LESSONS FROM THE LATIN AMERICAN CRISES FOR THE CURRENT ECONOMIC CONJUNCTURE

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A lot has already been said about the Latin American experiences as well as about the differences between these experiences and that of the euro area, and of the need to keep these in mind when drawing parallels or “lessons.”

The importance of crisis management

In light of this, I will focus in particular on one area where the experience gained during the Latin American crisis remains highly relevant. That is the general area of crisis management and crisis resolution, which clearly has been Europe’s Achilles’ heel.

This at a time when skilful crisis management has become even more important, given the much closer integration of economies, markets and financial entities that has occurred since the 1980s and 1990s.

The scope for spillovers and contagion risks has increased immensely, and thus also the onus on capable crisis management to contain these risks. Europe’s record to date has fallen woefully short on this front.

Lessons for crisis management

There are four main facets to the lessons on crisis management that emerge from the Latin American experience and that are relevant for Europe today. My points on these all rely quite heavily on the experience of the International Monetary Fund in this area.The four facets of crisis management are in turn:

- First, the timing of crisis management;
- Second, the instruments of crisis management;
- Third, the principal agent of crisis management; and
- Fourth, debt restructuring (and PSI) in crisis management.

1. *The timing and pace of crisis management*

A common characteristic of all the more successful adjustment programs, in Latin America and elsewhere, has been that of early intervention. As put by Alfonso Prat-Gray, ex-Governor of Argentina’s central bank, in an FT article:

"*One thing we have learned from our region's experience is that piecemeal, time-buying strategies always end up in a messier outcome – and almost always in the messiest possible one."*

A "piecemeal, time-buying strategy" aptly describes Europe's approach to the crisis to date, especially in its earlier phases.

In contrast, the best-known, "poster-child" case of early, pre-emptive intervention is that of Brazil in 2002, when unprecedented amounts of financing at a time of great market uncertainty were committed by the IMF – a difficult decision at the time, but one that has since been assumed as a model. The prevailing principle underlying this approach is that official financing should be accessible early and pre-emptively.

This has not been the European approach, where official financing has for a long time been seen as the last resort, an *ultima ratio*, to be provided only once all other options had dried up. This approach is clearly unmindful of the fact that delays are costly for all, ultimately requiring both more financing and sharper adjustment. The risk now is that the same approach may be followed with regard to bank recapitalization.

It is interesting to note that, more or less at the same time of this *ultima ratio* approach in Europe, EU Directors in the Fund were supporting steps in the opposite direction, with – for example – increasing recourse to the Fund's Emergency Financing Mechanism in order to respond rapidly (for e.g. in Hungary, Latvia and Iceland in late 2008), as well as an expansion of the Fund's crisis-prevention toolkit to include early intervention mechanisms (with an enhancement in 2009 of its Flexible Credit Line (FCL) – which is designed to provide insurance against external shocks to countries with strong economic policies – and the creation in 2010 of a new Precautionary Credit Line (PCL) – which is designed for the same purpose, but for countries with some remaining vulnerabilities).

2. *The instruments of crisis management*

This brings us to the second point, the instruments of crisis management. Let us focus here for a moment on the FCL, since it is one of the mechanisms that is, at least unofficially, being talked about as one of the possible means to ring-fence or "firewall" Spain and Italy. In this respect, too, the Latin American experience is relevant since, of the three countries that have to date accessed the facility, two (Mexico and Colombia) are from Latin America (the third being Poland) – all of them without drawing.

Mexico in fact pioneered the FCL in April 2009, and since then has had three successive Flexible Credit Line arrangements (currently with an access equivalent to US$73 billion). Similarly, Colombia was granted a FC line in May 2009, and is now also at its third successive FCL arrangement (for an amount of US$6 billion), which it too is treating as precautionary. The FCL is deemed by these countries' authorities to have added an important layer of protection, sustaining market confidence in uncertain times, by providing a significant buffer against potential tail risks.

As regards the one European country with an FCL arrangement in place since May 2009 – Poland, for some US$21 billion – it today enjoys a spread vis-à-vis German bunds that is narrower than that of Italy and approximately equal to that of our host country, Spain.

Notwithstanding these positive experiences, Europe has dedicated little or no thought to creating its own precautionary mechanisms, or to strengthen those of the Fund, with only a passing reference in the Conclusions of the European Council of July 21, 2011 to allow the EFSF to "act on the basis of a precautionary program." Much more meat will need to be put on this bone in the upcoming period.

