

The background of the slide is a blue-tinted photograph of the Bank of England building in London, featuring its iconic portico with columns. The text is overlaid on this image.

Some Lessons From the Recent Financial Crisis in Argentina (2001/2)

Mario I. Blejer

Director, Centre for Central Banking Studies

Bank of England

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mario.blejer@bankofengland.co.uk

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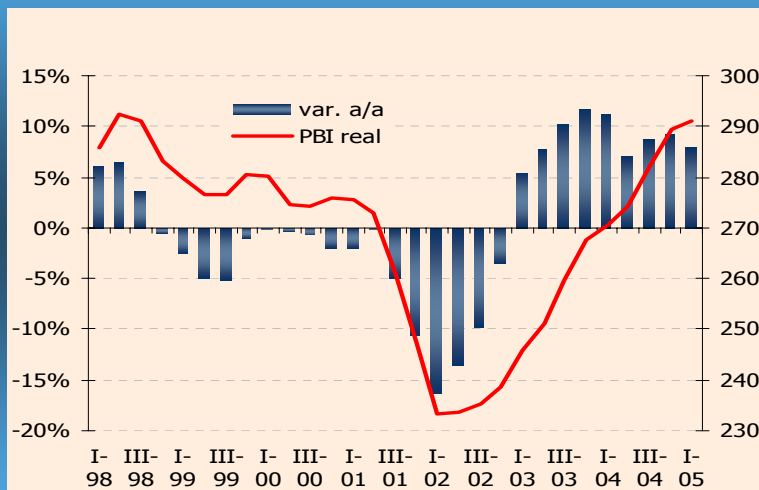
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1. Financial Fragility and the Role of Standards
2. The Consequences of Excessive Government Intervention
3. The Importance of Proper Liquidity Management

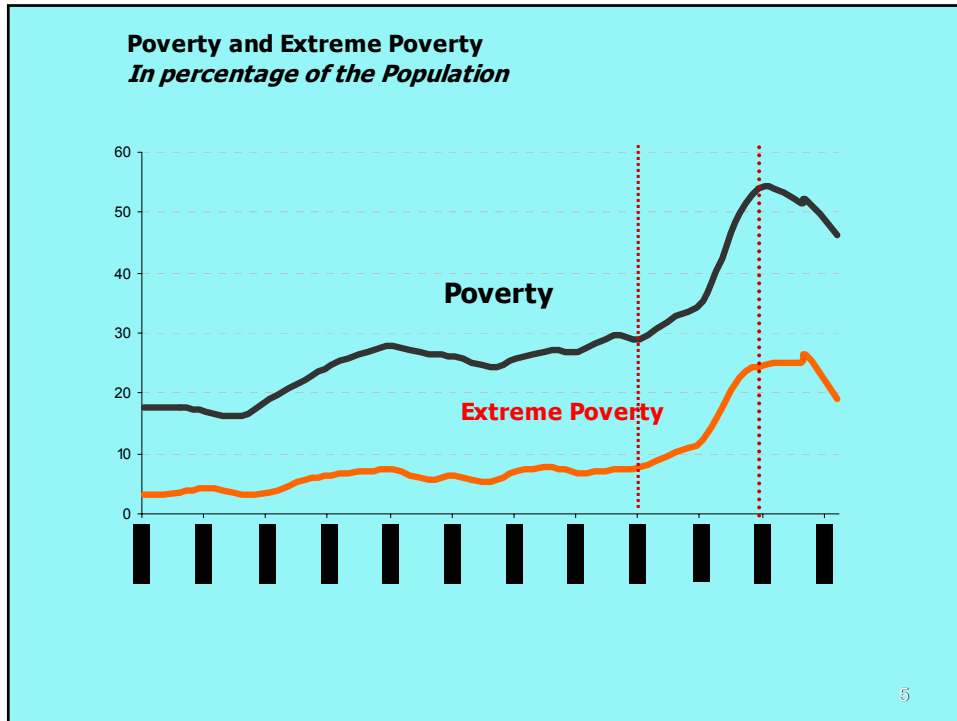
4. The Role of Foreign Banks
5. The "Currency" Problem
6. Capital Controls
7. Other Issues

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Real GDP (base 1993)



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1. The Nature of the Argentina Crisis

The Argentine crisis was both a **CURRENCY** and a **BANK** crisis – Inter-related but caused by a number and combination of different factors

Analytically, better to distinguish between them in an explicit manner

THE CURRENCY CRISIS

The Currency Crisis reached its peak with the January 2002 devaluation. It is usually analyzed in the context of the **ARGENTINE CURRENCY BOARD SYSTEM**, established in 1991 as an anti-inflationary devise.

