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## **From Mexico to Argentina**

### **What Have We Learned from Two Decades of Debt Crises?**

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Over the course of the last twenty years or so, the world has experienced a number of sovereign debt crises. Among many others, one can mention, in particular, the Latin American crisis of 1982, the Mexican "Tequila" crisis of 1994-95, the East Asian crises of 1997, the Russian meltdown in 1998, the Brazilian crisis of 1998-99, the Turkish crisis of 2000-2001, and Argentina's default since 2000.

Why has the world faced at least seven major sovereign debt crises in twenty years ? Is there a common thread behind all those disruptions ? How has the debt strategy evolved over the years ?

I shall try to address these issues under two headings :

1. What have been the sequence and causes of sovereign debt crises since 1982, how have they been dealt with, and what have been their broad economic consequences ?
2. What lessons have we — or should we — learn from those experiences ?

## **1. The History of Sovereign Debt Crises since 1982: Their Causes, Treatment, and Consequences**

What follows does not pretend to provide an exhaustive study of debt crises in emerging countries. Rather, for the sake of conciseness, I focus on a limited number of events, while attempting to give an illustrative overview of the main crises that occurred over the last two decades. I focus on the following cases:

1. the debt crises of Latin America (1982-90)
2. the second Mexican crisis (1994-95)
3. the East Asian debt crisis (1997)
4. the Argentine default (2000 and onward)

### ***The Latin American Debt Crisis of 1982***

*The factors.* A number of Latin American countries had engaged in significant sovereign borrowing from private international banks in the second part of the seventies. The inflationary environment of the time, low interest rates (which for a while were even negative in real terms), and higher oil prices (oil shock of 1979-80) were factors that had encouraged countries like Mexico to run up high fiscal deficits and to borrow heavily in foreign-denominated currencies. On the lending side, international banks that were receiving large deposits from Middle East oil-producing countries were eager to lend and "recycle" those funds. This explains how in the early 1980s the government of Mexico accumulated some \$500 billion of public indebtedness (the figure was less than \$50 billion in the early 1970s). The amount for Brazil was about \$80 billion (against \$15 billion ten years earlier). For Argentina, the figures, although smaller, show a similar trend (\$40 billion against less than \$10 billion). Thus the public debt of those countries had increased over ten years by a factor of 4 to 10. The ratios of public debt to GDP of those countries had reached levels around 50 percent (against less than 20 percent in 1973).

To many observers at the time, the increased indebtedness seemed sustainable as long as nominal prices and export revenues were continuing to rise. I was, I must say, much more pessimistic. But, be it as it may, unforeseen events precipitated the course of history. After the price hike observed in the wake of higher oil prices, Paul Volcker, chairman of the Federal Reserve, decided to break the pervasive double-digit inflation of the time. The Fed's monetary contraction led to a surge in interest rates. This interest-rate shock contributed in turn to a dampening of the world economy and to a weakening of international oil prices. Banks, beginning to worry about the ability of their debtors to repay, reduced their lending and shortened their maturities. This triggered the debt crisis.

The first manifestations of credit difficulties came from Poland in 1981. They quickly spread to other Eastern European countries and eventually struck Mexico in August 1982. All major Latin American countries followed.

*The stakes.* For Mexico, the issues were daunting. Losing access to international trade lines would have choked the economy. And the fiscal deficit (11 percent of GDP and rising rapidly) had to be addressed, which was all the more difficult since Mexico was in a period of

transition from the Lopez Portillo administration to that of de la Madrid. Furthermore, the weakening peso was adding to inflationary problems and straining overextended balance sheets. So it was clear that Mexico needed a stabilization program. It also needed breathing space and, therefore, international financial support.

The private international banks (which were by far the main creditors of Mexico) also had many reasons to worry. Their vulnerability from the three largest debt-stricken Latin American countries exceeded significantly their equity and reserves. Indeed, the capital exposure (credits to bank capital) of the nine largest U.S. banks to Latin America had reached 177 percent in 1982. European and Japanese banks also had very significant exposures. Thus, the whole international financial system was on the verge of seizure.

Something had to be done and swiftly.

*The debt strategy.* It was based on rather simple principles.

