

***LESSONS FROM RECENT
FINANCIAL CRISES IN
EMERGING COUNTRIES***

José Viñals
Banco de España

Central Bank of Finland, Helsinki, 22nd March 2004

Roadmap to presentation

1. An anatomy of crises in emerging countries.
2. Crises in this century: Differences between Argentina's collapse and Brazil's turbulences.
3. Recent developments in Argentina and Brazil.
4. Lessons to be drawn.

1. *AN ANATOMY OF CRISES IN EMERGING COUNTRIES*

1. Before 1994, many analysts narrowly focused on small fiscal deficits as the way to avoid new financial crises.
 - Mexico, however, did not have a fiscal deficit problem, and its crises did not repeat the pattern of the 1980s debt crisis.
2. After the Tequila crisis, many analysts thought high current account deficits and how savings were the main triggers of a crisis.
 - However, many Asian countries did not have these problems , certainly not lack of savings or growth.
 - There were also several episodes of contagion and the role of the IMF was put into question.

1. *AN ANATOMY OF CRISES IN EMERGING COUNTRIES (cont')*

3. The Russian crisis marked the return to fiscal problems, coupled with the presence of an implicit public guarantee: the pegged exchange regime.
 - Contagion spread beyond emerging countries.
4. The 2001 Argentine crisis is still different to the Russian one, 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)
- The boom and bust cycles are evident when looking at GDP growth, current account developments, as well as sovereign spreads and foreign financing (see Graphs.

	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

¹Average 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.

²Calculated 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.

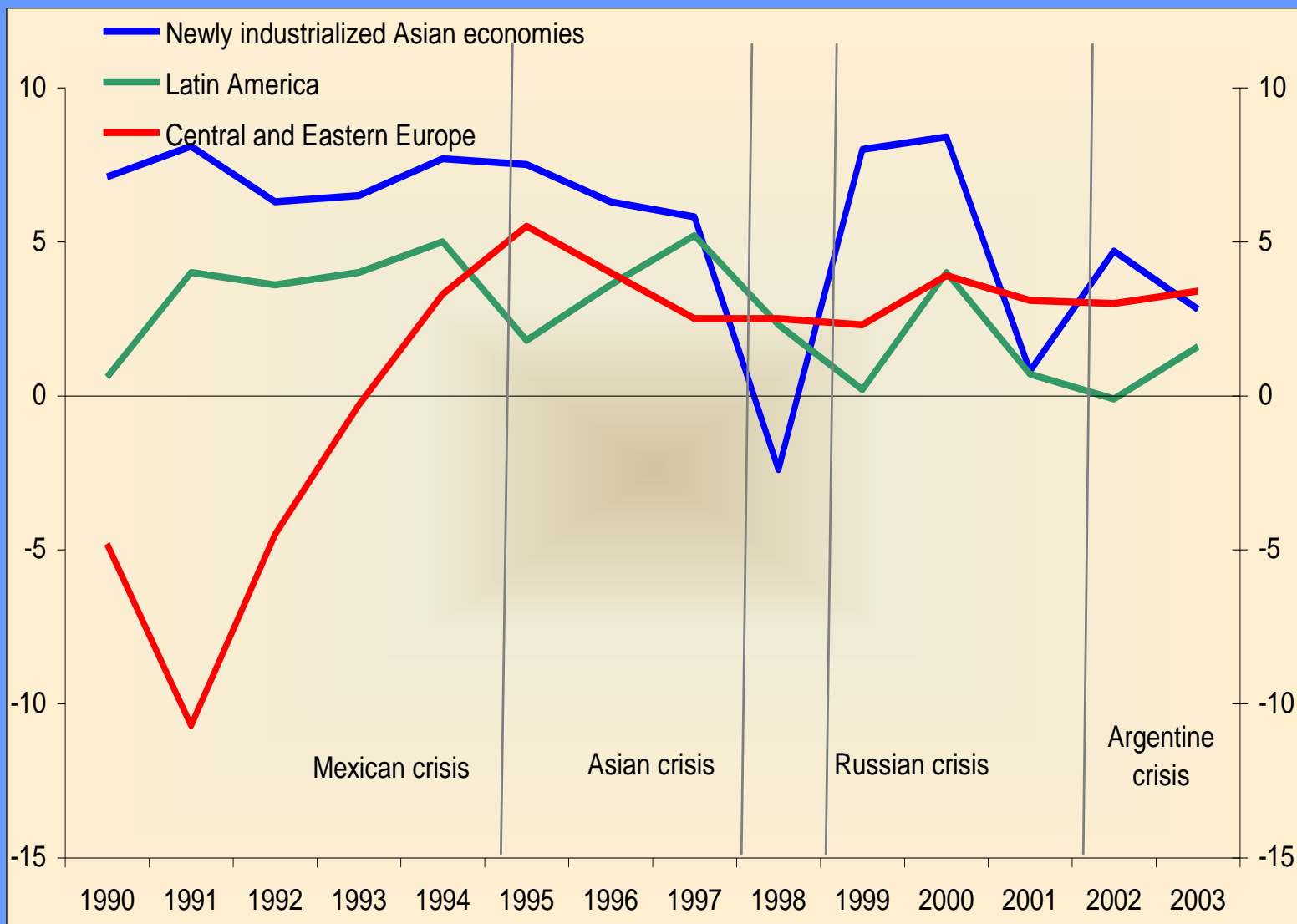
³Percent of crises in which output was lower than trend after the crisis began.

