Politics of Deposit Insurance Reform: the Case of Argentina

Geoffrey P. Miller
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This paper explores the decision by the Argentine government to abolish deposit insurance. Prior to 1991, the Argentine banking system operated under a regime of optional, explicit deposit insurance, coupled with extensive implicit deposit insurance in the form of central bank assistance to failing banks. In 1991 and 1992, Argentina reversed this policy by repealing the country's deposit insurance program and attempting to convince financial markets that it would not under any circumstances rescue a failing bank.

These events bear on U.S. deposit insurance reform because they allow the investigation of a real-world case in which a significant economic system repealed its program of deposit insurance. It is often said in the United States that cutbacks in the deposit insurance guarantee are politically impossible. Yet such reforms have been implemented in Argentina, so far with apparent success. This paper considers the bearing of the Argentine experience on proposals for U.S. deposit insurance reform.

I. INTRODUCTION

It is often said that countries that do not expressly guarantee deposits do so implicitly. When a bank fails, the government faces tremendous pressure to insure deposits from individual

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* Kirkland & Ellis Professor, University of Chicago Law School. I would like to thank the many Argentines who generously consented to be interviewed or otherwise assisted in this project, including Julio Alsogaray, Ricardo Anglés, Dr. Miguel A. Balestrini, Javier A. Bolzico, Juan J. Bruchou, Omar C. Crillo, Maria Elena Deligiannis, Cesar A. Deymonnaz, Dr. Roberto Domenech, Dr. Roberto Domínguez, Eduardo J. Fasulino, Roque Fernández, Javier González Fraga, José María Ibarbia, Enrique J. Loncán, Roque Maccarone, Dr. José Luis Machinea, Dr. Augusto C. Magliano, Facundo Gómez Minujín, Raul Passano, Norberto Carlos Peruzzotti, Ignacio J. Carlos Premoli, Gonzalo Sánchez Sorondo, Osvaldo J. Ventura, and Alfredo M. Vitolo. I would like to thank Tomás J.T. Baliño, Jose Barra, Roberto Gagarella, Dr. Augusto C. Magliano, Mark Ramseyer, and Liliana Schumacher for comments, and Ricardo Maldonado for valuable research help.
depositors who may have lost their life savings. The potential political costs to a government of not insuring deposits are so overwhelming that the responsible officials often have no choice—or so it is said—but to protect depositors even if doing so is seen as undesirable from the standpoint of social policy _ex ante._\(^1\)

In at least one country, Argentina, this accepted wisdom about deposit insurance is now being put to the test.\(^2\) Until 1991, Argentina both provided an explicit deposit insurance guarantee to participating institutions and, more importantly, offered implicit deposit insurance in the form of extensive open-bank assistance to troubled institutions. The current administration of President Carlos Menem, however, has repealed all forms of deposit insurance, explicit or implicit.\(^3\)

This paper—which draws on extensive interviews conducted in December 1992 with present and former Argentine government officials, politicians, economists, and attorneys—analyzes the government’s decision to abolish all forms of deposit insurance for banks. I address the following questions.

First, _has_ Argentina actually repealed deposit insurance? The Menem government’s claim that it will not back deposits in failed banks has not yet been put to the test, as there have been no major bank failures in Argentina since the repeal of deposit insurance. If a big bank did fail, the question is whether the government would be able to withstand the political pressures to bail out the bank’s depositors—particularly in a political culture such as that of Argentina, where the government has traditionally assumed the responsibility (albeit one incompetently fulfilled) for protecting the welfare of its citizens. Even if the government were able to withstand a single bank failure, would it adhere to a strict no-bailout policy if the failure of one bank led to systemic panic? In other words, what has the government done to precommit in a reliable fashion to not bailing out depositors in a failed bank even in the face of overwhelming political pressure to do so?\(^4\)

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\(^1\) See, for example, Edward J. Kane and George G. Kaufman, _Incentive Conflict in Deposit Insurance Regulation: Evidence from Australia_, 1 Pac Basin Fin J 13, 13-14 (1993).

\(^2\) Other countries in Latin America—Chile and Uruguay—are also in the process of repealing deposit insurance or otherwise cutting back on the safety net for bank customers. Personal interview with Dr. Augusto C. Magliano, Secretario Ejecutivo, Federacion Iberoamericana de Asociaciones Finacieras, Dec 14, 1992 (“Magliano Interview”).

\(^3\) Carta Orgánica del Banco Central de la República Argentina, Ley 24, 144 (1992).

\(^4\) On precommitment, see Jon Elster, _Ulysses and the Sirens: Studies in Rationality_
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It turns out that the Menem government has provided a surprisingly high level of assurance to domestic and international financial markets that it will not rescue a failing bank or its depositors. Legislation passed in 1992 bars the central bank from offering any form of deposit insurance, either implicit or explicit, and prohibits assistance to troubled banks except short term loans on good security. The central bank must also hold gold or foreign currency reserves at least equal to the domestic monetary base, a requirement that might be violated if the central bank were to bail out depositors in a major bank failure. Interviews conducted for this article revealed remarkable consensus among knowledgeable persons that the government will not rescue a failing bank.

This is not to say that the government's commitment to the repeal of all forms of deposit insurance would hold in the event of a nationwide banking panic, or that a new government (elections are scheduled for 1995) would adhere to the no-bailout policy. It appears, however, that the Menem government has accomplished as much as could reasonably be expected in convincing the relevant actors that there really is no deposit insurance in Argentina today.

A second question raised by Argentina's recent reforms concerns the underlying politics. In the United States, despite the disastrous failures of the deposit insurance funds for the savings and loan and banking industries over the past ten years, deposit insurance repeal appears to be politically unthinkable. What was different about Argentina?