1. As long as the problem could be considered as a *liquidity* and not a solvency issue (and that was the view we reached at the time), the prescription to enforce fiscal retrenchment was the right one.
2. Therefore, the debtor country was expected to take all possible measures to reach an agreement with the International Monetary Fund (IMF) on a meaningful adjustment program. That would restore balance-of-payments viability in the medium term.
3. But the solution could only come from a collective effort in which both parties to the debt problem (that is, debtors and creditors) were actively engaged. In this respect, private creditors, being the main lenders, had to be the main participants in the restructuring. They were asked to provide the necessary breathing space for the program to succeed. This meant that banks had to avoid cutting off access to short-term trade lines, and they were encouraged to provide the resources needed to finance a balance-of-payments gap consistent with the adjustment program. This could take the form of rescheduling, grace periods, new money, debt reductions, or debt-equity swaps. Bilateral official creditors were asked to match the effort of private creditors, taking into account their respective exposures.
4. The IMF's essential role was to ensure that the negotiated program was reasonable, well understood, in particular by the private creditors, and efficiently enforced. The IMF would participate financially in the deals but only for relatively modest amounts. Indeed, its role was not to hand out massive public funds but was, instead, to act as the adjustment instrument of the system. For example, the Fund provided Mexico an extended arrangement for three years that amounted to "only" \$3,7 billion (450 percent of Mexico's IMF quota). These figures are dwarfed by the massive financial packages that the IMF would hand out later, in the 1990s. The Fund credit was made conditional upon the creditors own contributions.
5. Last, the negotiation with banks was handled by bank advisory committees. For each country, a banking committee was formed to facilitate the negotiation with the many financial institutions involved and to reach agreement on the characteristics of the rescheduling, the amounts of new money, and so on. Bill Rhodes of City Bank

played a central role in steering these committees and reaching the "critical mass"<sup>1</sup> (that would allow the IMF to go forward).

This pragmatic, case-by-case cooperative model adopted by the IMF and strongly supported by Paul Volcker proved efficient. When, a few weeks after the Mexican event, similar crises broke out in Argentina and Brazil, the same principles and the same tools were applied.

*The results.* The adjustment of the current account imbalances was rapid and impressive. The total current account deficit of indebted developing countries fell from \$113 billion in 1981 to \$38 billion in 1984 (James 1996).

This was inevitably accompanied by reduced living standards and slower growth (from 1980 to 1990 average annual growth was 2,2 percent in Mexico, 3 percent in Brazil, -0,4 percent in Argentina, while the corresponding figures for the decade 1990-2000 are 3,4 percent, 2 percent, and 4 percent).

But before hastily concluding that the 1980s were a lost decade, one must take into account different elements.

1. The availability of softer financing was just not there. Would it have been a wise idea — as suggested by Professor Allan H. Meltzer — to let the banks write off their claims or to exchange them for some minority equity holdings? Given the state of the banks' balance sheets at the time, I believe that this solution would have precipitated an extremely serious banking crisis that, in turn, would have led to a global recession. Would it have been a good idea, as suggested by Peter Kenen, to establish a "debt discount corporation" that would have bought debt from banks at a 10 percent discount and converted it into long-term bonds with reduced interest rates? In my view, the answer is yes. But at the time such a solution was not seen as viable by the markets and the debtors. It had no political chance to materialize in the early 1980s, when pressing matters had to be sorted out quickly. However, as I will show later, the Brady Plan in 1989 adopted some of the main features and objectives of the foresighted Kenen proposal.
2. We must not forget also that the IMF programs of the 1980s contributed to restoring the fiscal discipline and macroeconomic stability that are always the foundations of sustainable growth.
3. And last, the openness rates of countries like Mexico enormously improved over the 1980s (from 10 percent of GDP to 15,8 percent), while the dependence on oil of that country (share of oil in total exports) was reduced from 68,5 percent in 1982 to 19,1 percent in 1991, thus lessening the vulnerability of the economy to external shocks.

I therefore believe that the picture is more nuanced than what is often presented and that many of the seeds of the successes of the 1990s were planted in the 1980s.

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<sup>1</sup> The banks agreeing to the deals were to represent at least 90 percent of total bank exposure to the interested country

*The Brady Plan.* The debt strategy evolved in the late 1980s with the Brady Plan (1989). This plan had two basic features:

1. The Fund and the World Bank would use part of their financing to buy back discounted debt of countries cooperating with the IMF.
2. The banks, for their part, were asked to, participate in debt reductions either by agreeing to, swap their old debt for fifteen-year "discount bonds" at 65 percent of their nominal value, or by accepting 1 to 1 "par bonds" but with a reduced interest rate. The principal of the new bonds would be guaranteed by collateral zero coupon bonds, thanks to funds and enhancements provided by the IMF, the World Bank, and Japan.

