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Coping with Financial Crises:

Latin American Answers to European Questions

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Abstract[1]

Europe faces challenges reminiscent of Latin American financial crises. The failure of recent liquidity support to normalize the situation in Europe suggests the need to refocus the policy debate on fundamentals: structural reform for growth and, where needed, restructuring to resolve banking crises and the debt overhang. Latin America's experience yields relevant policy lessons for Europe on those fronts except concerning the use of sharp real devaluations to spearhead recovery: euro-zone countries following suit by reintroducing devalued national currencies would invite catastrophe. Despite this constraint, Europe stands a better chance of navigating the path out of the crisis because it has cooperative mechanisms unavailable in Latin America. European cooperation can provide support for orderly crisis resolution as well as growth and competitiveness within the currency union fold, to the benefit of all members. However, the path is uncharted, and successful regional cooperation will require innovation and political will.

JEL classifications: E61, F33, F34, F36, F53, G01
Keywords: Latin America, Financial crisis, Euro, Debt overhang, Banking crisis, Sudden stops, Real devaluations, Currency union, Fiscal devaluation

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1. Introduction

Many peripheral euro zone countries are suffering from financial and competitiveness problems reminiscent of previous Latin American challenges. In this essay, we focus on selected areas in which the Latin American experience with crisis and recovery offers useful lessons for today's European concerns, namely high public debt risk premium, distress in the banking system, sudden stops of capital flows, and low growth and competitiveness.

We conclude that these lessons are relevant and important, but do not fully answer the European questions as to how to address the crisis because the currency union framework imposes a level of complexity that Latin America never faced: it is a constraining rigidity impeding recovery if it survives and an extremely serious complicating factor threatening stability if it breaks up. At the same time, on an optimistic note, the European Union (EU) affords instruments of international cooperation to address the crisis that were never available to Latin American countries. A case in point is the powerful European Central Bank (ECB), which is at the service of its euro-zone members only. This stands in contrast with a weaker and less reliable International Monetary Fund (IMF), a global multilateral governed by powers outside Latin America.

Our analysis suggests that while current crises in Europe are more complex and potentially more perilous than previous crises in Latin America, Europe stands a better chance of successfully navigating the dangers along the way because it has more tools to deal with it. Nevertheless, the path is uncharted, and success is by no means guaranteed. Our contribution is to highlight the areas in which the Latin American experience may be useful in shedding light on current European policy challenges.

Disentangling the underlying factors responsible for a crisis is a difficult task even after the fact, let alone as it is ongoing. The Argentina crisis of 2001/2002 is perhaps the closest to the current European crises in peripheral countries in terms of currency rigidity (a currency board instead of a full-fledged currency union) and overall complexity. The crisis in Argentina has been the object of numerous and diverse retrospective analysis concerning its diagnosis and, a fortiori, applicable treatment.[2] In particular, whether the main cause of the collapse was fiscal unsustainability, the rigidity of the currency board, or other factors was and remains contested. In fact, there is an argument to be made for a multiple equilibrium situation, in which the

[2] For a comprehensive review of the Argentinean crisis, see Cline (2003).

emergence of a fortuitous bad equilibrium results from the anticipation of the break of the currency board and vacillation from the international official sector about continuing financial support.[3] Likewise, diagnosing the underlying factors of the European crises with precision while events are still unfolding may be unrealistic. Furthermore, the political support needed in democratic societies may impose critical limitations on feasible policy responses, both in crisis and core countries. While it is difficult to ascertain how to translate the Latin American experience in this regard to today's European democracies, it is clear that democratic governance may impede crisis management and force ruptures. To ensure effectiveness of the policy responses, it may be prudent to control risks on all fronts, without disregarding any of them a priori, and bear in mind political economy limitations to policy decisions. It is in this agnostic spirit that we recommend the reader to consider the relevance of the Latin American experience analyzed below.

2. The Debt Overhang Problem

Latin America has an unenviable experience with unsustainable public debt. The Latin American debt crises of the 1980s, ominously known as the Lost Decade, may turn out to be useful for Europe now. While most of the crises were caused by fiscal excess leading to mounting public debt that suddenly became unsustainable when external borrowing conditions changed, their lessons do not apply exclusively to fiscally profligate economies such as Greece. For starters, the socialization of private debt—a scenario that may eventually apply to countries such as Spain—contributed significantly to excessive public debt in Latin America (e.g., Chile's excessive public debt resulted from a bank bailout). More generally, irrespective of how debt unsustainability originated, the resulting fiscal adjustment and debt restructuring contain lessons for all countries with impaired access to credit.

Having lost access to market financing, countries were forced for about 10 years to rely on external official financing and carry out fiscal adjustment.[4] Commercial debt obligations, mostly in the form of foreign bank loans in hard currency, were managed through protracted rescheduling (since they were issued in foreign currencies, they could not be reduced through inflation). This form of debt management was first supported by the United States Federal

[3] See Powell (2002).
[4] See World Bank (1993).

Reserve and then through a multilateral strategy called the Baker Plan. This strategy was designed to diffuse the threat of a banking crisis in the United States that could result from major international banks' inability to absorb impaired sovereign loans. The need to contain losses and to preserve financial stability created incentives for the governments of creditor countries to intervene and facilitate orderly debt rescheduling. It was hoped that, over time, staving off a catastrophe would also allow economic growth to reduce the debt burden and, together with fiscal restraint, restore fiscal sustainability in debtor countries. While the primary objective of containing an international banking crisis was achieved as banks cleaned up their portfolios or recapitalized, growth did not come to Latin America's rescue: the region lived through a period of chronic recession in which income per capita actually declined by about 10 percent on average for the largest countries.

Three major forces combined to push the region into a decade-long contraction. First, fiscal austerity proved inimical to growth. In particular, the collapse of public investment and infrastructure maintenance reduced economic productivity and the return to private investment (inflationary financing of public deficits led in some cases to high inflation, further contributing to distorted investment incentives). Second, the unyielding debt overhang acted as an implicit tax on investment (the fruits of growth would increase countries' capacity to pay and then be captured by external creditors) and, possibly more importantly, created deep uncertainty as to how the ultimate costs of eliminating it would be effectively adjudicated across economic agents. The debt overhang was dead weight on economic activity, paralyzing investment until it could be eradicated. And third, balance-of-payments pressures further constrained economic activity. In fact, forced fiscal adjustment and protracted debt overhang also led to capital outflows by domestic savings looking for security abroad which, coupled with lack of access to external market financing, meant forced external adjustment. A substantial portion of the adjustment took the form of import contraction (in response to large real depreciation) which, because it is intensive in machinery and productive inputs, further depressed investment and production.

