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In Mexico and  
Argentina

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214 Massachusetts Avenue, N.E.  
Washington, D.C. 20002-4999  
U.S.A.  
202/546-4400

# A Tale of Two Pesos: A Comparison of Currency Policies In Mexico and Argentina

By Steve H. Hanke

A sound currency is a necessary, but not sufficient, condition for the establishment of a stable government and the promotion of economic prosperity. This theme has been sounded over and over again by virtually all great economists in positions of influence.

After suffering the trauma of the 1922-1923 hyperinflation, no people has taken the call for sound currency and credit systems more to heart than the Germans. As West Germany's first Chancellor, Konrad Adenauer, put it: "Safeguarding the currency forms the prime condition for maintaining a market economy and, ultimately, a free constitution for society and the state" (Marsh, 1992, p. 30). Not surprisingly, Adenauer's economics minister, Ludwig Erhard, went so far as to proclaim that monetary stability was a basic human right. These sentiments are shared by all political parties in Germany. Indeed, one of the pithiest pronouncements on the need for sound money was uttered in parliamentary debate by Karl Schiller, the Social Democratic economics minister from 1966 to 1972: "Stability is not everything, but without stability, everything is nothing" (Marsh, 1992, p. 30).

The German views on sound money are enshrined in the Bundesbank Law of 1957. That law charges the central bank with one and only one objective: to defend the value of the German mark. And that is just what the Bundesbank does. Indeed, in the post-Bretton Woods era, the mighty mark has been the world's most stable currency (Deane and Pringle, 1994, pp. 353-354). This performance is, of course, music to the ears of most Germans: a recent poll found that almost 80 percent of the Germans identify their Germanness with the stability, strength, and international prestige of the mark (Nash, 1995).

After bearing the burden of one of the world's most unstable currencies for decades, Argentines appear to be following the path of the Germans (Hanke, 1995). In Argentina's most recent presidential election, all three major parties (which accounted for 96.2 percent of the popular vote) supported Argentina's Convertibility Law (Law 23.928). Under this law, which has governed monetary policy since April 1, 1991, the Argentine peso is fully backed by U.S. dollar denominated assets and is freely convertible at an absolutely fixed exchange rate of one peso for one dollar.

In contrast, Mexico's monetary policy is in disarray. Although Mexicans yearn for a sound peso, politicians from the three major parties and the technocrats who advise them have not been able to agree on a well defined exchange rate policy. The Banco de Mexico has allowed the peso to collapse during the last four presidential election periods and consequently has the distinction of being one the world's worst central banks (101st out of 108), judged on the basis of currency stability (Deane and Pringle, 1994, pp. 353-354).

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He spoke at The Heritage Foundation on December 12, 1995.

ISSN 0272-1155 © 1996 by The Heritage Foundation.

Given this, it is not surprising that the Banco has been unable to establish a transparent exchange rate policy.

The Banco de Mexico's monetary policy remains incoherent. Indeed, the numbers contained in the Banco's monetary plan for 1996 are not plausible. The Banco assumes that real GDP and inflation will increase by 3 percent and 20.5 percent, respectively, and that the monetary base will increase by 28.6 percent during 1996. This implies that the demand for pesos will dramatically increase and that the velocity of money will dramatically decline to -5 percent. Given the historical record in Mexico, this is highly unlikely (I.D.E. A. and the London School of Economics, 1995). Indeed, for velocity to decline to -5 percent, inflation would have to decline from 53 percent in 1995 to around 20 percent in 1996, and more important, such a drop in inflation and a stable exchange rate would have to be the prevailing expectation. Such a shift in expectations is highly unlikely, particularly given the central bank's low level of credibility.

