Argentina Should Abolish Its Central Bank

The Americas

By Steve H. Hanke

Since the days of Juan Peron, Argentina has had a proclivity for populist experiments. As a result, Argentina has led the world in creating inflation. From 1965 to 1980, its average annual inflation rate tipped the scales at 78.3%. That rate exploded to 334.8% during the period of 1980 to 1989. Since 1990, inflation has been all over the map, with the annualized monthly inflation rate hitting a high of 861% and a low of under 20%.

The direct cause of all that inflation has been the Central Bank. To buy votes, Argentine politicians have allowed government ministries and the country's web of state-owned enterprises to operate with "soft-budget constraints." Consequently, those entities have never had to face the discipline of a financial bottom line, and deficits have been the order of the day. The Central Bank filled the void by printing money.

Although monetary and currency reforms have been common, Argentines have had about as much confidence in these reforms as unreformed alcoholics have in their ability to kick the habit. The Central Bank, therefore, has little credibility, and to protect themselves from inflationary expropriation Argentines substitute dollars for australs (the local currency) with a vengeance.

However, the dramatic currency reform designed by Economics Minister Domingo Cavallo and introduced in April represents a genuine breakthrough in Argentine culture. Here was a disciplined monetary policy that seemed to leave little room for Central Bank fiddling. The exchange rate of australs for dollars was fixed at 10,000 to 1 precisely at the moment when the government had just enough hard-currency reserves to buy back the entire monetary base. In other words, every austral in circulation is now backed by a hard-currency instrument. Moreover, the Central Bank can no longer expand the monetary base unless the gold or foreign-currency assets grow at a parallel rate.

To date, the reform has produced favorable economic results. The monthly inflation rate has fallen from 11.1% in March to 1.8% in September. In addition, the Buenos Aires stock exchange has sizzled, racking up a gain in dollar terms of 103% in July. Those economic results, which seem little short of a miracle, are no doubt the reason that voters gave President Carlos Menem's Peronists a hearty pat on the back during the midterm September elections.

But Argentines and international investors remain deeply skeptical. They have been burned by the Central Bank too many times in the past. They know that the Central Bank's new operating rules contain a loophole that is big enough to drive a truck through, particularly if Mr. Cavallo should leave the scene: Under the new rules, the Central Bank is allowed to count dollar-denominated bonds, which are issued by the Argentine government, as part of its "foreign" reserves.

Under Mr. Cavallo's watchful eye, the Central Bank has not abused that loophole, with the so-called Bonex bonds varying between 3% and 9% of the monetary-base cover. However, everyone knows that the Central Bank could alter its course overnight and expand the Bonex share of the reserves. They also know that, although the government has always paid its Bonex obligations, it could refuse to honor Bonex bonds held by the Central Bank.

If those worries are not enough, the Parliament could change the monetary-reform law that requires foreign-reserve cover. In addition, although President Menem has exhibited fast footwork at dodging family-related scandals, he could stumble, particularly with the Bank of Credit and Commerce International scandal casting a long shadow over his government. If President Menem should falter, the skeptics would carry the day, and the Central Bank would not be able to withstand the ensuing speculative attack.

To lock in the Menem-Cavallo achievements and permanently remove skepticism from the Argentine monetary scene, Argentina should abolish its Central Bank and replace it with a currency board. The currency-board system would solve Argentina's monetary problems permanently. Indeed, there have been more than 60 currency boards—including the ones that still operate in Hong Kong, Singapore and Brunei—and all have operated successfully.

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Under a currency-board system, there is no central bank and no monetary populism because a board has no discretionary monetary policy. A currency board issues notes and coins. These are convertible into a foreign-reserve currency at a fixed rate on demand. As reserves, a board holds high-quality, interest-bearing securities, denominated in a reserve currency. Its reserves are equal to 100% of its notes and coins in circulation. A currency board does not accept deposits. It generates profits from the difference between the interest received on the securities it holds and the expense of maintaining its note and coin circulation.

Since the Argentine Central Bank's current operating rule is similar to that of a currency board, the transition from a central bank to a board would be smooth. Indeed, the board could use the same fixed exchange rate of 10,000 australs to $1. Moreover, the reserves required by the board could be obtained by transferring the Central Bank's assets to the board and converting them into dollar-denominated assets issued by the U.S.

With a currency board, the credibility problems that plague Argentina's Central Bank would disappear overnight. If capital- and current-account transactions are unimpeded and the dollar is the reserve currency, interest and inflation rates in Argentina would approximate those in the U.S. Foreign-exchange risks vis-a-vis the dollar would be eliminated. In consequence, Argentines would repatriate their overseas dollar hoards and foreign investors would rush to Argentina. Instead of sending "foreign aid" to the U.S. because of dollarization, Argentina would generate seigniorage, the board's profits. In addition, the soft-budget constraints that Messrs. Menem and Cavallo are battling to eliminate would be closed permanently because the board could not finance government deficits.

If President Menem wishes to replace his mentor, Juan Peron, as a more respectable Argentine icon and if Mr. Cavallo wishes to go down as Argentina's greatest economics minister, they should eliminate the Central Bank. They could accomplish that task in a matter of weeks. After all, under more difficult circumstances, John Maynard Keynes established a successful currency board in north Russia in 1918, only 11 weeks after he crafted its blueprint.

Mr. Hanke is a professor of applied economics at the Johns Hopkins University in Baltimore. Kurt Schuler, a graduate student at George Mason University, assisted in the preparation of this piece.