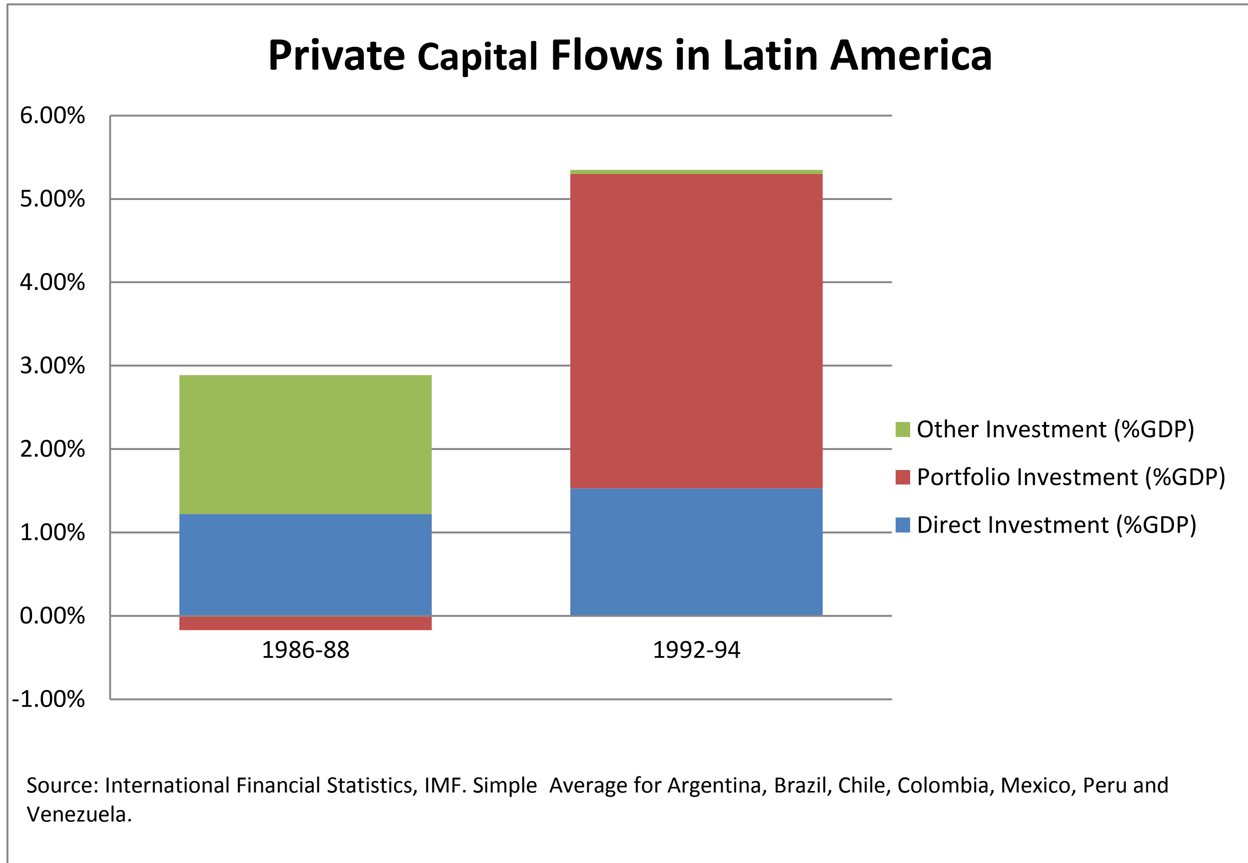
The passive strategy of protracted debt rescheduling, securing just enough liquidity to keep countries afloat, led to chronic depression and debt unsustainability. After several years of crisis, a new multilateral strategy eventually emerged, prompted by the start of social upheaval. This new strategy, the Brady Plan, recognized that the debt overhang needed to be eliminated through deep debt reduction, in a way similar to bankruptcy reorganization. To carry out this

plan, multilateral institutions lent long term substantial amounts to finance discounted debt buybacks or financial enticements (e.g., collateral) of the so-called Brady bonds to be exchanged for bank loan debt. This lending was done under the condition that a definitive settlement with creditor banks could be reached in one fell swoop. Brady bonds were tailored to creditors' circumstances, but they all entailed substantially lower debt obligations over time. The external official sector facilitated bilateral debt restructuring between countries and creditor banks, arguably to the benefit of all parties involved. Nevertheless, it preserved its interest by providing financing with seniority, as in bankruptcy arrangements. It also cajoled leading commercial banks into coordinating negotiation and avoiding free riding in their ranks, to prevent them from unduly benefiting from overall debt reduction without receiving a "haircut" (i.e., a reduction in the value of the sovereign debts they hold).

At the same time, it was also recognized that debt reduction would only pave the way to recovery. To effectively use the new opportunity for economic recovery by lifting the cloud of the debt overhang, it was imperative that the policy framework be geared toward encouraging investment (both high-return, domestic investment opportunities and secure savings from abroad to finance them). Countries became eligible for the Brady Plan only after meeting these investment readiness requirements. Starting in 1989, one country at a time, debt in Latin America was restructured within a few years. Markets were forward-looking, recognizing that the new regime emerging from the cleanup offered good business opportunities for both foreign direct investment (FDI) and portfolio flows (which were plentiful shortly afterwards).[5] Despite increased senior multilateral debt, debt reduction was deep enough to make room for additional market financing. Hence, market-friendly restructuring, along with official international support, paved the way for renewed access to external market finance (Figure 1).

[5] Fernández-Arias and Montiel (1996).

Figure 1.



More recently, Latin America has experienced another type of debt distress: crises of liquidity or contagion (as opposed to incapacity to pay or "insolvency"), which call for different modalities of international cooperation.[6] In contrast to the debt crises of the 1980s, in which the muddle-through strategy of the Baker Plan failed, these crises could be remedied by the provision of external liquidity (although high debt was a complicating factor, the solution did not require debt reduction). Some cases were caused by panic or uncertainty concerning a particular country, such as the bunching of short-term obligations in Mexico in 1994, or anticipation that the first leftist government in Brazil in 2002 would be unfriendly to markets and renegotiate debt frivolously. In both cases, liquidity provided by the international community in the form of bridge loans or credit lines helped minimize the risk of debt crisis. Other cases of liquidity or contagion distress were caused by shortages in the international credit supply, as in the aftermath of the Russian crisis of 1998 when institutions holding high-risk Latin American bonds suffered

[6] Fernández-Arias (2011).

funding shortfalls. These temporary financial disruptions led to a spike in sovereign risk spread throughout the region. Unfortunately, the international liquidity mechanisms that would have offset financial stress were not well developed at the time, and countries suffered various degrees of damage; some of them experienced a debt crisis.[7] In contrast to Latin America, the ECB is in a position to avoid unnecessary damage to any euro-zone member suffering from a temporary liquidity shortage.

