ARGENTINA'S DOLLARIZATION PROJECT: A PRIMER

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Benchmark case

- Consider a Currency Board with US$ 15 billion reserves, and 15 billion pesos in circulation (money base). Reserves earn 5% per year, thus yielding US$ 750 million a year.

Argentina's plan

- Sell US T-Bills held as reserves for dollar cash, and use the proceeds to buy back the entire money base.

- Negotiate with the US so that part of lost revenue (US$ 750 million) is given back to Argentina in the form of a permanent flow transfer. Thus, if the transfer is US$ 600, for example, US fiscal revenue would increase by US$ 150 per year.

- Using the US$ 600 transfer as collateral, Argentina should be able to borrow at the risk-free interest rates (here assumed to be 5%). Suppose, however, that the rate is 2% higher (i.e., 7%). Even so, Argentina could borrow more than US$ 10.7 billion which would almost <u>double</u> the present put option of the central bank. These funds could be borrowed in case of a banking crisis, and used to avoid a massive banking collapse.

Comparison with present system

- Currency crisis would be totally eliminated. At present there is a spread between peso and dollar interest rates. Admittedly, there are fiscal costs but they need not be large. In the above example, fiscal costs would amount to US$ 150 million, which is less than 0.01% of GDP.

- Currently, the central bank can generate additional liquidity by the equivalent of 30% of money base which, under the above assumptions, is equivalent to US$ 4.5 billion (= 0.3×15 billion). Thus, the dollarization project would increase that amount in more than 5 billion dollars <u>without creating a mismatch between reserves and base money</u> (as implied in the 30% rule mentioned above).

Incentives

- The US is fiscally better off and does not commit itself to additional credit lines or a seat at the Board. This should facilitate negotiations.

- For Argentina there is the risk of wasting the additional resources (i.e., the US$ 10.7 billion in the above example) in, for instance, projects unrelated to the financial sector. Moreover, the additional resources could induce laxer supervision. However, the treaty with the US may address these problems by, for example, extending US supervisory power to banks operating in Argentina (the additional costs could be financed out of the extra US fiscal revenue involved in this operation). Furthermore, the crisis fund could be managed by a committee involving US and Argentinean authorities.