Although the repeal of deposit insurance in Argentina was part of a complex process extending over at least a decade, the principal factors appear relatively straightforward. First, Argentina was in the midst of a catastrophic economic crisis at the time deposit insurance was repealed. Hyperinflation and economic deterioration had driven the country—one of the richest nations in the world in 1930—and Irrationality (Cambridge, rev ed 1984).

and notes 87-89 and accompanying text.


Gross national product per capita (GNP) in Argentina in 1990 was US$2,134, as compared with Canada's gross domestic product per capita (GDP) of US$19,500. Mark S.
As a result, the public reached a remarkable consensus that radical reforms were needed to shrink the bloated state-owned industrial base and deregulate the economy. There was surprisingly little political opposition to the basic elements of Menem's program of radical privatization and deregulation; indeed, the opposition Radical Party has sometimes claimed that Menem is simply implementing programs that it conceived.

Although one affected interest group—foreign banks—had no real objection to the repeal of deposit insurance, other major interest groups—domestic Argentine banks and financial institutions—did oppose repeal. However, all were willing to accept substantial limitations on the scope of the program. In addition, all banks recognized that Menem's overall agenda of market liberalization was in their interest, and their support for the broader program muted their opposition to deposit insurance reform. Further, and quite importantly, the economic collapse had driven most private deposits out of the banking system. Thus, the domestic banks which were principally affected by the repeal were not able to call on a substantial base of private depositors to support them in resisting deposit insurance repeal. In the end, the government's mandate to implement radical reforms overwhelmed the banking industry's lukewarm resistance to deposit insurance repeal.

A third question is how Argentine banks responded to the recent reforms. Have private arrangements replaced the government safety net? If so, how effective have these responses been?

It appears that repeal of deposit insurance has had some effects: private banks now offer varying interest rates on deposits; Argentine banks are seeking lines of credit from foreign banks and are organizing for mutual support in the event of a financial crisis; and private rating organizations are being established. As yet, there have been no significant runs on uninsured banks, nor have there been any major bank failures since deposit insurance was abolished. It is still too early to determine whether private market mechanisms will provide effective substitutes

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Hoffman, ed, 1993 World Almanac and Book of Facts 729, 739 (Pharos Books, 1992). This was roughly equal to the GDPs of Chile (US$2,130) and Malaysia (US$2,460), and significantly less than the GDP of Czechoslovakia (US$7,700) and the GNPs of Hungary (US$5,800) and Poland (US$4,200). Id at 742, 776, 747, 761, 790.

10 See Bill Hinchberger, Argentina's Master of Reform, 26 Inst Investor 79, 84 (May 1992).

11 Foreign banks in Argentina are widely viewed as extremely safe because the parent institutions will not fail and will not let their Argentine subsidiaries fail.
for deposit insurance.

This article is organized as follows. Part I addresses the general economic background, and Part II considers the reforms themselves. Part III analyzes the forces that allowed the changes to occur, addresses the question whether implicit deposit insurance remains in Argentina, and considers the strategies which the private sector has adopted to respond to the elimination of the government safety net. The article ends with a brief conclusion.

II. ECONOMIC BACKGROUND

The economic system in Argentina prior to the reforms of the Menem Administration, elected in 1989, can aptly be described as a corporatist state. Juan Perón, who came to power in 1946, committed the country to an economic system under which government ownership of or substantial intervention in industry was nearly a defining attribute. By 1990, the government owned many industries, including telecommunications systems, utilities, petroleum firms, iron and steel works, and much more. Along with government ownership of or control over industrial production came a system in which the bureaucracy often functioned more as a mediator between powerful interest groups than an independent formulator of policy. Powerful industrial unions and other industrial groups acted as de facto parts of the government, enjoying a "virtually monopolistic status as the quasi-official national representative for a particular functional activity."

The inefficiencies of the Argentine corporatist state were reflected in its economic output. Real gross domestic product (GDP) growth rates were anemic or negative through much of the 1980s, as shown in Table 1. These inefficiencies, together with the highly developed Argentine capacity to evade taxes, resulted in pervasive budget deficits, as shown in Table 2. The government funded much of its deficits by issuing currency, predictably resulting in inflation rates that ranged from the disastrous (by U.S. standards) to the catastrophic, as shown in Table 3.

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14 See id at 14.
Moreover, as shown in Table 4, Argentina's external debt more than doubled during the 1980s, from US$27 billion in 1980 to US$63 billion in 1989. The overall picture during the 1980s, in short, suggested an economy on the brink of disaster.

**Table 1: Growth (Decline) in Real GDP, 1980-89**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>1.5%</td>
</tr>
<tr>
<td>1981</td>
<td>-6.6%</td>
</tr>
<tr>
<td>1982</td>
<td>-4.9%</td>
</tr>
<tr>
<td>1983</td>
<td>3.0%</td>
</tr>
<tr>
<td>1984</td>
<td>2.6%</td>
</tr>
<tr>
<td>1985</td>
<td>-4.3%</td>
</tr>
<tr>
<td>1986</td>
<td>5.6%</td>
</tr>
<tr>
<td>1987</td>
<td>2.2%</td>
</tr>
<tr>
<td>1988</td>
<td>-2.7%</td>
</tr>
<tr>
<td>1989</td>
<td>-4.6%</td>
</tr>
</tbody>
</table>