Finally, Latin America has some experience with cooperative arrangements for sharing sovereign risk, for example, multilateral development banks, such as the Inter-American Development Bank. These multilateral arrangements have been extremely successful but are limited in scale, and they have been sustained under the premise of their senior creditor status. This creditor status has been enforced and observed to the point that no shareholder has ever lost money (other than through the concessional window available to poor countries only). In the same guise, there are experiences of cooperative arrangements of fiscal federalism within countries, but they have faced enforcement problems. Brazil's federal government successfully put an end to recurrent, ad hoc debt bailouts of Brazilian states in 2000 by establishing a system wherein federal bailouts were granted to the states in exchange for the states' surrender of their sovereignty to the federal government in certain matters of fiscal policy and the debt they can acquire.

What are the lessons of interest to the European Union that these experiences offer? First, correct diagnosis of the nature of the financial crisis in the affected country is crucial. Financial distress caused by panic/contagion or other transient market conditions can be remedied by liquidity provision. Otherwise, if the crisis is not counteracted with ample external liquidity to cover any temporary dislocation in financial markets and prevent deteriorating fundamentals from validating a market run (as in the traditional bank run paradigm), it will cause real damage, possibly leading to full-fledged debt crises. Yet at the same time, if the fundamentals themselves are the problem, liquidity alone will only feed debt unsustainability, as experienced in Latin America during the Lost Decade of the 1980s. How to know whether external liquidity provision is enough? In the Latin American experience, liquidity stress has usually been associated with identifiable shortcomings in international financial markets, while financial distress resulting from flawed fundamentals has been associated with excessive debt and low-growth prospects in

[7] Reviewed in Sturzenegger and Zettelmeyer (2007).

particular countries. Financial distress tends to be alleviated by sufficient liquidity support in the first case but is largely unresponsive in the second case. It is paramount to discern the factors behind the extreme financial distress in affected European countries, and why it has been resistant to liquidity support so far. The persistence of financial distress despite liquidity support is sufficient reason to refocus current policy debate to seriously consider the issue of debt overhang and debt restructuring as a policy alternative.

Second, when economic fundamentals underpin financial stress, liquidity provision to problem countries may simply postpone the day of reckoning at a cost to supporting partners whose resources will eventually be needed for fixing the fundamentals. Fiscal adjustment may be insufficient or even counterproductive to right the economy even if fiscal profligacy is the root cause of the problem, and likely if it is not. Debt overhang, fiscal contraction, and worsening capital accounts tend to reinforce one another in depressing economic activity, which makes it difficult for the system to find a growth solution to the debt problem despite liquidity support and a commitment to fiscal discipline. While a first attempt to stabilize the economy on the basis of liquidity support and fiscal austerity may be given the benefit of the doubt, a vicious cycle of low growth and prohibitive market financing costs should not be allowed to go unchecked, as it did in Latin America during the Lost Decade.

Third, a debt overhang is a permanent drag on growth. Debt restructuring to eliminate debt overhang should be considered as soon as it becomes reasonably clear that excessive debt cannot be reduced by prudent fiscal adjustment and expected growth. Liquidity provision to avoid disorderly debt default makes sense as a stopgap measure but digs a deeper hole over time if debt is unsustainable. Furthermore, it compromises the liquidity provider, which is increasingly exposed to credit risk and may be eventually unable to offer financial support when debt restructuring becomes unavoidable. Experience shows that recognizing debt restructuring as part of the solution is a difficult decision and one that is often excessively delayed (Sturzenegger and Zettelmeyer, 2007). Parties involved usually have incentives to postpone needed restructuring for far too long: creditors benefit from any upside and, perhaps, debtors pass on political responsibility.

Fourth, external multilateral intervention has a key role in helping to ensure that debt restructuring is orderly and constructive, to the benefit of creditors (and financial stability in creditor countries) and debtor countries. In this regard, the cooperative institutions of the euro

zone such as the ECB compare favorably with the support that IMF and other extra-regional multilateral institutions could provide to Latin America at the time and, as exemplified in the case of Greece's debt restructuring, have the muscle to cajole private participation in the absence of global institutions in charge of taking up this responsibility.[8] External multilateral intervention provides a coordinating mechanism and incentives for parties to agree on clean restructuring by using sticks (e.g., regulatory pressure with which to cajole creditors) and carrots (e.g., financing to make needed "haircuts" more palatable). Preconditions and conditionality attached to multilateral lending are helpful to ensure that growth recovery will result from debt restructuring. It is this efficiency gain that allows debt restructuring to be a winning proposition for all parties. Debt reduction without growth recovery is necessarily contentious and, ultimately, futile.

Fifth, concerns about market reluctance to invest after a debt restructuring have generally not been borne out by experience. Debt restructuring that was justified by fundamentals and certified by multilateral institutions following the logic of bankruptcy proceedings has not had negative consequences for regaining market access (despite the increase in official senior debt involved in the restructuring).

Finally, moral hazard has not been a problem in Latin America's financial rescue because countries repaid bailouts and therefore internalized all the costs and benefits from external official assistance without benefiting from opportunistic behavior. In the case of Latin America, conditionality imposed by supranational entities such as IMF to constrain imprudent policy behavior could perhaps be justified by domestic governance distortions but not by country moral hazard. Nevertheless, the experience of the federal rescue of Brazilian states suggests that a moral hazard risk exists when bailouts may go unpaid, and its control may require a permanent monitoring of the fiscal affairs of the beneficiaries to supplement bailout mechanisms. This risk may be relevant within European cooperation to the extent that external financing is more generous and its repayment enforcement more lax than multilateral senior lending to Latin America. This is especially relevant in the case of *pari passu* official lending to European crisis

[8] Current international financial architecture perilously relies on private markets to arrange "haircuts" through debt exchanges rather than on bankruptcy-like institutions to sort out debt restructuring. In most cases this has resulted in uncertainty and incomplete restructuring and in some cases in opportunistic defaults, acrimonious negotiations and lack of resolution. See Fernández-Arias (2011) for a proposal to reform the international financial architecture aimed at empowering multilateral institutions to intervene systematically in debt crisis resolution, consistently integrating their supporting roles in the areas of liquidity, economic adjustment and debt restructuring

countries. While senior official lending may fail in its objective by discouraging future junior private lending, *pari passu* official lending may induce moral hazard.

3. Banking Fragility and Crises

Latin America also had its fair share of banking crises whose origin can be traced back to both external and domestic shocks. Of these, it is of particular interest to analyze banking crises linked to public debt crises, which often go hand in hand and reinforce each other (and underlie the high incidence of twin banking and debt crises in the region).[9] When the public sector finds itself temporarily cut off from access to financing, recourse to bank liquidity by means of financial repression may be a second best option. However, banks loaded with sovereign debt, either as a result of financial repression or by choice, inherit the risk of a debt crisis. Conversely, deeper financial systems may yield a substantial growth dividend, but at the expense of making banking crises more costly to resolve when they occur. In particular, resolving banking crises after expansions that turn unsustainable usually draws fresh resources from the public sector, causing a substantial jump in public debt. Latin America has had interesting experiences, both successful and unsuccessful, in dealing with what can be a "fatal embrace."

