts to destruction of the rule of law, to the imperfect extent that it existed in Argentina. 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 they hardly exist any more. 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, surged ahead of it. If private property has no stability, there will be no reason for Argentines or foreigners to invest much in Argentina.

Observers who have praised the government's measures have also somehow failed to notice that a depreciating peso, which is the only kind Argentina is likely to get, is massively unpopular. Since central banking was established in Argentina in 1935, the peso has depreciated against the dollar by a factor of approximately 6,000,000,000,000. In the Argentine context, a floating exchange rate has always meant a depreciating rate. The convertibility system, though imperfect, was the cornerstone of Argentina's economic growth in the 1990s. Now that the cornerstone has been removed, much of the structure has already crumbled.

At a hearing of this subcommittee on February 6, 2002, John Taylor, the Under Secretary of the Treasury for International Affairs, remarked that he thought Argentina should have dollarized rather than frozen bank deposits on December 1. To me, it is astonishing that he did not communicate this view to Argentina's government, 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 1 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.

Interest rates in pesos are far above rates in dollars because of expectations of substantial inflation. They can be adjusted as they were in Ecuador, by establishing procedures for reducing nominal interest rates downward to reflect lower expectations of inflation.

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. The relevant provisions of Title 22 include sections 283r; section 284j; section 2370, subsection (e); and section 2370a, subsections (a) and (b).

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. Mr. Chairman and members of this committee, whether the administration will enforce the laws Congress has passed depends mainly on you and your fellow legislators. If American as taxpayers end up supporting a government that has robbed them as investors in Argentina, it will send a terrible signal.

Secure private property rights are an essential ingredient of our prosperity and that of every other wealthy country. 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. Therefore I urge you to ensure that the laws are upheld and that the United States 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.

ANNALS, *AAPSS*, **579**, January 2002

Currency Boards

By STEVE H. HANKE

ABSTRACT: In contrast to central banks, currency boards are rule-bound monetary institutions without discretionary monetary policies. Currency boards first appeared in the mid-nineteenth century, were widespread prior to World War II, were replaced by central banks after the war, and have made something of a resurgence in the 1990s. This article discusses the distinguishing features of currency boards and central banks. Data that compare the performance of currency boards to that of central banks are presented. The arguments against currency boards are itemized and evaluated. The article concludes that the opposition to currency boards ignores the empirical evidence and is, at best, half baked. In developing countries, currency boards are superior to central banks. By applying a remediableness criterion, the article concludes that there are more than sixty countries that should replace their central banks with currency boards.

Steve H. Hanke is a professor of applied economics at the Johns Hopkins University in Baltimore and chairman of the Friedberg Mercantile Group, Inc., in New York. He has played a role in the design and establishment of the currency board systems established in the 1990s (Hanke and Schuler 1991a, 1991b; Hanke, Jonung, and Schuler 1992; Hanke and Schuler 1994b; and Hanke 1996/1997).

NOTE: The author thanks Matt Sekerke for his assistance in preparing this article.

In the beginning God created
sterling and the franc.
On the second day He created the
currency board and, Lo, money
was well managed.
On the third day God decided
that man should have free will
and so He created the budget
deficit.
On the fourth day, however, God
looked upon His work and was
dissatisfied. It was not enough.
So, on the fifth day God created
the central bank to validate
the sins of man.
On the sixth day God completed
His work by creating man and
giving him dominion over all
God's creatures.
Then, while God rested on the
seventh day, man created
inflation and the balance-of-
payments problem.

—Peter B. Kenen (1978, 13)

Central banks issue currency and exercise wide discretion over the conduct of monetary policy. Although widespread today, central banks are relatively new institutional arrangements. In 1900, there were only 18 central banks in the world. By 1940, forty countries had them, and today there are 174. Of those, 6 are bound by currency board rules that do not permit discretionary monetary policies. In addition, there are seven monetary authorities that operate as stand-alone currency boards (see Table 1).

An orthodox currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves, it holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold. The reserve levels are set by law and are equal to 100 percent, or slightly more, of its monetary liabilities (notes, coins, and if permitted, deposits). A currency board's convertibility and foreign reserve cover requirements do not extend to deposits at commercial banks or to any other financial assets. A currency board generates profits (seigniorage) from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities. By design, a currency board has no discretionary monetary powers and cannot engage in the fiduciary issue of money. Its operations are passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined solely by market forces, namely the demand for domestic currency (Walters and Hanke 1992).

The currency board idea originated in Britain in the early 1800s. A notable proponent was David Ricardo. Sir John Hicks (1967) made this perfectly clear when he wrote, "On strict Ricardian principles, there should have been no need for Central Banks. A Currency Board, working on a rule, should have been enough" (pp. 167-78).

