Comments

María Soledad Martínez Pería: The paper by della Paolera and Taylor provides a historical interpretation of crises in Argentina since the 1880s. The study highlights the common features of these episodes and discusses the important differences between the present and the past. Understanding how past events relate to present circumstances is a valuable exercise, and the authors should be highly commended for this effort.

According to the authors, the common thread running through all crises in Argentina is the interaction of a weak, undisciplined, or corruptible banking sector and some other group of conspirators from the public or private sector that hastens its collapse. In other words, twin crises in Argentina have largely been the result of a form of crony finance, which has been referred to as gaucho banking. They argue that gaucho banking destabilized internal and external convertibility and thus led to the collapse of the exchange rate regime.

The authors' historical analysis of crises in Argentina focuses on the two currency board experiments that resulted in the 1929 and 2001 crises. To illustrate how crises may occur under a currency board and a fractional reserve banking system, they develop a dynamic model in which inside money is driven by the behavior of banks and outside money dynamics respond to capital flows (or gold flows in the case of the 1920s). The model yields multiple equilibria depending on whether banks' behavior is motivated by good or crony intentions. Furthermore, a number of shocks (namely, country risk shocks, hotter money shocks, illiquid asset shocks, and a so-called bank robbery shock) can move the economy from the good to the bad equilibrium.

The authors argue that in 1929 the pollution of the banking sector balance sheet (that is, gaucho banking) brought about external instability. In other words, the government bailout of reckless banks led to the collapse of convertibility. These events had their origin in the emergency rediscount law of 1914 that allowed the Banco de la Nación to provide assistance to troubled banks. In 2001, the insolvency of the public sector

combined with bank complicity (that is, aided by the behavior of gaucho bankers) led to the collapse of the banking sector and the most recent currency board. They claim that, in particular, the changes in the macroeconomic and central bank regime brought about by Cavallo after April 2001 triggered the crisis that ensued.

While the gaucho story put forth in the paper is compelling, the evidence offered by the authors to support the notion that this was a crucial element behind the recent crisis is weak. The authors present two main arguments to back this hypothesis: first, that banks had the previous episodes of bailouts that occurred in Argentina fresh in their minds; second, that the banks' acceptance of the megaswap proved that they were in collusion with the government.

Neither of these arguments is sufficient evidence of gaucho banking. In the first case, it is unclear why banks would perceive the situation in 2001 as similar to that of crises in the 1970s and 1980s rather than of the more recent tequila crisis, when a number of banks were allowed to fail. If anything, the asymmetric pesification adopted by the government (where dollar loans and deposits were converted into pesos at different exchange rates, causing large immediate losses for banks) and the lack of access to the Central Bank rediscount window indicate that it would not have been rational for banks (at least private banks) to expect a government bailout. Regarding the notion that the megaswap proved that banks were allied with the government, it is not clear why this would be the case when the authors themselves argue and cite studies (such as the paper by de la Torre, Levy Yeyati, and Schmukler included in this volume) showing that the government had to use moral suasion to persuade banks. At the same time, two statements made by the authors indicate that there was nothing endemically corrupt or prone to cronyism in private banks' behavior up until early 2001. The authors claim that "bad fiscal behavior need not have affected private banks or international reserves, if the laws passed in 1991 had been respected" and that the banking system exhibited signs of health and stability until 1999.

Perhaps a more suitable story to tell about the recent crisis would be one of gaucho or crony politicians who forced banks to become corrupt and infected institutions directly under their control, like Banco Provincia de Buenos Aires. The most convincing argument made by the authors linking crises over time in Argentina is the notion that fixed exchange rate regimes imply that the government has very limited instruments to deal with the

problems of external and internal convertibility. Under this setup, gaucho banking behavior is not required to justify the recent crisis. The fiscal situation alone is enough.

