

Depesifying – the starting point to solve Argentina's crisis

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In Argentina people demand US dollars for many reasons, the main one being that they wish their savings to be protected and they feel that Argentine pesos do not provide such protection. That is why they attempt to turn any spare pesos or government bonds issued under Argentine legislation into dollar notes or bank dollars deposited abroad. Because of this, the dollar rate is so high that it brings pressure on public expenses, which may end up in an unrestrained number of pesos issued. In those conditions, hyperinflation is an impending danger.

This situation was triggered by the pesification of the economy, not by the free flotation of the currency. If all contracts in US dollars had been honored, the dollar rate would have increased by a mere 50 or 60 per cent after abandoning the one American dollar – one Argentine peso convertibility system. When the US\$70 billion worth of bank deposits were turned into pesos at an arbitrary rate, people panicked and attempted to transform them back into dollars. But bank dollars no longer exist in Argentina, so the billions of pesos forced into personal portfolios translate into an exorbitant demand for dollar notes or bank dollars abroad.

The way to find a solution to Argentina's financial problem is that Justice revoke the pesification decrees, on the grounds that they are unconstitutional. Thus, all deposit and loan transactions paid while pesification was in effect shall be regarded as terminated. And non-cancelled assets and liabilities, as well as all the contracts formerly denominated in US currency which are still in force, will resurge as assets and liabilities in dollars. In other words, a depositor who had US\$10,000 and withdrew no pesos from his account will continue to have US\$10,000. A debtor who owed US\$ 10,000 and made no repayments whatsoever will continue to owe US\$ 10,000.

Back to dollars

Depositors, secured loan holders and pension funds companies will recover their financial assets in bank dollars inside Argentina. What does this imply? This means that, for the time being and until foreign financial relationships normalize, dollars shall be neither withdrawn from accounts in the form of bank notes nor transformed into bank dollars overseas, but they could be used to pay debts by means of checks, debit cards or inter account bank transfers within Argentina, to pay imports of foreign goods and services, or even to serve the private sector's financial debts abroad, after they have been restructured in compliance with the regulations set by the Central Bank of the Argentine Republic. The only dollars leaving the system will be those used to make payments abroad but then they will be subject to foreign exchange controls, that is, only commercial and financial repayments of restructured debts will be permitted; and in any case, these payments will

be presumably lower than the amounts received from exports. In order to authorize such payments abroad with bank dollars, the minimum conditions for restructuring the private debt shall be stipulated taking into account the foreign currency balance throughout time.

Bank dollars will move freely from bank to bank, depending on where the transfer needs to be made to pay debts by means of debit cards or checks. At the clearing house, the negative balances of accounts corresponding to banks which lose dollar deposits could be paid off with collateral loans in dollars for an equivalent amount. Thanks to this practice, the banks losing deposits will not need rediscounts.

Depositors will be able to deal with their bank dollars as they prefer. They will have the chance of keeping them as fixed term deposits at the interest rate offered by banks. Also, they will have the alternative to transfer them to current accounts or savings accounts - always in dollars-, for the payment of debts. To sum up, banks will operate with all types of dollar accounts, exactly as they did before pesification came into effect.

How will banks manage to resume their dollar liabilities with depositors? The answer to this question is that, at the same time, banks will recover all their dollar assets. Collateral loans in their assets are turned back into dollars under the terms initially set on the occasion of the domestic swap.

Likewise, loans originally granted in dollars to the private sector become dollar assets again. The National Government shall compensate the banks for the differences originated by asymmetric pesification but only for the transactions carried out while this measure was in force. There will be no need to compensate banks for the assets and liabilities that will be turned back into dollars.

How will bank portfolios recover after pesification is reversed? It is evident that if debtors are not given any sort of relief, many of the banks' assets will become bad debts. For this reason, it is highly important that dollar debtors be offered a subsidy. This benefit shall favor debtors exclusively, not banks, and only if they meet certain requirements.

If the debtor is a family that purchased real state or a car, or that spent any other reasonable amount of money, say up to US\$ 100,000, they could be granted a subsidy under conditions equivalent to those of pesification. Instead, when the debtor is a company, applicability for the subsidy will be assessed considering the amount of the debt. Company debts under US\$ 100,000 could be regarded in the same way as family debts. For all other amounts, the subsidy will provide for a percentage of the debt, not for the difference between the dollar rate and the former one dollar-one peso convertibility value.

Criteria

It is very important that major debtors do not profit from significant devaluation percentages (if they did, they would attempt to induce hyperinflation). In order to define the scope of the subsidy, several factors should be taken into account –the amount of the debt, whether the company sells in the domestic market or abroad (in which case, an exchange risk insurance could be provided only to equal the financial dollar to the exports dollar), if it has paid its taxes in due time and thus be favored with this benefit, etc.