Currency boards have existed in about seventy countries. The first one was installed in the British Indian Ocean colony of Mauritius in

TABLE 1
CURRENCY BOARDS AND CURRENCY BOARD–LIKE SYSTEMS TODAY

Country	System Began	Exchange Rate	Population	GDP (in U.S.$)[a]
Argentina[b]	1991	1 peso = U.S.$1	37 million	$374 billion
Bermuda	1915	Bermuda$1 = U.S.$1	62,000	$1.9 billion
Brunei[b]	1952	Brunei$1 = Singapore$1	320,000	$5.4 billion
Bosnia[b]	1997	1 convertible mark = DM 1	3.5 million	$5.8 billion
Bulgaria[b]	1997	1 lev = DM 1	8.2 million	$34 billion
Cayman Islands	1972	Cayman$1 = U.S.$1.20	39,000	$930 million
Djibouti[b]	1949	177.72 Djibouti francs = U.S.$1	450,000	$530 million
Estonia[b]	1992	8 kroons = DM 1	1.4 million	$7.8 billion
Falkland Islands	1899	Falklands£1 = U.K.£1	2,800	unavailable
Faroe Islands	1940	1 Faroese krone = 1 Danish krone	41,000	$700 million
Gibraltar	1927	£1 = U.K.£1	29,000	$500 million
Hong Kong[b]	1983	Hong Kong$7.80 = U.S.$1	6.8 million	$168 billion
Lithuania[b]	1994	4 litai = U.S.$1	3.6 million	$18 billion

SOURCES: Hanke, Jonung, and Schuler (1993); Central Intelligence Agency (1999).
a. Expressed in terms of purchasing power parity, not at current exchange rates.
b. Currency board–like system.

1849. By the 1930s, they were widespread in British colonies in Africa, Asia, the Caribbean, and the Pacific islands. Currency boards have also existed in a number of independent countries and city-states, such as Danzig and Singapore. One of the more interesting currency boards was installed in North Russia on 11 November 1918, during the civil war. Its architect was John Maynard Keynes, who was a British Treasury official responsible for war finance at the time (Hanke, Jonung, and Schuler 1993).

DISTINGUISHING FEATURES OF CURRENCY BOARDS AND CENTRAL BANKS

The features that distinguish typical currency boards and central banks are itemized in Table 2 and are generally self-explanatory. Several merit further comment, however. One concerns balance sheets. Unfortunately, most economists are incapable of performing basic balance sheet diagnostics and ignore these important documents. This was not always the case. Sir John Hicks—a high priest of economic theory and 1972 Nobelist—thought there was nothing more important than a balance sheet (Klamer 1989). I agree, particularly when it comes to understanding monetary institutions.

A balance sheet reveals a monetary authority's liabilities (high-powered base money). It also shows the make-up of those liabilities, or the split between net domestic assets (the domestic component of base money) and net foreign reserves (the foreign component of base money).

The asset side of a central bank's balance sheet contains both net domestic assets and net foreign reserves. This means that a central bank can engage in discretionary

TABLE 2
A TYPICAL CURRENCY BOARD VERSUS A TYPICAL CENTRAL BANK

Typical Currency Board	Typical Central Bank
Usually supplies notes and coins only	Supplies notes, coins, and deposits
Fixed exchange rate with reserve currency	Pegged or floating exchange rate
No conflicts between exchange rate policies and monetary policies	Frequent conflicts between exchange rate policies and monetary policies
No balance of payments crises	Frequent balance of payments crises
Foreign reserves of 100 percent	Variable foreign reserves
Cannot become insolvent	Can become insolvent
Does not hold domestic assets	Does hold domestic assets
Full convertibility	Limited convertibility
Rule-bound monetary policy	Discretionary monetary policy
Not a lender of last resort	Lender of last resort
Does not regulate commercial banks	Often regulates commercial banks
Transparent	Opaque
Immune from corruption scandals	Prone to corruption scandals
Protected from political pressure	Politicized
High credibility	Low credibility
Earns seigniorage only from interest	Earns seigniorage from interest and inflation
Cannot create inflation	Can create inflation
Cannot finance spending by domestic government	Can finance spending by domestic government
Requires no preconditions for monetary reform	Requires preconditions for monetary reform
Rapid monetary reform	Slow monetary reform
Small staff	Large staff

monetary policy—or fine-tuning—by buying and selling domestic assets (bonds and bills). This results in changes in the fiduciary issue of money, with the domestic component of the monetary base increasing when a central bank buys bonds and bills and contracting when a central bank sells bonds and bills.

Net foreign reserves are the only asset on a currency board's balance sheet because it cannot buy and sell domestic assets. Consequently, a currency board cannot engage in fine-tuning, and its monetary liabilities (base money) are exclusively made up of a foreign component. Changes in base money in a currency board system are, therefore, exclusively driven by changes in the balance of payments and net foreign reserves.

A quick glance at a monetary authority's balance sheet will show whether it is engaging in discretionary monetary policy and whether it is operating as a currency board or a central bank. Since currency boards conduct no monetary policy and have nothing to hide, they post their current balance sheets on the Web and are transparent. This is not the case for central banks. Of the 174 central banks, only 124 have Web sites. And, only 82 post some form of balance sheet. Of those, only 14 display current balance sheets (Hanke 2001). This lack of central bank transparency causes no end of problems for those who wish to conduct balance sheet diagnostics and determine what central banks are actually doing.

A second feature that distinguishes currency boards and central banks is the exchange rate regimes they employ. With currency board rules, a monetary authority sets the exchange rate—it is fixed—but it has no monetary policy. The quantity of base money in the system is solely determined by the demand for it in the market. Consequently, there can be no conflicts between exchange rate policies and monetary policies in a currency board system. Balance-of-payments problems cannot rear their ugly heads because market forces automatically act to rebalance financial flows. This explains why speculative attacks against currencies issued by currency boards have always ended in failure, with no devaluations. Argentina in 1995 and 2001 is but one example.

Central banks in developing countries simultaneously manage exchange rate policies and monetary policies. They operate with pegged exchange rate systems that are variously referred to as pegged, pegged but adjustable, bands, or managed floating systems. With pegged rates, the monetary base contains both domestic and foreign components because both net domestic assets and foreign reserves on the monetary authority's balance sheet can change, and these changes cause its monetary liabilities to fluctuate.