The authors conclude the paper by suggesting that policies like dollarization with narrow banking could help Argentina move forward and prevent future crises of the kind recently experienced. They do not fully explain how these policies would be implemented in practice, however. For example, narrow banking is usually understood as a system in which banks are only allowed to invest in safe assets (typically government paper), but how would this work in a situation of government default such as the present one? Which safe assets could banks invest in? Which institutions would replace banks in providing credit to the private sector? Also, the authors argue that narrow banking would allow for more depositor discipline in response to fiscal spillovers onto banks' balance sheets, but they do not explain or justify this assertion. Similarly, the prescription for dollarization needs further justification. While dollarization might have stopped the run on deposits before the *corralito* and the devaluation, what is the usefulness of it at this point? Dollarization is not a panacea, as is evident from the case of Ecuador; the problems of fiscal sustainability and financial sector restructuring would still need to be tackled. The paper is mute on these subjects.

While the authors should be commended and recognized for their efforts to try to link present and past crises in Argentina and to draw lessons for the future, their diagnosis of the recent crisis and the policies they suggest open up a number of questions and leave room for discussion, perhaps warranting further analysis in future work by the authors.

Enrique Cárdenas: The paper presented by Gerardo della Paolera and Alan Taylor provides a very interesting framework for analyzing the current financial crisis in light of its closest predecessor during the Great Depression. Their argument stresses the importance of what they call crony banking or gaucho banking, namely, the use of inside information and related loans by shareholders to save their private interests at the expense of the public sector and society in general. The authors argue that after the Baring crisis of 1890, the various reforms adopted by the government—namely, isolating the convertibility function from the banking regulatory function under the gold standard—served well until 1913–14, when the external shock of the First World War caused the system to

collapse. After that, the banking system became polluted during the suspension of convertibility, when a new, more liberal discounting law was enacted. This allowed the increase of outside money and the bailout of weak banking institutions that provided poor collateral during the 1929 crash. The authors argue that it was actually the banks' officers and shareholders who had the bad loans and who were actually bailed out by the Banco de la Nación, which did not have a mandate to serve as lender of last resort. But the 1929 crash was the Great Depression.

It is obvious that fragile monetary systems, with or without crony banks, survive better when the economy is growing and when there are continuous flows of foreign exchange either because of good export demand and prices or because of capital inflows. That certainly was the case with regard to Argentina's success with the gold standard before 1914. Once those flows stop, almost no pegged exchange rate system can survive. Also, fiscal orthodoxy during the crisis worsened the economic contraction. This type of external shock and a subsequent fiscal contraction had a lot to do with the 1929 crisis, as well, regardless of the kind of banking system in place. Naturally, a crony system made things much worse. A rigid exchange rate system made things worse, too, which is why Argentina changed the conversion regime and allowed the exchange rate to depreciate. Other countries that were similarly characterized by crony banking, such as Mexico, did not suffer a banking wipeout after 1929. Because Mexico had been in debt default since 1913, the economy did not suffer a sudden halt of capital flows, and it did not face the burden of debt payments. No paper money circulated; the country continued to use a bimetal standard, although legally it was on the gold standard. The Central Bank essentially had almost no monetary instruments at the time of the Crash. The depreciation of silver against gold provided the opportunity to relax the straightjacket, but the recession was deep. The government's reaction was to print money, which the public finally began to accept again after almost two decades of having repudiated it. The cost of barter was simply too high. Furthermore, a fiscal expansion helped the recovery, in contrast to Argentina.

