BANCO DE ESPAÑA

WHAT HAVE WE LEARNED FROM RECENT FINANCIAL CRISES IN EMERGING COUNTRIES?

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1. AN ANATOMY OF CRISES IN EMERGING COUNTRIES

1. **Before 1994, focus on small fiscal deficits as the way to avoid financial crises.**
   - Mexico does not fit: no fiscal problem.

2. **After Tequila crisis, many thought high external deficits and low savings were main triggers of a crisis.**
   - However, many Asian countries did not have these problems.
   - Several episodes of contagion and IMF role questioned.

AN ANATOMY OF CRISES IN EMERGING COUNTRIES (cont')

3. **Russian crisis marked the return to fiscal problems, coupled with the presence of an implicit public guarantee: pegged exchange rates.**
   - **Contagion.**
4. **Argentine crisis is different from Russian, not so much because of its origin but because of its duration and resolution.**
   - **This increased the cost of the crisis for Argentina**

AN ANATOMY OF CRISES IN EMERGING COUNTRIES (cont')

- **All in all, crises have been more frequent in emerging countries and also very costly (see Table)**

Table 15. Costs of Crises in Lost Output Relative to Trend

	Number of Crises	Average Recovery Time[1] (in years)	Cumulative Loss of Output per Crisis[2] (in percentage points)	Crises with Output Losses[3] (in percent)	Cumulative Loss of Output per Crisis with Output Loss[4] (in percentage points)
Currency crises	158	1.6	4.3	61	7.1
Industrial	42	1.9	3.1	55	5.6
Emerging market	116	1.5	4.8	64	7.6
Currency crashes [5]	55	2.0	7.1	71	10.1
Industrial	13	2.1	5.0	62	8.0
Emerging market	42	1.9	7.9	74	10.7
Banking crises	54	3.1	11.6	82	14.2
Industrial	12	4.1	10.2	67	15.2
Emerging market	42	2.8	12.1	86	14.0
Currency and banking crises [6]	32	3.2	14.4	78	18.5
Industrial	6	5.8	17.6	100	17.6
Emerging market	26	2.6	13.6	73	18.8

[1]Average amount of time until GDP growth returned to trend. Because GDP growth data are available for all countries only on an annual basis, by construction the minimum recovery time was one year.

[2]Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises.

[3]Percent of crises in which output was lower than trend after the crisis began.

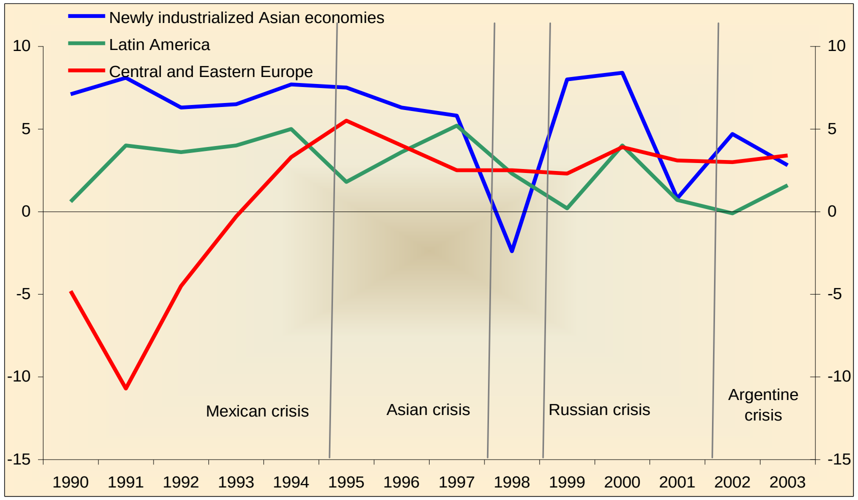
[4]Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises that had output losses.

[5]Currency "crashes" are identified by crises where the currency component of the exchange market pressure index accounts for 75 percent or more of the index when the index signals a crisis.