Pegged rates invariably result in conflicts between exchange rate policies and monetary policies. For example, when capital inflows become excessive under a pegged system, a monetary authority often attempts to sterilize the effect by reducing the domestic component of the monetary base through the sale of government bonds. And, when outflows become excessive, the authority attempts to offset the changes with an increase in the domestic component of the monetary base by purchasing government bonds. Balance-of-payments crises erupt as a monetary authority increasingly offsets the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the contradiction. This is exactly what happened in Turkey during February of 2001.

A third feature that merits attention concerns the issuance of credit by a monetary authority. Central banks can act as a lender of last resort and extend credit to the banking system. They can also make loans to the fiscal authorities and state-owned enterprises. Consequently, central banks can go bankrupt. The Bank of Indonesia is the most recent example of an insolvent central bank (Hanke 2000a).

A problem in many developing countries is that the rule of law is weak and so are the institutions of government. Consequently, a principal-agent problem exists because the voters (principals) have very little effective control over their agents (politicians) (Williamson 1996). Currency boards remedy the principal-agent problem, in part, because they cannot extend credit to the fiscal authorities or state-owned enterprises. In addition, currency boards cannot engage

TABLE 3
CURRENCY BOARD VERSUS CENTRAL BANK PERFORMANCES
(NINETY-EIGHT DEVELOPING COUNTRIES, 1950-1993)

System	GDP Growth Rate (%)	Annual Average Inflation (%)	Fiscal Deficit (% of GDP)
Currency board	2.6 (535)	7.0 (523)	2.2 (338)
Central bank	1.7 (2,694)	33.8 (2,663)	3.7 (1,769)

SOURCE: Based on Hanke (1999).
NOTE: Number of observations in parentheses.

TABLE 4
CURRENCY BOARD VERSUS CENTRAL BANK PERFORMANCES
(MEMBERS OF THE INTERNATIONAL MONETARY FUND, 1970-1996)

System	Number of Observations	GDP Growth Rate (%)	Annual Average Inflation (%)	Fiscal Deficit (% of GDP)
Currency board	115	3.2	5.6	2.8
Central bank	695	1.6	48.3	4.4

SOURCE: Based on Ghosh, Gulde, and Wolf (1998).

in lender of last resort activities. The fiscal regime, therefore, is subordinated to the monetary regime, and a hard budget constraint is imposed on the politicians.

Much as the gold standard was adopted to control the fiscal authorities (James 2001), I can attest to the fact that every currency board in the 1990s was adopted primarily to impose a hard budget constraint. With few exceptions, this key currency board feature has been overlooked by economists (Horváth and Székely 2001).

PERFORMANCE OF CURRENCY BOARDS AND CENTRAL BANKS

All currency boards have performed well, when compared to central banks (Hanke, Jonung, and Schuler 1993). Countries with currency boards have realized price stability, respectable growth rates, and fiscal discipline (for the first detailed quantitative study that compares currency boards and central banks in 155 countries, see Schuler 1996).

Tables 3 and 4 present pooled time-series, cross-section data for a large number of countries spanning nearly fifty years. The data speak for themselves. The currency boards' performance is unambiguously superior to the central banks'. Currency boards, therefore, satisfy Karl Schiller's (cited in Marsh 1992) test of a sound monetary system: "stability might not be everything, but without stability, everything is nothing" (p. 30).

Karl Schiller's test is particularly relevant when judging the performance of the five currency boards installed in the 1990s. All were installed in countries that were politically and/or economically very unstable. Furthermore, prior to the installation of currency boards, all countries had soft budget constraints and faced the prospect of continued instability. Argentina was attempting to cope with repeated bouts of hyperinflation. Estonia had just gained independence from the U.S.S.R and was still using the hyperinflating Russian ruble. Lithuania was in the grip of a collapsing real economy and very high inflation. To make matters worse, its new political institutions could not effectively control what threatened to be a runaway fiscal deficit. Bulgaria had defaulted on its international debt, narrowly escaped a revolution in late 1996, and was battling hyperinflation that had virtually wiped out its banking system and sent the real economy into a free fall. Finally, the newly independent Bosnia and Herzegovina had just come out of a bloody civil war, one that had disrupted and displaced most of the population, destroyed 18 percent and damaged 60 percent of the housing stock, and covered much of the territory with land mines. Its economy was in shambles, declining to about 20 percent of the 1990 level. With the exception of the deutsche mark, the other three currencies in circulation—the Bosnia and Herzegovina dinar, the Croatian kuna, and the Yugoslav dinar—were either unstable or very unstable.

Tables 5 through 9 constitute event studies, with the events being the installation of a currency board. Economic and financial data are presented before and after the event. Although these basic data speak for themselves, several points merit attention. For each of the five countries, the foreign reserves increased dramatically after the currency board was introduced. Given that the monetary liabilities of the boards are solely a function of the demand for those liabilities and given that they must be backed by a minimum of 100 percent foreign reserves, the demand for the domestic currency, as indicated by foreign reserve levels, increased dramatically after the introduction of the currency board.

The currency boards' imposition of a hard budget constraint is not fully revealed by the fiscal balance data. These data show fiscal balances on a standard cash basis, which excludes revenues from privatization. Also, in the years prior to the introduction of the currency boards, the fiscal authorities were all running up large arrears. This practice stopped after boards were installed. Consequently, the fiscal deficits prior to their introduction would have been larger if bills had been paid on time. In addition, in the years following their introduction, privatizations increased significantly. If these were included in the fiscal data, the deficits after the installation of the currency boards would have been much smaller. Therefore, the fiscal effects of currency boards are, in reality, much more impressive than those implied by the standard data presented in Tables 5 through 9.