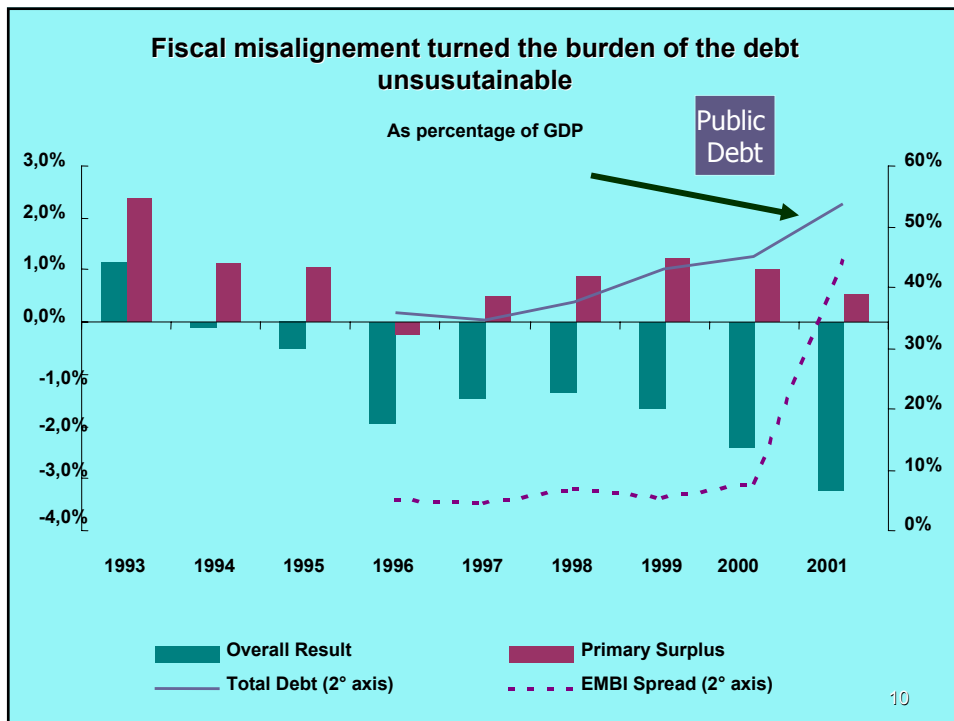
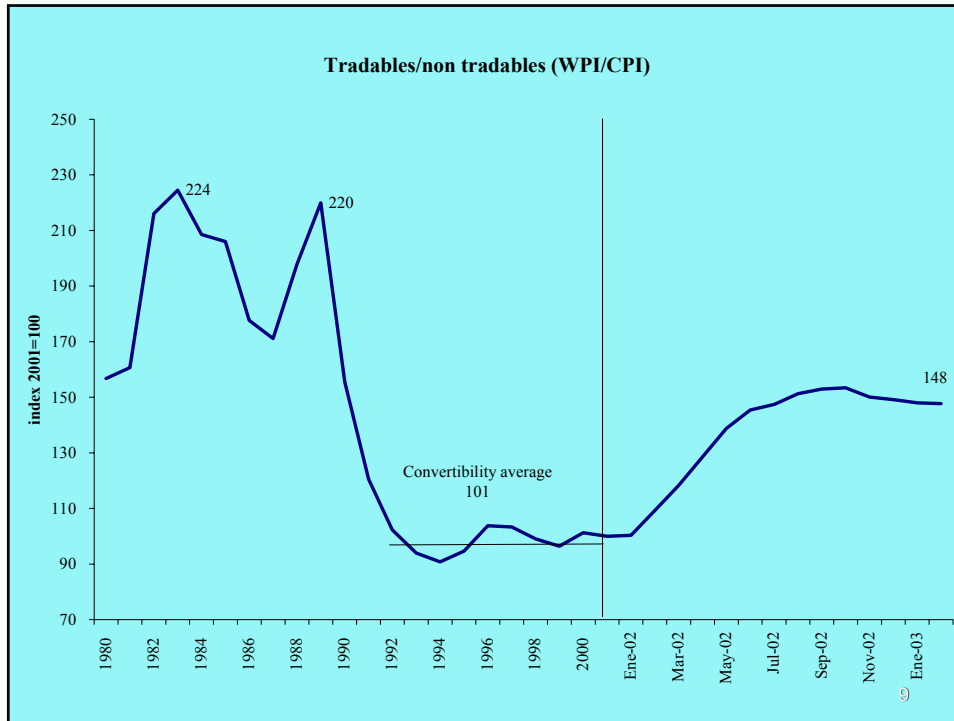
The question to be analyzed is:
What were the main causes for the demise of the convertibility regime?