This new scheme — which was predicated on renewed Fund programs — helped to alleviate the debt burden and to restore confidence in the financial sustainability of many emerging countries, thus encouraging foreign direct investment, which had been very limited in the 1980s.

### *The "Tequila" Crisis (1994-95)*

I shall be much briefer on the second Mexican debt crisis.

*The environment.* The environment had changed since the early 1980s. The Brady Plan had been a success and healthier growth rates had been restored in Latin America (except for Brazil). Banks had considerably, reduced their exposure to emerging countries, and external financing was increasingly taking the form of foreign direct investment and bonds issued in international markets.

This substitution of bonds to bank credits has, indeed, played a considerable role in the treatment of debt crisis. As bonds are dispersed in many hands (private holders, pension funds, mutual funds, and so on), it appears more difficult to apply the "cooperative" debt strategy that had been organized in 1982 in the context of a relationship between a sovereign and a limited number of private banks.

How could the IMF cope with the nagging dilemma of essentially avoiding the risk of a global financial market meltdown (if large amounts of bonds were to be defaulted), while not providing too much public multilateral money to the issuers (so as to counter the criticism voiced against using taxpayers' money bail out private creditors) ?

That is indeed the dilemma that the G7 and the international financial institutions (IFIs) continue to face — one they have not really managed to resolve.

The first test came with the "Tequila crisis" in 1994.

*The factors at play.* Mexico was in a difficult transitional phase in early 1994 with the Chiapas rebellion and the assassination of the appointed successor to President Salinas. In that troubled context, Mexico's current account was running a deficit of 8 percent of GDP,

significantly higher than what the market considered sustainable (see Rieffel 2003). Part of that deficit had been financed by "tesobonos" (that is, short-term bonds issued in pesos by the Mexican Treasury but providing buyers with dollar-linked protection). With \$50 billion to mature in 1995 while reserves stood at \$6 billion, *all* the ingredients of a crisis were thus assembled. In the event, capital outflows forced the government to float the peso and to implement a strong stabilization program. But what would be the debt treatment ?

*The handling of the debt problem.* The U.S. Treasury decided — contrary to past solutions — that all the financial needs stemming from Mexico's external liabilities (including debt amortizations, which had always been rescheduled in previous debt crises) would be financed by official resources. Thus, a huge "financial package" of some \$50 billion was put together (including the IMF<sup>2</sup>, other multilateral and bilateral agencies).

The holders of tesobonos got paid in full.

*The rationale.* Why did the U.S. Treasury decide to finance the liquidity crisis and discard a more "usual" solution that would have combined a smaller financial package with some restructuring of the Mexican debt ? It did it because the U.S. government was fearful that a restructuring of Mexico's debt would be perceived by the markets as a major default. This could make it more difficult for Mexico to reaccess capital markets in the future and could also degenerate into a global crisis of confidence in world financial markets.

But strong criticism was expressed at the time, notably in Japan and Europe, where many considered that the rules of the game — in particular the IMF access limits — were being distorted in favor of a country that had a particular importance to the U.S.

*The results.* The immediate results exceeded all expectations. Under President Zedillo, Mexico implemented a successful adjustment program that produced a sharp reduction in the current account as early as mid-1995 but entailed a severe contraction in real wages. Access to international markets was restored in 1996 and "by 1997 Mexico's economy was booming" (Rieffel 2003). All emergency loans were repaid on time or prepaid. And since then Mexico has developed a remarkable relationship based on transparency and trust with its creditors and the financial markets.

However, a question remains: did that massive financing operation induce "moral hazard" ? In other words, have private creditors been led to believe that in the case of future severe liquidity crises there would be forthcoming a public rescue package that "would take care of everything" ? Although there is little evidence that this has happened (a number of financial institutions were, in fact, hurt by the bankruptcies of Mexican companies that had overborrowed in dollars and collapsed after the depreciation of the peso), I cannot discount the notion that some sentiment of excessive reassurance was created. The enormous surge of lending to emerging countries in 1996<sup>3</sup> at very low spreads (that is, with a substantial risk underpricing) was a spectacular phenomenon that may well have been encouraged by the "large financial package" method of 1995, although other factors had already come into play.

