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Friday, February 1, 2002

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## Advisor ANALYSIS

Q

In a *Financial Times* column last week, U.S. economists Adam Lerrick and Allan Meltzer proposed a scheme to restart Argentina's economy by allowing Argentines to access their bank accounts through

the issuance of bank deposit receipts guaranteed by the government. Is this plan feasible? Would it be effective? What is the risk of inflation under such a plan?

A

**Guest Commentary: Suhas Ketkar:** "The issuance of government-guaranteed bank deposit receipts would at best ameliorate only one of the constraints on the emission of liquidity that is considered crucial for reviving demand and restarting growth: the problem of deposits fleeing weak(er) domestic banks, thereby raising the risk of systemic bank failures, once the limits on bank withdrawals are eliminated. The other risks of lifting limits on deposit withdrawals would, however, persist. For instance, the liquid, government-guaranteed certificates of deposit could be used to buy goods (thereby fueling inflation) or U.S. Dollars (thereby weakening the currency). Any restrictions placed on the use of these negotiable bankers' drafts would create parallel markets and introduce unwanted inefficiencies that detract from improving productivity and growth. The best approach at this stage appears to be one in which the limits on bank deposits are withdrawn together with floating of the currency while preserving the integrity of the banking system by securing a large enough multilateral credit package to underwrite the banking system's losses."

**Guest Commentary: Roger Taillon:** "Argentines would probably welcome any scheme which gives them greater access to the money locked into their bank accounts. Something like this may be feasible, but there are a number of thorny issues. Are these certificates supposed to be large-denomination or small? Dollar- or Peso-denominated? The scheme would seem more practical if the deposit receipts were large denomination claims on Dollar deposits offering some sort of return. In effect, this would further transform into negotiable time deposits those deposits that have already been turned from savings or short-term time deposits into long-term non-negotiable time deposits. It is unclear that a government guarantee would do much to stop people from differentiating between perceptions

"The scheme's effect on inflation is anyone's guess."

-- Steve Hanke

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as to the medium-term creditworthiness of banks in pricing these securities, given the state of the government's own creditworthiness. Furthermore, if they were Dollar-denominated, not only would the government's ability to honor the guarantees be questionable, the government would also be adding a huge contingent liability, making it that much more difficult to restore its own creditworthiness. If they were Peso-denominated, the government would have a greater ability to honor the guarantees, but the value of the certificates as an investment would be questionable, unless they were indexed to some foreign currency or inflation index (in which case the size of the guarantee could balloon over time). But if the aim of the proposal is truly to provide certificates usable as cash (another variation of the Patacon?), smaller denomination certificates would seem to be necessary. If these were Peso-denominated, people presumably would need to convert their Dollar deposits into Pesos in order to get the new certificates. With or without a government guarantee, the certificates still would probably trade at varying discounts based on the perceived medium-term creditworthiness of the banks. Or else, Gresham's law might apply, with people keeping some banks' certificates and spending others if someone else will take them. And, since Argentines are used to thinking in Dollar terms, and will be well aware of the depreciation of the Peso, they will probably try to spend them as quickly as possible, increasing the velocity of money and therefore inflation. But inflation is likely to increase in any event."

**Guest Commentary: Steve Hanke:** "The Lerrick-Meltzer bank deposit receipt (BDR) scheme is technically feasible. I am skeptical about its potential effectiveness and desirability, however. The scheme's effect on inflation is anyone's guess. If the BDRs supplement the Peso bank notes issued by the Central Bank, they will add to the inflation risk, and if the BDRs displace bank notes, they will not add to the inflation risk. Argentines today don't trust their Central Bank or the Peso. The Lerrick-Meltzer scheme fails to address these fundamental problems. To resolve them, the Central Bank and the Peso should be abolished. Private banks should be authorized to issue U.S. Dollar-denominated notes redeemable in U.S. Federal Reserve notes. Bank-issued notes would be much like bank-issued travelers checks, although the notes would pass from hand to hand without being endorsed." (Editor's Note: See Hanke's proposal, "How to Dollarize in Argentina Now," available at <http://www.cato.org/pubs/papers/schuler-hanke011231.pdf>)

**Susas Ketkar** is Senior Economist and Head of Emerging Markets Analysis at Royal Bank of Scotland.

**Roger Taillon** is Managing Director at Standard and Poor's.

**Steve Hanke** is a Professor of Applied Economics at The Johns Hopkins University.

## Economic News

### Trade Minister Seeks Greater Role for Brazil in World Economy

The crisis in Argentina should be seized as an opportunity to strengthen the South American Common Market (Mercosur) trade bloc, Brazilian Minister of Industry and Trade Sérgio Amaral said Thursday. "This is the time now for the partners of Mercosur to express solidarity and open

our markets to Argentina's exporters," Amaral told an audience at the Inter-American Dialogue during a visit to Washington. The trade minister said, however, that Brazil must expand its horizons beyond Mercosur. In what he termed the "second phase" of Brazil's integration into the world economy, Amaral stressed his country's desire to increase exports by aggressively participating in all of the major trade talk fora, including the World Trade Organization, the European Union, and the