**Table 2: Budget Deficits as Percent of GDP, 1980-89**

<table>
<thead>
<tr>
<th>Year</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>-7.1%</td>
</tr>
<tr>
<td>1981</td>
<td>-12.1%</td>
</tr>
<tr>
<td>1982</td>
<td>-15.0%</td>
</tr>
<tr>
<td>1983</td>
<td>-14.5%</td>
</tr>
<tr>
<td>1984</td>
<td>-11.6%</td>
</tr>
<tr>
<td>1985</td>
<td>-5.7%</td>
</tr>
<tr>
<td>1986</td>
<td>-4.9%</td>
</tr>
<tr>
<td>1987</td>
<td>-6.6%</td>
</tr>
<tr>
<td>1988</td>
<td>-9.0%</td>
</tr>
<tr>
<td>1989</td>
<td>-8.3%</td>
</tr>
</tbody>
</table>

Table 3: Consumer Prices, 1980-89

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Annual Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>100.8%</td>
</tr>
<tr>
<td>1981</td>
<td>104.5%</td>
</tr>
<tr>
<td>1982</td>
<td>164.8%</td>
</tr>
<tr>
<td>1983</td>
<td>343.8%</td>
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<tr>
<td>1984</td>
<td>626.7%</td>
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<tr>
<td>1985</td>
<td>672.2%</td>
</tr>
<tr>
<td>1986</td>
<td>90.1%</td>
</tr>
<tr>
<td>1987</td>
<td>131.3%</td>
</tr>
<tr>
<td>1988</td>
<td>343.0%</td>
</tr>
<tr>
<td>1989</td>
<td>3,079.2%</td>
</tr>
</tbody>
</table>


Table 4: Argentina’s External Debt, 1980-89

<table>
<thead>
<tr>
<th>Year</th>
<th>Disbursed Debt (Millions $US)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>27,157</td>
</tr>
<tr>
<td>1981</td>
<td>35,657</td>
</tr>
<tr>
<td>1982</td>
<td>43,634</td>
</tr>
<tr>
<td>1983</td>
<td>45,919</td>
</tr>
<tr>
<td>1984</td>
<td>48,857</td>
</tr>
<tr>
<td>1985</td>
<td>50,947</td>
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<tr>
<td>1986</td>
<td>52,374</td>
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<td>1987</td>
<td>58,423</td>
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<tr>
<td>1988</td>
<td>58,936</td>
</tr>
<tr>
<td>1989</td>
<td>63,314</td>
</tr>
</tbody>
</table>


The disaster struck in 1988 and 1989. In April 1988, the government defaulted on its foreign bank debt. In July, inflation accelerated: consumer prices rose 26.6 percent, and continued to skyrocket the following year, reaching 150.4 percent in

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President Raúl Alfonsín attempted to maintain a strong domestic currency against the dollar, but in late January and early February 1989, the central bank ran out of foreign currency and abandoned its support for the austral. The economy degenerated into one of the worst hyperinflations in history.

At the end of May 1989, two weeks after Menem won the presidential elections, Argentines looted supermarkets and rioted in cities across the country. Banks closed. Consumer prices increased 114.5 percent in June 1989 and 196.6 percent in July 1989. The nation was descending into chaos.

Menem took power in July 1989, five months before his scheduled inauguration, in the midst of virtually complete chaos and collapse. Hyperinflation struck again in October 1989, forcing a bank holiday in late December 1989 and early January 1990. During the bank holiday, the government substituted government bonds for deposits; as a result, when the banks reopened there was little for depositors to withdraw.

Meanwhile, Menem surprised almost everyone by announcing a program of privatization and economic liberalization as far-reaching as anywhere in the world. Privatization was extraordinarily sweeping, with sales or leases of the telephone company (notorious as one of the worst in the world), the national airline, television networks, the electric company, the national railway, and even 10,000 kilometers of state-owned highway.

Inflation continued at fever pace in 1990, with consumer prices rising 2,314 percent. In early April 1991, however, economic minister Domingo Cavallo implemented the so-called
convertibility program. This program required that domestic money be backed by government holdings of gold or foreign reserves. Also, under the program, the central bank agreed to convert domestic currency into dollars (and vice versa) at a fixed exchange rate.

The convertibility program appears to have accomplished an astonishing turnaround in Argentina’s economic fortunes. Inflation fell precipitously and has remained low; the inflation rate for 1992 was a mere 17.5 percent. The economy has boomed, with GDP growing 9 percent in 1992. Argentines repatriated a substantial portion of the $50 billion which they had been holding offshore as protection against the domestic chaos. The nation’s risk premium—measured by the spread between the yields on dollar-denominated Argentine bonds and LIBOR (a benchmark interest rate for international financial transactions)—fell from 31.9 percent in the first quarter of 1990 to 8.4 percent in the fourth quarter of 1992. The inflation rate for 1993 will almost certainly be lower still. The developments since 1991 appear little short of an economic miracle. However, whether they are miracle or mirage remains to be seen.

III. DEPOSIT INSURANCE REFORMS

Argentina has totally repealed all forms of deposit insurance for private banks, and has barred the central bank from providing open-bank assistance to troubled institutions. These changes are a radical break from the past and are part of a broader program devised by the Menem Administration to revitalize the Argentine economy.

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28 To say that the reform “dollarized” the economy, however, is somewhat misleading since, as a result of the financial crisis of 1989-91, the domestic currency had lost almost all credibility and the economy had effectively been dollarized by the private sector in any event.
30 Nash, NY Times at C6 (cited in note 29).
32 Banco de la Nación Argentina, Outlook, 8 Fundación Mediterránea Newsletter 1, 2 (Mar 1993).
33 See Banco de la Nación Argentina, Economic Indicators, 8 Fundación Mediterránea Newsletter 3, 3 (Sept 1993).
Traditionally, Argentina has had both implicit and explicit deposit insurance. Perón nationalized deposits in private Argentine banks in 1946, thus effectively backing them with the government’s own credit (and directing the deposited funds to uses favored by the government). The government privatized deposits in 1957, but continued to provide a full guarantee for local currency deposits. Deposits were again nationalized in 1973, and again returned to the private banking sector in 1977, with domestic currency deposits guaranteed in full.

