Presentation of Eduardo Levy Yeyati at the Banking panel

For various reasons, it is always difficult to analyze a crisis a posteriori. First, the lack of a counterfactual gives a lot of room for speculation about what should have been done. Second, there are usually many factors and policy decisions working simultaneously. On top of that, there is the natural bias of people that has been are personally involved in the process and are now heavily invested in the ideas they pursued at the time. As expected, they will tend to blame (sometimes with good arguments) other factors and other decisions for the crisis. This makes it very difficult to build a consensus explanation.

Accordingly, I will try to be cautious in my assessment of the past, focusing more on particular issues that might provide lessons about what should be done to avoid similar crisis in the future.

To put it briefly, I believe that, in the surface of the Argentine crisis there was a currency-growth-debt trap: An overvalued currency led to poor growth making the debt unsustainable, which in turn fed back into the perceived overvaluation of the peso as capital fled the country.

However, underscoring these symptoms there was a long-term strategy, formalized in the convertibility plan, that was successful in bringing down inflation and fostering on-shore financial intermediation at the cost of increasing the vulnerability of the country to both external and internal shocks. Thus, a diagnosis of the crisis that only takes into account the events of the last two-three years could be misleading.

The key driving factor behind this crisis (and many others in emerging markets) is the presence of a currency problem. Argentina had (and still has) a weak currency, that is, one that is not accepted as a store of value either by local or foreign residents. There are many factors underlying this weakness, including lack of institutional credibility and a terrible track record in managing the national currency.

Arguably forced by the circumstances, in 1991 Argentina chose a shortcut. Instead of nurturing the peso as a store of value (and incurring the costs and risks of doing so), it embraced the dollar as a ready-made solution.

It is easy to blame convertibiliy for the crisis at this point. But it is not at all clear whether there was at the time an alternative way out of the recurrent high inflation of the 80s. In any case, the benefits of the currency board came with important vulnerabilities that were downplayed at the time, and may have induced an excess of optimisms that delayed precautionary fiscal and financial measures that should have been taken in the midst of the boom in the early 90s:

1. An obvious one was the loss of the exchange rate as an adjustment mechanism to external shocks. Hard peg advocates are well aware of the need of nominal flexibility to fully reap the benefits of a stable exchange rate. The practical problem is, to put it simply, that this nominal flexibility is never when it is needed. Argentina had to undergo the pains of a four-year recession and a 20% unemployment rate to reach a price deflation that, by the time it came, was nonetheless insufficient.
2. A second vulnerability, ultimately related to the fate of the banking sector, was the limitation that the peg imposed on the fiscal front. In the early 90s there was the view that a peg, by imposing limits on the monetary financing of the deficit, would elicit fiscal restraint. Moreover, the higher exit costs from the currency board would dissuade the government from running deficits beyond what could be

financed in a non-inflationary way. That view proved wrong. Very little fiscal discipline materialized, and the budget constraint imposed by the currency board proved easy to circumvent through the issuance of quasi-moneys both by provincial and the national Treasuries.

But in their way to outright money printing, and after exhausting the resources from the sale of public assets and mounting the wave of capital inflows increasing the external debt in the early 1990s, the central and provincial governments violated in almost every way possible this budget constraint by borrowing from the domestic banking sector and eroding the stock of dollar liquidity accumulated for prudential reasons. By the time the run was at full speed, the banking sector had lost a major part of the safety net built in the aftermath of the Tequila crisis.

3. A third vulnerability was the currency imbalance associated with financial dollarization itself, or, more precisely, with liability dollarization, a phenomenon that the policies in the 1990s implicitly (and sometimes explicitly) fostered. If the CBA borrowed credibility by increasing the cost of an exit, it was precisely because of the cost of a substantial devaluation on the solvency of the banking sector and the government. Thus, it was never a surprise that if the exit was ever decided (or anticipated by the public), it will bring the banking sector with it.

   One has to stress at this point that the currency imbalance inherent to financial dollarization not only hits the banking sector in the event of a nominal devaluation. The recession cum deflation that preceded the collapse of the currency board had already started to take its toll on bank debtors (both private and public) and bank returns well before the devaluation took place.

A post-mortem evaluation reveals that, in the months leading up to the crisis, people first dollarized their deposits out of fear of a devaluation, and ultimately run out of fear that their dollar assets would be pesified or confiscated (or both) as soon as the effects of the expected devaluation started to take its toll on bank solvency. Not surprisingly, the dynamic closely resembled that of the 1995 deposit run 1995 as a result of the Tequila crisis.

On top of that, the government, by increasing banks´ exposure to fiscal contagion in 2001 and partially exhausting the stock of dollar liquidity that was supposed to substitute for the lack of lender of last resort, only accelerated the run. Again, one can only speculate about what would have happened if the government has gone for an earlier debt restructuring process preserving banks´ liquidity holdings.

