

# Argentina and Uruguay in the 2000s: Two Contrasting Experiences of Banking Crisis Resolution<sup>1</sup>

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## I. Introduction

Over the last three decades, systemic banking crises have been a recurrent phenomenon in Latin America. No country typifies this better than Argentina, where a “systemic crisis per decade” has characterized the performance of the country’s financial system. Indeed, along with many other countries in the region, Argentina experienced a severe banking crisis that started in 1982 and took an entire decade to resolve. In 1994-95, the country joined Mexico in facing a banking crisis whose resolution led to a reduction in the number of banking institutions by about 40 percent.<sup>2</sup> Most recently, in 2002, Argentina entered into its most severe financial difficulties ever: a trio of banking, debt and balance of payments crises that involved the abandonment of a fixed exchange rate system under the “convertibility law.”

Uruguay has also experienced systemic banking crises in the last decades. In 1982, the country joined Argentina, Chile, Mexico and other Latin American countries that faced severe financial difficulties. In contrast to Argentina, however, Uruguay’s banking system recovered in the late-1980s and remained strong during the 1990s. After a decade and a half of stability, a new major banking crisis erupted in Uruguay in 2002; an outcome that has been widely characterized as “contagion” from the Argentina’s crisis. Sharply differing from Argentina, Uruguay quickly solved an emergent external debt problem.

This paper deals with the recent experience of banking crisis resolution in Argentina and Uruguay. These two cases are chosen to show that, even under the very stringent constraints that emerging market economies face during a banking crisis, these economies can indeed bring their banking systems back to solvency *if* they adhere to basic principles of banking crisis resolution<sup>3</sup>. The two countries under study displayed important similarities at the eve of their respective crises but striking differences in outcomes: While

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<sup>1</sup> This paper has greatly benefited from the excellent research assistance of Sebastian Sotelo. The paper draws heavily from Rojas-Suarez (2004).

<sup>2</sup> See Basu et. al. (2004) for an analysis of the consolidation process of the banking system in Argentina during the second half of the 1990s.

<sup>3</sup> Most of the analysis and conclusions derived for Latin America also applies to other emerging market regions. See, Goodhart et al (1998)

the end of Argentina's financial problems is not even in sight yet at the time of this writing, Uruguay's banking system is on track to a full fledged recovery. The analysis of the experiences shows that the *process of banking crisis resolution* accounted for the differences in results. Based on previous experiences of banking crises in the region, the paper also argues that the chosen mechanism of banking crisis resolution is an indicator of a financial system's capacity to avoid future crises.<sup>4</sup>

The rest of this paper is organized as follows. Section II presents the framework used for analyzing the banking crises resolution programs in Argentina and Uruguay. This section first states the main objectives that a banking crisis resolution needs to pursue and the basic principles that have to be followed for achieving these objectives. Then, the section identifies the differences in constraints for banking crisis resolution faced by regulators in industrial and emerging market economies, in general, and Latin American countries, in particular. Section III discusses how the combination of constraints faced by policymakers and deviation from principles for effective crisis resolution has shaped the features that distinguish banking crisis in Latin America from those in industrial countries. Section IV uses the framework presented in Section II to evaluate the resolution process of the recent banking crises in Argentina and Uruguay. This section demonstrates that the regulators' willingness to adhere to basic principles of effective crisis management explains to a large extent the sharply contrasting outcomes between the two countries. Section V concludes the paper.

## **II. Banking Crisis Resolution in Industrial and Latin American Countries: Similar Principles, Different Constraints**

To provide a framework for the analysis of banking crisis resolution in Argentina and Uruguay, this section answers three questions: (a) What are the objectives of banking crisis resolution and why should achievement of these objectives be a priority for Latin American countries facing systemic banking difficulties?; (b) What are the basic principles that a crisis resolution program needs to follow in order to meet the desired objectives?; and (c) What are the differences in constraints between industrial countries and Latin American economies in dealing with systemic banking crisis?

### **1. The Main Objectives of Banking Crisis Resolution**

Studies of financial systems in Latin America show that the region stands out for the frequency, depth and costs of its banking crises relative to other regions of the world.<sup>5</sup> A number of analysts have attributed the large costs associated with these crises to the authorities' long delays in fully recognizing the extent of the problem and the difficulties in setting up a credible program for crisis resolution<sup>6</sup>. A central explanation behind these

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<sup>4</sup> For a paper dealing with the issue of avoiding banking crisis recurrence, see Rojas-Suarez (2002)

<sup>5</sup> See for example, Rojas-Suarez and Weisbrod (1996)

<sup>6</sup> This presence of long delays in solving a systemic banking crisis is, of course, not unique to Latin American countries, as the long process involved in solving the S&L crisis in the United States and the recent crisis in

delays lies in the scarcity of funds available to deal with the problem. After all, facing severe financial deficiencies in priority areas for development, such as health and education, why should Latin American congresses approve the allocation of resources for the solution of banking crises? Although it is certainly undeniable that avoiding the eruption of a systemic banking crisis is a first best solution, if the authorities find themselves facing a crisis, the critical questions that need to be answered are ones of cost/benefit. Why should restoring the banking system back to solvency be given the highest priority? At what cost to society?