For the four countries in which data were available (see Tables 5-8), foreign direct investment and portfolio flows registered healthy increases after currency boards were installed.

TABLE 5

ARGENTINA BEFORE AND AFTER SETTING UP A CURRENCY BOARD (1 APRIL 1991)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Annual inflation (year-end %)	4,928.6	1,344.5	84.0	17.5	7.4	3.9	1.6	0.0	0.3	0.7	–1.8	–0.5
Change in real GDP (%)	–6.9	–1.8	10.6	9.6	5.7	5.8	–2.8	5.5	8.1	3.9	–3.1	–0.2
Interest rates (money market rate, % per annum, at year-end)	1,387,179	9,695,422	71.33	15.11	6.31	7.66	9.46	6.23	6.63	6.81	6.99	8.15
Fiscal balance (% of GDP)	–7.6	0.1	–0.1	–0.2	0.9	–0.3	–1.0	–2.2	–1.5	–1.4	–2.5	–2.4
Foreign reserves (in U.S.$ billions)	3	6	7	12	15	16	16	20	22	25	26.4	22.9
Foreign direct investment (in U.S.$ millions)	1,028	1,836	2,439	4,045	2,555	3,635	5,610	6,949	9,161	7,280	24,148	11,154
Portfolio assets (investment abroad by Argentines, in U.S.$ millions)	NA	–241	–8,261	–80	–2,037	–1,485	–2,882	–2,380	–1,449	–2,065	–2,037	–1,456
Portfolio liabilities (investment by foreigners in Argentina, in U.S.$ millions)	–1,098	–1,105	8,227	1,060	22,345	9,853	4,752	12,209	11,753	10,829	–4,418	–94
Exports (% of GDP)	13.0	10.4	7.8	6.7	7.0	7.6	9.7	10.5	10.6	10.4	9.8	10.8
Seigniorage (% of GDP)			0.24	0.30	0.33	0.38	0.35	0.42	0.48	0.43	0.52	0.52

SOURCES: International Monetary Fund, Argentine Ministry of Economy, Banco Central de la Republica Argentina, Lehman Brothers.

NOTES: (1) The fiscal balance is calculated on a cash basis and excludes privatization revenues. The arrears were very high in 1990, suggesting that the cash deficit as a percentage of GDP would have been quite high in 1990 if the government had been paying its bills on time. (2) For portfolio assets, a negative number indicates an increase in holdings of foreign assets by Argentines (a net outflow of capital), while a positive number reflects a decrease in holdings. Conversely, for portfolio liabilities, a positive number indicates an increase in holdings of Argentine assets by foreigners (a net inflow of capital), and a negative number reflects a decrease in Argentine assets held by foreigners. (3) Seigniorage is calculated by multiplying foreign reserves less gold, special drawing rights, and the country's net International Monetary Fund position by the long bond yield in the reserve currency.

TABLE 6

ESTONIA BEFORE AND AFTER SETTING UP A CURRENCY BOARD (20-24 JUNE 1992)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Annual inflation (annual average %)	23.1	210.5	1,076	89.0	47.7	29.0	23.1	11.2	8.1	3.3	4.0
Change in real GDP (%)	–6.5	–13.6	–14.2	–9.0	–2.0	4.3	4.0	10.4	5.0	–0.7	6.9
Commercial banks average lending rates (short-term, 1-3 months, %)	NA	NA	59.2	36.6	24.6	19.0	14.8	11.9	15.1	11.1	7.4
Fiscal balance (% of GDP)	2.9	4.7	–0.3	–0.7	1.3	–1.2	–1.5	2.2	–0.3	–4.6	–0.3
Foreign reserves (in U.S.$ millions)	NA	NA	196	389	447	583	640	760	813	906	935
Foreign direct investment (in U.S.$ millions)	NA	NA	82.3	162.2	214.4	201.5	150.2	266.2	580.5	305.2	386.9
Portfolio assets (investment abroad by Estonians, in U.S.$ millions)	NA	NA	NA	–0.4	–22.5	–33.2	–52.7	–165.0	–10.9	–132.3	39.9
Portfolio liabilities (investments by foreigners in Estonia, in U.S.$ millions)	NA	NA	NA	0.2	8.4	11.1	198.1	427.5	1.1	153.3	76.2
Exports (% of GDP)	NA	31.9	60.0	70.3	76.0	72.4	67.1	78.1	79.8	77.4	96.2
Seigniorage (% of GDP)			1.25	1.26	1.29	1.06	0.82	0.83	0.68	0.71	0.97

SOURCES: International Monetary Fund, Estonian Central Bank, European Bank for Reconstruction and Development, Lehman Brothers.

NOTES: (1) Reliable data for interest rates and foreign reserves are not available for 1990 and 1991 because Estonia was still part of the U.S.S.R. during most of that period. A referendum was held in March 1991, and 77.8 percent of the votes cast favored Estonian independence. Estonia declared independence on 20 August 1991, and an independent status was conceded by the U.S.S.R. State Council on 6 September 1991. (2) When the currency board was established in June 1992 and the kroon replaced the Russian ruble, foreign reserves were $98.1 million. (3) For portfolio assets, a negative number indicates an increase in holdings of foreign assets by Estonians (a net outflow of capital), while a positive number reflects a decrease in holdings. Conversely, for portfolio liabilities, a positive number indicates an increase in holdings of Estonian assets by foreigners (a net inflow of capital), and a negative number reflects a decrease in Estonian assets held by foreigners. (4) Seigniorage is calculated by multiplying foreign reserves less gold, special drawing rights, and the country's net International Monetary Fund position by the long bond yield in the reserve currency.