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<sup>2</sup> The access to the Fund's resources amounted to 688 percent of the Mexican quota.

<sup>3</sup> Private flows to emerging countries jumped to a record of \$338 billion in 1996 (against \$201 billion in 1994 and \$75 billion in 1990).

I shall add that one of the dangers of these huge IMF handouts is that if things go wrong later on, the Fund will be left with large amounts of loans outstanding. That, in turn, can have serious consequences on the neutrality and credibility of the institution, as will be shown later.

### *The East Asian Crisis of 1997*

*The factors.* As in preceding cases, the Asian crisis took the world by surprise. In this regard, the lack of transparency was a huge factor for such a "surprise." It started with Thailand in May 1997. A few months later it struck the Philippines, Malaysia, Indonesia, and South Korea. This was the manifestation of the contagion effect that so often characterizes debt crises.

Why did the crisis break out? These export-led economies seemed to be rather successful in the first half of the 1990s. Their growth was enviable (7 percent on average from 1990 to 1996), their savings rates were high, their price inflation was relatively moderate (5-7 percent yearly average), their reserves appeared comfortable and their fiscal positions were in good order.<sup>4</sup>

But behind those reassuring figures, different sources of preoccupation were receiving insufficient attention.

1. Current account deficits were growing and hovering between 4 and 8 percent of GDP in the n
2. The currencies of those countries were pegged to the dollar. This de facto fixed exchange rate system systematically encouraged borrowing in dollars (nonhedged). Local financial institutions and corporations were, indeed, tempted to borrow dollars because it was cheaper than borrowing local currencies (domestic markets were relatively inefficient) and because there was apparently no exchange risk.
3. Asset prices (stocks, real estate) were skyrocketing.
4. The international financial community was engaging in dangerous lending to insufficiently tra
5. Thus, a huge mismatch between revenues (in local currencies.) and mounting liabilities (in dollars) had been allowed to accumulate in the private sector of those countries.

Monetary policy had a grave responsibility in this regard: indeed, it did not sufficiently control the expansion of credit<sup>5</sup>, and did nothing to constrain the currency mismatches. Besides, it provided an illusory "exchange rate safety net."

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<sup>4</sup> Thailand, Indonesia, and Korea all had fiscal surpluses in 1995-96, and their sovereign debt ratios to GDP were modest (5 percent for Thailand, 13 percent for Korea).

<sup>5</sup> Short-term debt incurred by the five Asian economies in question *vis-à-vis* foreign banks had almost doubled from the end of 1993 to the end of 1996 (from \$82 billion to \$152 billion).

Therefore, the private sector was extremely vulnerable to a credit crunch, to higher interest rates, to an exchange rate depreciation, to a change in asset prices, and so on. Eventually, with a considerable time lag, the market started realizing this in early 1997.

*The treatment of the crises.* On the whole — with some variations — the Mexican (1995) strategy was applied. Large financial packages were provided — 505 percent of Thailand's quota, 490 percent for Indonesia, 1938 percent for Korea (although in the latter case, the quota was clearly undersized). With the other components (World Bank, regional multilateral development banks, bilaterals, and so on), Thailand was provided \$17 billion, Indonesia \$36 billion, and Korea \$58 billion.

In the case of Korea, there was an exception to the new practice of “nonparticipation” of the private sector in debt solutions. Private banks were asked to provide a standstill to Korea and to restructure \$22 billion of short-term credits into bonds guaranteed by the government. This was a plus in the sense that private creditors were asked to pitch in (which had not been requested in the 1990s). But it was at the expense of “nationalizing” the debt previously owed by private institutions.

*The consequences.* In the countries in question, local governments rescued to a large extent their banks and corporations by guaranteeing bank deposits and replacing nonperforming loans with government bonds. Agencies were formed to restructure the collapsed banking systems.

The burden of adjustment on local populations was significant. Private investors and medium-term lenders (domestic and foreign) also had to take their losses. But banks had managed to reduce their short-term exposure (except for Korea) in the wake of the crises and in a way benefited from the liquidity provided by the financial packages.

All in all, the countries, after a deep contraction in 1997-98 recovered relatively rapidly. Emergency aid was repaid or prepaid. If growth has not regained its precrisis levels, it is more because of lag in structural reform than because of insufficient access to foreign resources.