In addition, it is important to mention that Mexico—unlike Argentina and Chile, for example—has also failed to produce a coherent program to cut public spending and to privatize and deregulate its economy. As the *Economist* magazine put in its recent *Survey of Mexico*, “much of the economic liberalization of recent years has not been up to scratch. Privatization sometimes merely served to replace public monopolies with private ones—amid much scattering of lucrative favors.... [And] financial reform was late and poorly regulated.” (*Economist*, October 28, 1995, p. 15). If this is not bad enough, Mexico continues to embrace the principle of wage-price controls. This principle was enshrined in October 1995, with the approval of yet another pact, the Alliance for Economic Recuperation (DePalma, October 30, 1995).

An incoherent monetary policy and half-baked economic liberalization are hardly the foundation upon which to build stability and robust economic growth. Indeed, this combination of policies is a recipe for continued financial and political turmoil in Mexico.

To avoid future turmoil, Mexico must correctly define its exchange rate regime. Exchange rate regimes come in three varieties: pegged (fixed, but adjustable), floating, and fixed.

Pegged exchange rates are favored by most developing countries. Some developed countries, most notably those that are members of the European Exchange Rate Mechanism, also employ pegged exchange rates. This regime is not a free-market mechanism for international payments. It is an interventionist system, and should be rejected on principle.

In practice, pegged exchange rate regimes, not surprisingly, do not perform well. They require central banks to manage simultaneously a currency's exchange rate, the domestic liquidity, and the capital account. This is a tricky, if not impossible, task, particularly in developing countries, where the instruments for discretionary monetary policies are limited (Fry, 1995). Consequently, a pegged rate inevitably results in contradictory policies that invite a speculative attack. When under siege, a peg cannot last unless interest rates are raised to sky-high levels or foreign exchange controls are imposed. Alas, such episodes usually get out of hand and result in an “adjustment” to the peg (a devaluation).

This is what happened with Mexico's old pegged system in which the peso was linked to the U.S. dollar. Under that peg, the peso was allowed to trade within a tolerance band of some plus or minus 3 percent. The band “crawled” downward daily, allowing an annual peso depreciation of about 4 percent against the dollar.

To keep the peso within this band, the Mexican central bank had to manage at the same time both the peso-dollar exchange rate and the peso money supply. This is a difficult balancing act, as Mexico discovered in 1994, and as members of the ERM discovered in 1992 and 1993.

Interestingly, Lord Keynes anticipated the difficulties posed by pegged systems. As he put it in 1923, “we cannot keep both our own price level and our exchanges stable. And we are compelled to choose” (Keynes, 1971, p. 126). Alas, despite the evidence, advocates of pegged exchange rates are alive and well. Indeed, some research institutions, notably the Institute for International Economics in Washington, D.C., are evangelical in their promotion of pegged systems (Bergston and Williamson, 1983).

To put the failure of pegged exchange rates into a broader context—particularly in developing countries, where they are almost universally used—consider the performance of central banks in developing countries since 1971, when the U.S. closed the gold window (Schuler, 1995). The median annual rate of inflation of the 126 developing countries with central banks has been double that of the 19 developed countries. And 37 developing countries have experienced annual inflation from 100 percent to 999 percent, and 19 have endured hyperinflation of over 1,000 percent per year. In the same period, 13 developing countries have confiscated their currencies.

Not surprisingly, the currencies of the developing countries have lost most of their value relative to the U.S. dollar. The median depreciation has been 79 percent since 1970. And if you reside in a developing country, it is difficult to legally avoid the effects of currency depreciation because 88 percent of those countries impose some form of exchange controls.

And here’s the saddest part: The low-quality junk money produced by the central banks in developing countries has been a drag on per capita economic growth. Since 1971, the developed countries have grown at almost twice the rate of the developing nations,

In an attempt to avoid being robbed by their central banks, citizens in developing countries resort to all means, legal or illegal, to get their hands on “high-quality” money. Consequently, Gresham’s Law in reverse is at work in most of the world.

As much as some might complain about the U.S. dollar, the greenback is the world’s preferred currency, with the German mark coming in a distant second. Indeed, between \$185 billion and \$260 billion in cash is held outside the U.S.—50 percent to 70 percent of the total U.S. dollar notes outstanding (Blinder, 1995).

