EMERGING MARKET CRISES AND EUROZONE TURMOIL: LESSONS AND THE ROLE OF THE IMF

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It is very welcome that this session of the conference is looking at the lessons from emerging market crises which may be relevant to the turmoil confronting the Eurozone today.

We do not pay enough attention to the lessons from history.

In the 1980s, 1990s and early 2000s, financial and economic crises were largely identified with emerging markets.

But today the instability, vulnerability and weak economic performance of Europe and some other advanced economies stands in stark contrast with the relative stability and stronger economic growth performance of the emerging economies.

It is further evidence of the dramatic shifts that are underway in the global economy.

In 2011, emerging markets and developing countries contributed over three quarters of global economic growth. The pace of growth may ease in emerging markets in 2012, but their contribution to global economic growth is likely to be even higher than in 2011. This reflects their continuing strong performance and the weakening in prospects for many developed economies.

A number of emerging markets have learnt some lessons from the crises they experienced in the 1990s and early 2000s. The result is that the shift in economic weight towards the emerging markets is gathering momentum.

Much has been written comparing the crises confronting the emerging markets in the 1990s and early 2000s with the Eurozone crisis.

Martin Wolf wrote a column in the Financial Times in December last year with the heading 'It's a Balance of Payments Crisis, Stupid', a variant on the 'It's the economy stupid' theme that won the presidency for Bill Clinton in 1992. Referring to the euro area crisis, Wolf said;

'….this, then, is a balance of payments crisis. In 2008, private financing of external imbalances suffered 'sudden stops'; private credit was cut off. Ever since, official sources have been engaged as financiers'.[1]

A 'balance of payments crisis,' with sudden stops of capital flows, could be termed a 'bread and butter' emerging market crisis.

There are certainly many similarities between the crisis confronting the Eurozone and those experienced by the emerging markets a decade or more earlier, and certainly there are lessons from the emerging markets for Europe.

And a particular aspect that needs to be considered is the role of the IMF, for there are many calls for the IMF to play a more prominent role in addressing the Eurozone crisis.

Last month, the Eurozone Finance Ministers announced that they would, in the context of further steps that Europe was proposing to take to deal with the euro area problems, lend the IMF an additional $US195 billion. They called on other countries to similarly increase the available resources of the IMF.

At the Cannes Summit, G 20 leaders announced that they stood ready to ensure that additional IMF resources could be mobilised in a timely manner and called on Finance ministers to work on deploying a range of options to increase IMF resources.

The next meeting of G 20 Finance Ministers is on 25-26 February and G 20 Finance Deputies will meet tomorrow and the next day to prepare for the February G 20 Ministerial meeting, where the Eurozone crisis and increased IMF resourcing will be on the agenda.

With this focus on an enhanced role for the IMF in combating the euro crisis, it is relevant that the Fund's experience in the emerging market crises be examined.

A question to be asked is what lessons did the IMF draw from the emerging market crises of the 1990s and early 2000s and how will these lessons

[1] Martin Wolf, Financial Times, 7 December 2011.

influence the role the Fund is/can play in dealing with the Eurozone crisis of today.

Comparing the crisis in Europe with emerging market crises

But first a comparison between the crisis in Europe with that in many emerging markets. More specifically, many comparisons have been made with the Argentine crisis in 2001, which has a number of parallels with the problems that some European countries are now facing.

Argentina was facing a deep recession in 2001, it had a fiscal and current account deficit along with an overvalued exchange rate, but devaluation was not an option because of its currency board.

Argentina tried to restore competitiveness through domestic deflation and reducing its public debt by fiscal consolidation in the midst of a recession.

The country resorted to large financial packages from the international organizations, particularly the IMF, which were intended to be a catalyst for private sector investment.

In the end, these efforts failed. The fixed exchange rate regime collapsed and the country declared what was at the time the largest sovereign default in history.

The peso depreciated by 70 per cent against the US dollar. This had a massive impact on the balance sheets of firms and individuals who had their debts denominated in dollars. To address this problem, the authorities forced the conversion of most financial assets and liabilities that were denominated in dollars into pesos at the old parity.

This policy was disruptive, especially among small depositors who had significantly lost purchasing power. It affected property rights and resulted in the arbitrary transfer of wealth from creditors to debtors. But it did prevent widespread bankruptcies.