⁴Calculated 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.

⁵Currency “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.

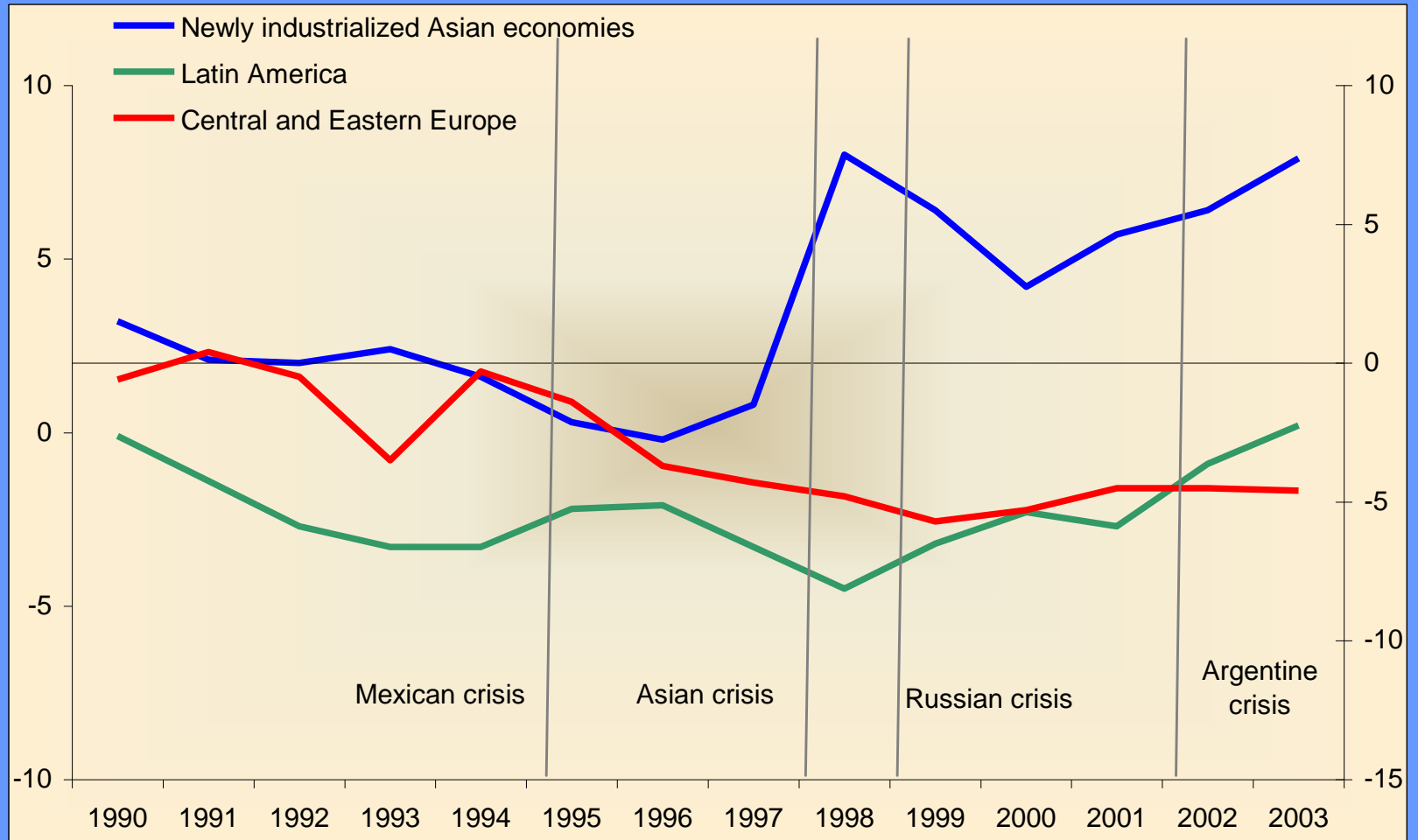
⁶Identified when a banking crisis occurred within a year of a currency crisis.