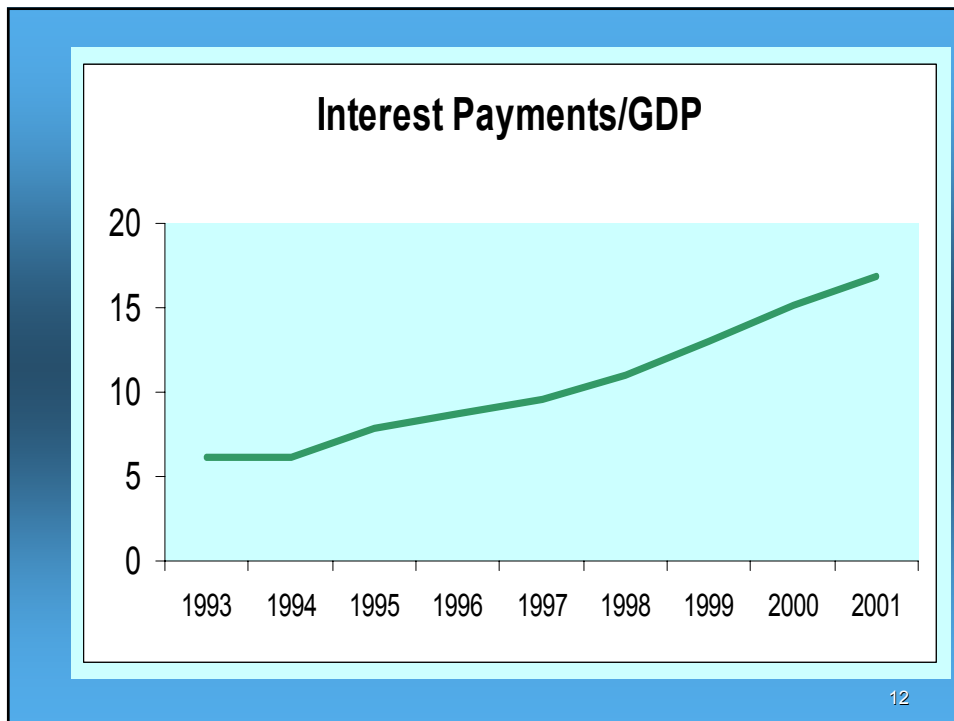
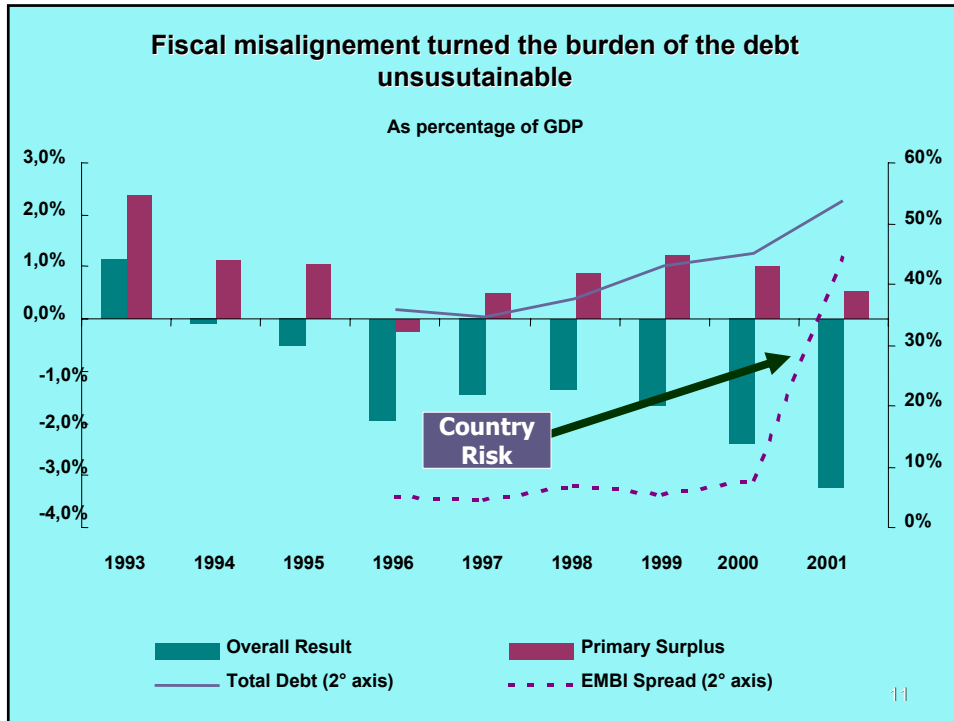
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THREE APPROACHES:

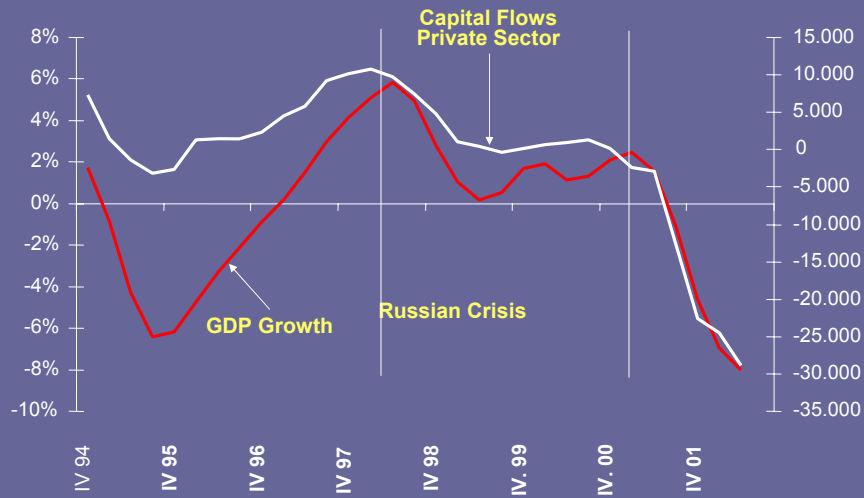
1. The loss of competitiveness of the Argentine economy
2. Macroeconomic policy inconsistencies
3. The "*Sudden Stop*" argument