An important element of some banking crises that have been resolved successfully is the use of mechanisms to contain and isolate the banking crisis, minimizing its interaction with sovereign risk. If liquidity risks appear to be at play in a situation of bank distress, experience shows that it is paramount to swiftly provide ample liquidity, in accordance with the traditional Bagehot doctrine, rather than wait to confirm whether that treatment is necessary and will be effective for the problem at hand. For example, contagion of the 1995 Tequila Crisis to the heavily dollarized Argentine banking sector (which did not count with deposit insurance before the crisis) was contained with external liquidity support to the Argentine Central Bank. Due to the sovereign risk link, it is better to err on the side of overtreatment than let preventable bank liquidity problems end up infecting sovereign debt.

Fundamental bank insolvency problems are more difficult to address because insolvent banks require additional capital to operate. Nevertheless, the principle of minimizing the entanglement between banking crisis resolution and sovereign debt still applies. With a fragile public debt situation, it is better to err on the side of resolution mechanisms that economize

[9] See IDB (2004).

public resources. For example, in the case of Argentina in 1995, many provincial banks were privatized, while insolvent banks were closed—or reorganized to shed their unviable portion—rather than recapitalized. This helped to minimize the burden of resolving the banking crisis on the public sector.

The catastrophic crisis that took place in Argentina in 2002 when the currency board broke down is an example of how explosive banking and debt risks can be when the two are mixed. To begin with, increasing sovereign risk contributed to the bank runs in 2001. Crisis resolution in Argentina conflated risks by penalizing bank assets through currency conversion (i.e., pesoification) at arbitrary conversion rates which, in turn, were compensated with public debt. This arrangement failed to inspire confidence in depositors, who could only be contained from running by enacting highly punitive controls.[10] Argentina emerged from the experience with a minuscule and dysfunctional banking sector and, despite a deep debt-restructuring haircut, substantial public debt.

In contrast, Uruguay, facing a similar but arguably larger shock (resulting in part from the Argentine debacle), minimized entanglement by allowing foreign banks in a strong financial position to take care of their depositors themselves and sort out loan renegotiations with their clients on a private, bilateral basis. As for the remaining institutions, all available external resources were pooled to ring-fence and fully secure the payment system, while the maturities of time deposits were gradually stretched by legal fiat to help stabilize the system by itself. In parallel, public debt was restructured separately with bondholders at large (a tactic that also followed a minimalist approach of stretching maturities and restoring pre-crisis interest rates). This balkanization strategy was successful in diffusing the financial crisis and allowing normalization afterwards.[11] Nevertheless, it would not have been possible without external support. First, foreign banks were not made part of the problem, thus simplifying resolution of the crisis.[12] Second, the IMF and other multilateral institutions put together a line of credit large enough to credibly shore up the resolution strategy for the banking system, and were generally supportive of the debt-restructuring strategy.

[10] See IDB (2004).
[11] See Fernández-Arias (2007).
[12] However, they were not an active part of the solution either, failing to contribute to stabilization beyond their own narrow corporate interests.

These experiences contain important lessons for some European countries with fragile public debt situations whose banking systems are under stress. First and foremost, entangling banking crisis risks with sovereign debt crisis risks is a recipe for disaster. There is a high premium on keeping these risks separate. Depending on the circumstances, this general principle may take different forms. If liquidity considerations due to contagion or panic are at work, it is important to swiftly provide ample liquidity even if some resources are put at risk, rather than wait for more clarity. The spread of banking risk to sovereign risk may be a point of no return. On the other hand, if banking problems are more fundamental (e.g., bad real estate loans), liquidity remedies will be ineffective and decisive banking crisis resolution must be implemented, but always with an eye to minimizing emerging fiscal liabilities. In the Latin American experience, some of the methods utilized to this end include: the privatization of troubled public banks; the reluctance to recapitalize banks with public money to salvage institutions; and the use of a minimalist approach of reducing the size of the required support and attendant contingent public liabilities, leaving healthy banks (generally foreign ones) free from interference and concentrating resources in key functions, such as the payment system.

Financial dollarization in the banking system was a critical complicating factor in the Latin American experience because Central Bank support required committing scarce international reserves or relying on multilateral help, as opposed to printing money to back up local currency bank liabilities. This complication is absent in euro-zone countries because the ECB can provide unlimited bank support in euros. Nevertheless, ECB decisions are mediated by a cooperative arrangement requiring the agreement of others, as opposed to being under sovereign control as in the case of a country's own Central Bank. In any event, the protection of the sovereign is, of course, maximized when financial resources to support the banking system are external. In the European context, their own EU institutions (not just the IMF) may support bank liquidity and provide credit lines to implement needed bank support. It is clear that for the purpose of minimizing entanglement, it is preferable that these resources not be sovereign guaranteed. While this was an unthinkable privilege in the case of Latin America, it may be feasible in the context of EU supranational entities such as a banking union, to the great advantage of peripheral European countries.

4. Facing the Challenge of Sudden Stops

As mentioned above, following the Lost Decade of the 1980s, capital markets remained closed to Latin America until implementation of the Brady Plan. As financial integration resumed in the 1990s, the region became increasingly more exposed to sudden stops in capital flows. Sudden stops occur when foreign investors reduce holdings of domestic assets (collapse in gross capital inflows) and/or when local investors suddenly accumulate foreign assets (surge in gross capital outflows). Regardless of how they materialize, sudden stops affect the financing of the overall balance of payments. As a result, an affected country that was running a current account deficit has to abruptly close it. This is usually done through large real exchange rate depreciations.

In the 1990s, Latin America suffered several episodes of current account reversals caused by contractions in net capital flows (Figure 2). Moreover, sudden stops in the region usually coincided with banking crises and, in the case of countries with fixed exchange rates, with currency crises as well.[13] Some of the currency crises were forced by speculative attacks against local currencies pegged to the dollar: an increase in demand for hard currency when uncertainty surged led to a currency crash when the Central Bank ran out of reserves. Fortunately for Europe, lacking local currency, euro-zone countries in crisis are not vulnerable to destabilizing speculative attacks.