TABLE 7

LITHUANIA BEFORE AND AFTER SETTING UP A CURRENCY BOARD (1 APRIL 1994)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Annual inflation (year-end %)	1,175	188.8	72.2	35.5	13.1	8.4	2.4	0.3	1.5
Change in real GDP (%)	−21.3	−16.2	−9.8	3.3	4.7	7.3	5.1	−4.2	2.7
Commercial banks' average lending rates (short-term, 1-3 months, %)	135.2	91.6	33.0	29.5	20.0	13.3	13.3	14.5	13.4
Fiscal balance (% of GDP)	0.5	−5.3	−4.8	−4.5	−4.5	−1.8	−5.9	−8.5	−2.8
Foreign reserves (in U.S.$ millions)	107	412	587	819	834	1,063	1,460	1,242	1,356
Foreign direct investment (in U.S.$ millions)	NA	30.2	31.3	72.6	152.4	354.5	925.5	486.5	378.9
Portfolio assets (investment abroad by Lithuanians, in U.S.$ millions)	NA	−0.9	−0.2	−10.5	−26.9	7.7	−10.1	−1.9	−141.4
Portfolio liabilities (investment by foreigners in Lithuania, in U.S.$ millions)	NA	0.6	4.6	26.6	89.6	180.5	−42.7	507.5	405.9
Exports (% of GDP)	23.3	82.5	55.4	53.0	53.4	54.5	47.2	39.7	45.5
Seigniorage (% of GDP)			0.85	0.81	0.62	0.66	0.68	0.63	0.70

SOURCES: International Monetary Fund, European Bank for Reconstruction and Development, Lehman Brothers.

NOTES: (1) For portfolio assets, a negative number indicates an increase in holdings of foreign assets by Lithuanians (a net outflow of capital), while a positive number reflects a decrease in holdings. Conversely, for portfolio liabilities, a positive number indicates an increase in holdings of Lithuanian assets by foreigners (a net inflow of capital), and a negative number reflects a decrease in Lithuanian assets held by foreigners. (2) Seigniorage is calculated by multiplying foreign reserves less gold, special drawing rights, and the country's net International Monetary Fund position by the long bond yield in the reserve currency.

This, in part, can be attributed to the fixed exchange rate regimes and the marked reduction in exchange rate risks that accompany a currency board system.

The story of Hong Kong provides another event study. The authorities allowed the Hong Kong dollar to float in November 1974. The floating Hong Kong dollar became wildly volatile and steadily lost value against the U.S. dollar. The volatility reached epic proportions in late September 1983, after the fourth round of Sino-British talks on Hong Kong's future. Financial markets and the Hong Kong dollar went into tailspins.

At the end of July 1983, the Hong Kong dollar was trading at Hong Kong$7.31 to U.S.$1. By Black

TABLE 8

BULGARIA BEFORE AND AFTER SETTING UP A CURRENCY BOARD (1 JULY 1997)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Annual inflation (year-end %)	338.9	79.4	63.8	121.9	32.9	310.8	549.2	1.7	7.0	11.4
Change in real GDP (%)	−11.7	−7.3	−1.5	1.8	2.1	−10.1	−6.9	3.5	2.4	5.3
Interest rates (money market rate, % per annum)	69.6	49.7	66.4	101.2	39.8	435.0	7.0	5.2	4.6	4.7
Fiscal balance (% of GDP)	−3.7	−5.2	−10.9	−5.8	−5.6	−12.7	−2.5	1.0	−1.0	−1.0
Foreign reserves (in U.S.$ millions)	616	1,207	960	1,311	1,545	793	2,474	3,056	3,222	3,460
Foreign direct investment (in U.S.$ millions)	56	42	40	105	90.4	109.0	504.8	537.2	806.1	1001.5
Portfolio assets (investment abroad by Bulgarians, in U.S.$ millions)	NA	NA	NA	−222	9.7	−7.1	−13.7	−129.5	−207.5	−62.0
Portfolio liabilities (investment by foreigners in Bulgaria, in U.S.$ millions)	NA	NA	NA	−10	−75.4	−122.2	146.5	−112.0	8.0	−114.9
Exports (% of GDP)	43.4	47.3	38.1	45.1	44.7	62.9	61.4	45.2	44.1	NA
Seigniorage (% of GDP)							1.10	0.99	1.02	NA

SOURCES: International Monetary Fund, Lehman Brothers, European Bank for Reconstruction and Development.

NOTES: (1) For portfolio assets, a negative number indicates an increase in holdings of foreign assets by Bulgarians (a net outflow of capital), while a positive number reflects a decrease in holdings. Conversely, for portfolio liabilities, a positive number indicates an increase in holdings of Bulgarian assets by foreigners (a net inflow of capital), and a negative number reflects a decrease in Bulgarian assets held by foreigners. (2) Seigniorage is calculated by multiplying foreign reserves less gold, special drawing rights, and the country's net International Monetary Fund position by the long bond yield in the reserve currency.

TABLE 9
BOSNIA AND HERZEGOVINA BEFORE AND AFTER SETTING UP A CURRENCY BOARD (11 AUGUST 1997)

	1995	1996	1997	1998	1999	2000
Annual inflation (annual average %)	–4	–25	14	5	0	2
Change in real GDP (%)	21	86	40	13	9	10
Commercial banks' median lending rates to households (short-term, 1-3 months, %)	146.7	55.6	29.6	26.0	28.0	24.0
Fiscal balance (% of GDP)	0	–3	–1	–2	–1	–3
Foreign reserves (in U.S.$ millions)	207	235	80	175	455	488

SOURCES: Central Bank of Bosnia and Herzegovina, International Monetary Fund.

