Capital Swap à la Russe for Argentina

By Michael S. Bernstam and Alvin Rabushka

Recently we came across an article by Joseph Salerno, entitled "Understanding Argentina." (www.mises.org/fullstory.asp?control=965) Salerno is senior fellow of the Mises Institute and teaches economics at Pace University. Salerno blames the IMF for Argentina's current economic difficulties and strongly urges its government to shun any further advice or assistance from the IMF. Salerno put forth a plan to reform Argentina's monetary and financial system. The text of his plan follows below.

"Fortunately, there is a program that it can implement unilaterally that will permit its currency to quickly return to circulation as a medium of exchange, especially among its poorer citizens, and at the same time restore confidence in domestic financial institutions and markets. This involves recognizing the effective bankruptcy of all banks and handing their assets over to their depositors.

"Specifically the demand liabilities of each bank, which includes savings as well as checking accounts, should be written down to the level of its cash reserves and prorated among its depositors according to the size of their nominal checking and saving deposits. Since they now will be effectively backed 100 percent by cash, depositors will be able to freely redeem their deposits in currency or continue to access them by check or debit card without threat of a contagion of bank collapses.

"In addition, ownership of the loan and investment assets will be transferred to the depositors by distributing equity shares to them, the number of nominal shares received by each individual to be equal to the original quantity of pesos in his bank deposit minus his quota of the banking system's cash reserves. The value of these shares, which will be saleable on the market, would be determined by the market value of the asset portfolio and would fluctuate according to market conditions, falling more or less below the value of a peso, depending on the quality of each fund's asset portfolio.

"All banks will thus be split into two independent institutions—a 100-percent deposit bank and no-loan mixed-asset mutual fund. Argentine depositors of all income levels will now have unimpeded access both to a medium for making exchanges and to their savings. The deposit banks will be under court mandate to retain 100-percent reserves for all deposits, and the system will be able to issue additional peso-denominated demand deposits one-for-one in exchange for deposits of peso currency.

"Every mutual fund will be empowered to redeem and sell its shares and to buy and sell financial assets on the open market, as well as to originate loans. Initially, court-appointed trustees will be put in charge of operating these institutions, defraying the costs of operation by assessing user fees on depositors and mutual fund shareowners."

A paralyzed monetary and financial system is not unique to Argentina. Russia's default and devaluation of

August 17, 1998, were the consequence of a similar mess. Indeed, we had been giving consideration to the issue of reforming Russia's banks for a full year before the Great Default. In July 1998 we published *Fixing Russia's Banks, A Proposal for Growth* (Stanford: Hoover Press, 1998). We posted the book to this site, which we launched on July 1, 2000.

In our book, we described Russia's banks as *ersatz banks*, rather than real banks. Real banks intermediate savings to borrowers. Russia's banks did not and still largely do not. To remedy this problem, we set forth a proposal to reform Russia's banking system. In a nutshell, the proposal involves the swap of assets, of debt for equity. The federal and regional governments would establish *funds* owned by various groups of holders of the governments' internal debt, e.g., depositors of the state Savings Bank who lost their savings during the big inflation of the early 1990s. Other holders of implied government liabilities include Russian citizens with claims on current and future government expenditures (e.g., housing, health care, education, etc.) These funds would be capitalized with real assets, such as natural resources, pipelines, forests, and municipal and agricultural land.

The newly capitalized funds could establish new banks and either replace or takeover existing insolvent banks. The existing debt of the commercial banks would be privatized to the owners of the new funds/banks; in return, the new funds/banks would acquire the equity of the indebted commercial banks. (The full details of our proposal are found on pages 91-98.)

Capital swaps are a general proposal that can be applied to reform bankrupt financial institutions in most countries. Our proposal for Russia was, really, a general concept that we developed for Russia's particular circumstances. We are gratified to find that this general concept has found applicability in such other countries as Argentina.