Where have all the greenbacks gone? Between 1988-1991, most went to Latin America. Since then, Europe has been the dominant destination, with Russia demanding the lion’s share. In 1994 well over half of the total foreign shipments of dollars went to Russia, a total of about \$20 billion. The rate of shipments to Russia has increased in 1995, with flows running at a remarkable \$100 million per business day. After Europe, the Far East and Middle East now account for about 30 percent of the shipments, and the remainder of the dollars flow to Latin America (Porter and Judson, 1995).

The export of greenbacks is a very profitable business for the U.S. No other export can match the profit margins earned by the Federal Reserve’s shipments of cash overseas. The Fed prints and hands over little pieces of noninterest-bearing green paper at almost no cost and gets hard currency in exchange. This amounts to an interest-free loan from foreign holders of those pieces of green paper. The Fed then invests the proceeds in U.S. government securities and turns the profits over to the U.S. Treasury.

The profits are huge, between \$11 billion to \$15 billion per year—equal to federal receipts from estate and gift taxes. Moreover, it is a growing business: Foreign holdings of U.S. dollars are growing faster than the U.S. economy.

Unlike pegged exchange rates, floating and fixed rates are free-market mechanisms for international payments. Under a floating regime—such as that which governs the U.S. dollar, German mark, and Japanese yen—a national currency seeks its own level in relation to other currencies that it floats against. Although many currencies in developed countries float, few of the developing countries float their currencies, and for those that do float, it tends to be a short-lived experiment (Schuler, 1995).

Even though there is nothing wrong with floating, in principle, this type of regime is plagued with practical problems in developing countries, where most central banks have very poor records and lack credibility. Consequently, to achieve price stability under a floating regime, a central bank must impose a relatively restrictive monetary policy and relatively high real interest rates for an extended period. Alas, this would be accompanied by an economic slump or very slow economic growth. This is why few developing countries have adopted floating rates.

Fixed exchange rates are favored by a handful of countries—most notably, Argentina, Estonia, Hong Kong, and Lithuania. These countries employ currency board-like systems in which their local currencies are backed 100 percent by a reserve currency and are freely convertible into the reserve currency at an absolutely fixed exchange rate.

Consequently, a country operating under this discipline forgoes an independent monetary policy and becomes part of a unified currency area with the country to which its local currency is linked. Unlike floating regimes, currency boards have a rich and successful history in developing countries (Hanke, Jonung, and Schuler, 1993).

More than 70 countries have had currency boards. The first currency board was established in 1849 in the Indian Ocean island of Mauritius, then a British colony. Currency boards spread to other British colonies and to independent countries that wanted to earn income from having their own currencies, yet maintain fixed exchange rates with an anchor currency. Most currency boards used the pound sterling as their anchor currency, but some used the U.S. dollar, the Australian pound, gold, or silver.

Beginning about 1913, the currency board system spread rapidly, and eventually it reached almost all parts of the world. Currency boards were common in Africa, the Middle East, East Asia, the Caribbean, and Oceania. In South America, Argentina had a currency board. In 1899 Argentina passed a law re-establishing the gold standard and requiring the Caja de Conversión, previously a conduit for unbacked paper money, to hold 100 percent gold reserves for all new liabilities. The system became fully operative in 1902. The period of its operation was one of great prosperity for Argentina, which at the time was among the world's richest countries. Argentina suspended the system just after the First World War began, apparently because the government feared a drain of gold to countries that had already suspended the gold standard. Argentina re-established a currency board briefly from 1927 to 1929, but suspended it again in December 1929, as a result of the worldwide stock-market crash and the resulting cessation of foreign investment in Argentina. Both in 1914 and 1929, the gold reserves of the Caja and commercial banks were high, and the rationale for suspending the system appears dubious in retrospect (Hanke, 1995).