However, no distinctions should be made between debts contracted under Argentine jurisdiction and those ruled by foreign law, as this would be an arbitrary and unfair differentiation. This aspect will make the subsidy attractive to large companies indebted under foreign legislation. To apply for this advantage, debts shall be previously restructured under the same conditions ruling payments with bank dollars.

Subsidies will mean a fiscal cost in dollars to be budgeted over each of the following years. Such cost could be stipulated to represent exactly the same amount of money and to imply the same time profile as the dollar bond that was going to be issued to compensate banks for the disadvantages of asymmetric pesification. So as to comply with budget restrictions, the subsidy for large companies shall be moderate.

In the case of peso accounts within the banking system, limits on cash withdrawals will have to extend some time longer, but payments by means of debit cards, checks or inter account bank transfers should be unlimited. All restrictions must be lifted to let people move their fixed term deposits into savings accounts or current accounts. This entails reversing the compulsory rescheduling of fixed term deposits imposed early this year. It is essential for economic recovery that people spend their savings. When payments are made by moving money from one account to another, funds remain in the country's banking system, and transactions concerning real assets and goods in general are not restrained because cash does not drain out of this system.

The dollar rate

What will happen with the dollar rate? Initially, there will be a inter bank transfer dollar rate within the Argentine system that will surely have a discount in front of dollar notes or transfer dollars abroad. Such discount will show the lack of confidence in the Argentine financial system, but with the passing of time and as the situation tends to stabilize, the difference between them will become smaller.

The rate paid for dollar notes or for the transfer abroad will drop because the demand for US currency will fall. Many savers whose deposits were pesified will feel confident because they will have recovered their dollars and thus they will not turn to such options as purchasing dollar notes from the market or transferring dollars abroad in the way they attempted initially.

For the dollar rate to decrease, it is necessary that depositors feel satisfied, even when they still distrust the system. If pesification is not reversed, savers will continue to doubt.

Regaining people's confidence is always a gradual process. However, there lies a great difference between promptly setting the process in motion or simply delaying its start. By depesifying, confidence will be slowly restored, although it will take a very long time to reconstruct it completely. But the mere start of the process will be enough for the dollar rate to go down. When people perceive that the drop in the currency rate is not just a temporary situation but a sustained tendency, they will rush to sell their dollars while they can still get a high value. Consequently, the rate of dollar notes will fall, even when it is bank dollars that are converted into pesos.

The Rule of Law

The main benefit of reversing pesification is that Argentina will recover the Rule of Law for its economy. This will enable the future implementation of a stabilization and growth program without having to import foreign institutions. If pesification is not reversed, the country will be doomed to use foreign currency and to sign all contracts under foreign jurisdiction. This intrinsically means that there will not exist transactions with collaterals, for example mortgage loans, as these cannot be ruled by foreign law. In other words, Argentina will be condemned to a very limited range of contracts, which entails stagnation and impoverishment.

The depesification process must apply to all the contracts of the economy. In view of the present emergency, parties will have to renegotiate contracts to substitute for pesification and denominate them back in the currency that they had formerly decided, because changing the currency denomination by law is unconstitutional. However, should the Supreme Court declare these changes to be constitutional, people would conclude that the Argentine Constitution fails to guarantee property rights. And, if this were the case, a market economy would not be viable.

Those contracts that have always been denominated in pesos, such as contracts of employment and many real transactions, will remain in pesos since that was the original currency. But from now on, parties will decide whether they wish to keep on signing such contracts in pesos or if they denominate them in US dollars. The idea is to allow people to choose freely the currency they prefer, which was and still is the essence of the convertibility policy. The one Argentine peso-one American dollar conversion rate was simply a stage in the system, not its essence. It was not the free flotation of the peso that put an end to convertibility. The effective end of the system was marked by the introduction of the pesification process. That was precisely the big mistake that should now be corrected.

Recovery

By reversing pesification, confidence in the Argentine financial system could be renewed. It will take time, it cannot be magicked up. But there is a good chance that the system will exist as long as there is absolute legal certainty for contracts in foreign currency. However, this will not be the case if the violation of contracts committed early this year is validated by Justice. Here lies the true importance of depesifying the economy.

The decision of depesifying will meet with the IMF and the G7's approval because it will restore the Rule of Law. The IMF will certainly ask for a budget scheme that provides for the cost of subsidies as a part of public expenditure, and fiscal goals will have to be set taking into account these future outlays. This is inevitable. But if savers are made to pay these future expenses, no one will ever again be persuaded to keep his deposits in Argentina. Such situation will translate into no financing for public or private investments and will eventually leave Argentina doomed to live without credit.