With regard to the current crisis, the authors mention the inconsistencies of one instrument, the Central Bank, and two goals, internal and external convertibility. They also touch on the issue that the public was aware of this Achilles' heel all along, and that despite relatively good performance of loans, the megaswap of public debt for thirty-year bonds at a 16 percent interest rate sent the signal to run. The more knowledgeable did

so first, followed by the common saver and investor. The government declared that it could do no more and that it was going to repudiate its commitment, and people listened. These types of signals have been seen in many crises around the world. One extreme case that comes to mind involves the revolutionary government in Mexico in the 1910s. After issuing enormous quantities of paper money to finance the revolution, the authorities tried to institute a stabilization program by exchanging the old money for new at a loss of fifty times for those in possession of government money. They decided to cash most taxes in gold and silver rather than in its own money, thus signaling that only metal money mattered. People ran away from the paper money as fast as they could. This story has occurred in many places and times. What makes the case interesting is the way in which stability was restored. When money ceased to function as money and the government repudiated it, it collapsed. Within a few days, people stopped hoarding gold and silver and started using it to pay for the necessities of life, effectively reversing Gresham's Law. The economy was back into a metallic regime, without government support or a public gold or silver fund. Indeed, it is an outstanding monetary phenomenon that could be of interest to Argentina today.

In the current Argentine case, however, the fact that interest rates remained so high for so long despite very low inflation reflects a structural problem. How can an economy grow with such a high cost of capital? To what extent did it really reflect crony banking, as opposed to capital scarcity? People suspected all along that the convertibility system was bound to collapse eventually, that property rights were not firmly grounded, and that the need for such a large premium stemmed from excessively high risks. The balance of payments also showed the same situation over the years. But why punish the Argentines twice, first by charging them such high interest rates and then again once the risk materialized as fact? This is another lesson to be drawn from the experience, and one just wonders at the strength of self-fulfilling prophecies maneuvered by the market.

A crony banking system clearly is not the best structure for forging a strong banking system. It may actually cause enormous damage not only to the banks, but also to the economy as a whole—and for more than a generation. That also applies quite squarely to the Enron and WorldCom frauds that caused millions of people to lose their savings, not only in the United States but also abroad, and with lasting effects that will extend for more than a generation. There are crooks everywhere, so Argentina is not

alone. What is worrisome is the realization of just how frail one's wealth (or perceived wealth) really is.

The authors ask a question that touches on an important related issue. Why is it that no one—including the political class, the International Monetary Fund (IMF), and the economic intelligentsia—was able to avert such a disaster? How could so many people—laymen and specialists alike—not have seen the problem coming? While they can (reluctantly) understand the position of Domingo Carvallo, who essentially fell into his own trap for political considerations (Mexico shows some parallels in 1994), they are unable to find such an excuse for the IMF or the economic intelligentsia having misjudged the situation. There was some sort of collective wishful thinking for the convertibility system to work—again as when Mexico entered the North American Free Trade Agreement (NAFTA) in 1992–94—but deep down, most people did not think it would.

This may explain why the IMF was first a sponsor and later a sharp critic of Argentina. Was there cronyism there too? As Professor Mussa mentioned at the National Bureau of Economic Research (NBER) Conference (as reported by the authors): the root of the crisis was fiscal, simply because "it ended in a sovereign default." I agree, but that is as true for Argentina in 2001 as it was for Mexico in 1995. Mexico had U.S.$28 billion of short-term government debt denominated in dollars, yet the U.S. government bailed out the Mexican state, and in less than a year the government had converted the short-term debt into long-term debt. A terrible crisis was averted and growth resumed rapidly. Why was something of this sort not done in the Argentine case, given the success of the Mexican bailout? Are Mexicans really more trustworthy than Argentines? Does it have something to do with timing? Perhaps it depends on whether the person living in the White House is a multilateralist who believes in the goodness of the Kyoto Protocol and the International Court of Justice, or someone who could not care less. I applaud the recent initiative taken by the G8 countries to try to find a solution for this sort of situation. Beyond any improvements that may be made to banking and financial institutions, as well as to regulatory and auditing agencies (badly needed not only in Argentina, but also in the developing world more generally), unpredictable situations require other sorts of institutional arrangements to deal with sovereign bankruptcies. It is not possible to continue with current institutions, as they are in the throes of the various crises that the world has experienced in the recent past.

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