To answer these questions, it is important to go back to the basic distinction between banks and other financial intermediaries. In both industrial and emerging market economies, banks' uniqueness, namely their "franchise value" lies in their special power to provide means of payments in non-cash transactions.<sup>7</sup> When a bank customer withdraws funds from his bank deposit or writes a draft against that account, the bank delivers "good funds"-- namely reserves on deposit held at the bank or at the central bank, or cash—to the customer or to the bank of the payee named on the draft. In fact when other liability issuers, such as other financial institutions, promise to deliver payments, they promise to deliver bank deposits. Take for example, the case of money market mutual funds. These funds invest in money market assets, such as commercial paper (in industrial countries) and treasury bills, and issue short-term claims on this portfolio to investors. When an investor wants to use money market mutual fund shares to purchase goods and services, the money market mutual fund must deliver funds from its bank deposit to the bank deposit of the payee designated by the investor. *Thus, as no other financial institution, banks are at the core of the payments system. A disrupted or non-functioning payments system resulting from a systemic banking crisis is extremely costly to society, be it an industrialized or an emerging market economy, as it severely inflates the costs of "doing business" and might even completely prevent the execution of essential transactions during the production/distribution/consumption process, with the consequent detrimental effects on overall economic activity. Therefore, restoring the functioning of the payments system needs to be the first objective of banking crisis resolution since an adequate payments system is essential for the appropriate operation of a market economy.*

But, what resources should be used to resolve the banking crisis? When a large portion of a country's banking system is threatened with insolvency, funds set aside to resolve isolated bank failures, such as deposit insurance funds and emergency central bank credit, are usually inadequate for the task at hand.<sup>8</sup> Thus, in systemic crises, if the integrity of the banking system is to be maintained or restored, public funds must often be used to resolve bank failures. That is, a systemic banking crisis becomes a fiscal problem.

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Japan testifies. As will be explained below, however, the *reasons* behind the delays have differed significantly between industrial and Latin American countries.

<sup>7</sup> See Corrigan (1991) and Garber and Weisbrod (1992) for a discussion of the franchise value of banks in the U.S. and other industrial countries. Rojas-Suarez and Weisbrod (1995) include a similar analysis for the case of emerging market economies and is the main source of the discussion contained in this section.

<sup>8</sup> Garcia (2000) discusses cases in which the establishment of a full deposit insurance guarantee during a banking crisis is warranted. In those cases, however, the author recommends extreme caution as the guarantee needs to be *credibly* known as a temporary policy to avoid a deepening of a moral hazard problem.

It should be clear, however, that the use of public money to solve a systemic banking crisis belongs to the family of “second best” solutions. In an optimal situation, a systemic banking crisis could have been prevented with some weak banks failing and being replaced or absorbed by other healthy institutions, perhaps from abroad, in a timely manner. If the crisis is being induced by unsustainable policies at the macroeconomic level, financial transaction would migrate abroad. The use of public funds to solve systemic banking crises is justified on two grounds. First, mobility of bank capital across the world is imperfect and slow due to uncertainties about the “true” value of the portfolio of banks in trouble. Second, consistent with the argument above, since the Great Depression in the United States, there has been almost universal agreement that, because banks play a crucial role in the payments system, and this system still remains in the national domain in most countries in the world, public funds must be used to resolve individual bank problems to ensure that a banking system survives the crisis.

Whether the regulatory system has an explicit deposit insurance program or not, inevitably, maintaining the integrity of the banking system requires that some bank liability holders be protected from the consequences of bank failure. Hence, the commitment of public funds for restructuring implies a transfer of resources from the public sector to the banking system. The objective of public policy is to ensure that the transfer is limited to those parties whose protection from bankruptcy is necessary to preserve the integrity of the banking system. In other words, *the second objective of solving systemic banking crisis should be to minimize the amount of public funds used in the restructuring process*. While this objective is universal, it is particularly important for Latin American countries facing severe fiscal budget constraints.

## **2. Principles for Effective Banking Crisis Resolution <sup>9</sup>**

General principles for a bank-restructuring program can be derived directly from the main objectives outlined above. There are three basic principles that policymakers need to follow when executing a bank-restructuring program that bring the banking system back to solvency while minimizing the use of public funds. In all three principles, the common thread is the preservation or restoration of the payments system.<sup>10</sup> Just as in the case of the objectives, the principles identified here apply for both industrial and emerging market economies.