GDP GROWTH



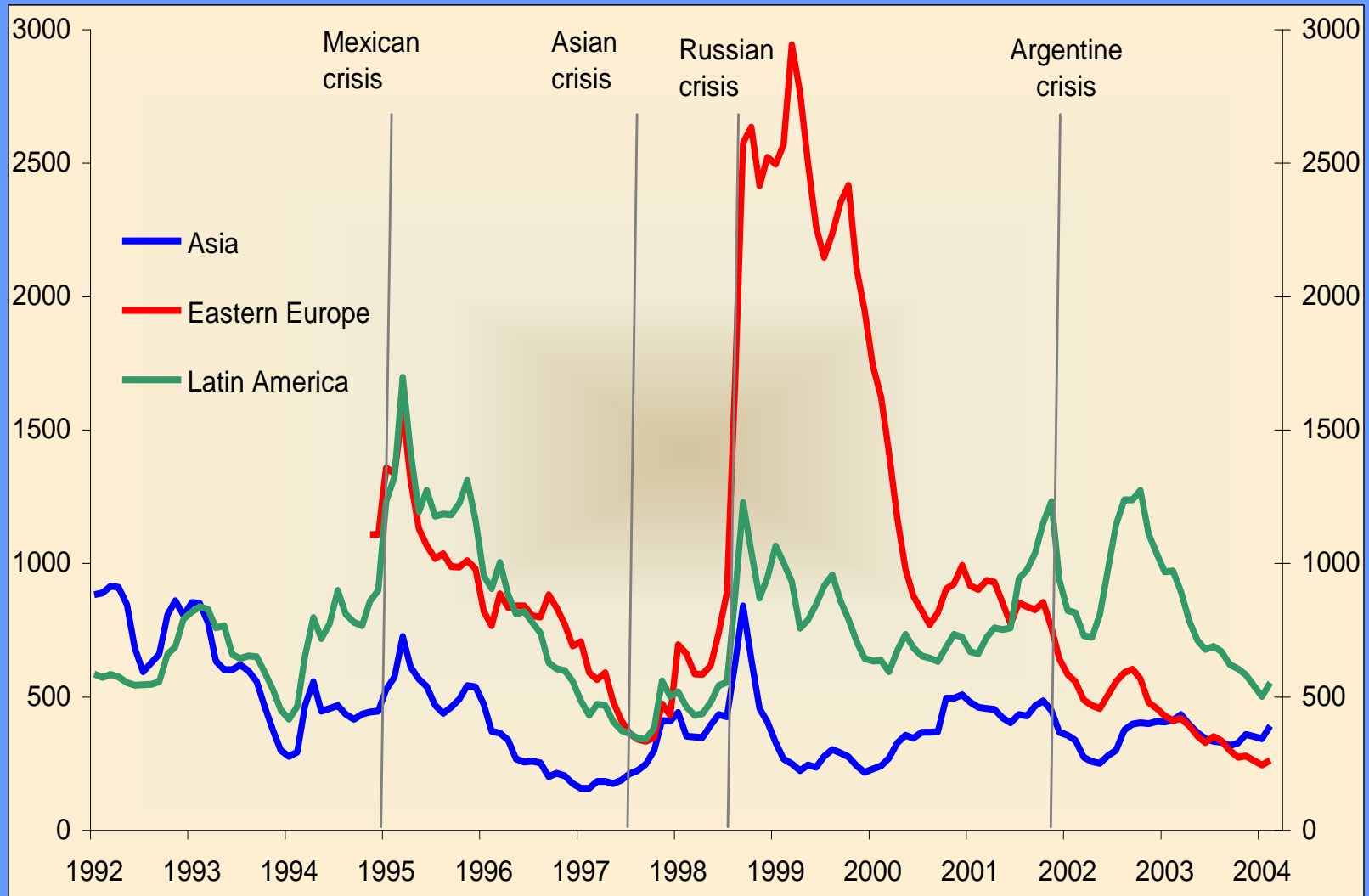
Source: IMF (WEO)