But whatever bold (or less bold) steps Europe may decide for leveraging the EFSF in upcoming meetings, they will take time to be implemented. Time that Europe does not have and that the crisis cannot afford. Funds are needed now. From this angle, the IMF appears to be the only feasible source. It is thus disappointing that the emerging markets' attempt to strengthen the IMF's firepower at the last G-20 meeting – led largely by Latin America (in particular by Guido Mantega of Brazil) – was thwarted by the US, UK and others – in essence, by countries that still have the votes but not the money, or at least not the political will to commit it. This may however still change at the G-20 summit of early November 2011, and the Fund may well – in the end – be given the required firepower, or big bazooka – perhaps in the form of a new GAB, tapping oil exporters, China, and some Latin American countries. Only time will tell.

3. *The principal agent of crisis management*

A third broad lesson of the Latin American experience, that was not apparent at the time but has become evident by comparison with the European handling of the crisis, is the importance that the ***crisis be managed by an entity that does not have a direct stake in the game*****,** and can thus act broadly as an independent arbiter or facilitator. In the Latin American crisis, this role was largely fulfilled by the IMF who played the role of a single coordinator and a point of reference. This contrasts with the "troika" set-up, not to mention the 17 countries in the eurogroup and the 27 in the EU.

An important element of this role was that the Fund – in virtue of its preferred creditor status – did not have its resources directly at risk. This again contrasts with the situation in Europe, where EU creditor countries are exposed via their guarantees to the EFSF, as is the ECB itself through its holdings of peripheral country debt and of peripheral banks' bonds as collateral.

Add to that creditor countries' concerns about the effect of a restructuring on their own domestic banks, with the associated need for bank capital injections from the national treasuries, and the effect that *that* may have on sovereign credit ratings. These factors make for a toxic mix of conflicts of interest that lead to the policy paralysis that we have witnessed.

Given this, how can one expect the EU creditor countries to take a dispassionate view about the need or otherwise for a debt restructuring, or the size of a required "haircut" when they themselves would be severely affected? One need only to have listened to the many ECB pronouncements on the catastrophic consequences of a Greek restructuring to realize that the term "dispassionate" hardly applies. In fact, how can these players be expected to generate professionally candid debt sustainability scenarios when adverse incentives are so great? It is indeed unsurprising that most of the scenarios put out by the "troika" failed a basic credibility test.

Hopefully, the moment of truth has arrived with the latest "troika" report, reportedly being delivered shortly to EU Ministers, which will determine the financing gap and, relatedly, the needed private sector participation.

4. *Debt restructuring as part of crisis management*

This brings us to the fourth and last lesson, that concerning debt restructuring and private sector involvement as part of successful crisis management. In the Latin American crises, the absence of a direct financial stake in the game (thanks, as noted, to its preferred creditor status) allowed the IMF to inaugurate its policy (in 1989) of "lending into arrears" without undue concerns for its own balance sheet. At the same time, the Fund established a policy of making its resources available to members to help finance the up-front cost of Brady debt and debt-service reduction operations.

Also, many of the debtors (for example Uruguay in 2003) enjoyed unambiguous U.S. support (not only in bringing on board the rest of the G-7, but also more concretely via bridge loans and guarantees) that contrasts markedly with the prevailing Greek-German antagonism. Such “big brother” backing placed debtor countries in an appreciably stronger negotiating position vis-à-vis their private creditors than that enjoyed by Greece today.

In addition, the Fund’s “lending into arrears” policy was widened in 1998, from covering only arrears to commercial banks to include also arrears on international bond issues – which of course are now the prevailing sovereign debt instrument. This extension allowed, inter alia, the successful restructuring of Ecuador’s bonds (the first to cover Brady bonds and Eurobonds governed by New York law, and which took place about a year after Ecuador’s initial default).

No such procedure is in place for Europe, with the consequences we know: an essential stalemate, with Greece finding itself confronted by a woefully insufficient 21 percent haircut “deal” tabled back in July 2011, and private sector creditors holding the program hostage, possibly forcing the public sector to fill the gap until it remains virtually the only creditor – a clearly untenable state of affairs.

Latin America of course offers ample material on debt restructuring, with the Latin American and Caribbean region having experienced over 25 restructurings in the last 35 years, and about 10 since 2002. Given this wealth of material, I will focus more narrowly on the more recent cases of restructuring of *bond* debt – the issue immediately at hand in Greece.

Pakistan became the first country in the modern era to restructure sovereign bonds, in 1999, followed by the Ukraine, Uruguay, and the Dominican Republic. These cases all made recourse to the traditional tool of a bond exchange offer. They did so in a pre-emptive manner, before an actual default, and successfully so. Their experience suggests the importance for a debtor country to get ahead of the game and make a constructive offer while its adjustment program is still on track, rather than wait until its hand is forced. By putting generally reasonable offers on the table, these countries managed to have between 90-99 percent of bondholders participating, minimizing free rider problems (thanks also to instruments such as Exit Consents, which penalize potential holdouts). And the data also shows that countries that restructured pre-emptively experienced smaller output declines on average.