AN ANATOMY OF CRISES IN EMERGING COUNTRIES (cont')

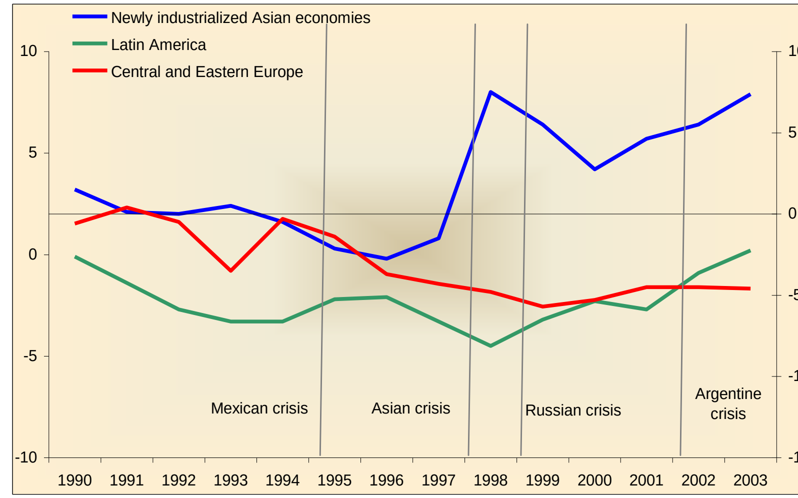
- **The boom and bust cycles are evident when looking at GDP growth, current account developments, as well as sovereign spreads and foreign financing.**

GDP GROWTH



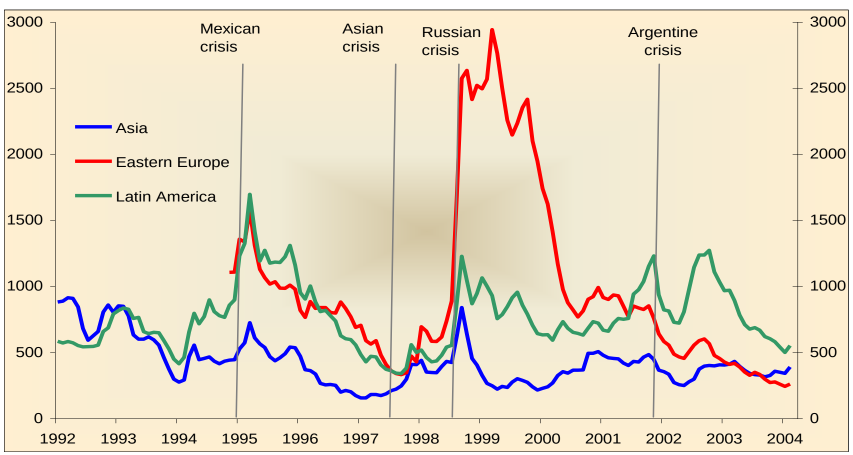
Source: IMF (WEO)

CURRENT ACCOUNT BALANCE
percent of GDP



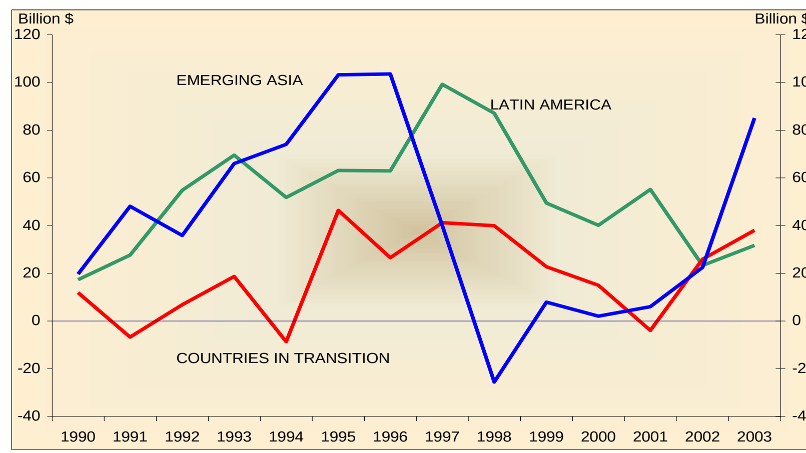
Source: IMF (WEO)

EMBI +



Source: JP Morgan

TOTAL EXTERNAL FINANCING (a)



Source: IMF.
(a) Total external net flows, billions of dollars.

2. CRISES IN THIS CENTURY: ARGENTINA'S COLLAPSE AND BRAZIL'S TURBULENCES.

1. **Although Argentina's crisis had well known origins (fiscal and competitiveness) also had certain characteristics which made it relatively special.**

   - **Large balance sheet effects.**
   - **Argentina extended, to the maximum extent possible, the impasse before the country devalued and defaulted→high costs**
   - **Crisis management significantly increased the costs.**

CRISES IN THIS CENTURY: ARGENTINA'S COLLAPSE AND BRAZIL'S TURBULENCES (cont.).