In the meanwhile, the G7 was getting uneasy. With those large financial packages — which, by the way, the private sector had requested — criticism was mounting. The rhetoric asked : Why should public institutions bail out private creditors who are responsible for most of the accumulated debt ?

That is why, after having put together massive financial rescue packages that facilitated the contraction of short-term bank exposures the international community started to change gears. The problem was to find ways to “involve” the private sector in debt solutions. Once short-term credit was reduced, the main issue to tackle was bonds held by the private sector.

But as I said earlier, restructuring debt with dispersed bondholders is more complex than rescheduling bank credits.

The IMF made three attempts to promote (or force) bond restructurings. The idea was for the debtor sovereign to hire a few investment banks that would go to the market with a unilateral exchange “offer.” The old bonds would be exchanged against new ones that would carry debt reductions and rescheduling features consistent with the IMF programs. This was done in

1999-2000 for Pakistan, Ecuador<sup>6</sup>, and Ukraine. The three exchanges had one very negative common trait : they were not negotiated or even really discussed with bondholders but to a large extent were unilaterally imposed. This bears considerable consequences for the future access to financial markets by countries that resort to such measures.

So, by a strange set of circumstances, private sector involvement was resuscitating, after years of oblivion, but it was occurring in a much less cooperative environment. Indeed it was more a forced participation than a market-oriented mechanism.

### ***Argentina's Default (2001 and Onward)***

*Factors.* After a history of hyperinflation, Argentina engaged in the “convertibility plan” designed in 1991 by the economy minister, Domingo Cavallo. Monetary policy was defined by the full convertibility of the currency and the intangible peg to the dollar. The plan was successful in eradicating inflation, restoring confidence, and reviving economic growth.

Unfortunately, in the mid-1990s the fiscal position slipped into deficit and after 1998 growth eventually slowed down. In the process, Argentina borrowed heavily abroad (including from the Fund) and its public debt ratio to GDP (which was less than 30 percent at the start of the Cavallo Plan) reached almost 50 percent at the end of the decade. And the country's total external debt (principal) at the end of 2003 exceeded \$100 billion.<sup>7</sup>

Given the amount of external debt and the rigidity of the exchange rate, confidence waned. The strains were amplified by the reverberation of the Russian crisis in August 1998 and the Brazilian difficulties. An adjustment program backed by a financial package of \$40 billion (including \$14 billion from the IMF) was put in place in March 2000. Cavallo was called back in March 2001. But neither domestic political conditions nor international markets allowed the adjustment to operate. This time, the debt crisis — contrary to other examples — was not a surprise. Bond-holders had lost faith in the summer of 2001 (Rieffel 2003), and spreads on Argentina skyrocketed to intolerable levels (3.300 basis points in November 2001).

*The approach to the crisis.* In spite of the unfolding of the crisis and the gradual deterioration of the situation, the official international financial community was strangely silent. Indeed, over the course of 2001 the market did not perceive any active discussion between the Argentine government and the IMF, let alone a consultation with private creditors who had stated that they were ready to participate in any reasonable arrangement. It is as if the government were unable to act and that things had to get really worse before action could be envisaged.

Be it as it may, the IMF continued to provide some halfhearted support (\$8 billion in August 2001). But the market was not impressed. The default was official in December 2001 and has remained such ever since.

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<sup>6</sup> The exchange for Ecuador included, as prescribed in the arrangement with the IMF. The restructuring of Ecuador's Brady bonds. But this was not consistent with the Brady conditions.

<sup>7</sup> Taking into account the accumulation of unpaid interest, Argentina's government owes some \$100 billion to private bondholders (of which \$66 billion are owed to foreign holders), 31 billion to multilateral institutions, 14 billion to commercial banks, and 6 billion to bilateral public agencies.

A year after, in early 2003, the Fund approved an "interim" arrangement with Argentina (SDR 2,17 billion) that was intended to help the country to avoid a default vis-à-vis the IMF before the presidential elections. Since President Kirchner took office in May 2003, another standby arrangement was approved by the IMF (for \$8,9 billion). The amounts provided by the IFIs are calculated to maintain their exposure constant (in principal). The conditionality attached to the program appears weak to observers (3 percent/GDP primary fiscal surplus) and seems calibrated to allow Argentina to remain current on its debt-servicing obligations to the IFIs. But that leaves practically no margin to service the debt owed to the private sector. The government of Argentina stated, in October 2003, that it was prepared to pay 25 percent of its debt to private creditors in principal terms. But if one takes into account the interest owed since the default, the "haircut" amounts to 92 percent in net present value terms (NPV). This was rejected by the different creditors groups. Since then, there have been no meaningful negotiations.