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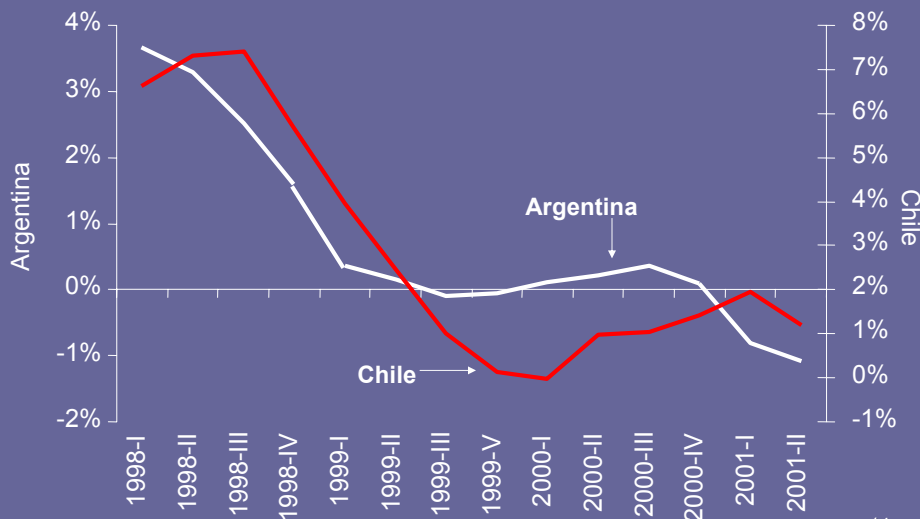


Capital Flows and Economic Activity (Accumulated 4 quarters - U\$Sm. GDP Cyclical Component)
















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Sudden Stops in Argentina and Chile (Private Capital Flows, Percentage of GDP)



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Financial Vulnerabilities to Capital Flows Reversals			
	Argentina	Brasil	Chile
Public Debt (% of GDP)			
Public Sector External Unhedged Exposure			
Private Sector External Unhedged Exposure			
Banking Sector Exposure To the Public Sector			
	 = High Vulnerability	 = Medium Vulnerability	 = Low Vulnerability

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THE BANKING CRISIS

While the problems of convertibility and the consequent exchange rate uncertainty played a role, the **banking** crisis was largely caused by the government **“abuse” of the banking sector**, given its inability to to adjust the budget deficit

1. The Fragility of Financial Institutions

The Argentine experience indicates that **solid and solvent financial structures**—that comply well with international standards—**could deteriorate quickly in the face of inadequate interventions**, distorted incentives and misguided policies.

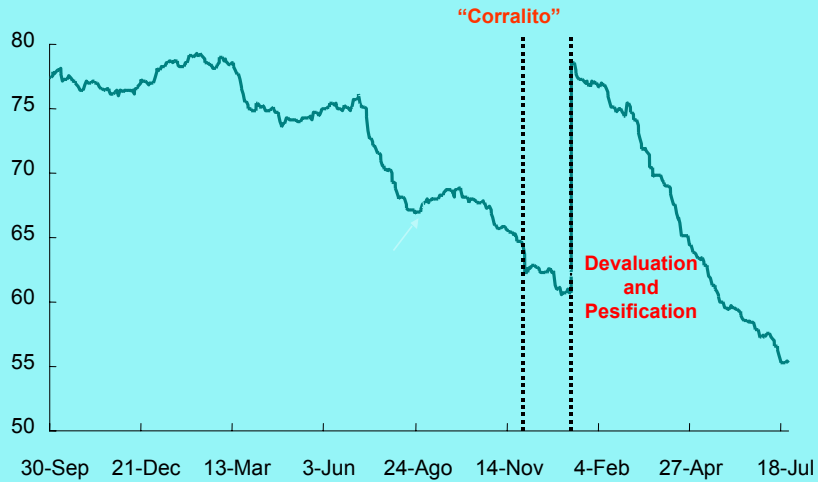
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The Argentine Bank Run

- Between March 2001 and July 2002, Deposits fell from U\$S 85b. to U\$S 15b.
- Domestic Credit to the private sector fell from U\$S 54b. to U\$S 14b. and continued to fall until the end of 2003.

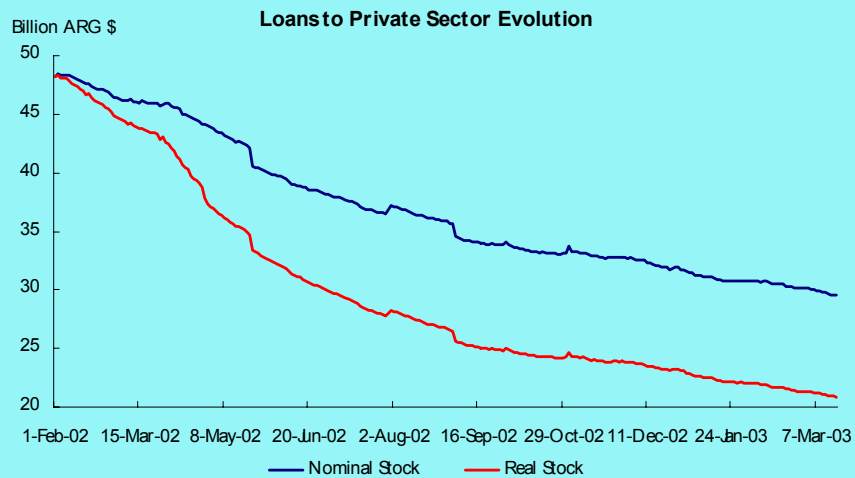
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The Argentine Bank Run: The Evolution of Private Deposits (2001-02)



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Credit to Private Sector



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The fact is that weak financial sectors are not necessarily crisis prone. Financial crises have been generated, in many instances, by inconsistent policies and by an unstable macroeconomic environment.