The first principle relates to the funding needs of a bank restructuring program. The principle is that a society *should exert strong political will to make bank restructuring a priority in allocating public funds while avoiding sharp increases in inflation*. The importance of avoiding drastic increases in inflation during a restructuring program for the purpose of preserving the payments system can not be over-emphasized. Banks’ claim to

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<sup>9</sup> This section and the next draws from Rojas-Suarez and Weisbrod (1996)

<sup>10</sup> The literature on identifying guidelines for effective banking crisis resolution in emerging market economies includes work by Dziobek and Pazarbasioglu (1997), Enoch, Garcia and Sundararajan (1999), Hawkins and Turner (1999) and Claessens, Klingebiel and Laeven (2001). The conclusions from this research are consistent with the principles identified in this paper.

deliver means of payments is more credible than claims of other liability issuers partly because banks maintain deposits at the central bank and have access to a central bank facility, usually referred to as discount window privileges<sup>11</sup>. If, however, the central bank extends large amounts of credit to banks to keep bank deposits liquid during a banking crisis, inflation would follow and the value of the franchise value of banks would be severely curtailed; this is so because the real value of bank deposits would decrease. Hence, funding for a successful banking crisis resolution needs to come from non-inflationary sources of funds.<sup>12</sup>

The second principle is to *ensure that parties that have benefited the most from the risk-taking activities of the banking business bear a large portion of the cost of restructuring the banking system*. For example, bank stockholders should be first to lose their investment along with large holders of long-term liabilities such as subordinated debt<sup>13</sup>. Also, delinquent borrowers must not be given favorable treatment at public expense. In this regard, “debtor programs” need to be minimized. As evidenced in Rojas-Suarez (2002), excessive use of debtor programs in a number of Latin American countries has unnecessarily increased the fiscal cost of banking crisis resolution.

Indeed, a central component of a successful bank restructuring program consists in enhancing banks’ abilities to recover trouble loans. Regulators and supervisors of the banking system must ensure that banks develop procedures to monitor the ability of their loan customers to deliver cash. Proof of liquidity by borrowers is a requirement for achieving banks’ solvency on a sustainable basis. Thus, reconstructing or establishing a good monitoring system by banks both enhances the capacity of banks to extend sound credit and protects the franchise value of banks by helping to restore banks’ credibility regarding their capacity to deliver liquid means of payment. In sum, executing the second principle not only limits current restructuring costs by forcing private parties to bear part of the loss, but it also creates incentives to restrain risk taking in the future, which strengthens the banking system in the long term.

The third principle is that *prompt action should be taken to prevent problem institutions from expanding credit to highly risky borrowers or capitalizing unpaid interest on delinquent loans into new credit*. Execution of this principle implies implementing policies that distinguish between banks by quality and, therefore, reduces the moral hazard risk in bank restructurings that arises when institutions with low and declining net worth continue to operate under the protection of public policies designed to maintain the integrity of the banking system. This principle also implies that, when possible, insolvent

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<sup>11</sup> In dollarized emerging market economies, the credibility of banks to deliver means of payments is largely related to the dollar reserves they keep (either at the bank, at the central bank or in other financial institutions). In this situation, a central bank’s overall ability to provide liquidity to banks is constrained by its holding of net international reserves.

<sup>12</sup> The empirical work by Honohan and Klingebiel (2000) concluded that open-ended liquidity support to banks during a banking crisis has significantly contributed to escalate the fiscal costs of crisis resolution around the world.

<sup>13</sup> It is possible that some large liability holders of money market instruments might need to be subsidized to some extent because the money markets must be operational for the payments mechanism to survive.

institutions should be removed from the hands of current owners, either through closure or through sale.

To execute a successful crisis resolution program, policymakers must faithfully adhere to all three principles. However, the ability of regulators to carry out these principles is affected by the economic environment in which they operate. Even if a society has mustered the will to fund a bank rescue, it may face a resource constraint that is so severe that it jeopardizes the success of the restructuring program. For example, an economy may not be able to access debt markets for funds. In this case, to finance bank restructuring, it may be necessary to reduce fiscal expenditures in other areas to avoid inflation. Obviously, as the funding constraint becomes tighter, the task of assigning priorities becomes more difficult. In what follows, the paper identifies the major differences in constraints faced by industrial and Latin American regulators in designing banking crisis resolution programs.

### **3. Differences in Constraints between Developed and Latin American Countries**

Regulators in emerging market economies countries, in general, and in Latin American countries, in particular, face more extreme constraints for banking crisis resolution than their counterparts in developed ones. Constraints can be divided into three categories: (a) availability of financing resources, (b) availability of markets to sell banking institutions and their assets, and (c) regulatory independence.

Even if a Latin American country has followed a very conservative fiscal policy before the onset of a banking crisis, policymakers face a daunting task in *obtaining adequate funds* for a restructuring program. For example, in contrast to industrial countries, almost no Latin American country possesses a domestic long-term bond market, although many have access to international bond markets<sup>14</sup>. However access to long-term bond markets dries up when international markets perceive that a crisis is imminent.

This would seem to leave the issuance of short-term debt as a more common funding option in Latin America. However, the risk in the short-term market is that the government must not only cover interest payments but also principal payments if the debt cannot be rolled over. Thus, the slightest hint of deterioration in the government's capacity to service its debt may shut the government out of the market, which, in turn, increases the pressure for inflationary finance.