*The consequences.* This creates a new and worrisome development. Normally, the IMF should be lending to a country in arrears only if its government is engaged in good-faith negotiations with its creditors. For some time, it was argued in Washington that it was difficult to gauge such a good-faith negotiation condition, because bondholders had not formed a meaningful representative committee. But since December 2003, things have changed. Most different bondholders committees have federated in a global committee — the Global Committee of Argentina Bondholders (GCAB) — that represents more than two-thirds of the outstanding bonds held by foreign holders. The representativity of the GCAB has recently (in the latest Fund's review of the program in March 2004) been recognized by the IMF and Argentina's government. It is to be hoped that true negotiations will make quick progress. It must be stressed that the good-faith criterion for lending into arrears is part of the IMF's own fundamental standards.

But there remains a basic issue for the functioning of the international financial system. The very large claims on Argentina held by multilateral institutions (\$31 billion)<sup>8</sup>, compound the difficulties of the adjustment mechanism. It is one thing to preserve 100 percent of NPV for multilateral claims (which represent almost 30 percent of the total external debt of the country), but it is quite another thing for the IFIs to agree on a program whereby the fiscal primary surplus does not allow for providing more than 15 percent NPV to the private bondholders. Are we moving toward a "new paradigm" where a "reverse bailing out" becomes the norm, where private bondholders are being asked to "finance" the IFIs or even to negotiate their own — additional — adjustment program? Conflicts of interests of that magnitude will have to be addressed if financial markets are to regain confidence and restore their contribution to the financing of emerging economies.

For the time being, Argentina has been recovering (+ 8,4 percent growth in 2003 after four years of severe recession)<sup>9</sup>; inflation has remained moderate, interest rates have gone down, the fiscal position has improved, and private external debt service is no more a burden. But structural problems are still to be addressed and the country will need external capital inflows notably to revive the basic infrastructure which already shows signs of saturation in particular

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<sup>8</sup> Of which, \$15 billion is held by the IMF

<sup>9</sup> -3,4 percent in 1999, -0,8 percent in 2000, -4,4 percent in 2001, and -10,9 percent in 2002.

in the energy sector. So the private debt problem cannot be discarded if one looks to the medium-term growth requirements of the economy and the need for foreign capital.

## 2. Lessons Learned or to Be Learned

### *Macroeconomic Imbalances Have Always Been at the Root of the Crisis*

If one wants to learn the lessons of past experience, one must first understand what went wrong and why.

I hear more and more nowadays that the "classical" current account imbalances (sources of past crises) are being replaced by capricious capital account shifts which are said to be the new culprits of most financial crises. There is no doubt that, in an increasingly globalized and financially deregulated world, capital movements constitute a powerful transmission and amplification mechanism in the development of financial disruptions.

But behind this capital account volatility, there is always, in my view a macroeconomic imbalance at the root of financial crises.

1. This was the case in Mexico in 1994-95 (widening fiscal deficits, excessive borrowing in foreign currency-linked instruments, over-valuation of the exchange rate).
2. This was the case in Brazil (the fiscal deficit reached some 9 percent of GDP in 1998, with a high ratio of indebtedness and little confidence in the viability of the exchange rate).
3. This was the case in Southeast Asia (in spite of fiscal stability, there was a lethal combination).
4. This was the case of Turkey, which, since the mid-1990s, had run large fiscal deficits, increasing the debt.
5. This was the case of Argentina, as I have just described.

Thus, there is a common thread behind these various events. Put simply, it is *excessive borrowing*.

*The first lesson is, therefore, to increase surveillance and to focus on the prevention of crises : improving multilateral surveillance is of the essence.* This is the basic role of the IMF. More than being a lending agency concentrating large resources on a few countries (be it of first or fast resort),<sup>11</sup> the Fund should be seen primarily as responsible for the adjustment process. It has the expertise to perform that task and should never compromise on the quality of its programs.

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<sup>10</sup> The ratios of corporate debt/equity were 500 percent in Korea and 950 percent in Indonesia in 1997 (compared with more "normal" figures of 200 percent).