In 1979, the military government made deposit insurance for private banks optional and required that insured banks pay a premium of 3/10,000 of average liabilities subject to reserve requirements. The central bank provided full coverage for the first 1 million pesos (about US$640) and 90 percent coverage thereafter.

These changes gave way to the exigencies of the banking crisis of 1980-1982. The failure in 1980 of a large private bank resulted in losses to uninsured depositors. Depositors began to withdraw funds from private banks and to place them in banks deemed to present little risk of failure—primarily foreign banks and banks backed by government entities. Shakier private banks also found themselves unable to obtain funds on the inter-bank call market—the market in which banks borrow from and lend to one another. A bank panic ensued.

To cope with the growing crisis, the central bank retroactively increased by a factor of 100 the ceiling on deposits covered in full under the deposit insurance law—raising full coverage to

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24 Augusto C. Magliano, 1 La Proteccion al Depositante 85-86 (Federacion Iberoamericana De Asociaciones Financieras, 1988).
25 Id at 86.
29 Id at 87 & 87 n 50.
30 Id at 91; Magliano, 2 La Proteccion al Depositante 191 (Federacion Iberoamericana de Asociaciones Financieras, 1988).
32 Id.
33 Personal interview with Dr. José Luis Machinea, economic consultant, Dec 15, 1992 (“Machinea Interview”).
approximately US$60,000.\textsuperscript{44} It also created a facility to provide open-bank assistance to banks whose deposits were being drained, and quickly provided assistance to three of the worst-hit institutions.\textsuperscript{45} In addition, reforms instituted in 1980 and 1982 greatly increased the central bank's powers to facilitate mergers.\textsuperscript{46} One consequence of the new policies was an enormous increase in central bank lending to financial institutions: the ratio of such central bank loans to reserve money rose from 1.87 percent in February 1980 to 110.11 percent in December 1982.\textsuperscript{47}

As a result of the troubles in 1980-1982, seventy-one financial institutions were liquidated.\textsuperscript{48} The central bank incurred high costs in administering the insolvencies. By the end of 1982, well before the full extent of the losses from this period were known, the central bank had set aside an amount equal to US$364 million to cover losses from liquidation of failed banks alone. However, the reserves understated the true costs, because the central bank could use non-earmarked reserves to cover the losses.\textsuperscript{49}

In 1985 another crisis occurred when difficulties at the Bank of Italy precipitated a run on uninsured foreign currency deposits.\textsuperscript{50} Again, the central bank intervened—this time by backing foreign currency deposits under certain conditions.\textsuperscript{51}

Finally, the banking system imploded once more at the end of 1989.\textsuperscript{52} The government's decision to free the foreign exchange market and decontrol prices on December 20, 1989, sparked sudden price increases.\textsuperscript{53} When banks could not meet withdrawals by fixed term depositors,\textsuperscript{54} the government declared

\textsuperscript{44} Baliño, \textit{The Argentine Banking Crisis of 1980} at 92 & 92 n 58 (cited in note 36).
\textsuperscript{45} Id; Magliano,'2 \textit{La Proteccion al Depositante} at 156 (cited in note 40).
\textsuperscript{46} Baliño, \textit{The Argentine Banking Crisis of 1980} at 99-100 (cited in note 36); Magliano, 2 \textit{La Proteccion al Depositante} at 154 (cited in note 40).
\textsuperscript{47} Baliño, \textit{The Argentine Banking Crisis of 1980} at 102 (cited in note 36).
\textsuperscript{48} Id at 58.
\textsuperscript{49} Id at 103-04.
\textsuperscript{50} Magliano, 2 \textit{La Proteccion al Depositante} at 160 (cited in note 40).
\textsuperscript{51} Id.
\textsuperscript{52} See, for example, personal interview with Javier González Fraga, Asesor, Mercado de Valores de Buenos Aires S.A., Dec 15, 1992 ("Fraga Interview"); Magliano Interview (cited in note 2).
\textsuperscript{53} See Argentina, IBC Intl Rep (Jan 8, 1990), available on LEXIS (WORLD library, IBCINT file).
a six-day bank holiday and converted deposits in excess of one million australes (about US$800) into dollar-denominated, 10 year, six percent government bonds (Bonex). This measure effectively reduced the money supply by eliminating short-term bank deposit accounts; it also allowed the government to finance part of its deficit by effectively selling Bonex to private bank account customers rather than by issuing new currency and consequently inflating the money supply. The plan was a rude shock to depositors: their ostensibly guaranteed deposit accounts were converted overnight to government bonds which immediately traded at twenty two percent of par and did not pay interest for at least four months. The measure was understandably unpopular with depositors, and necessitated the resignation of the president of the central bank as propitiation. The Bonex plan did, however, stabilize the situation and allow the government some time to formulate more fundamental reforms.

In March 1991, the central bank drastically limited the scope of the deposit insurance guarantee. Deposits were insured only up to an amount in australs equal to approximately US$1000, with no insurance thereafter. Furthermore, the government's total commitment to the insurance program was limited to a special fund containing US$50 million in dollar-denominated Bonex.