The performance of currency boards through out the world has been excellent. All have maintained full convertibility into their anchor currencies. Furthermore, countries with boards have generally had price stability, respectable economic growth, and balanced government budgets. (Hanke and Schuler, 1994).

What type of exchange rate regime should Mexico adopt? A pegged system should be rejected on two counts: it is unsound in principle, and in practice, pegged regimes have a poor record, particularly in Mexico. A floating regime, though sound in principle, is unsatisfactory for developing countries with central banks that have low credibility, such as is the case in Mexico. Alas, many free-market economists have recommended that Mexico float the peso. Two notable examples are Dr. W. Lee Hoskins and Professor Allan H. Meltzer (Hoskins and Coons, 1995 and Meltzer, 1995).

Apparently, these free-market economists have failed to pay heed to Professor R.H. Coase and his complaints about economists who engage in abstract theorizing to the neglect of acquiring a detailed knowledge of the actual institutions involved (in this case, central banks in developing countries). This, of course, is not the first time this type of error has been committed in debates about exchange rate regimes (Hutchinson, 1977).

Both on principle and in practical terms, a currency board for Mexico offers the most attractive exchange rate regime. Sir Alan Walters and I first argued in favor of this approach in July 1994 (Hanke and Walters, 1994). Specifically, we concluded that the peso was overvalued and that Mexico's crawling peg system would fall apart. We recommended that the peso should be devalued by 16 percent, to 4 pesos per U.S. dollar, and that a currency board system should be installed. By introducing a completely new and credible exchange rate regime, inflation expectations would have been dramatically altered in Mexico and the new exchange rate would have remained absolutely fixed at 4 pesos per U.S. dollar from that point onward. Hence, we are not "airy-fairy" devaluationists, as Sir Roy Harrod has called them (Hutchinson, 1977, p. 101).

Moreover, we are not the only free-market economists who see currency boards as the only means to achieve monetary stability in developing countries. Professor Milton Friedman, never one to overlook real world institutional detail, has written that:

[F]or developing countries, the case against using monetary policy primarily as an instrument for short-run stabilization is far stronger than for developed countries. The crucial problem for developing countries is to achieve sustained growth, not to smooth short-run fluctuations. In addition, such countries seldom have financial markets and banking institutions sufficiently sophisticated to permit what has come (most inaccurately) to be called "fine-tuning" of monetary policy.

... [F]or most such countries, I believe the best policy would be to eschew the revenue from money creation, to unify their currency with the currency of a large, relatively stable, developed country with which they have close economic relations, and to impose no barriers to the movement of money or of prices, wages, or interest rates. Such a policy requires avoiding a central bank. (Friedman, 1974, p. 274).

So why has Mexico eschewed a currency board? Many hypothetical objections have been raised. Most of these have been presented in a recent book (Williamson, 1995). And all have been refuted (Hanke and Schuler, 1994). But, the Mexican technocrats, unable to mount a

substantive attack on the currency board system, turned to a practical argument. They claimed that Mexico did not have enough reserves to fully back the Banco de Mexico's liabilities (Buirra, 1995). Even if this was true, it is irrelevant. A viable currency board can be started with less than 100 percent reserves on existing, old liabilities, if all new liabilities are required to have 100 percent reserve backing. In the past, this type of marginal reserve rule has been successfully employed.

For example, while the fiat issue of pesos that Argentina's currency board inherited in 1902 was virtually unbacked by gold (which served as the reserve cover), new pesos could only be issued if they were backed 100 percent by gold reserves. Once the new system was installed, the demand for new pesos grew rapidly. Consequently, the gold cover for all outstanding pesos rose from only 0.11 percent in 1902 to almost 73 percent in 1913 (Hanke, 1995).

This leaves us with two unanswered questions: How well did the Argentine currency board-like system stand up to the ravages of the so-called tequila effect? And what lessons can Mexico draw from Argentina's experience?