The de-dollarization of the banking system was highly disruptive, but again, it did reduce the financial vulnerability of the banking system because the central bank could act as lender of last resort.

Argentina suffered a major economic and financial crisis. From peak to trough, GDP fell by nearly 20 per cent.

Four years after announcing the default, Argentina finally restructured 72 per cent of its debt and managed to achieve a 65 per cent hair cut in net present value terms.

But while the crisis was very disruptive and painful, the economy recovered relatively quickly. Argentina's nominal exports grew by 15 per cent in 2003 and 17 per cent in 2004. Real GDP grew by 8.8 per cent in 2003 and 9 per cent in 2004.

What explained the Argentinean recovery? What are the lessons for Europe?

There is no consensus, but clearly the massive depreciation significantly benefited Argentina's competitiveness at a time when the external environment was improving and demand for one of its main exports – soybeans – was rising. Luck was on Argentina's side.

The Argentinean experience demonstrated that a default can be achieved, although with the benefit of hindsight, Argentina could have handled the default much better, and if it had done so it may not have lost investor confidence for over a decade.

But while the sovereign default helped deal with refinancing and liquidity problems, it of itself did not restore competitiveness and help promote growth.

To come back to Martin Wolf's assessment that 'It's a Balance of Payments Crisis Stupid', he points out that unless Europe achieves external adjustment, which will require major shifts in competitiveness, fiscal austerity alone will just cause prolonged and deep recessions. The Argentinean experience reinforces this observation.

Financial crises in emerging markets are often followed by 'phoenix-like recoveries ' – but the key to these recoveries is a significant depreciation in the currency which makes exports extremely competitive with the result that there is a large turn around in the trade balance.

But if this is a lesson from how emerging markets have dealt with balance of payments crises, it is precluded to members of a currency union.

However, while abandoning the currency union would be an extremely disruptive and painful course of action for a country, the question has to be asked whether the pain and period of adjustment may be less then attempting to achieve the required improvement in competitiveness through many years

of internal depreciation and fiscal austerity, during which time domestic demand is likely to decline or at best stagnate.

But even if abandoning the Euro may be considered to be the least costly course of action for one country, the unpredictable contagion effects may be much worse for the countries that are euro partners.

Contagion concerns were a factor in previous emerging market crises and decisions to attempt to stick with a fixed exchange rate arrangement.

For example, when there was intense pressure on the Brazilian real in 1998, a major justification for defending the exchange rate regime was that an exit from the peg at that time would have unsettled international financial markets which were already nervous after the Russian default and the experience of Long-term Capital Management.

In the Argentinean crisis, again the justification cited for continuing with Argentina's exchange rate arrangements, including by the IMF, was concern of contagion in other areas of the world and that countries with currency boards may come under pressure if a crisis in Argentina revealed that such exchange rate arrangements were vulnerable.

The studies by the IMF's Independent Evaluation Office (IEO) of the Fund's role in the Argentinean crisis and the Brazilian crisis points out that, admittedly with the benefit of hindsight, contagion concerns at the time were overplayed.[2]

But the situation is different in the case of Europe. Contagion following a country leaving the Euro would likely be very large and is very different from the destabilizing impact that may be felt by countries in a similar situation but not a member of the currency union.

If a return to former national currencies and a large devaluation are precluded because of concern over the magnitude of the disruption on the euro area as a whole, then the nature of the required adjustment should be seen as a euro-area wide task. This goes beyond building European 'firewalls' to limit contagion – as important as they are – but the nature of the adjustments required within the euro area as a whole.

European countries predominantly trade with each other and the least competitive countries tend to be most oriented towards other European

[2] IMF Independent Evaluation Office – Report on the Evaluation of the Role of the IMF in Argentina, 1991—2001. July 2004.

markets. Unlike the Argentinean and Brazilian situations, the European countries at the center of the crisis do not have the exportable natural resources that were in high demand in other parts of the world.

Most of the competitiveness and aggregate demand realignment that is required to solve the Euro area crisis needs to occur within Europe itself.

While GDP will fall in the highly indebted and least competitive countries which must attempt to improve competitiveness through deflation, Europe's surplus economies should expand demand and an expansionary monetary policy is required which will lead to a lower value in the euro.

So a lesson for Europe is that all European countries have a role to play in implementing the required adjustments to solve the Euro crisis.

Lessons for the IMF

What did the IMF learn from its role in dealing with emerging market crises which may be relevant to its role in Europe?