CURRENT ACCOUNT BALANCE percent of GDP



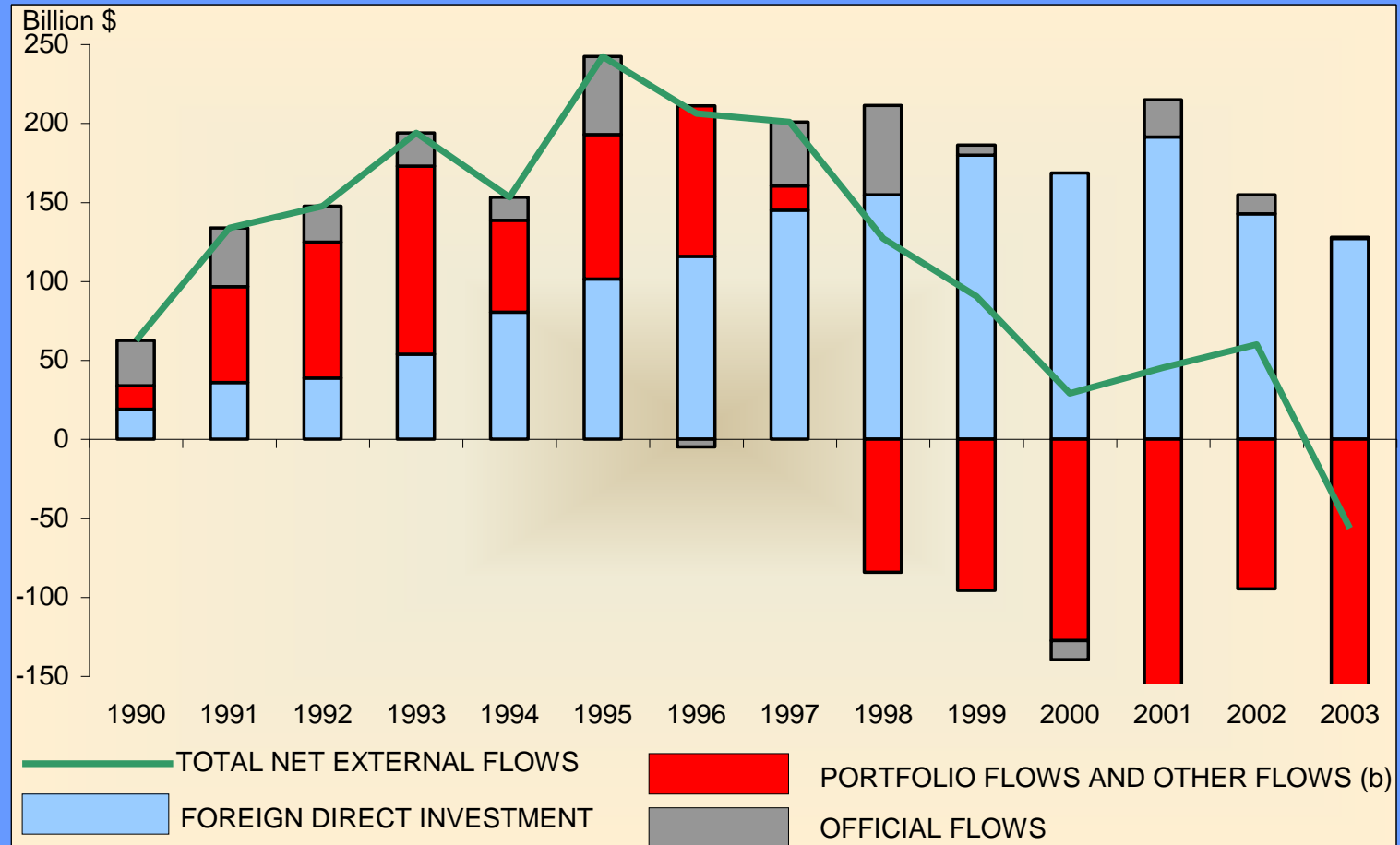
Source: IMF (WEO)

EMBI +



Source: JP Morgan

TOTAL EXTERNAL FINANCING (a)