The shock imposed on Argentina by Mexico's financial crisis had four distinct phases (Banco Central, Republic of Argentina, 1995). The first phase lasted from December 20, 1994 through February 1995. External drains from the currency board-like system occurred, with the central bank's liquid reserves falling from \$15.8 billion before the crisis to \$13.3 billion at the end of February. (Note that Argentina's system is not orthodox because only 80 percent of the system's reserves must be held in dollar denominated assets issued by foreign governments. These are called "liquid reserves." The remaining reserves must be dollar denominated, but can be issued by the Republic of Argentina. Both types of reserves must be marked-to-market (valued) at current prices.) There were also internal drains of both peso and dollar deposits from commercial banks. Wholesale banks and small retail banks were most strongly affected. Two small wholesale banks, with a high proportion of their assets in Argentine government bonds, were suspended.

During the first phase, the broad money supply, M3 (pesos outside banks plus peso and dollar deposits), decreased by 3.2 billion pesos, or 5.8 percent, by the end of February. And bond prices fell sharply, with yields on peso denominated bonds moving from 22.6 percent before the crisis to 38.9 percent at the end of February. The prime rate on peso denominated loans also increased during the period, from 12.5 percent to 22.7 percent. Dollar denominated bond yields and the dollar prime rate also increased, but not by as much as those on comparable peso denominated instruments. The peso-dollar bond yields, for example, increased from 480 basis points to 934 basis points (Pre 1 vs. Pre 2 bonds), reflecting an increase in the perceived exchange rate risk.

The central bank took steps to tighten the link between the peso and the dollar. On January 12th, it eliminated the spread between buying and selling rates for dollars, making the rate exactly 1 peso = \$1. It also required banks to hold their current accounts at the central bank in dollars instead of pesos (these accounts are used for clearing and reserve requirements). That reduced the central bank's potential gain from a devaluation.

To increase the liquidity of banks, the central bank temporarily reduced reserve requirements on deposits on the 28th of December and again the 12th of January. On January 12th, it also established a safety net (lender of last resort facility) financed with 2 percentage points of existing required reserves. These funds could be loaned to solvent banks with li-



quidity problems. Previously, there had been a private, voluntary safety net to buy loans from banks with temporary liquidity problems.

Subsequently, the government took further action to assure bank liquidity. Decree 286 of February 27th created the Fiduciary Fund for Provincial Development to help privatize banks owned by provincial governments, many of which were notoriously weak. Decree 290 of February 27th amended the Organic Law of the central bank to broaden its power to lend to illiquid banks, and amended the Law of Financial Institutions to allow the central bank to play a more active part in reorganizing troubled institutions.

The liquidity squeeze that the financial system had endured became a true crisis in the second, post-tequila phase, which started in late February 1995 and lasted through March. On February 27th, the international banks with branches in Argentina cut off credit lines to their branch operations, citing "country risk" as the rationale for such drastic action. This shocked branch bank managers and sent them scurrying unprepared into the domestic interbank market. The consequences were predictable. The interbank interest rates rose dramatically, from about 20 percent on peso deposits to over 50 percent within hours after the international credit lines were cut. Also, the massive entry of the international branch banks into the interbank market was interpreted as a vote of no confidence for Argentina's currency board-like system. Consequently, both external drains from the currency board-like system and internal drains from the commercial banks became great floods.

It is important to stress that the withdrawal of the credit lines from the international banks was the event that pushed Argentina from a liquidity squeeze into a liquidity crisis. Viewed from a historical perspective, this event is unusual, if not unique. With absolutely fixed exchange rate regimes, either currency boards or the classical gold standard (1880-1914), foreign banks have provided liquidity during times of liquidity squeezes (Hanke, Jonung, and Schuler, 1993; Gallarotti, 1995). Indeed, private foreign banks have traditionally acted as lenders of last resort in absolutely fixed exchange rate systems. This was not the case in Argentina, because its currency board-like system was relatively immature and untested. Alas, Argentina had to pay a price for the sins of its monetary past.