<sup>11</sup> The IMF had \$105.4 billion total credit and loans outstanding at the end of February 2004; 64 percent of that amount was concentrated on three countries (Argentina, \$15.8 billion, Brazil, \$28.2 billion, and Turkey, \$23.2 billion).

The surveillance activity of the IMF concerns not only fiscal matters but also monetary policy and, in particular, the evolution of net domestic assets. Macroeconomic policy-mix problems such as those I have just mentioned, unsustainable exchange rates, excessive indebtedness, and the lack of adequate surveillance over banks have all paved the way to debt crises and should therefore be the object of *early* surveillance. This is, of course, easier said than done, because countries are often politically unwilling to act before a crisis, especially if external finance is easily available. But there has been some progress in this area. The IMF now publishes annual reports on countries (called article IV reports) that give it some leverage to encourage governments to act at earlier stages.

This also implies that market participants should do a better job of analyzing emerging economies. The performance of banks (see the 1996 unjustifiable tightening of spreads) and of rating agencies<sup>12</sup> (they all missed Argentina's fiscal slippage of the mid-1990s, slippage that proved to be the fatal turning point in an apparently stable financial situation, and that was precisely when the Fund started lending very large amounts to the country) was far from being adequate.

This preventive approach also entails data transparency (much has been realized, under the aegis of the IMF, in this field). It also requires a constant dialogue between debtors and their creditors. This is now a systematic practice — built around strong programs of investor relations — in a number of countries like Mexico, Brazil, and Chile and could be enhanced further.

*The second lesson is to discourage short-term foreign borrowing.* I am not referring to trade lines and normal interbank lines that are an essential way of financing exports and imports. I am thinking of short-term “hot money” that often rushes in a country with high yields, only to exit when the picture deteriorates or when a political crisis occurs (except Mexico in 1994). Should one allow these short-term inflows to operate with complete freedom ?

Excessive short-term foreign deposits should, in my view, be discouraged as much as possible. I know this is a complex and controversial question. I am not advocating necessarily a return to exchange controls “à la Malaysia.” But I think that prudential regulations deterring domestic banks from excessive short-term external liabilities are perfectly reasonable. The experience gained by Chile in this regard should be carefully reviewed with no negative prejudice.

In any event, the ratio reserves / short-term foreign liabilities should be closely (daily) monitored.

*The third lesson is, more generally, to encourage emerging economies to put in place a strong system of financial regulation and surveillance.* Banks should not be allowed to take unlimited open positions in foreign currencies: their liabilities (currency wise) should be in line with their assets. This is all the more important because when a crisis breaks out in the face of overextended banks, governments are often called in to take over collapsing financial

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<sup>12</sup> Korea was rated at the same level as Sweden as late as September 1997.

institutions (see East Asia). Therefore, the private external debt becomes public and compounds the problems of the sovereign.

More widely, the corporate sector should be encouraged to avoid currency mismatches. In other terms, corporates should borrow in foreign currencies only if they can count on future external cash flows. The private sector is starting to learn that lesson. If you look at balance sheets of corporations in a number of emerging economies (Mexico, Brazil, and so on), you will see that companies are limiting their foreign borrowing to trade-related financing (if not, exchange rate hedging is becoming a growing practice). Local financial markets are also gradually developing.

*The fourth lesson is that flexible exchange rates are much less conducive to debt crises than (overvalued) pegs.* This has been abundantly evidenced in past crises. The examples I gave above show, indeed, that pegged exchange rates can give an illusory sense of stability and comfort to borrowers in foreign currencies.

*The fifth lesson is related to the reactive roles of the three major players (countries, IMF, creditors) when a crisis is about to erupt (or has erupted).* (1) The IMF should be encouraging meaningful and credible adjustment. To this end, it should negotiate with debtor countries pragmatic programs, based on a case-by-case approach, that contribute to restoring balance-of-payments viability in the medium term and that encompass not only macroeconomic measures but also a limited number of indispensable structural reforms.

If the interested country is not ready to take enough significant measures up front, the Fund should not give its seal of approval to too weak a program. Providing large financial assistance for poor actions is, indeed, a recipe for failure.

(2) *The debtor government* should mobilize its energy and political clout to explain the issues to the public so that the country can "own" its program. Indeed, an adjustment process can never be successfully implemented, if it is just seen as "coming from Washington." It must carry domestic political support.