A second constraint affecting the implementation of the principles in Latin America is the *very limited availability of markets for financial institutions or for financial assets held by these institutions*. This is partly a reflection of the lack of the legal and market infrastructure necessary for secondary markets to develop. The existence of such markets can be useful for minimizing public expenditure because they permit private investors to

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<sup>14</sup> Among Latin American countries, Chile stands out for having an incipient domestic market for long-term bonds.

recognize the franchise value of a failed bank’s customer base and its distribution system. Revenues from the sale of these valuable assets can be used to offset public absorption of credit losses.

In contrast to Latin America, markets are large and funding is abundant relative to the size of the problem in many industrial countries. In these latter cases, regulators have a wide variety of choices available to resolve banking problems that can be classified into three broad categories: private sector merger or sale; take over and management by the regulatory authorities; and, as a last resort, bailout of an existing institution with ownership left largely in place.

Regulatory know how is sometimes in short supply in a number of Latin American countries as well. However, even in markets with skilled professionals in bank supervision, if bank regulators do not have political independence, they may not be able to sell banking properties through arm's length transactions. *Lack of regulatory and supervisory independence* is the third severe constraint in many Latin American countries getting in the way of an effective application of the principles for banking crisis resolution. This problem also arises in the developed world, but they are less important than in Latin America because other constraints are less severe.

Thus, the constraints on bank supervisors in emerging market economies make it much more likely that the bailout option is taken in these countries than in industrial countries. Nonetheless, restructurings, even under the most severe constraints, are more likely to be successful if policymakers attempt to enforce the three general principles outlined above. As an examination of the experiences in Argentina and Uruguay in Section IV will reveal, it is the capacity of the authorities to adapt principles to local conditions, more than the severity of the constraints that often determines whether a bank restructuring effort will be successful.

Table 1 summarizes the differences in constraints facing policymakers in industrial countries and in Latin America. The next section will explore how the mere presence of severe constraints has affected salient features of banking crises in Latin America.

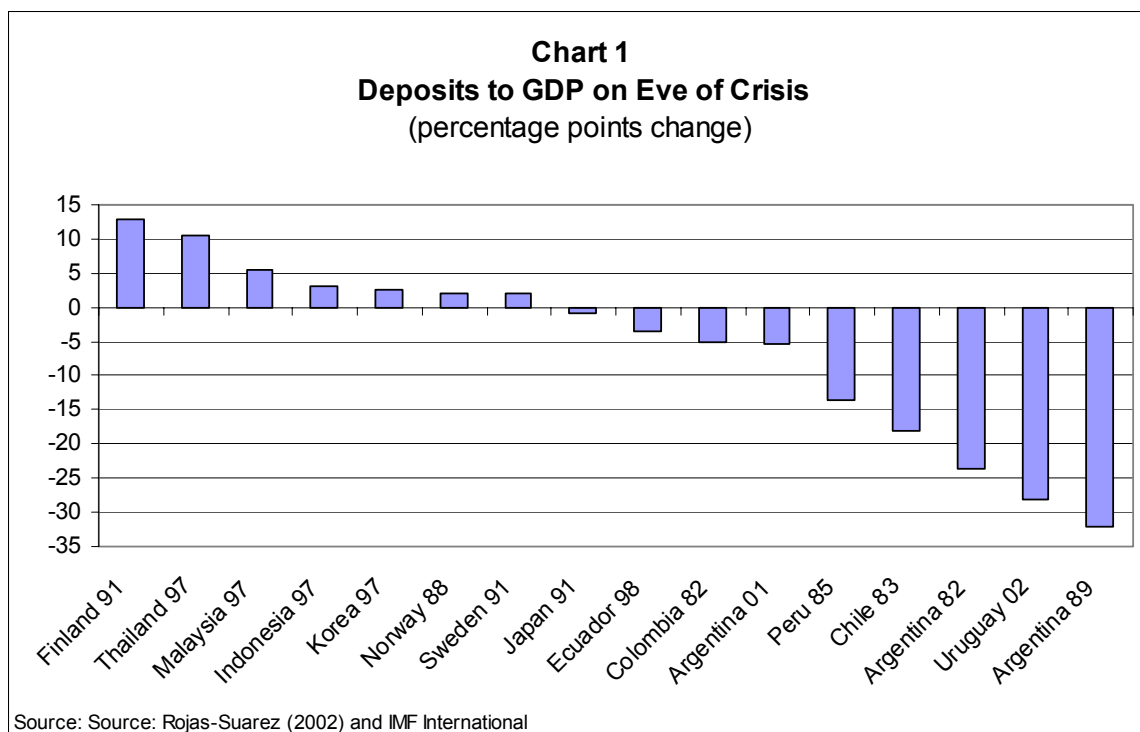
**Table 1**  
**Differences in Constraints Between Industrialized Countries and Latin America**