NOTES: (1) Interest rate data for 1996 are for April. All interest rates are for the federation only. (2) Between 1995 and 10 August 1997, the National Bank of Bosnia and Herzegovina (NBBiH) operated and issued a Bosnia-Herzegovina dinar (BHD). That currency was pegged to the German mark at BHD = DM 100. During that period, the NBBiH operated as a pseudo-currency board. However, there were some deviations in which credits were issued to the government. Moreover, those credits were not fully backed by DM assets. On 11 August 1997, the Central Bank of Bosnia and Herzegovina (CBBiH) was established, and the convertible marka (KM) became the unit of account. The CBBiH operates under currency board–like rules. On 22 June 1998, the KM notes were put into circulation, and on 9 December 1998, KM coins were put into circulation. On 7 July 1998, the BHD ceased to be legal tender. (3) The last cease-fire agreement in the civil war was signed on 10 October 1995; the Dayton/Paris Treaty that ended the war was initialed in Dayton on 21 November 1995 and signed in Paris on 14 December 1995.

Saturday, 24 September, it had fallen to Hong Kong$9.55 to U.S.$1, with dealer spreads reported as large as ten thousand basis points. Hong Kong was in a state of panic, with people hoarding toilet paper, rice, and cooking oil. The chaos ended abruptly on 15 October, when Hong Kong reinstated its currency board.

In the seventeen years since the currency board, Hong Kong's GDP growth has been positive and strong in all but one year, 1998, the year after the Asian crisis engulfed the region. Annual inflation has come down from 9.2 percent during the floating period to an average of 3.7 percent during the currency board period. And, the fiscal authorities have generated budget surpluses in fourteen out of the seventeen years.

THE DEMISE AND RESURGENCE OF CURRENCY BOARDS

Given the superior performance of currency boards, the obvious question is, What led to their demise and replacement by central banks after World War II?

The demise of currency boards resulted from a confluence of three factors. A choir of influential economists was singing the praises of central banking's flexibility and fine-tuning capacities. In addition to changing intellectual fashions, newly independent states were trying to shake off their ties with former imperial powers, which sometimes included chasing away foreign investment. And, the International Monetary Fund (IMF) and World

Bank, anxious to obtain new clients and "jobs for the boys," lent their weight and money to the establishment of new central banks. In the end, the Bank of England provided the only institutional voice that favored currency boards. That was obviously not enough (Tignor 1998).

Why, then, did currency boards begin to make something of a resurgence in the 1990s? As someone who observed these developments at close range, I can attest that it had very little to do with the usual things economists write about currency boards. Instead, the resurgence was largely motivated by the desire to install a monetary regime to which the fiscal regime would be subordinated. By putting the monetary authorities in a straitjacket, currency boards were viewed as a means to impose fiscal discipline. And, as Tables 5 through 9 indicate, they have satisfied that expectation, a fact acknowledged in the IMF's (2001f) most recent edition of the *World Economic Outlook*: "a currency board tends to discourage persistently large fiscal deficits and the use of the inflation tax" (p. 131).

The resurgence has not gone unchallenged, however. Indeed, a cottage industry housing passionate opponents of currency boards has developed over the past decade. The works they produce, much like those in development economics, have been promoted by "the disregard for contrary opinions" (Bauer 1976, 231). Indeed, they suffer from parasitic citation loops in which opponents exclusively cite other opponents. As for the empirical evidence, it is swept away like flies. Indeed, the opponents use as their method "nirvana economics" in which the ideal of central banking is compared to the actual operation of currency boards.

But, why all this opposition? The most charitable answer to this phenomenon was given by Michael Polanyi (1958). He wrote that it is "the normal practice of scientists to ignore evidence which appears incompatible with the accepted system of scientific knowledge" (p. 138).

Be that as it may, there are a number of objections that were anticipated and refuted in a chapter devoted to that task (Hanke and Schuler 1994a). Unfortunately, these objections have become little more than clichés (Williamson 1995) and merit comment, once again.

The most common cliché that has been propagated by the opponents of currency boards is the notion that certain preconditions must be satisfied before currency boards can be adopted. It was embraced by the Council of Economic Advisers (1999), which wrote, "A currency board is unlikely to be successful without the solid fundamentals of adequate reserves, fiscal discipline and a strong and well-managed financial system, in addition to the rule of law" (p. 289).

This statement is literally fantastic and demonstrates how far off base professional economists can get when they fail to carefully study the history, workings, and results of alternative real-world institutions. After all, none of the successful currency boards of the 1990s was installed in a country that came close to satisfying even one of the alleged preconditions.

The second oft-cited criticism of currency boards asserts that they are rule bound and rigid. Consequently, countries that employ them are more subject to external shocks than are countries with central banks. If this were true, the variability of growth measured by the standard deviations in growth rates in currency board countries would be larger than in central banking countries. The facts do not support this thesis (Hanke 1999). Indeed, the variability of growth rates between the two sets of countries is almost identical. This suggests that while currency board countries are subject to external shocks, central banking countries are subject to internal shocks, and their magnitudes are almost the same. The currency board shock argument is, therefore, little more than a straw man.