A key source of the lessons comes from the IEO evaluations.[3]

In the case of the IMF's role in Argentina from 1991 to 2001, one of the major findings from the IEO's work is that the IMF supported countries' policies too long, and provided substantial resources to preserve a policy regime that was ultimately doomed to failure.

Furthermore, while country ownership is fundamental to achieving a successful IMF program, the IEO concludes from the Argentinean experience that an emphasis on country ownership can lead to an undesirable outcome. The IEO proposed that the IMF should be prepared not to support strongly owned policies if it judges they are inadequate to generate a desired outcome.

Such a conclusion may be particularly relevant to the role the IMF is currently playing in Europe, where it is essentially a junior partner in the financing arrangement. But while the IMF may not be the major player, it is essential that it make its own assessments as to the likelihood of a program being successful.

[3] IMF Independent Evaluation Office. "Report on the Evaluation of the Role of the IMF in Argentina 1991-2001. July 2004.
Report on the Evaluation of "The IMF's Approach to Capital Account Liberalisation. April 2008.

The IEO also noted that a critical error that the IMF made in its dealings with Argentina in the lead up to the crisis was the failure to have an alternative strategy if the path adopted under the program was not successful. The result was that when Argentina broke from its peg to the US dollar and defaulted on its debt, the IMF was basically sidelined from the crisis - it effectively became an observer.

The view within Argentina continues to be that the key to overcoming its crisis in 2001 was abandoning IMF advice. For example, as the Argentinean sociologist, Norma Giarraca has observed:

> '*The 2001-02 crisis was the result of adjustment policies prescribed by the IMF in the 1990s, the same policies that are driving Europe's situation.'*[4]

Does the IMF have an alternative strategy for its European involvement? If not, the lesson from history suggests that perhaps it should. As the IEO noted, the IMF must take a proactive approach to crisis resolution, including providing financial support to a policy shift which is bound to be very costly whenever it is made.

The key lesson is that the Fund should be supporting the 'right' adjustment policy, and if the chosen path is not working, it should be prepared to change track. The difficulty, of course, is knowing what is the right policy path and when to change track.

As to the size of IMF programs, the Fund usually only provides a proportion of the financial resources that a country needs. But IMF loans are a signal that a country's economic policies are on the right track, which reassures investors and the official community, helping the country find additional resources.

The IMF programs with Argentina in the 1990s were intended to be catalytic in terms of encouraging private sector involvement. One of the lessons from the IEO's examination of the role of the IMF in Argentina, 1991-2001, was that for the catalytic approach to be successful, then: the country's economic fundamentals must be sound; the government must be credible in terms of policy actions; serious debt sustainability analysis must suggest that the country's debts are sustainable; and the exchange rate regime must be broadly assessed as being sustainable.

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[4] Argentina Shows World how to Beat the Crisis. Marcela Valente. 19 December 2011. IPS.

The IEO observed, however, that in all past episodes of a financial crisis triggered by large capital outflows, the catalytic approach had failed before a more flexible exchange rate regime was forced onto the country.

Another relevant lesson from the IEO's evaluation of the role of the IMF in emerging market crises is that delaying action can significantly raise the eventual costs of the crisis, as delayed action can inevitably lead to further output loss, additional capital flight and further erosion in asset quality.

Conclusion

To conclude, it is timely and relevant to compare the experience of past emerging market crises with the current crisis in Europe. There are many lessons, but there are also differences in circumstances.

An important lesson is that the path out of a balance-of-payments crisis requires an improvement in competitiveness. And history shows that a nominal depreciation in the exchange rate which is transferred into a real depreciation will significantly enhance a country's competitiveness.

But a significant difference between the situation in Europe and the emerging market crises of a decade earlier, and that is the existence of a euro area currency union. The contagion impact from a departure from the euro would likely be very considerable – and the contagion impact from the Eurozone crisis is likely to be larger than the spillover effects of previous emerging market crises.

Perhaps the only definite conclusion that can be made is that the problems confronting a number of European economies are not only larger than those confronting emerging markets, but also more complex.

And history shows that while the IMF can play a significant role in helping countries deal with a crisis, the challenge is identifying the appropriate adjustment path to support, along with having an exit strategy if the chosen adjustment path is not sustainable and a change in policy course is required.

In short, there are no easy answers.