At the same time, however, such voluntary, pre-default restructurings rarely saw creditors ready to go beyond a “lite” or modest reprofiling of maturities, with little impact on net present value (NPV), as in Uruguay in 2003 (a five-year lengthening of maturities, with no haircut to principal or change in coupons, resulting in an average 20% reduction in NPV).

As we know, next to these voluntary operations, Latin America also saw *other* approaches that were essentially unilateral defaults, some more or less orderly (Ecuador), others less so (e.g., Argentina's "aggressive" default, as well as – outside Latin America – that of Russia – in itself the trigger that reversed financial flows to emerging economies, precipitating major Latin American crises as from 1999).

What is interesting to note from these experiences is that restructurings are somewhat "bipolar" in this way – either friendly or aggressive – and that the NPV reductions obtained (based on data from 202 sovereign debt restructurings) show a distribution with very fat tails, with one half of the haircuts either lower than 23% (the pre-emptive restructurings) or higher than 53% (the aggressive ones). This would seem to have clear implications for Greece, who by all accounts needs at least a 50% haircut.

From this, there seem to be two main lessons for Europe from the Latin American debt restructuring experiences:

- First, voluntary debt exchanges, such as that of Uruguay, are possible if effected early on in the process, with an exchange offer that is made pre-emptively by a debtor moving ahead of the curve while – as noted by Carlos Steneri – its adjustment program is working. Even so, such exchanges are unlikely to yield a significant discount. For this approach, it is far too late, and its likely results anyway insufficient, for Greece. To put it bluntly, Greece in 2011 is simply not Uruguay in 2003.

- That seems to leave only the second option, of a default – which can be more or less orderly or managed. The degree of orderliness largely depends on the attitude of the official financial community, and on the backing it gives or denies the debtor country – the cases of Ecuador and Argentina being two distinct examples in this respect. If Europe wants to avoid an Argentine-type solution, as it surely does, it will need to provide supportive backing and a seal of approval via some form of "lending into arrears," as Greece engages in good faith negotiations with its private creditors. The alternative is to continue to bail-out – rather than bail-in – private creditors – an unacceptable course of action.

Finally, it may be noted that the considerable difficulties Europe is encountering on the debt restructuring issue are, once again, largely due to the continued absence of a permanent international statutory mechanism to handle unsustainable debts, along the lines of an international bankruptcy mechanism. As is well-known, the quest for a formal restructuring mechanism has revealed itself to be among the most intractable issues in international finance: the last attempt in this direction – Anne Krueger's proposal of a Sovereign Debt Reduction Mechanism (SDRM) – foundered in the early 2000s, despite considerable effort, research, and academic backing. Europe's sovereign debt crisis provides the opportunity to relaunch efforts in this direction.

At a time of high public debts and of sharply elevated sovereign risk across a large range of countries, reflected also in major sovereign credit downgrades, preparing for orderly sovereign debt restructuring via such a mechanism would be appropriately far-sighted. Europe would do well to become its active advocate.

In closing, the organizers are to be applauded for setting up this conference. As a European, my only disappointment is that it took two essentially non-European organizations – the IDB and the IberoAmerican General Secretariat – to bring us together. It is telling that it has not occurred to any European entity to do so – an indication of what is wrong with the management of the eurozone crisis: that is, the very fact that European policymakers, in a truly misplaced sense of pride, have over and again *refused* to look at lessons from elsewhere – be it from Latin America, Asia, or from the IMF's own decades-long experience in crisis management and resolution. This eurocentric attitude prevailed from the very start, with the obstinate refusal to turn to the IMF at the outset of the Greek crisis, and it has persisted throughout. Europe simply does not seem to recognize that "we have been here before" (obviously, *mutatis mutandis*).

So, by way of final conclusion I would venture that a key ingredient to resolving the eurozone crisis resides in a downsizing of Europe's ego, with much more modesty in accepting others' input and greater readiness to draw from the experience of the international financial community – Jacques de la Rosière spoke yesterday of the "act of humility" of recognizing one's problems as the first step to healing. This may be beginning to happen, after the criticisms directed at the Europeans at the IMF's Annual Meetings in September 2011 and the pressure being exercised by both advanced and emerging market partners.

To end on an optimistic note, Europe, while likely to continue to go to the brink, in the end – as Churchill said of the Americans – "can be counted upon to do the right thing, after having exhausted all other options."