Fuel was added to the crisis, when in the last days of February, rumors spread that the government might freeze deposits, as it had done with the "Bonex plan" of early 1990. Many people were also apprehensive that the decrees of February 27th were a prelude to broader powers that would reduce the rule-bound nature of the currency board-like system. There was also fear that a possible devaluation in Brazil would have effects in Argentina.

In March, the broad money supply fell by 4.3 billion pesos, or 8.4 percent; it reached its low point for the crisis at the end of the month. Peso deposits, dollar deposits, and currency outside banks all fell, reflecting a desire by many Argentines to hold their money outside the local financial system, either in dollar deposits abroad or dollar caches locally. Interest rates jumped; the peso prime rate increased from 28 percent at the end of February and peaked at 45 percent in March. Dollar interest rates likewise increased, with the prime rate peaking at 30 percent. The exchange rate risk exploded, with the peso-dollar interest rate spread moving from 934 basis points at the end of February to 1,647 basis points at its peak. Since dollar interest rates were many times those prevailing in the United States, market participants evidently perceived that there was a high risk that borrowers of dollars would default or that the Argentine government would interfere with loans and deposits in dollars.

With the crisis worsening, the central bank took additional measures to further increase liquidity for banks. On March 10th it temporarily allowed all banks to use up to 50 percent of their peso and dollar vault cash to fulfill reserve requirements, and allowed banks that had

bought assets from institutions with liquidity problems to use the remaining 50 percent in the same way. The central bank also used its excess reserves to make short-term loans (discounts and repos) exceeding 900 million pesos to solvent banks with liquidity problems. As a result of its loans and the reduction in pesos outside banks, the central bank's liquid reserves fell to a low of 10.2 billion pesos at the end of March, compared with 15.8 billion pesos in late December. However, at no time during the crisis did the ratio of liquid reserves to the monetary base fall below the statutory minimum of 80 percent.

On March 14th, the government announced a package of measures, totaling 11.4 billion pesos, to contain the financial crisis. It accelerated privatizations. It reduced its planned government spending by 2 billion pesos, including cutting the wages of senior government employees by 5 percent to 15 percent. It increased several taxes, most important the value-added tax (a temporary increase of the rate, lasting until March 31, 1996, from 18 percent to 21 percent). And it announced plans to borrow up to US\$7 billion—a three-year US\$1 billion domestic “patriotic” bond issue from Argentines, a three-year US\$1 billion bond issue from private foreign lenders and US\$5 billion from the IMF, World Bank, and Inter-American Development Bank.

Argentina's success in putting together the (oversubscribed) \$1 billion Patriotic Loan turned the corner. The loan was a convincing domestic affirmation of the creditworthiness of the Menem-Cavallo administration, and the IMF et al. tagged along. This soon opened up the system with a fall in interest rates as dramatic as the February-March rise. The crisis was over.

From the beginning of April to the presidential election of May 14th, phase three, the crisis leveled off in some respects and eased in others. The broad money supply remained approximately constant: dollar deposits decreased, while peso deposits and pesos outside banks actually increased. Interest rates declined slightly; the peso prime rate eased from about 27 percent at the beginning of April to 24.5 percent in mid-May. Perceived exchange rate risk also declined, with the peso-dollar spread narrowing from 1,224 basis points at the beginning of April to 713 basis points in mid-May. And on April 12th, the government announced the creation of a privately financed, voluntary Deposit Guarantee Fund for peso and dollar deposits.

Despite the crisis, the Convertibility Law continued to enjoy support across the political spectrum, including the three leading candidates and parties in the presidential election. Nonetheless, people were apprehensive about what might happen if President Menem were defeated or forced into a runoff election. However, President Menem's re-election in the first round, and the strong showing of his Justicialist Party in Congress, calmed the fears that a change in the government would undermine the Convertibility Law.