Constraints	Industrialized Countries	Latin America
Financing Sources	Access to markets remains during the crisis	Access to international capital markets disappears
Markets	Domestic capital markets and secondary markets for long-term assets exist	Lack of an adequate legal and judicial infrastructure as well as repeated financial crises prevent secondary assets markets from developing.
Regulatory Independence	It is subject to strict standards, though scandals eventually occur	In some cases, lack of independence is so severe that regulators and supervisors do not do their jobs, even if adequate tools are available

### III. How do Principles and Constraints Combine to Differentiate Banking Crises in Latin America from those in Industrial Countries

As discussed in Section II, in a large number of cases, when a banking crisis hit a Latin American country, authorities have found out that they lack sufficient and adequate (economic, financial and political) policy tools to effectively set in place a banking crisis resolution program. The combination of these constraints with the lack of willingness to adhere to the basic principles of banking crisis resolution has resulted in a long list of poorly solved banking crises in the region. In turn, these experiences have significantly contributed to shape many of the features that currently characterize Latin American financial systems and the *dynamics* of banking crises in the region.

Indeed, major aspects of banking crises in Latin America differ significantly from those in industrial countries. For example, since Latin American's financial systems are very fragile, even relatively mild shocks to the banking sector can quickly result in sharp reductions in the deposit base and trigger a crisis. An indicator of this fragility is presented in Chart 1, which displays the percentage change in the ratio of deposits to GDP for selected Latin American and industrial countries during the early phases of a systemic banking crisis.



The evidence indicates that depositors in Latin America are much more prone to flee the banking system when bank borrowers' capacity to pay is adversely affected than



are depositors in other countries in the world. These data suggest that, to a large extent, depositors in Latin America fear that they will suffer a real financial loss following a systemic banking crisis whereas depositors in industrial countries, and even depositors in emerging Asia, believe that, even in a crisis, the real value of their deposits will be preserved. Thus, investors in a variety of regions of the world believe that banking crises, while severe, are temporary events and that the long-run viability of the system will soon be restored. This contrasts sharply with depositors' beliefs and behavior in Latin America. This evidence is consistent with both the severe constraints facing policymakers in Latin America to resolve systemic banking crises and, even more importantly, in a number of countries, with the perceived lack of trust in the authorities' capacity to solve banking problems without the depositors being the bearers of resolution costs (lack of trust in the commitment to the principles for banking crisis resolution). A long history of incorrectly resolved banking crises in a number of countries have resulted in large bank runs at the onset of problems, therefore further aggravating the severity of the crisis.

The sharp drop in confidence in Latin American financial systems that follows initial signals of banking distress is common to both domestic and foreign investors. As a result, periods of banking difficulties are also associated with loss of access to international capital markets and countries in Latin America have not been able to raise sufficient funds in international capital markets to finance the cost of the crises. This shows the severity of the funding constraint facing Latin American policymakers. As a result, countries are forced to either run current account surpluses and/or lose significant amount of foreign exchange reserves. Sovereign bonds placed in the international capital markets provide an indicator of investors' confidence. Periods of banking crises are manifested in sharp declines in the price of these bonds. For example, in late 1994 and early 1995, the drop in confidence in the financial systems of Argentina and Mexico resulted in a 30 percent drop in the bond indexes for these two countries. Similar behavior was observed during the eruption of the banking crisis in Ecuador in 1998 and in Argentina in 2001).<sup>15</sup>

The experience of Latin America sharply contrasts with that of periods of crisis in industrial countries. For example, the balance of payments position of Norway and Sweden were largely unaffected during the Nordic banking crises in the late 1980s and early 1990s. Moreover, long-term government bond prices in Norway and Sweden were largely unaffected by the crisis.