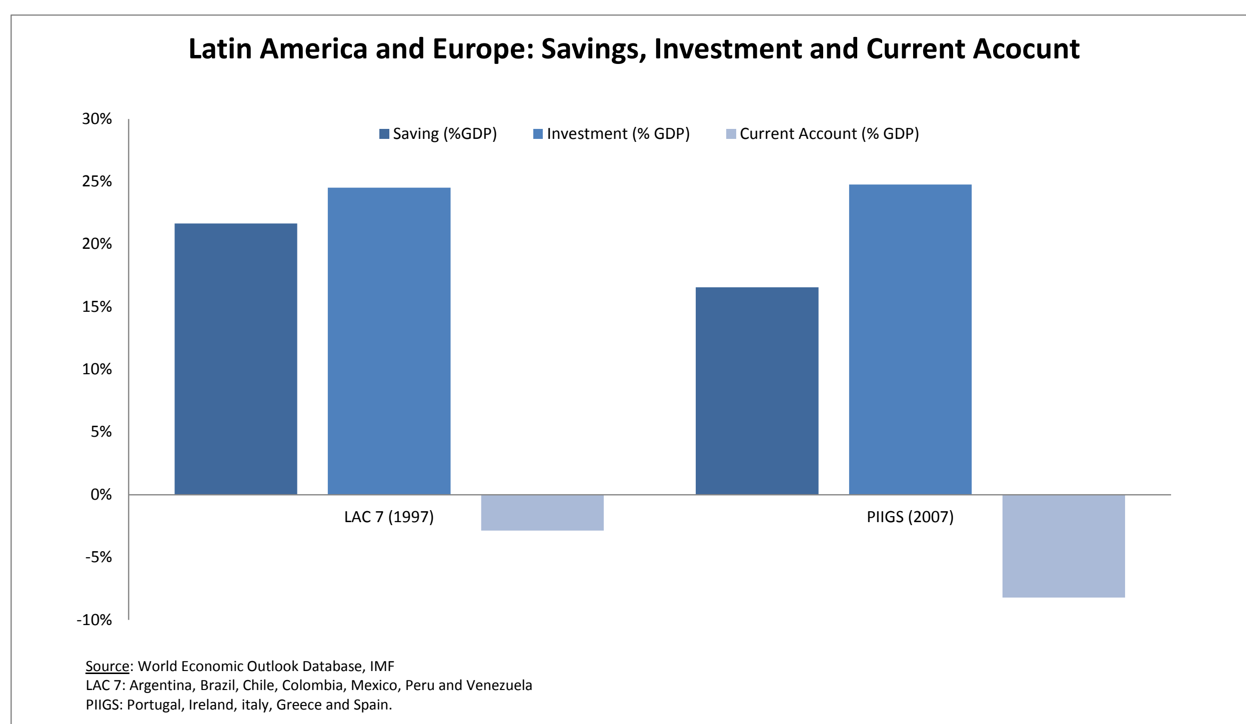
Figure 2.

Source: International Financial Statistics (IFS), IMF.
Simple Average s of current account and ner capital flows for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Systemic Banking Crises dates in the region from Laeven and Valencia (2008)

[13] Calvo, Izquierdo, and Talvi (2006).

A structural factor contributing to Latin America's vulnerability to sudden stops is low domestic saving rates leading to increased dependence on external savings to cover investment financing gaps. The main manifestation of the domestic savings shortfall is large current account deficits (as a percentage of GDP). In this respect, the situation in peripheral European countries today is even more challenging than that of Latin America in the mid-1990s (Figure 3). What useful lessons, then, can vulnerable European countries learn from Latin America's experience with sudden stops?

Figure 3.



In the Latin American case, the disruptive nature of sudden stops was compounded to a large extent by liability dollarization and by the low ratios of tradable output in many countries. For a given current account deficit, the smaller the tradable component of output in an economy, the larger the real exchange rate depreciation needed to close the current account deficit when external financing dries up.[14] Large real exchange rate depreciations, in turn, may be disruptive

[14] See Cavallo and Frankel (2008).

because they increase the cost of servicing foreign currency debts, triggering bankruptcies and large output costs.[15]

The European case is a priori different, but only to a degree. Any external financing shortfall imposed by the crisis on peripheral economies that is not offset by liquidity support from external sources needs to be accommodated; therefore adjustment remains a problem. While the ability of the ECB to provide balance of payments support to control financial stress compares favorably with that of the IMF to help offset sudden stops in Latin American countries, it cannot resolve the crisis if underlying economic fundamentals call for adjustment. If some adjustment is required, then the Latin American experience with sudden stops could be useful to Europe in the present. Despite European countries being open economies with large tradable sectors, the currency union severely restricts the scope for engineering the adjustment through real exchange rate depreciation and may induce a recessionary adjustment to dampen domestic demand. However, with the crisis still lingering, the irreversibility of the euro cannot be taken for granted, and the threat of euro-zone exit by one or more countries currently experiencing "sudden stops" symptoms is being widely discussed. The materialization of the euro exit scenario would entail the reintroduction of a local currency and an extreme Latin American-style "liability dollarization" problem.

There are cyclical and structural elements to the post-sudden stop adjustment. On the cyclical front, the challenge for governments is to smooth the adjustment to a tighter external financing constraint and to avoid spillovers to the banking system. In a review of policy responses to sudden stops in Latin America, Cavallo and Izquierdo (2009) document the crisis resolution mechanisms of the late 1990s for eight Latin American countries. They conclude that successful crisis resolution is more likely to be achieved when countries are able to stimulate the economy through expansionary macroeconomic policies during the external credit crunch. Nevertheless, the authors caution that, unless the international community is prepared to step in with large sums of largely unconditional money to bridge a protracted fiscal gap, a successful crisis resolution requires that each country finance its own stimulus by saving when times are good. Given that countries in distress are rarely able to fend by themselves on the fiscal front, a lesson from the Latin American experience is that external financial packages are the crucial financing mechanism to smooth the post-sudden stop adjustment. This explains, for example,

[15] See Calvo, Izquierdo, and Mejía (2008).

why Mexico recovered fairly quickly in the aftermath of the Tequila Crisis in 1994 after receiving a US$ 50 billion package that was partially financed by the U.S. government, whereas Argentina's economy collapsed when the IMF withdrew its support in November 2001.

In the case of Europe, impediments to expansionary macroeconomic policies are particularly relevant because euro-zone countries do not control their monetary policy and peripheral countries experiencing "sudden stop" symptoms have very limited fiscal cushions. However, while individual countries may lack the tools to implement countercyclical policies, those tools do exist at the euro zone level. Of course, using those tools would inevitably entail a reallocation of resources within the European Union, from the creditworthy countries to the less creditworthy ones. Such support is reminiscent of a standard external financial package, which would carry moral hazard risks to the extent that it is given as a transfer or lent with credit risk.

On the structural front, a lesson from the Latin American experience is that the longer it takes for private capital flows to resume, the more likely it is that solvency will be at risk and require some form of debt restructuring and/or growth-oriented policy reforms to restore it. In the late 1990s, when the effects of the Asian and Russian financial crises began to be felt in Latin America, there was still a great deal of confusion about the nature of the shock and the possible implications. The region had only recently recovered from the contagion effects of the Tequila banking crisis of 1995, and for a time it was believed that the 1998 crisis would be similar, that is, the credit crunch would be short-lived and contagion would ultimately be contained. But things proved to be quite different: three years into the crisis, capital flows had not yet returned to the region at normal levels. Assessing the damage caused by liquidity stress and the point at which liquidity problems cease to be temporary is critical to policymaking. For example, in the case of Argentina, more than three years into the credit crunch, the authorities were still working under the assumption that liquidity could be restored, and they bought additional time by pursuing a debt swap that pushed obligations forward in time. When the authorities finally switched strategies in late 2001 by launching an orderly debt restructuring program to reduce the debt burden to sustainable levels, the IMF also changed strategies by withdrawing financial support due to disagreements with authorities over the macroeconomic framework.[16] The

[16] Argentina's vulnerability made it clear that a protracted sudden stop requiring substantial real exchange rate depreciation almost inevitably called for debt restructuring, given Argentina's substantial liability dollarization. However, there is reason to believe that the restructuring process could have been much more orderly had it been conducted with international support.

unfortunate timing precipitated the events that led to a disorderly sovereign debt default, the end of the convertibility system, and the collapse of the domestic financial system.