After the presidential election, all monetary indicators improved, marking the last phase the crisis, which ended by the beginning of August. Interest rates fell; the peso prime rate fell from 24.5 percent in mid-May to 14.5 percent by late July, while the dollar prime rate fell from about 18.5 percent to 12 percent in the same period. The broad money supply increased, though by the end of July it was still about 10 percent below the pre-crisis level. Pesos outside banks, peso deposits, and dollar deposits all registered increases. Bank credit to households and businesses, which had fallen about 4 percent from the beginning of the crisis to the low point at the end of April, began to recover. Further, the central bank reduced its repos by about half between the end of March and the end of July, while its liquid reserves held against the monetary base rose above 90 percent. The perceived exchange rate risk also eased, with the peso-dollar spread narrowing from 713 basis points at the beginning of phase three to 500 basis points at the end of July.

At the present, the Argentine monetary indicators roughly reflect the “pre-tequila” magnitudes. The peso-dollar exchange rate remains absolutely fixed at 1 to 1. And inflation for 1995 was 1.6 percent, one of the lowest rates in the world and the lowest annual inflation in Argentina since 1944. The central bank’s liquid reserves increased by \$3 billion during December 1995, to reach \$15 billion, almost the pre-tequila level of \$15.8 billion. Dollar denominated time deposits currently stand \$500 million higher than those of December 1994, and M1 has returned to its December 1994 level. And the peso and dollar prime interest rates are 9.5 percent and 8.25 percent, respectively. Both rates are lower than their pre-tequila levels. The perceived exchange rate risk is actually lower than the pre-crisis level, with the peso-dollar spread currently standing at 359 basis points, 121 basis points lower than the pre-crisis spread. Like tempered steel, Argentina’s currency board-like system has been toughened by the crisis, and as the peso-dollar spread indicates, the system is stronger than ever. In addition, unemployment has started to come down and economic activity is starting to show signs of life. So, Argentina’s currency board-like system has proven its critics, such as Professor Krugman, wrong (Krugman, 1995). As the Duke of Wellington often observed victory is the avoidance of being crushed by an onslaught, and Argentina’s currency board-like system has certainly kept Argentina from being crushed by the tequila effect.

What lessons can Mexico draw from the Argentine experience?

- ❶ Currency boards, much like the classical gold standard, provide a constraint on monetary authorities. This is not to say that the monetary authorities do not attempt to maneuver around the constraints. Indeed, writing about the gold standard in 1932, Professor F. A. Hayek concluded that “Every effort has been made to obviate [the gold standard’s] functioning at any point at which there was dissatisfaction with the tendencies which were being revealed by it” (Hayek, 1984, p. 134). During Argentina’s recent experience, the authorities also squirmed as much as they could within the confines of Argentina’s currency board-like system. However, as much as the monetary authorities tried to maneuver and introduce discretion into Argentina’s rule-bound, absolutely fixed rate system, they failed to shake its irksome constraints (Gallarotti, 1995 and Hayek, 1984).
- ❷ Consequently, currency boards create price stability, even in times of severe crisis.
- ❸ The hard budget constraints imposed by currency boards motivate deeper liberal economic reforms, as well as desired automatic adjustments in the economy. For example, before the Mexican crisis, Argentina’s banking system was notoriously weak. Given that Argentina had no central bank that could print pesos at will or act liberally as a lender of last resort, many people thought that the weak banking system would be Argentina’s Achilles’ heel. It was not and is not. Argentina’s banking system is rapidly being strengthened and consolidated, with a few weak banks going to the wall and many more being bought by strong banks. Now, 80 percent of all Argentinean deposits are in the 25 largest banks. In addition, virtually all the weak banks owned by the provinces are on the block in a mass privatization. The discipline imposed by the currency board has put in place a virtuous cycle.
- ❹ And perhaps most important, the results produced by currency board systems can give politicians a platform from which they can win elections.

If Mexico wants to clean up its monetary mess, it must ponder the lessons provided by the Argentine experience. By facing reality, even Mexico’s braying pack of technocrats might finally appreciate that a currency board system is the only way for Mexico to provide Mexicans with what they yearn for: a stable peso.

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