2. **Brazil's turbulences in 2002 are also worth looking at in comparison with Argentina.**
   - Vulnerability high in both countries (high debt and reliance on foreign financing) but Brazil had little dollarisation and exchange rate flexibility.
   - However, the flexibility of the system was not enough to avoid generating a vicious circle (indexation of public debt to e or i).
   - In any event, Brazil did not suffer from a pure solvency problem as Argentina's but rather from one of multiple equilibria.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- **Macroeconomic performance quite different.**
  - In 2003, Argentina led growth in the region (9%)
  - Brazil registered its first year of negative growth in a decade.
  - Both countries enjoy competitive exchange rates and current account surpluses but in Argentina the latter is much larger.

ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- However, a deeper look at both cases offers a different view.
  - Argentina will remain outside the world capital markets as long as the debt is not restructured and when it manages to return, it will most certainly be with a very high risk premium.
  - Brazil is enjoying a very favourable access to capital markets.

ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- The recovery in Argentina is commensurate to the deep recession it went through. In Brazil, recent growth has been burdened by large adjustment (to preserve macroeconomic stability).
- Argentina maintains a high degree of interventionism while Brazil is pushing for structural reforms.

ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- Argentina is profiting from high growth but is not taking the steps to make it sustainable.
- Brazil has moved from a bad equilibrium to a good one, backed by appropriate macroeconomic policies and reforms.
- Risks exist for both economies but they are different in extent and nature.

ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- Argentina urgently needs to restructure its external debt. Economic reforms cannot wait. A crucial one is restabilising the credibility of the legal and regulatory system so that FDI can eventually return.

- Brazil is still financially vulnerable: external factors and domestic political difficulties.

4. LESSONS FROM ARGENTINA AND BRAZIL

1. For the domestic authorities.

– The Argentine case shows:

  - ***Fixed pegs suffer from important political-economy exit problems***
  - ***High foreign-currency debt, financial but not trade openness, and lack of exchange rate flexibility is a deadly combination.***
  - ***The costs of a crisis are not exogenous to the authorities' management of the crisis.***

LESSONS FROM ARGENTINA AND BRAZIL

– The Brazilian case shows:

- ***Exchange rate flexibility can be useful to help move from one equilibrium to another avoiding abrupt changes.***
- ***However, the fact that the debt is indexed, rather than denominated in foreign currency, is only a second-worse.***
- ***This seems clear when comparing Brazil with Chile and Mexico, where public indebtness is lower and also less linked to the exchange rate.***

LESSONS FROM ARGENTINA AND BRAZIL

- A strong commitment to sound macroeconomic policies and structural reforms can move a country from a vicious to a virtuous cycle.
- External factors are also important, in particular the degree of global risk aversion.

LESSONS FROM ARGENTINA AND BRAZIL

2. **For private investors.**
   - The Argentine case has been very costly both for financial investors and foreign direct investors, probably much more than in other crises since new types of risks have appeared, among which:
     - ***Balance sheet effects related to dollarization-mismatches.***
     - ***Asymmetric pesification in the case of the banking system.***
     - ***Abrupt changes in the rules of the game.***
     - ***A government-induced worsening of the public's perception of foreign companies.***

LESSONS FROM ARGENTINA AND BRAZIL

– Not only new risks but also extremely difficult to cover.
  - *Political risk insurance still at early stages.*
– In banking system, foreign banks suffered the consequences of large balance sheet effects. This risk was not hedged due to the accumulated credibility of the currency-board, and probably impossible to hedge given the small size of tradable sector.

LESSONS FROM ARGENTINA AND BRAZIL

- Argentina shows that large foreign bank participation can constitute a target for discriminatory treatment.
- As a result, foreign banks are re-assessing their emerging market risk exposures and market strategies.

LESSONS FROM ARGENTINA AND BRAZIL

3. **For international financial institutions.**
   - Risk of excessive concentration of IMF lending although this should not be taken to the limit. Brazil's shows that IMF assistance can help avoid a crisis.
   - Brazil's case signals importance of crisis prevention in the IMF toolkit: precautionary programs?.
   - Yet when countries are clearly insolvent, international institutions seem to have very few tools available.

LESSONS FROM ARGENTINA AND BRAZIL

– In more general terms, it seems that international financial architecture still requires improvement to minimise the risks of crises and their related costs.

  - ***Banco de España (2004) reviews the improvements in the international financial architecture which have been introduced since the Russian crisis and finds that they have been relatively modest.***