Dealing with sudden stops is difficult because there may be conflicts between the underlying cyclical and structural challenges. From a cyclical standpoint, expansionary macroeconomic policies may help to smooth the adjustment. If countries are not able to finance the stimulus themselves—as is usually the case—external official assistance is needed. In the context of the present discussion in Europe, the implication is that without Troika financial support—including decisive intervention by the European Central Bank to backstop stress in sovereign debt markets—countries that are exhibiting "sudden stop" symptoms in peripheral Europe would likely experience a disorderly adjustment leading to costly outcomes (perhaps with exit from the euro zone by one or more countries).

However, to the extent that a sudden stop in a country is underpinned by structural factors (for example, insolvency due to debt overhang and weak growth prospects), external resources alone are no solution. In that case, unconditional external financial assistance would only serve the purpose of delaying an otherwise unavoidable adjustment in the economy to a permanently tighter financing constraint. Countercyclical policies financed with external financial assistance can allow time for economies to adjust, but they are no substitute for structural reforms aimed at reducing the underlying vulnerabilities and restoring long-term growth. Troika financial support would not be a solution by itself. External support ought to be conditional on the country strengthening its structural weaknesses.

5. Low Growth and Lack of Competitiveness

Robust growth is an essential part of resolving financial crises, as it reduces high debt burdens and improves bank assets. A case in point is the resolution of Latin America's public debt crisis in the 1980s. Debt reduction was implemented concurrently with structural reforms, giving credibility to fiscal discipline and allowing for productive use of renewed investment. Right after the Brady Plan restructuring of the 1990s, growth-oriented reforms enabled external market financing to include new instruments like portfolio debt and equity; debt reduction alone was not enough.

5.1 Structural Reforms in Latin America

To what extent did structural reforms promote growth in Latin America? Following Lora and Panizza (2002), we focus on five areas of reform: trade liberalization, financial reform, tax reform, privatization, and labor code legislation. The central focus of the reforms first adopted in the late 1980s was largely to liberalize markets and remove controls on the allocation of productive resources. During that period, the structural reform process in Latin America was incomplete and quite uneven, both across countries and across areas of reform. The greatest advances occurred in the early 1990s in the areas of trade liberalization and financial market reforms to avoid financial repression.[17] Results in the areas of tax reform and privatization have been more uneven across countries. Labor reforms are the only area in which progress was quite limited, both in degree and in the small number of countries pursuing it.

In terms of the economic impact of reforms, Lora and Panizza draw two main conclusions. First, the reforms had significant but transient effects on growth: growth accelerated by more than 1 percentage point on average in the aftermath of the strongest wave of structural reforms, but the growth effect abated as the reform impetus waned.[18] The implication is that in order to enhance the effectiveness of reforms to accelerate growth, the reform impulse has to be sustained over time. Second, the growth-enhancing effect of reforms was higher in countries with better institutional environments (measured as good rule of law).

What are the implications for Europe today? Applying the lessons from the Latin American experience to Europe in this area too loosely would be unwarranted. In the areas in which Latin America had the most reform in the 1990s (e.g., trade openness and financial market reform), European countries arguably do not need reform. Instead, in the area of labor markets, where peripheral European countries have more room to reform in the direction of liberalizing markets, Latin America did not pursue deep reforms. This notwithstanding, an important lesson from Latin America is that the crisis itself may present opportunities to implement growth-enhancing reforms. Crises are, in essence, periods in which important policy decisions altering the status quo are made both within countries and in the international arena. The experience in Latin America shows that it is more likely that growth-enhancing reforms will be implemented in

[17] The main objective of financial sector reforms was to improve the efficiency and soundness of a country's financial system by eliminating interest rate controls and other mechanisms, such as directed credit.

[18] The estimates imply that in the period of fastest reform (1991–93), reforms accelerated annual growth by 1.3 percentage points. However, when the reform process started decelerating, the growth effect dropped substantially; from 1997 to 1999, it accounted for only 0.6 percentage points of additional growth.

the aftermath of crises in countries where political institutions foster cooperative behavior.[19] Arguably, these empowering conditions are more likely to be met in European countries where the institutional framework is generally stronger. Furthermore, the political union embodied in the supranational nature of the European Union facilitates cooperative outcomes by meshing together the interests of countries, while in Latin America regional political integration was not as deep. To the extent that political union is preserved to a substantial degree amidst the crisis, it is more likely that reform impulses could be stronger and more resilient in Europe.