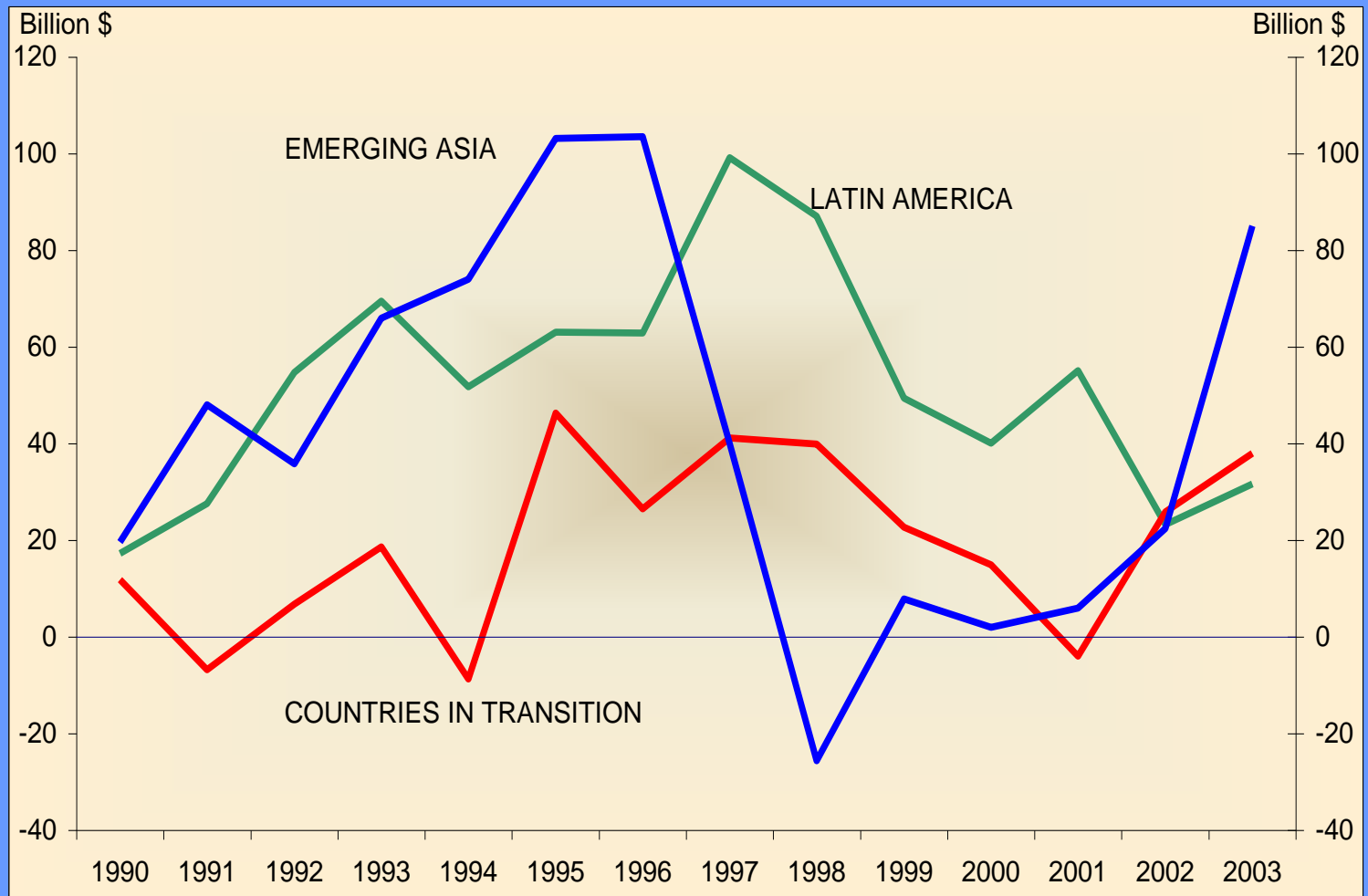


Source: IMF.

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

(b) Including bank lending.

