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Straining at the Anchor: The Argentine Currency Board and the Search for Macroeconomic Stability, 1880-1935: A Review

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Straining at the Anchor: The Argentine Currency Board and the Search for Macroeconomic Stability, 1880-1935
by Gerardo de la Paolera and Alan M. Taylor
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One of Karl Marx's lasting aphorisms is that history repeats itself, first as tragedy and then as farce. In *Straining at the Anchor,* Gerardo della Paolera and Alan Taylor apply a \vide range of economic and econometric theory to understand the forces that induced the government of Argentina to adopt a currency-board arrangement in 1891; to document how that arrange- ment provided a backdrop of stability fostering economic growth that brought Argentina into the first league of advanced economies; and to explain how the currency board succumbed under the strains of a world depression in 1930, leaving Argentinian monetary policy unanchored and setting the stage for subsequent bouts of high inflation. With the book completed in 2001, it is left to the reader to find echoes of this history in the recent replay of events marked by the collapse of Argentina's currency board and crushing economic contraction.

The book is a must read for anyone interested in understanding the economic roller-coaster so many emerging markets ride in to this day. della Paolera and Tavlor tell the stow of Argentina's search for monetary stability from 1880 to 1935 in three acts. The early history given in the first act was one of monetary anarchy, with competing note issuers, inconsistent fiscal policies, and excesses by some banks that ultimately were assumed by the government. The shock that produced more lasting reform was the Baring

Crisis of 1890 (talk about history repeating itself), which they term the "first-ever full-fledged emerging market crisis of the modern era." What emerged from this rubble (the " second act) was the Conversion Office, a currency board, as the exclusive monetary authority. For the next quarter century. The relative stabilility of the currency encouraged a narrowing of Argentina's risk premium on world capital markets and substantial capital inflows that averaged one-fifth of GDP. The discipline of a currencv board arrangement became too confining when the global economy suffered the blows of world war and great depression. In the closing act, della Paolera and Tavlor describe how the Conversion Office was effectively converted into a central bank in a series of moves culminating with the creation of the Banco Central.

The relatively early move off the fixed exchange rate insulated the economy somewhat from the forces of world depression, but it also highlighted the allure of revenue from money creation to Argentinian politicians, a temptation often subsequently embraced. This fine book should be read not just by specialists in the economic historv of Latin America. The more general reader will see useful applications of many of the theories of modern interna- tional finance, including empirical work showing that gold flows were consistent with the monetary approach to the balance of payments. Argentina's periodic financial strains are demonstrated to be early examples of the phenomenon of the " b i n crises" of banking and balance-of-payments problems. Moreover, the timing of those events matches the intuition provided by first-genera-tion models of balance-of-payments crises.

Substantial care is devoted to describing the real economic dislocations that follow when capital flows come to a sudden stop. Two unifying themes provide overall discipline to *Straining at the Anchor.*

First, Argentina's history repeatedly shows that no monetary arrangement can completely insulate a small open economy from a severe global shock. The push-ing out of the Argentinean frontier and the modernization of its economy required massive inflows of foreign capital. In the late nineteenth century, the Argentinean government allowed open access to the financial system, with an impressive share of banks owned by foreigners. That reliance on foreign capital no doubt raised the level of national welfare, but it also raised the variance of welfare because strains in global financial markets could cut off that capital and lead to a wrenching readjustment. No more was that clearer than in the Great Depression, when the decision to move off the peg buffered, but did not offset completely, the forces of global deflation.

Second, *Straining at the Anchor* correctly puts the government's flow budget restraint center stage. No monetary arrangement can paper over fiscal profligacy. In most cases, the monetary mechanisms tried in Argentina ultimately failed because the pressures to fund deficits became too severe. On several important occasions, this occurred because contingent liabilities of the government-its support of the major national bank or banks in general-became explicit. della Paolera and Taylor show with repeated examples that "unpleasant monetarist arithmetic" can be unpleasant indeed. This leads to two quibbles.

The authors repeatedly write of the inconsistency of a lender of last resort with a currency board. More correctly, lender of last resort is a fiscal function involving the

transfer of real resources to one sector of the economy from the rest. True, that function is often delegated to central banks because they have expertise in dealing with banks and a source of financing (money creation) that allows them to move quickly with less public scrutiny. Adoption of a currency board removes the ability of a central bank to fund that lender-of-last-resort function. But if the government held that function to be important, mechanisms to provide the necessary resources could be developed even under a currency board.

Monetary arrangements take pride of place in explaining Argentina's successes and failures in the book. One wonders if the superb economic performance of the "Belle Epoque" owed at least in part to the application of existing technology (railroads, refrigerated cars, and the telegraph) to a vast land mass. Merely moving the Argentine economy out to the envelope defined by the world's best practice would ensure substantial productivity gains that would lure foreign capital. When efficient production processes were put in place, growth would naturally slow. On a final note, della Paolera and Taylor illustrate turning points in policy with editorial cartoons of the time. In an analvsis that relies so much on the public's expectations about policy, providing insight as to what the public was reading at the time seems as useful then as it does now.