Free Trade Area of the Americas. "There is a perception in Brazil that we have to be present at any available negotiating table," Amaral said. He cited import tariffs on Brazilian products entering the U.S., Europe, and Japan as the biggest challenge to deeper market penetration, while noting that Brazil's highest import tariff stands at 35 percent. Amaral also pointed out Brazil's major domestic challenges to establishing its presence abroad, such as reform of the burdensome tax system and lowering financing costs.

### Ecuador Reports January Inflation of 1.8 Percent

Ecuador's inflation rate slowed to 1.8 percent in January versus 6.97 percent during the same month a year earlier, the Statistics and Census Institute (INEC) said Friday. Annualized inflation stood at 16.5 percent, the lowest rate recorded in Ecuador in January in the last 20 years, according to INEC. The government aims to reduce inflation to single digits this year, after posting 22.4 percent inflation in 2001, the country's lowest rate in over a decade. Rising fuel costs contributed the most to the January figure, INEC said. December inflation was 0.67 percent.

## Political News

### Brazil Invites United Nations to Investigate Human Rights Issues

Brazil extended an open invitation to the United Nations to investigate human rights issues, making it the first Latin America country to do so, U.N. human rights chief Mary Robinson said Thursday, according to Reuters. Two U.N. rapporteurs will make separate trips to Brazil in the coming months to examine charges of denial of food to prison inmates and extrajudicial killings. Robinson said the government's new found openness demonstrates an increased commitment to human rights issues since she made her last visit to the country in

## ARGENTINA WATCH

### A Summary of the Latest Headlines on Argentina ...

- President Eduardo Duhalde may veto part, or all, of bankruptcy legislation approved by Congress on Wednesday. The International Monetary Fund (IMF) criticized the bill, which would hurt banks by suspending bankruptcy proceedings for six months.
- A finance secretary source said the timeframe for the free flotation of the Peso was the biggest disagreement between the IMF mission and Argentina's economic team during meetings Thursday. The government believes it should not freely float the Peso until it secures financial assistance from the Fund or other international financial institutions, according to the source. The IMF views the floating currency as a prerequisite for providing assistance.
- Preliminary data released Thursday showed a trade surplus of \$6.3 billion in 2001. Exports reached \$26.6 billion, up 1 percent from the previous year, while imports amounted to \$20.3 billion, a 20 percent decline from 2000. December exports totaled \$1.9 billion and imports totaled \$931 million.

Sources: *La Nación*, INDEC

May 2000. The U.N. human rights official noted, however, that there are continued human rights problems in the country, including a high level of violent crime in big cities, particularly in São Paulo. The killing of two opposition mayors over the past four months has raised further concerns about an increase in political violence, although Robinson expressed doubt that the assassinations were politically motivated.

## Company News

### Mexico's Grupo Alfa Fourth Quarter Operating Income Up 4.3 Percent

Mexico's second largest industrial conglomerate, **Grupo Alfa**, said Thursday that fourth quarter operating income rose 4.3 percent to 935 million Pesos (\$US 102.2 million) from 897 million Pesos in the fourth quarter of 2000, Bloomberg reports. Operating profit fell 14 percent from 1.08 billion Pesos in the third quarter. EBITDA (earnings before interest, taxes,

depreciation, and amortization) fell 7 percent to 1.601 billion Pesos from the previous quarter, but remained on par with the Q4 2000 figure. Alfa, which is struggling because of low international prices for its main steel and petrochemicals products, reported sales of 10.969 billion Pesos in the October-December period, down 2 percent from the same period in 2000.

### Peruvian Banco de Credito's Profits Grew 162 Percent in 2001

Peru's biggest bank, **Banco de Credito**, said Friday that profits grew 162 percent in 2001 to 179.9 million Soles (\$US 51.4 million) from 68.6 million Soles in 2000. The bank, controlled by financial holding **Credicorp**, reported that fourth quarter profit in 2001 was 46.1 million Soles, up 47.3 percent from the same period in 2000. Banco de Credito said that bad loans fell by 8.6 percent in December, while the ratio for provisions to bad loans was 105 percent at the end of the year, a 94.5 increase from year-end 2000.

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