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 shares some of its characteristics with others, particularly its origin (mainly on the fiscal and the competitiveness front (Alberola, 2002), it also had a number of characteristics which make it relatively special.
 - Large balance sheet effects, Chang and García Herrero (2003) show their large negative impact on a country's risk premium.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- Argentina extended, to the maximum extent possible, the situation of impasse before the country devalued and default.
 - This had a detrimental effect on Argentina because it increased the number of distortions. On the other hand, it reduced contagion to other emerging countries.
- The authorities of the crisis management, most probably increased the costs.
 - Taking the banking sector as an example, Dages and García Herrero (2003) calculate that two thirds of the losses incurred by the banking system were related to policy decisions.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

2. Brazil's turbulences in 2002 are also worth a look in comparison with the Argentine case.
 - Vulnerability was high in both countries but Brazil had more flexibility.
 - However, the flexibility of the system was not enough to avoid generating a vicious circle.
 - In any event, Brazil did not suffer from a pure solvency problem as Argentina's but rather one of multiple equilibria.
 - This explains, the strong and positive reaction of all political parties endorse the IMF program.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

1. The main macroeconomic facts display a rather striking picture.
 - Argentina is leading growth in the region -higher than 8% last year- while Brazil has just registered its first year of negative growth since 1992.
 - Inflation in Argentina is below 3%. In contrast, Brazil inflation was above 10% after the turbulences.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- Both countries enjoy competitive exchange rates and current account surpluses but in Argentina the latter is much larger.
2. However, a deeper look at both circumstances 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 huge risk premium. Brazil is enjoying a very favourable access to capital markets.

. 3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- The impressive recovery in Argentina is commensurate to the deep recession it went through. In Brazil, growth has been burdened by large macroeconomic adjustment.
- Argentina has maintained a large degree of interventionism while Brazil has pushed for structural reform.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

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

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- Argentina needs to carry out the restructuring of its external debt as soon as possible. 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 very vulnerable to financial conditions, which can worsen due to external factors or, even more so, to a loosening of the current economic policies.

3. ARGENTINA AND BRAZIL: RECENT DEVELOPMENTS

- It is interesting to note that the discrimination which characterized the Argentine crisis has led to a relatively equal treatment of all sovereign countries in their external financing
 - See increase in correlation from very low levels during Argentine crisis.

CORRELATION OF SOVEREIGN SPREADS DERIVED FROM EMBI (a)



Source: own calculations.

(a) Average of three months cross correlations of differences of sovereigns spreads of Latin America countries included in the EMBI index.

4. *LESSONS FROM ARGENTINA AND BRAZIL*

1. For the domestic authorities.

- The Argentine shows:
 - High foreign-currency debt, financial openness, commercial closeness and non exchange rate flexibility is a deadly combination.
 - The costs of a crisis are not exogenous to the authorities' reaction.
- The Brazilian case shows:
 - Exchange rate flexibility can be useful to move from equilibrium to another avoiding abrupt changes.

4. *LESSONS FROM ARGENTINA AND BRAZIL*

- 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 indebtedness is lower and also less linked to the exchange rate.

4. *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.
- However, such commitment has a short term cost in terms of growth, can only be considered a second best. A better situation is that in which the absence of vulnerabilities where you conduct countercyclical fiscal policies, such as Chile.

4. *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.
 - 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 are these new risks which foreign direct investors had hardly anticipated but they are also extremely difficult to cover.
 - Political risk insurance is still at early stages as compared to the size and nature of risks.
- In the specific case of the banking system, foreign banks, suffered the consequences of large balance sheet effects. This risk was not hedged due to the accumulated credibility of the convertibility law, and would probably have been impossible to hedge given the small size of the tradable sector.

4. LESSONS FROM ARGENTINA AND BRAZIL

- In addition, the Argentine case shows that large foreign bank participation can constitute a target for discriminatory treatment.
 - For the specific case of the banking system, the choice of the legal form can contribute to minimizing such risks. In particular, the financial independence of subsidiaries can turn very useful.
- Finally, it seems dead evident that foreign banks are re-assessing their emerging market risk exposures and market strategies.

4. LESSONS FROM ARGENTINA AND BRAZIL

3. For international financial institutions.

- There is a risk of excessive concentration of IMF lending although this should not be taken to the limit. Brazil's shows that the IMF assistance can help avoid a crisis.
- Brazil's case point to the importance of crisis prevention in the IMF toolkit, particularly through precautionary programs.
- As for the case where countries are clearly insolvent, international institutions seem to have very few tools available.

4. *LESSONS FROM ARGENTINA AND BRAZIL*

- In more general terms, it seems that international financial architecture still requires improvement to minimise the risks of a crisis as well as their related costs.
- Casas, Fernández de Lis, González y Mira (2004) review the improvements in the international financial architecture which have been introduced since the Russian crisis and find that they have been relatively modest.