5.2 The Competitiveness Problem

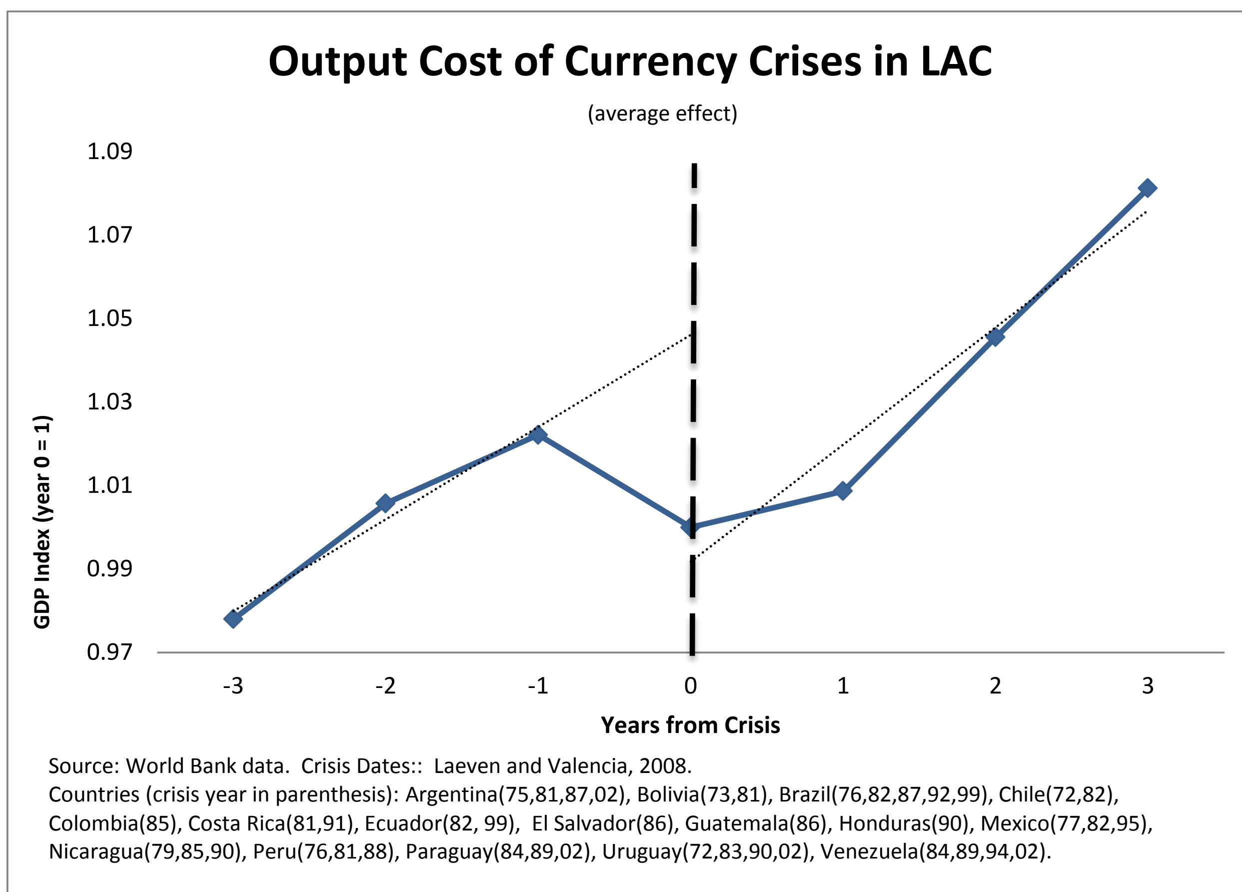
Lack of competitiveness may be at the root of low growth in peripheral euro-zone countries affected by the financial crisis. Countries that find themselves in situations where they have lost competitiveness due to protracted real exchange rate appreciations have to engineer real depreciations in order to regain external competitiveness. The Latin American experience emphasizes the contractionary effects of real devaluations through the cost of imported inputs and through balance sheet effects: if a country's debts are denominated in foreign currency, the indebted banks' and corporations' balance sheets outside the export sector are hit in proportion to the real depreciation.

Real depreciations entail either nominal devaluations or lower domestic price inflation, even deflation in extreme cases. Many economists believe nominal devaluations are preferable because they ease adjustment costs and provide a quicker boost to exports. In fact, it is to be expected that deflationary adjustment is slow and contractionary. At the same time, nominal devaluation may trigger inflation, thus leading to uncontrolled real exchange rate processes punctuated by high volatility and overshooting. The Latin American experience, illustrated in Figure 4, does not support the idea that growth can be restored simply by devaluing local currencies. A simple event study shows that currency crises (i.e., large nominal devaluations) in Latin America led to output drops (2 percentage points on average) during the crisis years that

[19] Cavallo and Cavallo (2010) study the conditions under which crises can lead to growth- enhancing reforms and conclude that this will depend on the prevailing institutional framework at the time of the crisis, with democratic regimes being the most conducive of growth-enhancing reforms. In a similar vein, Tommasi (2004) argues that even though crises might facilitate the introduction of some policy reforms, in general, how well those policies are implemented depends on the quality of the implementation of those policies, which in turn is conditioned by the country's overall institutional environment.

persisted at least three years after the crisis.[20] The bottom line is that currency "freedom" is no panacea, and is, in fact a double-edged sword, an instrument with very costly side effects in the presence of financial dollarization. Devaluation has often led to inflation running out of control and triggered high inflationary costs.

Figure 4.



In the case of euro-zone countries, nominal devaluations in principle would be altogether precluded. However, if one country decided to abandon the euro, the resulting nominal devaluations of the newly issued currencies could entail high costs far beyond those experienced in Latin America. There is no doubt that flexible exchange rate arrangements may be useful to facilitate necessary relative price changes in the face of external shocks and, in retrospect, perhaps this is a factor that was not sufficiently appreciated by some of the countries now

[20] We use Laeven and Valencia's (2008) definition of currency crisis. They define a "currency crisis" as a nominal depreciation in the currency of at least 30 percent that is also at least a 10 percent increase in the rate of depreciation, compared to the year before.

belonging to the euro zone. However, once in the euro zone, nominal devaluations would require the re-introduction of national currencies whose high and disruptive costs could easily outweigh the benefits.

In all likelihood, currency reintroduction would mean breaking up all pre-existing domestic contracts (not only financial but also labor contracts) to express them in local currency at conversion rates that would likely distribute wealth against those previously entitled to receive euros. This in turn would lead to protracted litigation if not open conflict. The local currency will be found unattractive for storing value, which will lead to financial "euroization" and severe capital flight. Arguably, the scarcity of euros and the pent-up demand for them would lead to financial controls to fight against domestic financial "euroization" and also debt default on foreign debts whose terms cannot be converted. The Argentinean meltdown of 2002—when the currency board collapsed, leading to "pesoification" of dollar contracts and controls on financial dollarization—offers a reminder of the great risks of uprooting exchange rate arrangements. In the case of Europe, there are compounding factors that suggests that the potential cost of such uprooting would be even higher. Some of these factors include i) the greater scope of the currency conversions;[21] ii) deeper domestic and international financial integration, which makes breaking-up contracts more complicated; iii) and higher investment in institutions that would be wasted. Moreover, courts in Europe—where the rule of law is stronger—would likely give due course to legitimate complaints by those adversely affected by currency conversions, leading to protracted litigation.

What can countries operating under an irrevocable exchange rate peg do to maintain it and still regain external competitiveness, while avoiding the perils of deflationary adjustment? A higher level of euro inflation in core countries would provide space for peripheral countries to open an inflation gap in order to regain competitiveness without incurring the macroeconomic costs of deflation. Indeed, the measure of peripheral inflation that high euro inflation would afford could also be helpful in diluting nominal wage contracts impeding the adjustment necessary for full employment and competitiveness down the road. Of course, this assumes that, in contrast, wages in core countries are renegotiated to incorporate euro inflation. This is a scenario that could materialize only if there is cooperation between countries. In the Latin

[21] Argentina had most labor contracts and a fraction of financial contracts stipulated in pesos, which is not the case in Europe, where all contract are set in euros.

American experience, inflation typically played a key role in resolving financial crises by diluting debts in local currency and allowing a rapid reduction in real wages at full-employment levels (nominal wages, being sticky in nominal terms, tend to impede adjustment in both the public and the private sectors).

In our view, fiscal devaluation is a possible alternative to currency devaluation without the risks of inflation. Fahri, Gopinath and Itskhoki (2011) define fiscal devaluation as a set of unilateral fiscal policies that implements the same real allocation as under a nominal devaluation, but holding the nominal exchange rate fixed. Two sets of policies have been proposed: i) a uniform increase in import tariffs and export subsidies; and ii) a uniform increase in Value Added Taxes (VAT) and a reduction in payroll taxes (to make the price of domestic output cheaper relative to that of domestic absorption).