The inability of a currency board to extend credit to the banking system, or what is referred to as the lack of a lender of last resort, constitutes a third criticism. As the United Nations Conference on Trade and Development (2001) put it, "a currency board regime makes payments crises less likely only by making bank crises more likely" (p. 117). This is another straw man argument. The major banking crises in the world have all occurred in central banking countries in which the lender of last resort function was practiced with reckless abandon (Frydl 1999). In contrast, currency board countries have not only avoided banking crises, but their banking systems—knowing they would not be bailed out by a lender of last resort—have tended to strengthen over time. Bulgaria is but one example. The 1999 Organization for Economic Cooperation and Development (OECD) Economic Survey of Bulgaria stated, "By mid-1996, the Bulgarian banking system was devastated, with highly negative net worth and extremely low liquidity, and the government no longer had any resources to keep it afloat" (p. 60). However, the OECD also observed, "By the beginning of 1998, the situation in the commercial banking sector had essentially stabilized, with operating banks, on aggregate, appearing solvent and well-capitalized" (p. 59).

A fourth cliché states that competitiveness cannot be maintained after the adoption of a currency board. Hong Kong contradicts this conventional wisdom. Since its currency board was installed in 1983, it has retained its rank as the most competitive economy in the world (Gwartney and Lawson 2001). Moreover, countries that adopted currency boards in the 1990s have maintained their competitiveness measured by exports as a percent of GDP (see Tables 5-8). Argentina is of particular interest because virtually every report about the current problems in Argentina contains an assertion about how the currency board–like system has made Argentina uncompetitive. What nonsense. Exports are the only bright spot in Argentina's economy. Indeed, the value of exports in the first half of 2001 grew by 3.2 percent compared to the first six months of 2000 (Dow Jones Newswires 2001).

A fifth assertion made by opponents of currency boards is that they are desirable only in small, if not tiny, economies. It is true that most currency boards today are in relatively small economies (see Table 1). However, Argentina and Hong Kong are not small. Indeed, Argentina and Hong Kong rank as the seventeenth and twenty-fourth largest economies in the world, respectively (World Bank 2001). If the size of Argentina's economy is the standard, then 115 countries—including every one in Africa—would qualify for currency boards because their economies are smaller than Argentina's (World Bank 2001).

A sixth concern expressed by economists is that currency boards are not suitable for most countries because the prospective currency board country is not in an optimum currency area with the anchor currency country. An optimum currency area is an artificial construct within which exchange rates should be fixed and between which exchange rates should be flexible. The problem is that the facts on the ground contradict the economists' notion of an optimal currency area. For example, Argentines have voluntarily chosen to hold most bank deposits and make most bank loans in dollars, and the value of the dollar notes (paper money) held in Argentina exceeds the value of the peso notes held. Therefore, Argentines have themselves determined that the dollar is the best currency, no matter what the optimal currency area theorists have concluded.

A seventh argument designed to stir populist ire concerns sovereignty. It is argued that monetary sovereignty is lost by the adoption of a currency board. An independent monetary policy is given up. True. After all, a currency board has no monetary policy. However, national sovereignty over a country's monetary regime is retained. Indeed, history has shown that many countries that once had currency boards have unilaterally exited from those rule-bound systems, albeit to their peril.

In closing, one final comment merits attention because it reveals just how confused and confusing the debate about the desirability of a currency boards is. Has the IMF been for or against currency boards? Well, it depends on when you ask. *Ex ante* the IMF has generally been opposed and has employed many of the clichés mentioned. The most notable case was in 1998 when the IMF vehemently opposed the establishment of a currency board in Indonesia (Hanke 2000b; Culp, Hanke, and Miller 1999). This prompted Robert Mundell (cited in IMF 2000b), the 1999 Nobel Laureate in Economics, to chastise the IMF at an IMF economic forum, where he said,

> I have been very disappointed in the way the IMF has treated currency board arrangements, by and large. I think they should have grasped onto it. After all, let's suppose that apart from the fact that the United States dollar would be at the center of this thing, you could imagine a world of currency boards, where all central banks operate like currency boards—not currency boards, but currency board systems. After all, that's what the gold standard was—it was what people nowadays call a currency board system. That's what the adjustment mechanism was. It was automatic until countries decided in the 1930s to go off on independent mone-

tary policies; then they got off on the wrong track.

Ex post the IMF has had nothing but praise for the five currency boards installed in the 1990s, as well as Hong Kong's (IMF 2000a, 2001a, 2001b, 2001c, 2001d, 2001e). According to the IMF, they have strengthened fiscal discipline and the banking systems, have motivated reforms, and have been the linchpins for growth.

ARGENTINA

Even though one might agree that the opponents of currency boards have ignored the evidence and put forward a wide variety of nonsensical arguments, the current travails in Argentina might cause one to pause before embracing the currency board idea. Just how did Argentina become embroiled in yet another financial turmoil? After all, it has a currency board–like system.

Even though Argentina emerged intact from Mexico's tequila crisis of 1995 and its GDP grew by 5.5 percent in 1996 and 8.1 percent in 1997, its economy ran into trouble in 1999, after Brazil's devaluation and before its own presidential elections.

The inauguration of Fernando de la Rua as president in December 1999 engendered some economic optimism, but the de la Rua government was a weak left wing coalition. It quickly proved incapable of reforming the supply side of the economy and bringing order to Argentina's fiscal affairs. A crisis of confidence ensued.

Earlier this year, de la Rua was forced to appoint Domingo Cavallo as his economic czar. Cavallo designed Argentina's unorthodox currency board, which killed the country's hyperinflation. But this time around, Cavallo has made missteps that have worsened Argentina's predicament.