The principal motivation for this action appears to have been the high costs and inflationary effects of the prior system of implicit and explicit deposit insurance. During the 1980s, 51 banks and 119 nonbank institutions (savings and loans, credit companies, or financial companies) failed, and others were merged with government assistance in order to avoid failure. Additional

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55 See Argentina, IBC Intl Rep (cited in note 53).
56 See Latin American Newsletters, IDB Bullish on Argentine Outlook, Latin Am Regional Rep: Southern Cone 6 (Nov 22, 1990), available on LEXIS (WORLD library, LAN file); World Bank, Argentina: Public Finance Review at 180-81 (cited in note 27).
58 See Argentina, IBC Intl Rep (Apr 20, 1990), available on LEXIS (WORLD library, IBCINT file). Fraga Interview (cited in note 52).
60 Fraga Interview (cited in note 52).
61 Magliano Interview (cited in note 2).
62 World Bank, Argentina: Public Finance Review at 181 (cited in note 27); Personal interview with Ricardo Anglés, President, and Juan J. Bruchou, Vice President and Argentina General Counsel, Citibank, N.A., Dec 21, 1992 ("Citibank Interviews").
63 Business International, The Monetary System - National Monetary Institutions, Fi-

These failures, and other interventions such as assisted mergers and open-bank assistance, were enormously costly. During the 1980s, the central bank paid approximately US$15 billion on deposit guarantees. Costly in their own right, these expenditures exacerbated inflation by pumping large amounts of new money into the banking system.

Leading forces behind the government's decision to limit deposit insurance included Eugenio Pendás, a director of the central bank, and Roque Fernández, the incoming central bank president. Fernández had written several articles in the 1980s blaming deposit insurance for some of the problems in the Argentine financial system during 1980-1982.

Legislative action on deposit insurance came in 1992. The new law explicitly guarantees the independence of the central bank from the political branches of government. It prohibits the central bank from granting loans to the national government, or to provinces or municipalities, except when secured by government bonds. While this provision is principally designed to prevent the central bank from monetizing fiscal deficits, it has the effect of limiting the ability of government entities to borrow from the central bank in order to pay out depositors in the large state bank sector. Further, the law prohibits the central bank from granting any special guarantees which "directly or indirect--

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64 Magliano Interview (cited in note 2).
66 Fraga Interview (cited in note 52) (quoting a 1990 central bank report which concluded that during the 1980s the central bank lost US$67 billion).
67 Id.
69 Carta Orgánica del Banco Central (cited in note 3). The law grants central bank board members six-year terms, id at Art 7; provides that they cannot be removed except for poor performance, id at Art 9; and states that "in the creation and execution of monetary and financial policy, the central bank will not be subject to orders or instructions from the National Executive Power [i.e., the President]." Id at Art 3.
70 Id at Art 19(a).
ly, implicit or explicitly, cover obligations of financial entities, including depository institutions.”

This is a direct prohibition of any form of deposit insurance. Finally, the law prohibits the central bank from providing temporary liquidity assistance to financial institutions for periods of more than 30 days or for an amount greater than the institution’s capital; and it requires that any such temporary liquidity assistance be backed by adequate security. The new law thus unequivocally states that the central bank may not provide any sort of insurance for bank deposits, either implicit (by assisting troubled banks) or explicit (by paying off depositors after failure).

The repeal of deposit insurance appears to have been principally the idea of persons within the central bank, including Fernández and Pendás. They saw deposit insurance as distorting banking markets and posing a danger of costly and inflationary government bail-outs. Many other influential groups, on the other hand, opposed deposit insurance repeal. For example, the Radical Party supported retention of deposit insurance and argued that the central bank should have greater power to provide liquidity assistance to troubled banks.

The leading private bank interest groups also opposed deposit insurance repeal, although all were willing to accept a relatively low ceiling for insurance protection. The foreign banks had no real interest in the matter since virtually all opted out of the system in the 1980s. The World Bank, which had strongly rec-

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71 Id at Art 19(k).
72 Id at Arts 17(b-c), 19(d).
73 The law does provide depositors with a priority in bankruptcy up to the first $3,000 in peso deposits, however. Id at Art 49; Personal interview with Raul Passano, Subdirector Ejecutivo, and Ignacio J. Carlos Premoli, Director Ejecutivo, Asociación de Bancos del Interior de la República Argentina (ABIRA), Dec 17, 1992 (“ABIRA Interview”).
74 Personal interview with José Maria Ibarbia, Diputado de la Nación, Bloque Ucede, Dec 14, 1992 (“Ibarbia Interview”); Personal interview with Dr. Miguel A. Balestrini, Diputado de la Nación, Dec 17, 1992 (“Balestrini Interview”).
75 Personal interview with Osvaldo J. Ventura, Subgerente General, Chemice Bank Argentina, and Cesar A. Deymonnaz, Subgerente General, Banco Holandes Argentina, Dec 14, 1992 (“ABRA Interviews”); Ibarbia Interview (cited in note 74); Personal interview with Norberto Carlos Peruzzotti, Director Ejecutivo, Maria Elena Deligiannis, Jefe del Dpt de Estudios Economicos, and Roque Maccarone, Presidente, Asociación de Bancos Argentinos, Dec 16, 1992 (“ADEBA Interview”); ABIRA Interview (cited in note 73). Public provincial banks, which enjoy an (ostensible) deposit guarantee from their governmental owners, favored deposit insurance repeal, which would place them at a competitive advantage vis-a-vis their private counterparts. Personal interview with Julio Alsogaray, Director Administrativo, Asociación de Bancos de Provincia de la República Argentina, Dec 16, 1992 (“ABAPRA Interview”). Cooperative banks also opposed deposit insurance
ommended legislation establishing the independence of the central bank, did not advocate repeal or even limitation of explicit deposit insurance. Instead, the World Bank recommended that deposit insurance and bank regulation be carried out by an authority separate from the central bank. In fact, the World Bank and the International Monetary Fund privately opposed repeal of deposit insurance on the ground that it would threaten the stability of the Argentine banking system.