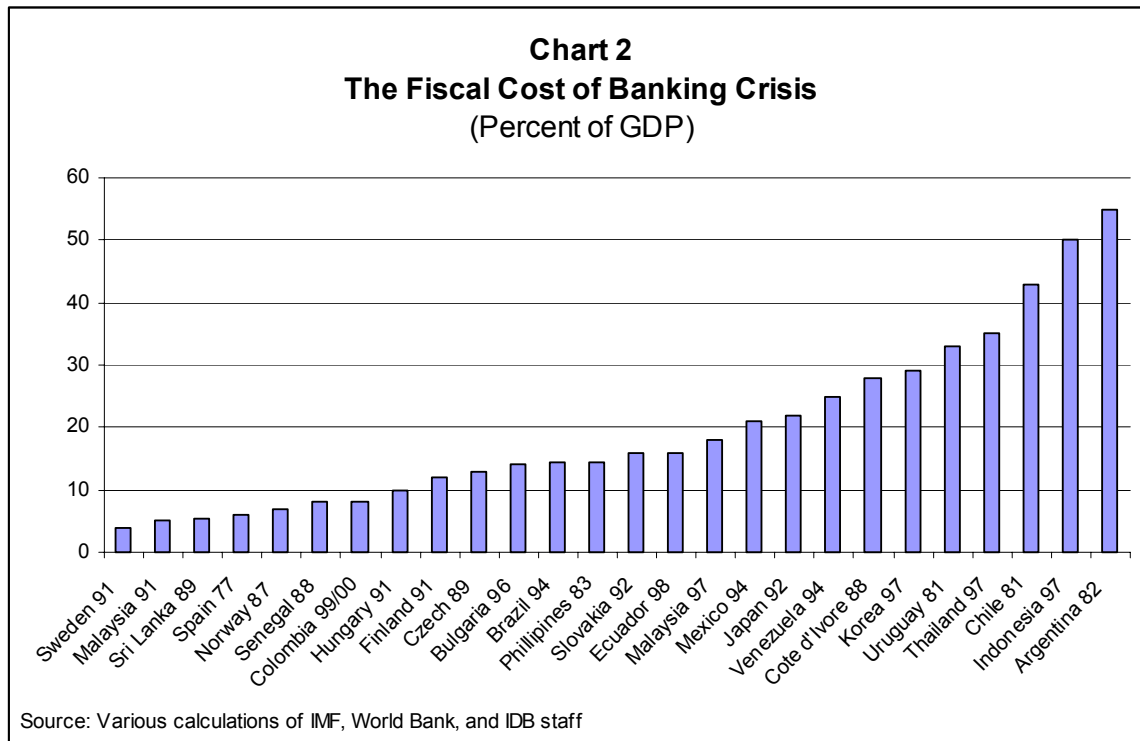
Not surprisingly, the severe constraints faced by Latin American policymakers and the long experience of non-adherence to the basic principles for effective crisis resolution in a number of countries in the region have translated in the high costs associated with restructuring banking systems after a crisis.<sup>16</sup> Chart 2 shows the fiscal cost of banking crises as a percentage of GDP for a number of crisis episodes around the world. The concentration of Latin American banking crises at the right side of the chart, where costs are higher; is apparent; although it is important to recognize that resolving the East Asian

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<sup>15</sup> The sharp drop of deposits (around 20 percent) in Argentina's banking sector in 2001 signals the eruption of the banking crisis in that country.

<sup>16</sup> Data and information on features of banking crisis experiences and their resolution around the world can be found in Caprio and Klingebiel (1996) and del Villar et al (1997).

crises were as costly as resolving those in several Latin American countries. This contrasts with experiences in most crises in industrial countries, which appear at the low end (left side) of the cost spectrum.