In June, Cavallo introduced a dual-currency regime. Under this setup, all exports (excluding oil) take place with a devalued peso, all imports with a revalued peso. All other transactions take place at a peso-dollar rate of 1:1. Then a law was passed in which the peso's anchor will switch from the dollar to a basket of 50 percent euros and 50 percent dollars once the euro reaches parity with the dollar.

Not surprisingly, these changes were viewed by the markets as moves by Argentina to abandon its currency board. Interest rates shot up in anticipation of a devaluation.

This raises the issue of whether, and how, to drop an exchange rate regime. Countries that exited from pegged regimes and adopted currency boards in the 1990s have all seen dramatic improvements in their macroeconomic indicators. Indeed, a shift from a soft regime to a hard one has always ended currency crises. But not so with shifts from hard regimes to soft. Recall Hong Kong's exit from its currency board in November 1974.

Domingo Cavallo should understand that merely talking about the idea of abandoning a hard regime in the middle of a crisis is playing with dynamite. In July, the dynamite exploded. Military history teaches the same lessons about the dangers of discussing exit strategies. In his new book, *Waging Modern War*, General Wesley Clark showed that every time the U.S. Department of Defense spoke about exit strategies for U.S. troops in Bosnia, the Bosnian Serbs would intensify their efforts, causing no end of problems for the allies (Clark 2001).

THE WAY FORWARD

What is the way forward for currency boards? The analytical poverty of nirvana economics must be eliminated. Hypothetical ideals are operationally irrelevant. Within the feasible subset of real-world options, the relevant test should be whether an alternative can be described that can be implemented with expected gains. It is this remediableness criterion that should be adopted.

When that criterion is applied, currency boards stand head and shoulders above central banks for many developing countries. Just how many pass the test? According to the World Bank, average annual inflation has exceeded 10 percent in sixty-one countries with central banks during the past decade (World Bank 2001). As a rough estimate, then, sixty-one new currency boards could pass the remediableness test. Indeed, for these countries, central banks are an expensive luxury they can ill afford.

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THE WASHINGTON POST TUESDAY, MARCH 5, 2002 A19

Peter Hakim

Aid to Argentina: Strings Attached

Argentina is an economic mess. Its banks are broke, surviving by not paying depositors. Its federal and state governments cannot pay employees and suppliers; foreign debt payments are suspended; economic activity has slowed to a crawl; unemployment is heading toward 30 percent; and the nation's health and education systems are reeling.

A broad consensus—shared by economic analysts of every political stripe—has formed that, in order to resolve this crisis, Argentina will require substantial external support from the International Monetary Fund and other sources. The U.S. government and the IMF—which will not take action without Washington's say-so—have made clear, however, that no aid will be given until the Argentine government comes up with a coherent program for a sustainable economic recovery.

The two-month-old government of President Eduardo Duhalde is still struggling to develop a program that is convincing to the U.S. Treasury. While succeeding on some important fronts, including facing up to the country's powerful governors and reducing payments to Argentina's profligate provinces, the president still has a long way to go. Indeed, another consensus is forming—that the Duhalde government will not, on its own, ever be able to put together and execute a viable economic program. The government does not now have, and seems incapable of galvanizing, enough political support to pursue the range of measures required to revive the Argentine economy.

Thus, either (a) the U.S. government and the IMF have to reconsider their position (i.e., that Argentina will not get a cent without an economic program in place), or (b) Argentina will be plunged into a deeper and more dangerous crisis. Some analysts are now predicting a devastating hyperinflation. Nobody knows where the country's politics will end up, but concern is increasing that Argentina's 25 years of democratic rule may be at stake.

This turn of events would not only be disastrous for Argentina. It would be a blow to other Latin American countries, many of which are confronting their own economic and political troubles, and could play havoc with U.S. objectives in the hemisphere. So far the consequences of the Argentine collapse have largely been contained, affecting in a serious way only its small neighbor, Uruguay. Yet there are disturbing signs of a decline in investment flows to Latin America—which, if it continues, will threaten the region's economic stability and growth.

The worse the Argentine crisis gets, the more it will damage U.S. relations with other Latin American countries. Already, many Latin Americans believe that Washington has turned its back on its strongest ally in the region (while assisting Turkey, a country facing similar problems but deemed strategically more important). U.S. policy toward Argentina is widely pointed to as evidence of Washington's loss of interest in Latin America, particularly since Sept. 11. These attitudes will make the negotiation of hemispheric free trade harder and could result in less cooperation on other key fronts.

What, then, can the United States do? First, the administration, in tandem with the IMF, should now provide the Argentine government with a clear and precise statement of the essential elements of a program that the United States could support. It should also make plain what level of resources the United States will help mobilize to make the program work. If the Argentine government accepts this as the right basis to move forward, the United States should join with the IMF and the Argentine government to develop a full-fledged policy blueprint—and undertake to secure the necessary contributions from the international financial institutions, the G-7 countries and private investors.

With appropriate prior consultations, this set of initiatives would, I believe, gain strong political backing from most Latin American countries—many of which have been urging U.S. assistance for some time. And there is a good chance that an intensely engaged United States, with broad regional support, could end the political impasse in Argentina and give the government the resolve it needs to address the crisis.

All this might not work, but without the leadership and intense engagement of the United States, the Argentine government will likely remain immobilized. The country's economy and politics will deteriorate, doing terrible and lasting damage to Argentina, possibly spreading the harm to other countries of Latin America and potentially undercutting U.S. policy objectives across the hemisphere.

The writer is president of the Inter-American Dialogue.

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