In this context one need to rethink the emphasis put on the “enforcement” of conventional standards and codes (and the cost/benefit ratio of the exercise)

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Comments on Standards

- Current policy paradigm is dominated by the effort to converge to international standards. It is misguided to equalize financial stability *and financial development* with convergence to standards.
- Standards based on industrial countries institutional settings may have unexpected negative impact in emerging markets (e.g., Basel II and SMEs)
- **International standards may be largely unrelated to the financial sector challenges of emerging markets (efficiency, completeness, deepness, etc.)**

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2. The Negative Consequences of Excessive Government Intervention

Premise

- ✦ Government interference generates distortions that lead to, *inter alia*, financial repression, unsound risk management, and moral hazard

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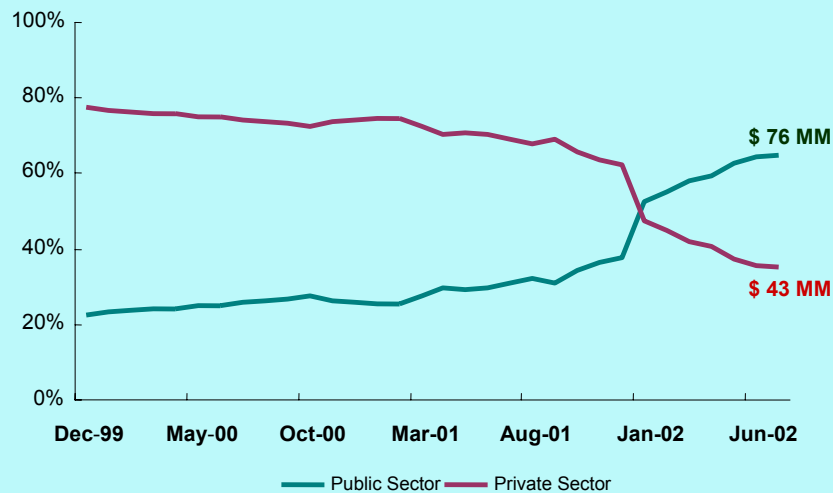
The main cause for the Argentine banking crisis was the Government appropriation of banking resources to finance its deficit.

This resulted in generalized fear that banks would be rendered insolvent by government policy and that deposits would be confiscated.

An important reason behind this fear was the fact that ***private sector assets were being displaced by public sector assets in bank's balance sheets.***

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ARGENTINA: Private Sector assets are displaced by Public Sector assets in bank's balance sheets

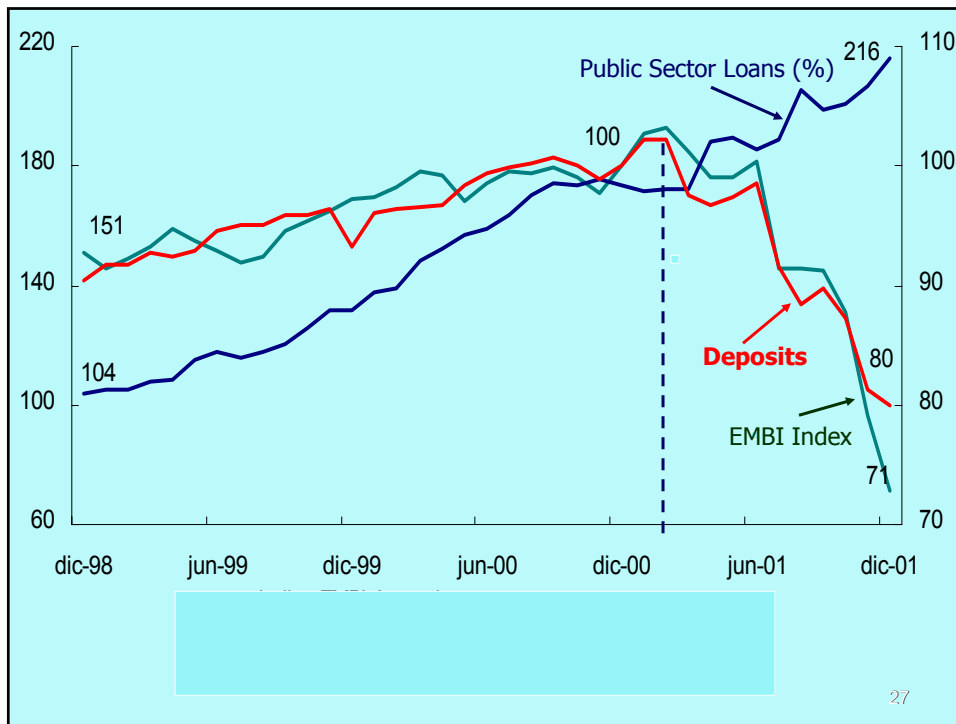


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The increasing banking exposure to the public sector was accompanied by:

1. a rapid decrease in deposits and
2. a sharp increase in country risk

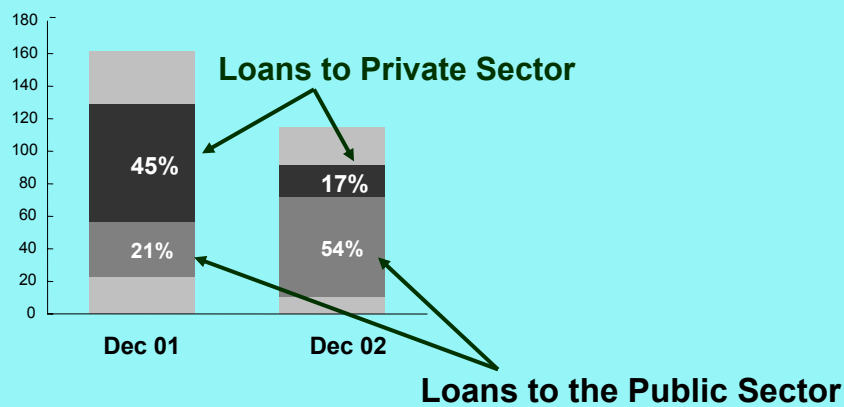
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The Deterioration in the Bank's Balance Sheet

December 2001– December 2002



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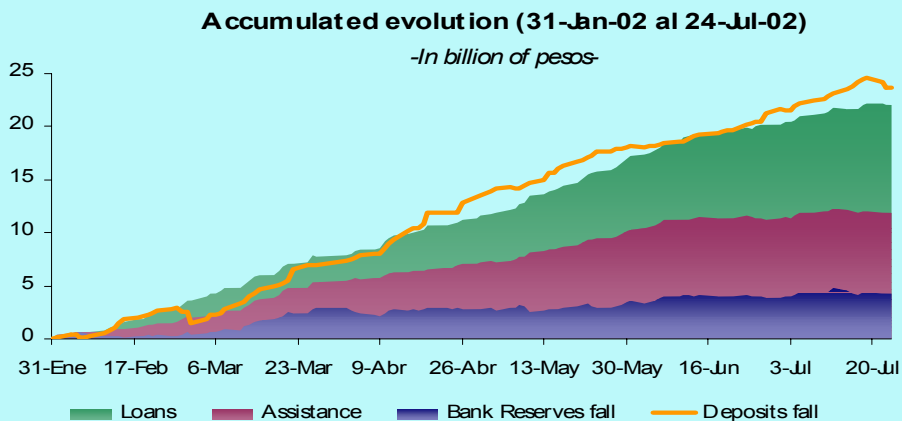
3. The Importance of Proper Liquidity Management

Availability of liquidity is a crucial element in the prevention and the management of financial crises

LOLR does not guarantee stability but its absence accelerates the erosion of confidence

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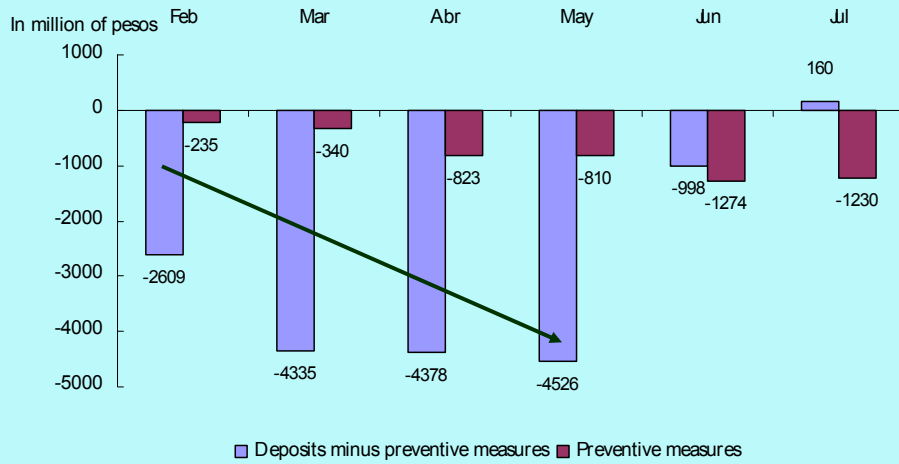
The central bank provided rediscounts to illiquid banks and financed about 1/3 of the deposit drop



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Initially deposit withdrawals continued