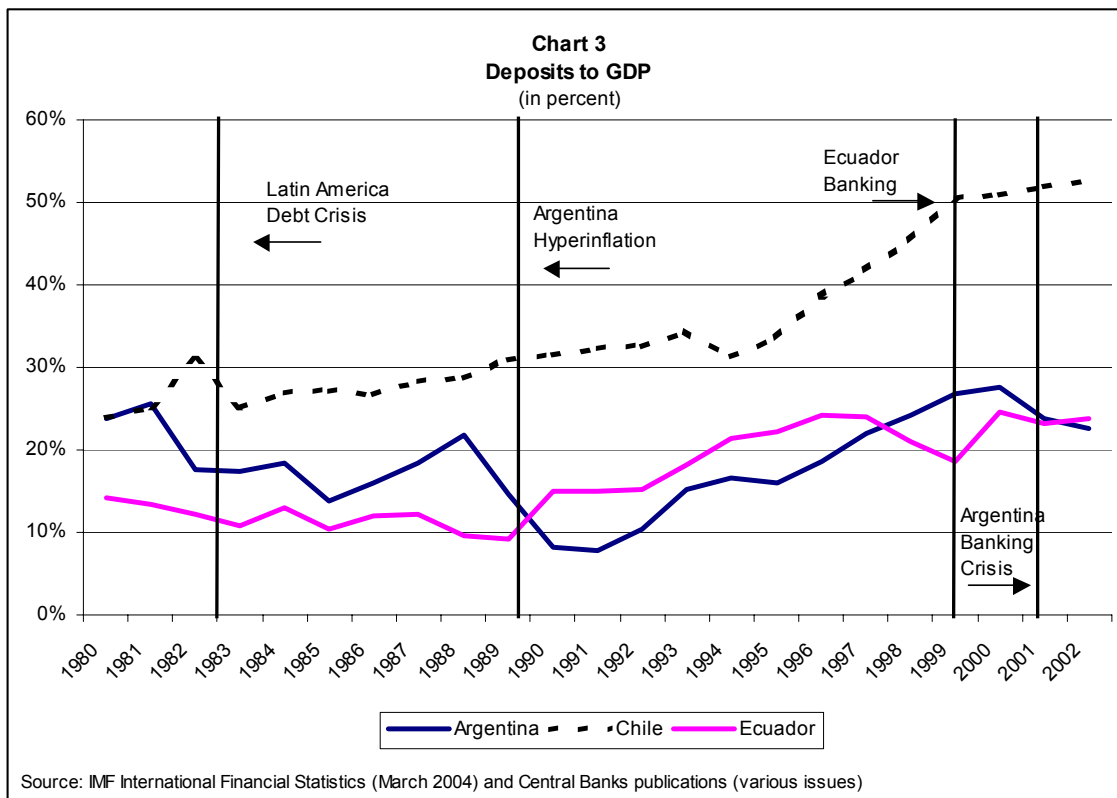


The distressing facts presented above are the legacy of a long history of recurrent crises and the inadequacy of the resolution process in many countries in the region. Sometimes one hears a popular belief that “depositors forget” and that, regardless of the manner in which a crisis is resolved, they will return to domestic banks after a while. The evidence does not support that belief. In countries where the authorities have often resorted to policies that hurt depositors the most, such as the introduction of freezing of deposits, interest rate controls and/or recourse to inflation to resolve bad loan problems, financial intermediation has remained extremely low even many years after the crises. Argentina in the early 1980s and early 2000s, Mexico in the mid 1980s and Ecuador in the late 1990s are prominent examples. In all these cases, parties not responsible for the crisis took sharp losses, in drastic violation of the second principle for effective banking crisis resolution. In most countries where banking crises were poorly solved, crisis recurrence has been prevalent.

There are, however, other examples in Latin America demonstrating that, even under tight constraints, regulators have sometimes been able to fashion a policy that has remained sufficiently close to the principles to be successful. The most noted example of this is Chile in the early and mid 1980s. While funds to close failing banks were limited and markets were not available to sell large impaired institutions, regulators fashioned a recapitalization and loan rescheduling program that minimized incentives to capitalize unpaid interest or expand balance sheets by taking increased risk. Consistent with

adherence to the basic principles for effective banking crisis resolution, Chile's banking system has remained strong and has avoided a recurrence of crisis episodes, even in situations when most Latin American countries have been affected.

Chart 3 exemplifies the argument above. Argentina and Ecuador, two countries with a history of poorly solved banking crises show a persistence of low financial intermediation, with the ratio of deposits to GDP fluctuating around a mere 20 percent. In contrast, financial intermediation in Chile has gained in depth and soundness.<sup>17</sup>



#### IV. The Crises of Argentina and Uruguay in the early 2000s: Similar Beginnings, Contrasting Outcomes

The process of banking crisis resolution in Argentina and Uruguay in the early 2000s serves to exemplify the central theme of this paper, namely, that adherence to the principles stated in Section II makes all the difference in achieving results. As this section will show, since the eruption of the banking crisis in Argentina by the end of 2001, authorities have consistently departed from the principles for effective crisis resolution and, as a result, the banking system remains largely insolvent when asset valuation is measured at market prices. In contrast, while still facing important difficulties, regulators in Uruguay better

<sup>17</sup> See Rojas-Suarez (2004) for a comprehensive analysis of a number of experiences of banking crisis resolution in Latin America.

adhered to the principles, and by mid-2004, the restructuring program was making important progress in the right direction.

## **1. Origins of the Crises and Constraints for Crisis Resolution**

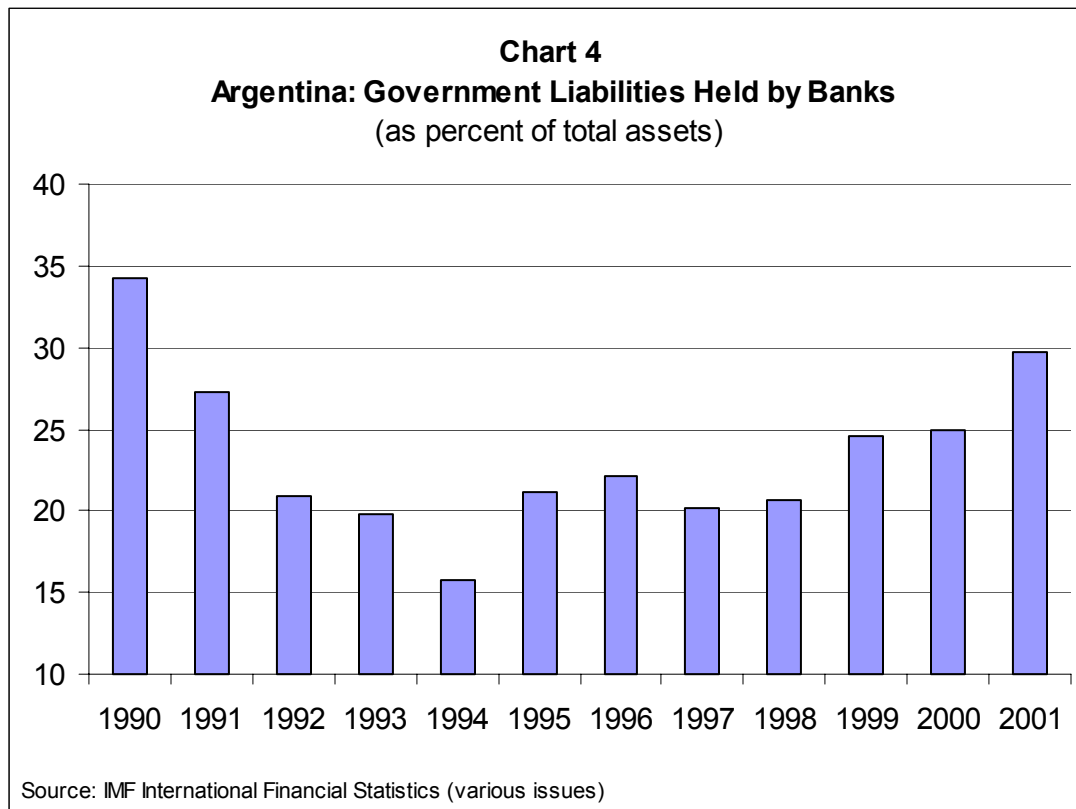
Although this paper has not dealt with the *causes* of banking crises, a brief discussion of the roots of the Argentinean banking crisis is important to understand the constraints faced in designing an effective resolution program and to contrast them with the constraints faced by the authorities in Uruguay