With the reform measures instituted by the Menem government, especially the convertibility law effective in April 1991, depositors began to return to the Argentine banking system. As shown in Table 5, the banking system held only $12.9 billion in deposits at year-end 1989. As the banking crisis worsened, deposits continued to fall to $9.7 billion by year-end 1990. By March of 1991, deposits reached a nadir of $8.4 billion. However, the convertibility law appears to have reversed this trend: between March 1991 and August 1992, deposits nearly tripled, rising to $22.8 billion. These figures are shown in Table 5.

<table>
<thead>
<tr>
<th>Date</th>
<th>Domestic Currency</th>
<th>Foreign Currency</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/89</td>
<td>11.8</td>
<td>1.1</td>
<td>12.9</td>
</tr>
<tr>
<td>12/90</td>
<td>7.1</td>
<td>2.7</td>
<td>9.7</td>
</tr>
<tr>
<td>3/91</td>
<td>6.0</td>
<td>3.4</td>
<td>8.4</td>
</tr>
<tr>
<td>12/91</td>
<td>8.7</td>
<td>6.6</td>
<td>5.2</td>
</tr>
<tr>
<td>8/92</td>
<td>12.7</td>
<td>10.1</td>
<td>22.8</td>
</tr>
</tbody>
</table>

The increase in bank deposits is a sign of enhanced stability in the banking system. However, the system is not yet fully stabilized. Most importantly, the improvements have largely occurred in Argentina's private banking sector. The public banks—owned by the national government, the provinces, or the municipalities—are a disaster by anyone's measure. For many years these banks—often staffed by unqualified political appointees—made loans principally to the governments that own them, or to politicians or friends of persons in the government. Not surprisingly, the performance of loans at public banks has not been favorable. As indicated in Table 6, more than 62 percent of the loans of national public banks and more than 52 percent of the loans of provincial and municipal banks were of doubtful status. In comparison, less than 15 percent of the loans of all categories of private banks, and a mere 5 percent of the loans of private banks in Buenos Aires, were of doubtful status.

Table 6: Doubtful Loans as a Percentage of Assets, By Type of Institution, April 1982

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Percent Doubtful Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Public Banks</td>
<td>62.83%</td>
</tr>
<tr>
<td>Prov. &amp; Mun. Public Banks</td>
<td>52.32%</td>
</tr>
<tr>
<td>Private Buenos Aires Banks</td>
<td>4.99%</td>
</tr>
<tr>
<td>Private Interior Banks</td>
<td>13.07%</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>4.83%</td>
</tr>
<tr>
<td>Cooperative Banks</td>
<td>17.84%</td>
</tr>
<tr>
<td>Total for All Banks</td>
<td>42.72%</td>
</tr>
</tbody>
</table>

Source: ADEBA, Memoria Anual 1992 at 64.

The national government has yet to take action on the public sector banks, which are nearly all insolvent by standard accounting measures. Immediate deregulation of the state-owned banks might provoke catastrophic runs. The central bank, quite reasonably, takes the position that the provincial and municipal banks are the problems of the provinces and municipalities, and

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81 Ibarbia Interview (cited in note 74).
82 ABAPRA Interview (cited in note 75).
83 Ibarbia Interview (cited in note 74).
not the national government's responsibility. At some point, however, the mess will have to be cleared up by the government, since most of the provinces and municipalities that own banks do not have the resources to resolve their difficulties. How the resolution will occur is yet to be seen.

IV. ANALYSIS

I now turn to an analysis of deposit insurance reform in Argentina, addressing three questions: (1) how is it that repeal of deposit insurance was possible in Argentina, when similar reform would appear to be out of the question in the United States; (2) has Argentina reliably committed itself not to rescue a failing bank and not to intervene in the event of a single bank failure that generalizes into systemic panic; and (3) how has the private market adjusted to the apparent repeal of all forms of deposit insurance in Argentina, implicit as well as explicit?

A. The Politics of Fundamental Reform in Argentina

From the standpoint of United States banking regulation, the decision by the Argentine government to relinquish any role in bank deposit insurance is a matter of considerable interest. The United States banking industry has itself recently passed through a crisis of staggering dimensions, one which dwarfs, in absolute terms, the comparable problems in Argentina. The deposit insurance funds for both the savings and loan industry and the commercial banking industry became insolvent, requiring a taxpayer bailout that may end up costing $200 billion in present value terms.

But when the U.S. Congress turned to consider deposit insurance reform, in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), it failed to reduce the deposit insurance ceiling of $100,000 per depositor per institution—a ceiling so generous that any depositor in his or her

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84 Fernández Interview (cited in note 78).
right mind can obtain effectively infinite protection by splitting money among accounts in different institutions. The FDICIA did nothing to alter the essential nature of the U.S. system. Deposit insurance in the United States appears impervious to truly meaningful reform.\(^9\) What explains the dramatic differences between the treatment of deposit insurance by the two countries?

In large measure, the reforms in the Argentine deposit insurance system can be explained by the broad political and economic circumstances of 1989-1991—circumstances which, elsewhere, I have described as a "constitutional moment" in modern Argentine history.\(^9\) Plagued by the disaster of hyperinflation and exhausted by years of political instability, the Argentine public reached a remarkable consensus that fundamental reform was necessary to rectify the deteriorating situation. Above all, the important political actors recognized that in order to stanch hyperinflation it was essential to close the taps of government spending and subsidies.\(^9\)

In addition to these general conditions, which facilitated fundamental reforms in a number of areas, several unique factors in the banking industry made repeal of deposit insurance politically feasible. First, from the standpoint of the Argentine experience, the decision to abolish deposit insurance did not appear to impose the sorts of extreme risks that might be perceived if a similar reform were adopted in the United States. Compared to the dangers and costs of rampant hyperinflation—or even to the losses associated with the 1989 Bonex plan—the risk posed by the removal of deposit insurance did not seem particularly significant.\(^2\) Besides, deposit insurance was of limited value to Argentine depositors. Even when depositors were paid during the hyperinflation period, they often had to wait months for their money, during which time the value of their funds in real terms rapidly dissipated.\(^3\)

Moreover, Argentines tend to have a well-warranted suspicion concerning the evenhandedness of government programs, having observed over many years that government subsidies tend to go to persons with influence. The discretionary liquidity assis-

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\(^1\) See, for example, ADEBA Interview (cited in note 75).