In this context, pesification was a huge mistake. If the bank run reflected the fears that savings would be pesified, pesification only created a huge monetary overhang that exacerbated the run as people struggle to redollarize their savings, correctly anticipating the real exchange rate adjustment that followed. There was no way to do this right in order to avoid a bank run.

Had the government devalued preserving the dollar denomination of financial contracts (possibly including the dollarization of peso-denominated ones), the run *might* have been reverted. This would not have eliminated the need to bail out currency-imbalanced debtors and, in turn, the banking sector, but would have reduced the costs, by reducing the pressure on the banking sector and the exchange market. More importantly, by honoring the terms of financial contracts, it would have gone a long way to preserve domestic financial intermediation.

How can we think of the future of the banking sector in light of what happened so far? Here we have to think in terms of a two-step strategy.

The first, and more urgent, step is the resolution of the actual crisis, particularly the solution to the frozen deposits. After months of thinking about this issue I virtually run out of creative. I always end up with some sort of compulsive securitization, through deposit-bond swap (either issuing public bonds or a bank certificate of longer maturity than the actual reprogrammed deposits) to put an end to the liquidity run in the near future. The alternative policy of tightening monetary policy and limiting liquidity assistance by the central bank also involves a compulsive securitization, this time through the liquidation of illiquid banks. The final outcome will probably be a mix of the two.

The next step is the design of the banking system for the future. My preference here is to try and avoid the typical excesses of creativity that Argentina tends to elicit from economist at home and abroad. Once the crisis is resolved, banks' activity, besides the management of the remaining assets in their portfolios, will likely be reduced to the provision of payments services. On this, once restrictions to cash withdrawals are lifted, there is basically no need to adopt further measures. Argentina never had a big currency substitution problem; transactions were and still are conducted in pesos, and the transactional demand for pesos have remained relatively stable throughout the crisis. A transparent lender of last resort policy by the central bank is all that is needed to sustain the payments system.

In contrast, the generation of bank credit looks like an insurmountable problem. On the one hand, to have bank credit we need people to save in domestic banks. On the other, it would not be advisable to repeat past mistakes by redollarizing financial intermediation. On top of all this, there is the inheritance of the pesification plus confiscation episode: Now that people know that their dollars are not in the bank, and not even the dollarization of deposits may do the trick this time around. Recent proposals like offshore or narrow banking should be discussed in this light.

It is immediate to see how offshore banking misses the point. It may help some subsidiaries keep their operations in the country going, but it certainly does not generate domestic credit. Indeed, Argentine residents already have a considerable amount of offshore assets that is clearly not returning to the country in the form of credit. Moreover, by lowering the cost of capital flight, offshore banking may further reduce the amount of loanable funds within the country.

Narrow banking is subject to a similar caveat. In a narrow banking scheme, transactional demand for bank balances does not generate credit. Therefore, it calls for separate institutions that collect savings and channel them to domestic borrowers. This strategy raises some serious doubts. An immediate one is, of course, that narrow banking does not exist anywhere in the world. Again, Argentina is not a laboratory of new ideas and one has to be cautious about excesses of creativity. A second, more concrete concern relates to its benefits in terms of solving the intermediation problem. While narrow banking certainly enhances and protects the transactions segment, it is ineffective in creating domestic credit: It is not easy to imagine Argentine residents pouring money into uninsured investment banks unless interest rates are unreasonably high.

To conclude, let me stress that the issue of the future of the banking sector and, in particular, of financial intermediation in Argentina is intimately related to the weak currency issue. The fact that people have learned the hard way that convertibility and dollarization did not insured the value of their savings have placed peso and dollar assets on leveled ground, if only because both have become highly unreliable. In a context in which any bad that could have been done to the banking sector was already done in the worse imaginable way, perhaps the only “advantage” is that we can start thinking the problem from scratch, avoiding this time the temptation of an uncertain dollarization boom with the inevitable vulnerabilities that this generates.

Instead, Argentina has the opportunity of strengthening the peso by strengthening the underlying monetary and fiscal institutions. If this is the path to follow (and I believe it is) and the peso (possibly indexed to the CPI Chilean style) is the currency of denomination of financial intermediation, there is not a strong case for departing from the universal bank scheme. Eventually, dollar savings could be allowed in a restricted manner (as they are many countries, and in Argentina right now), for example, to be channeled to export financing or subject to a 100% reserve requirement at the central bank. On the other hand, while everybody agrees that the fiscal deficit has to be sustainable, Argentine banks still need strict quantitative limits on their fiscal exposure to protect them from fiscal contagion in the future.

In sum, it may take time to rebuild confidence in the system and a sizeable credit market and, until then, a prudent strategy may be accompanied by disappointing growth. But perhaps the main lesson from the crisis is that Argentina had better go slower to get further.