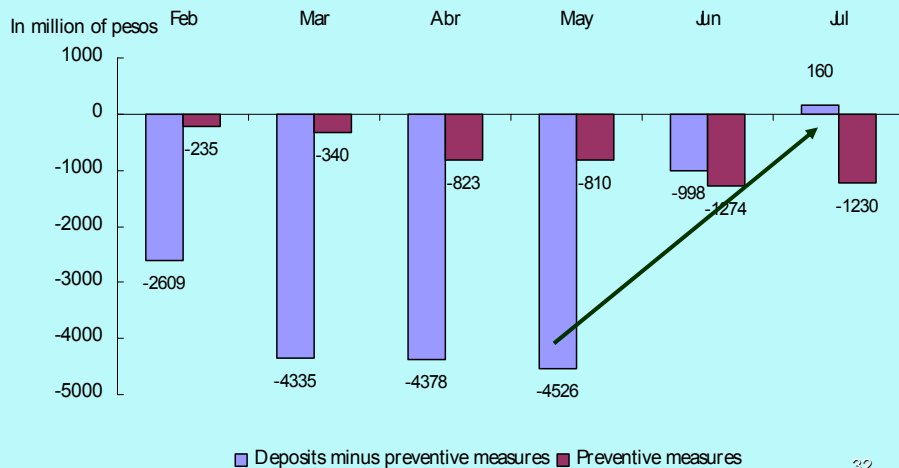
Private Sector Deposits - Year 2002



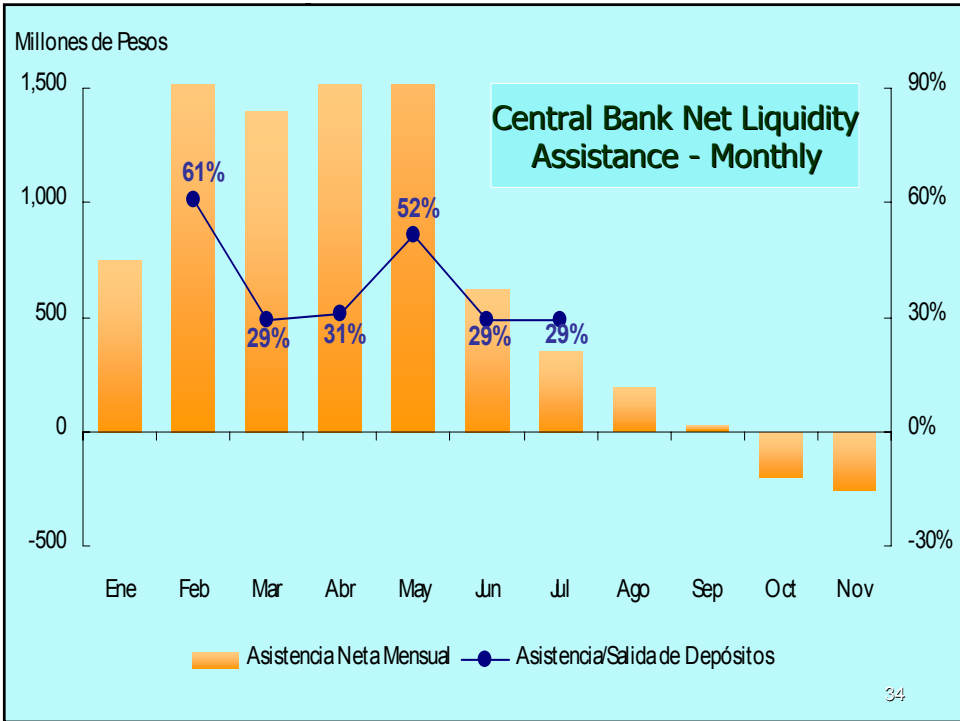
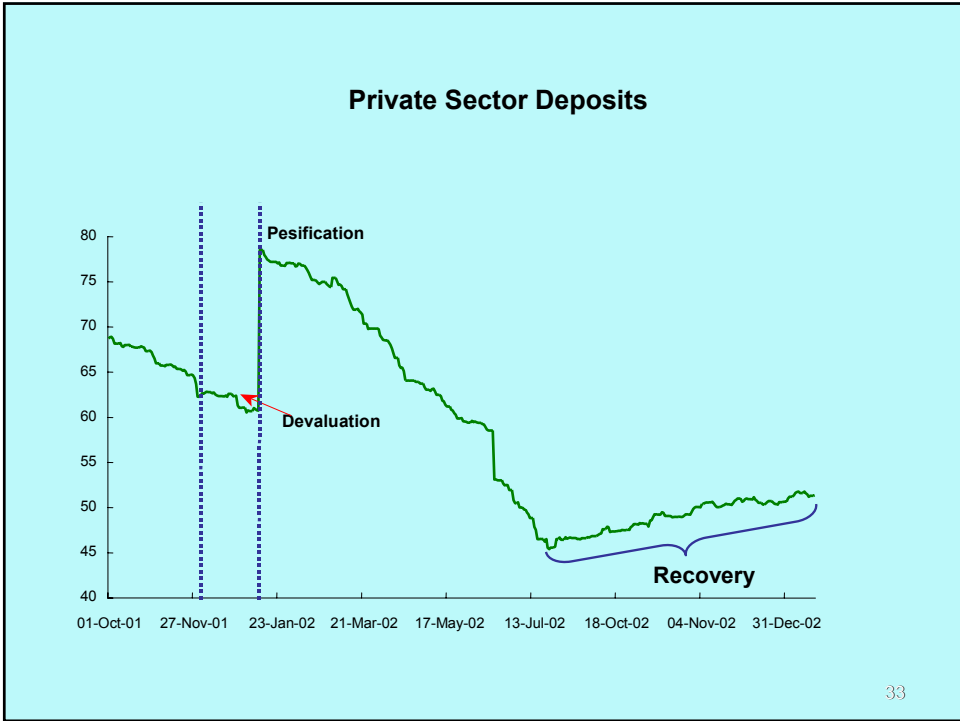
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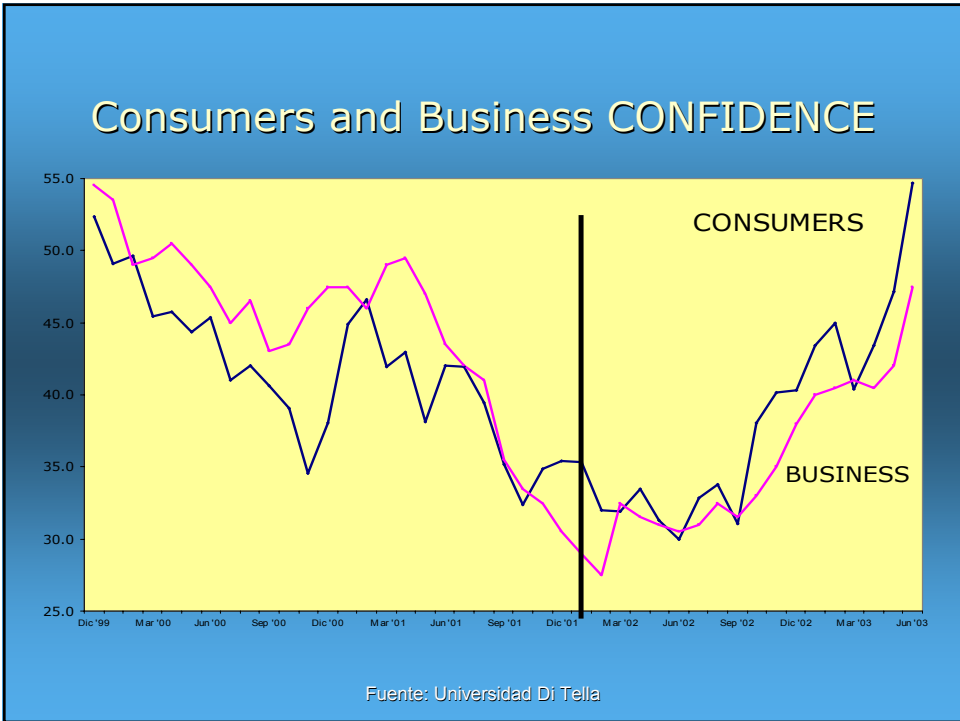
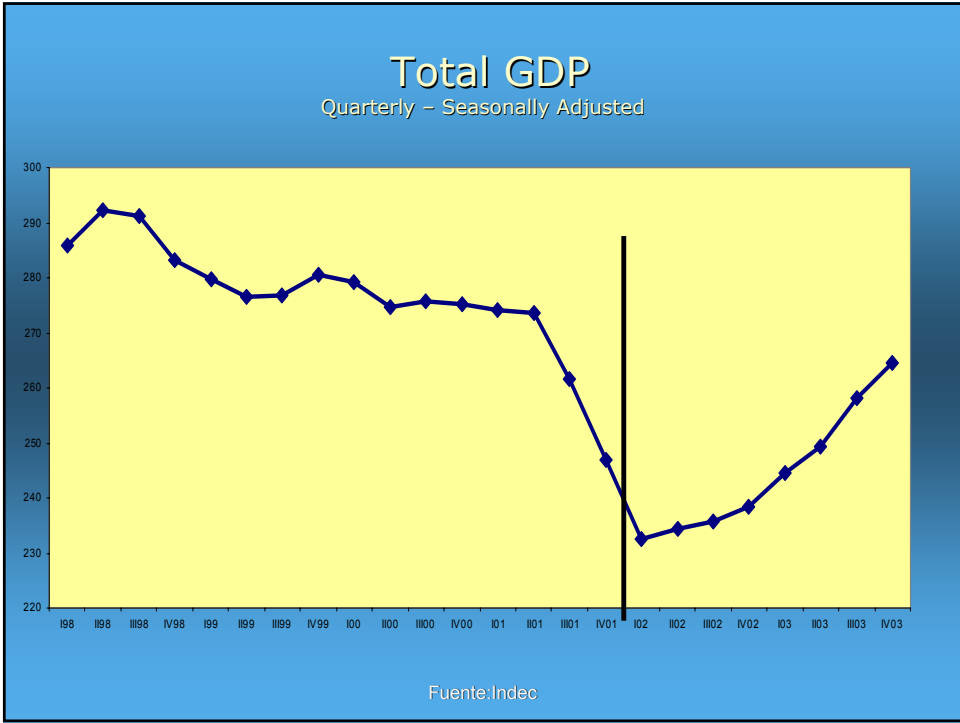
However, the trend reversed after four months

Private Sector Deposits - Year 2002



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4. The Role of Foreign Banks

- Do they reduce financial vulnerability?
- Can they provide, implicitly, LOLR function?

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5. The "*Currency*" Problem

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Financial vulnerability arises from the public's reticence to use domestic currency as a store of value

- Trade-off between shallow financial intermediation and financial dollarization and the risks of balance sheet mismatches
- The "original sin" is not such but just a corollary of the currency problem

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If full dollarization is ruled out, the policy question to reduce vulnerabilities is how to solve the "currency" problem.

- "Pesification" *a la* Argentina
- Macroeconomic and Institutional Credibility and – in the transition: Indexation

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- If FX deposits are significant, then central bank should hold large international reserves (as a share of FX deposits) and/or banks' reserve requirements should be high.
- A complementary strategy is to give incentives for banks to increase local currency deposits by, for example, lowering their reserve requirements relative to FX deposits.

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6. Capital Controls

Does capital account integration reduce financial vulnerability?

Long run desirability vs. short run, transitional, risks

Capital controls and crisis management

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Other Issues

- The Role Public Sector Banking
- The Location and Structure of the Prudential Supervision Authorities
- Central Bank Independence

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