\(^2\) Magliano Interview (cited in note 2).

\(^3\) ABIRA Interview (cited in note 73).
tance loans that the central bank made repeatedly during the 1980s smacked of this kind of political favoritism. Banks that extended loans to friends of the incumbent politicians might well be in a better position to seek central bank assistance than banks that did not do so; and banks whose owners or managers were well-connected in government circles might be more likely to obtain assistance than banks whose owners or managers were out of favor. As a result, the repeal of deposit insurance probably appealed to many Argentines as a means for reducing political favoritism in the dispensation of government benefits.

Another significant factor was the impact of hyperinflation. As we have seen, the government’s implicit and explicit deposit insurance guarantees were extremely costly to the central bank. When the central bank advanced these funds, the effect was to pump new money into an already inflationary economy, thus exacerbating the price increases. In a country such as Argentina, which through harsh experience is sensitized to the dangers of hyperinflation, deposit insurance is seen by many as much more dangerous than in the United States because of its procyclical effect on the inflationary spiral. By the same token, repeal of deposit insurance promised to reduce the threat of further rounds of hyperinflation in the future.

B. Does Implicit Deposit Insurance Exist in Argentina Today?

Argentina has attempted to repeal all forms of deposit insurance, implicit as well as explicit. However, the question remains whether the government will keep its promise not to bail out depositors if a significant bank fails or if the banking system as a whole falls into a panic such as those that occurred in 1980-1981 and 1989-1991. As yet, there have been no major bank failures under the new regime, so the government’s commitment to the announced policy of not providing any deposit insurance has yet to be tested.

However, the Argentine government has utilized a variety of

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94 The central bank’s statistics on the astonishing costs to the government of assisting failing banks during the 1980s, released in April, 1992, gave added impetus to passage of the legislation that established the independence of the central bank and prohibited it from protecting depositors. Ibarbia Interview (cited in note 74). The central bank law is discussed at text accompanying notes 69-74.

95 See notes 63-68 and accompanying text.

96 There have, however, been a few small bank failures. Fraga Interview (cited in note 52).
pre-commitment devices to assure world financial markets that it will not, in fact, bail out depositors. For example, the central bank's newly independent status gives it a more reliable ability to resist the political pressures that will inevitably arise if a major bank or series of banks fails. Equally important, the central bank is now prohibited by law from providing deposit insurance, and has only limited powers to provide liquidity assistance to struggling banks. For the central bank to act contrary to these legal prohibitions, new legislation would be required (unless the government elected to act illegally).

Moreover, leading government officials have been willing to state for the record, unconditionally, that they will not rescue banks or bail out depositors. The current central bank president, Roque Fernández, so stated in an interview granted for the preparation of this paper. The message which the government has given to the financial sector and, indirectly, to the public, is straightforward and unequivocal: no form of deposit insurance, explicit or implicit, exists in Argentina today.

A further pre-commitment device is the convertibility law, which is widely viewed as the fulcrum of Argentina's recent economic recovery. If the central bank were to cover depositors in a failed bank and the bank were big enough, the consequences would be to create a new deficit in the central bank's accounts. Such a deficit would threaten to violate the convertibility law by potentially expanding the domestic monetary base beyond the central bank's stock of gold and foreign reserves. If that were to happen, the financial sector might lose confidence in the convertibility program as a whole and run the peso, leaving the government with the uncomfortable choice between accepting renewed hyperinflation or explicitly dollarizing the economy. Because these choices are both unpalatable, the government is unlikely to abandon the convertibility law in the interest of rescuing a bank unless the banking sector is truly in crisis.

Thus, despite the political pressures to provide ex post implicit deposit insurance which the central bank will inevitably

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97 See text accompanying notes 70-71.
98 See text accompanying notes 72-74.
99 Fernández Interview (cited in note 78).
100 Leading figures outside the government tend to agree that the government would not bail out failing banks. See, for example, Machnea Interview (cited in note 43).
101 See text accompanying note 80.
102 See Fraga Interview (cited in note 52) (if government were to break its commitment not to bail out banks, the convertibility law would be violated as well).
Politics of Deposit Insurance Reform

face in the event of a major bank failure, fairly good mechanisms are in place to prevent this from happening.

This is not to say that the central bank would adhere to its commitment not to rescue banks or depositors in all circumstances; if conditions become unstable enough, the government might find that it has little to lose from reneging on its promise. Several interviewees doubted whether the government would adhere to its promise if a major bank failed. Further, there is no assurance that a new government (presidential elections are scheduled for 1995) would adhere to the no-bailout policy as stringently as the current administration. Nevertheless, the mechanisms adopted to date provide a fairly high level of assurance that banks and depositors in Argentina will not be able to look to the government for succor when financial institutions fail.

C. Market Responses to Deposit Insurance Reform

Finally, although the total repeal of deposit insurance is still a recent event, it is not too early to examine some of the early market responses to this action. Are institutions evolving to mitigate the risks that an uninsured banking sector poses for depositors and others who utilize banking services?