There is limited experience in Latin America with successful fiscal devaluations.[22] Argentina implemented those policies before the crisis exploded in late 2001 through a series of sectoral "competitiveness plans" that lowered labor costs in certain economic sectors by allowing firms to expense payroll taxes against the VAT.[23] In addition, the government levied a uniform tariff on imports of final goods that was transferred to exporters.[24] These policies were ultimately insufficient to avert the crisis in Argentina because the fiscal situation deteriorated sharply and the country lost access to credit, including from the IMF. European countries would have a greater scope for fiscal devaluation because they have more extensive and better-enforced tax systems (and external support to allow these policies time to work). In the case of Europe, the relevant question is: how much fiscal devaluation would be required to achieve the necessary reduction in labor costs to restore competitiveness in peripheral countries? This is a key issue that has received some attention in the media and discussion forums, but it is still not center stage in policy discussions in Europe.[25] The effectiveness of fiscal devaluations would be strengthened if the relatively more competitive countries in the European Union applied opposite measures (i.e., fiscal revaluations) to strengthen the competitiveness of peripheral countries within the euro zone.

[22] Fernández-Arias and Talvi (1999) were early proponents of fiscal devaluation in the Latin American context.
[23] The plan was not applied to all economic sectors simultaneously to minimize the fiscal impacts, because the fiscal situation was very fragile in 2001.
[24] The actual rates fluctuated with the EUR/USD exchange rate. In addition, tariffs on imports of capital goods were reduced to zero in order to lower industrial production costs.
[25] See Cavallo and Cottani (2010); de Mooij and Keen (2012); IMF (2011).

6. Is the Glass Half Full or Half Empty?

Latin America provides a number of useful lessons concerning the need to provide swift and ample external liquidity support to mitigate the financial stress caused by sudden stops of capital flows, spikes in sovereign risk, and banking system instability. Arguably, limited external support was behind the depth of Latin America's great collapses. At the same time, as shown by Latin America's failed experience with the Baker plan for debt restructuring in the 1980s, if underlying fundamental problems are at the root of financial distress, liquidity alone is no cure. It even becomes counterproductive over time because it allows the rot to deepen and embroils official liquidity providers in credit risk. The continued failure of liquidity support to European crisis countries to cure their financial distress is an indication that fundamental policy reform is probably needed and ought to be conducted alongside such measures. If domestic political economy factors impede needed change or repayment enforcement is doubtful, implementing structural reforms should be a condition for continued financial support.

A public debt overhang is deleterious to growth because it acts as an implicit tax on investment, especially in the absence of clear rules for its resolution. Fiscal contraction may easily fail to reduce the debt overhang to the extent that it depresses economic activity. The recognition that debt reduction is in order tends to be delayed, leading to a protracted state of recession, and sometimes social unrest or political instability. The Latin American experience shows that orderly debt reduction in the right economic environment for growth can be the solution to growth recovery and renewed capital inflows. Where debt restructuring is needed, multilateral support conditional on an appropriate policy framework appears to be instrumental to ensuring that debt reduction is a solid base for recovery.

Another relevant lesson from Latin America is that entangling banking crisis risks with sovereign debt crisis risks is a recipe for disaster. If bank troubles require injecting more capital to banks, banking crisis resolution must be implemented with an eye to minimizing emerging fiscal liabilities. In the Latin American experience, some of the methods utilized to this end include i) the privatization of troubled public banks, ii) the liquidation rather than the re-capitalization of some banks and iii) a minimalist approach to only address problem banks and target assistance to preserve key functions of the banking system, such as the payment system.

In all cases, successful crisis resolution requires restoring economic growth to reduce high debt burdens, improve bank assets and reduce the probability of political backlash. External

official support to troubled economies can provide time for economies to adjust, but is no substitute for structural reforms aimed at reducing structural vulnerabilities and restoring long-term growth. The experience in Latin America shows that it is more likely that growth-enhancing reforms will be implemented in the aftermath of crises, especially in supportive institutional environments.

The Latin American experience—as it relates to some of the fundamental policy choices concerning financial distress in public debt markets and the banking sector, as well as fiscal adjustment and low growth—is relevant to peripheral euro-zone countries in crisis. Some of the policies concerning debt restructuring, banking crisis resolution, countercyclical policy and structural reforms for growth, are directly applicable depending on each country's specific circumstances. However, the ability to effect a real exchange rate depreciation to promptly regain competitiveness that has been so prevalent in Latin America is severely impaired for countries in the euro zone. In our estimation, abandoning the euro zone would be catastrophic for the country attempting to re-introduce its local currency—so costly that it should not be considered an option if it can be avoided. Lacking this policy instrument makes the European problem more complex and, in a sense, more worrisome than in Latin America.

On the other hand, the existence of the European Union creates possibilities that were not available in Latin America. The scope for regional cooperation is much larger. Supranational institutions, such as the European Central Bank, are able and ready to play supporting roles to national policies concerning sovereign debt, the banking system, and general balance-of-payments support. Furthermore, the core of the European Union is resourceful and in a position to help. While currency devaluation is not an option, cooperation could enlarge the scope of alternative competitiveness policies, such as complementing fiscal devaluation in less competitive economies with fiscal revaluation in core countries in the euro zone, and buy time for these policies to work gradually. None of these conditions of regional cooperation were available to Latin American countries, which could only count on limited, and not necessarily reliable, multilateral senior loans. Having these resources of international cooperation available makes the European problem easier to solve.

The fact that the euro zone has more tools to address the complex problems that peripheral countries in Europe are currently facing does not guarantee success. The euro zone is navigating through uncharted waters, and determining the correct course of action for

policymakers in crisis and core countries alike is difficult and requires innovation. Furthermore, democratic governance in European countries may limit the policy space of national governments trying to find a cooperative solution. If available tools are not put to good use, Europe would lose its advantage in coping with financial crises and the difficulties in the Latin American experiences reviewed in this essay could underestimate European perils.

The Argentina crisis of 2001/2002 is perhaps the closest of the Latin American experiences we reviewed to the current European crises in peripheral countries in terms of the difficulties associated with currency rigidity. The experience of Argentina suggests that the costs of exiting the currency union would be very large for the crisis countries in the euro zone, conceivably larger than in Argentina. In addition, the likely spillovers of a euro exit crisis would likely threaten financial stability in the core countries. It is in the interest of all parties that alternatives to a euro exit are exhausted. However, if the break-up becomes ultimately unavoidable because the external adjustment in peripheral countries is unmanageable without larger and more rapid real exchange rate depreciation than what the system allows, or if it is politically unfeasible to adjust, the Argentine case suggests that it would be better for all sides that the exit happens in a context in which peripheral countries continue receiving financial support in a spirit of full cooperation to facilitate necessary adjustments in order to avoid catastrophic outcomes.

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