(3) *The creditors* should be brought in the picture at an early stage of financial difficulties. They should be consulted on the adjustment process negotiated between the Fund and the debtor. This was systematically done in the 1980s (with economic bank subcommittees). Indeed, it seems rational to explain to the creditors — who are asked to contribute to, the financing of the country — what the intellectual underpinnings of the program are.

Even at the early stage of a crisis, the private sector can play a useful and cooperative role (for example, in 2002, the international banks accepted voluntarily agreed to maintain their short-term trade lines to Brazil in order to help that country to manage a difficult political transition).

When a crisis erupts, creditors should be in a position to negotiate with the debtor country to restructure agreements that are reasonable, consistent with the medium-term outlook of the program, and acceptable to both parties. Creditor committees (the recent case of Argentina shows that bondholders *can* federate) should normally be the channel for such agreements (especially when the debt is substantial and complex in its structure). In some cases,

"exchange" offers might be considered, but only if there is a meaningful dialogue and discussion process that ensures that the operation will be accepted by a large majority of bondholders.

*The sixth lesson is that we still have a long way to go before having a satisfactory "architecture" for the solutions of debt problems (Kenen 200 1). Let me state just a few simple thoughts.*

There are basically two, ways of going about this. One is to try and develop a "statutory" approach to, the problem. For example, in 2002 the IMF proposed a system called the Sovereign Debt Restructuring Mechanism (SRDM). This mechanism was intended to facilitate an orderly process of debt negotiations with available recourse to a dispute resolution forum financed and nominated — indirectly — by the IMF.

But the plan — initially supported by the G7 — did not take off ; after a year of discussions, it was put aside. The basic reason was that the private sector and the main debtors (issuing countries) thought the idea was more dangerous than helpful. Most representatives of debtors and creditors felt indeed that "market solutions" were better and that countries that had gained the confidence of investors could lose a lot if the market perceived the SDRM as an international form of Chapter 11 and as a way of turning a complacent eye to systematic restructurings and defaults.<sup>13</sup>

So the private financial community — under the strong leadership of the Institute for International Finance (IIF) — has been working in recent years on a set of practices and principles that could provide a pragmatic, market-friendly framework for debt negotiations. This work has been going on in close cooperation with major issuing countries while the official community has been kept informed of the progress.

A first positive development has been the wide use of collective action clauses (CACs) in international bond contracts. Some twenty emerging countries have been using such clauses for the last couple of years. With the passage of time and the repayment of maturities of "old" bonds which do not feature such clauses, this will help, of course, the restructuring process (more and more bond exposure will be covered by renegotiation clauses).

A second complementary avenue is the preparation of a code of principles that would provide clear and simple foundations for what should be (and had been in the 1980s) a collaborative framework.

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<sup>13</sup> See de Larosière (1999) : "The paradox of the situation we have been experiencing over the last three years, is that the more public money is provided, the greater are withdrawals of short term bank credits. And the more commercial banks have been perceived as running down their lines, the more the G7 have been tempted later by mandatory solutions. This becomes indeed a political necessity: tax payers money must not be seen as facilitating the exit of commercial banks or the payment of bonds. But as this 'mandatory' reaction came *after* large short term bank withdrawals, the IMF/G7 are now left with what remains, that is, medium-term credits and bonds. In some extreme cases, this 'mandatory' oriented solution has led the IFIs to press countries into defaults on their bonds."

For example, the principles would insist on several essential points. I shall just mention a few as an illustration.

1. The sanctity of contracts. This seems to have been less prominently stressed by official circles over the last years, but is crucial to keep trust and well-functioning financial markets.
2. The combined responsibility of all parties. The IMF is not there to bail out private creditors but to, promote adjustment and provide reasonable financing. The debtors have to, do all they can to honor their commitments. The creditors must accept losses, since that is part of the risk taken by investors, but they should be able to count on fair treatment, meaningful negotiations, and reasonable outcomes.
3. The "lending into arrears" by the Fund should be allowed only if good-faith negotiations with
4. The principles also aim to contain crises in order to, avoid restructuring whenever possible.

I very much hope that this code of principles will be endorsed and that the international community will come out of the present difficulties. All parties should work together to promote a climate of confidence between the private sector, the issuers, and official institutions, while underscoring the Fund's central role as the impartial and credible guardian of the financial system. What is needed is leadership, clear strategic thinking, and trust.

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