One important force for ensuring that banks in Argentina, are well-managed and do not take improper risks with depositors funds is the interbank call market—the market for short-term lending and borrowing between banks. The call market is an active and important part of the financial sector, largely because the central bank has placed a high reserve requirement on current account and sight balances in order to stem inflationary forces—75 percent in 1992. Banks buy and sell funds on the call market in order to stay just within their required reserve ratios. Banks active in this market provide one another with their financial statements as filed with the central bank. A bank that runs into financial difficulties will quickly find itself unable to borrow funds in the call market unless it can convince a lending bank that it is in fact a good credit risk. In addition, banks in the call market routinely provide one another with updated financial statements filed with the central bank in order

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103 See, for example, ABIRA Interview (cited in note 73).
104 Business International, 4.2 Monetary Policy, Financing Foreign Operations (Jun 1, 1992), available on LEXIS (WORLD library, FINFOR file).
105 ABRA Interview (cited in note 75).
to demonstrate their solvency. In the case of Argentina, Citibank has taken on the de facto role of principal supervisor of other private banks. During the crisis of 1989-1991, Citibank advanced substantial call loans to banks in financial trouble when other call money dried up, on the strength of Citibank’s belief that the banks were in fact good credit risks.

One might suppose that the repeal of deposit insurance would provide an ideal opportunity for insurance firms to step into the gap left by the government and offer forms of private deposit insurance. Sources interviewed were unanimous, however, that this has not happened and is not likely to happen any time soon because the Argentine insurance industry is financially incapable of offering reliable guarantees.

A number of other private arrangements, however, have begun to develop to replace the now-defunct government safety net. Argentine banks have attempted to negotiate lines of credit from U.S. banks to assist them in the event of financial difficulties. Several interviewees said that private Argentine banks are also attempting to work out agreements to help one another in the event of a financial crisis. Other interviewees, however, denied that formal understandings for mutual support are being negotiated.

Rating agencies began operating in November 1992, and are expected to provide information to the market about the solvency of banks as well as industrial firms. It is anticipated that all private Argentine banks will eventually have published credit ratings.

Also in 1993, the central bank announced the creation of a risk appraisal office, which will offer a data bank containing information on bank credits and a listing of debtors to financial entities. The purpose of this service is to allow lenders to evalu-

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106 Citibank interviews (cited in note 62).
107 Id.
108 See, for example, ADEBA Interview (cited in note 75).
109 Magliano Interview (cited in note 2).
110 Id; Fernández Interview (cited in note 78). These agreements, however, are difficult to negotiate because banks lack fully effective means to control one another’s behavior. Magliano Interview (cited in note 2). President Fernández indicated, however, that the central bank stood ready to coordinate private rescue efforts in the event of the failure of a significant Argentine bank. Fernández Interview (cited in note 78).
111 ADEBA Interview (cited in note 75).
112 ABRA Interview (cited in note 75). Opinions of rating agencies are required for the issuance of bonds. Id.
113 Id.
114 Banco de la Nación Argentina, *Outlook*, 8 Fundación Mediterránea Newsletter 2-3
ate the creditworthiness of major borrowers by finding out what loans they have outstanding at other institutions.

In addition to the reforms intended to ensure market discipline, the central bank now requires banks doing business in Argentina to maintain capital (i.e., net worth) equal to at least eight percent of risk-adjusted assets, in general accord with the risk-adjusted capital guidelines adopted by the Bank for International Settlements in Basle.115

In short, it appears that the Argentine banking system is indeed adjusting to the repeal of deposit insurance and private market mechanisms are springing up to replace the loss of the government safety net. It is too early to assess whether these private market adjustments are adequate replacements for the government's deposit insurance guarantee, but the initial appraisal by knowledgeable people interviewed for this article was hopeful. Time will tell how effectively private mechanisms can substitute for government insurance in the depository institution industry. For that reason, among others, the Argentine experiment is well worth careful scrutiny by all those interested in the fundamental problems of banking law and regulation.

CONCLUSION

In this article, I have examined the decision of Argentina's government to repeal its programs of implicit and explicit deposit insurance. After discussing the political and economic background of the repeal, I addressed three important questions: (1) how could fundamental reform such as this have occurred in a society which has for so many years been dominated by powerful vested interests; (2) has Argentina indeed repealed all forms of deposit insurance, implicit as well as explicit; and (3) how has the private market responded to the deposit insurance reforms.

Three general conclusions follow. First, fundamental reform could occur because Argentina was in the midst of a political and economic crisis in which the public had reached a consensus that profound changes were necessary for Argentina to achieve stability and regain some of its lost prosperity. More particularly, deposit insurance repeal was facilitated by the fact that most bank deposits had fled the system at the time the reform occurred, by

(Apr 1993).

the uncertainty and losses that bank depositors had experienced even with deposit insurance in place, and by the connection which important policy makers drew between the costs of deposit insurance and the problems of inflation and hyperinflation, which corroded the very fabric of Argentine society.

Second, Argentina has provided a surprising degree of assurance to markets that deposit insurance has indeed been repealed. This assurance takes the form of three mechanisms: (1) the independence of the central bank, which insulates that institution to a degree from political pressures to bail out particular institutions or depositors; (2) statutory prohibitions on deposit insurance and stringent limitations on the central bank's ability to loan money to governments or to shaky banks; and (3) the convertibility law, the centerpiece of recent successful reforms, which would be threatened if the central bank were to expend large amounts of funds rescuing failed or failing banks or their depositors.

Third, some private market mechanisms are developing to respond to the withdrawal of the government safety net. It is too early to assess whether the private market response will be adequate in light of the risks, but the initial indications appear favorable.

Argentina's experience with deposit insurance repeal should be of considerable interest to policymakers in the United States because it offers a test case in which a major economy engaged in radical reforms to its system of banking regulation. It will be useful to examine how those reforms play out over time in order to evaluate whether the United States should consider experimenting with more stringent limitations on deposit insurance than have been feasible until now, despite the catastrophic failures of both the savings and loan and bank insurance funds over the past decade.