Interestingly enough, there is yet no consensus regarding the origin of the Argentinean crisis. While some argue that the banking system was strong all the way until 2001 when the government implemented policies that severely damaged the banks' capital base, others argue that the banking system suffered from important fragilities during the late 1990s that were bound to emerge if an adverse shock hit the system. The evidence suggests that there is truth in both arguments; namely, that while fragilities in the banking system developed during the late 1990s, policies undertaken by the government during 2001-02 completely destroyed the franchise value of banks by rendering the payments system ineffective.

The increasing fragilities that emerged during the late 1990s were twofold. First, banking system soundness depended on maintaining the exchange rate fixed (the convertibility law) because of the large amounts of banks' dollar lending to borrowers with peso-denominated sources of income (in particular loans to the non-tradable sector). There are a number of arguments explaining this development. The claim here is that the increasing high exposure to credit risk denominated in foreign currency can be explained, at least partially, by the government's offer of a free guarantee to the banking system. The free guarantee derived from the promise of keeping the convertibility law without making it costly for the banks to extend dollar loans to borrowers with peso-denominated income. This guarantee implied that a large fiscal contingent liability arose during the late 1990s. It would be hard to argue that banks managers and the authorities were not aware of the augmented risk to the sustainability of the convertibility law, especially after the stream of shocks that affected Argentina's competitiveness since the Russian crisis. However, in spite of increased perceptions of exchange rate risk, currency mismatches between banks' assets and borrowers' sources of income continued to increase and the percentage of dollar-denominated loans in total loans increased from about 63 percent in 1997 to about 75 percent by 2001. This upsurge occurred without a corresponding increase in the ratio of loan loss reserves even though there was a significant reduction in the capacity to pay by borrowers resulting from the economic recession that started in 1999. Under-pricing of credit risk cum exchange rate risk was an important (and increasing) fragility that paved the way to the crisis.

The second fragility arose from banks' increased exposure to government risk. Chart 4 shows the evolution of the share of government paper in banks' balance sheets since 1990. This share declined significantly up to 1994, increased temporarily as a result of the banking crisis resolution in 1995-96; but after a partial correction in 1997-98, the

ratio resumed an upward path and by end-2001 had reached a level close to that in 1990. Among all types of banks, public banks had the largest share of government paper in their assets. While it is true that there was a compulsory sale of government bonds to banks, this only happened in late 2001. Thus, partly as a consequence of attempting to keep profitable in a recessionary period, banks underestimated the risks of holding government liabilities. This risk increased during the late 1990s and into 2001 as the fiscal balance deteriorated during the period and the public sector indebtedness increased.



Before the crisis, the full potential adverse effects of these fragilities were not apparent from the traditional indicators of financial soundness. On an overall basis, banks did not appear to suffer from under-capitalization or lack of liquidity. However, as shown in Table 2, banks' quality differed significantly according to ownership.<sup>18</sup> Public banks not only displayed a significantly higher ratio of past-due loans to total loans, but also the lowest ratio of provisioning as indicated by the ratio of loan loss reserves to past due loans. This under-provisioning overestimated the "accounting capital" reported by banks.<sup>19</sup> The opposite was true for private foreign banks, which had the strongest indicators in the

<sup>18</sup> Data in Table 2 covers only the 18 largest banks in the system which by end-2001 accounted for about 83 percent of total assets. Analysts' reports indicate that small banks (not included in the Table) were the least efficient in the system (see Gutierrez and Monte-Negret, 2004).

<sup>19</sup> Table 2 only reports the ratio of equity to assets. A better indicator of bank capitalization, the risk-weighted capital to assets ratio was not available for the different categories of banks considered in that table.

system. As a result of the recession, bank earnings remained low for all categories of banks during 2000-01 and even became negative for public banks by end-2001.

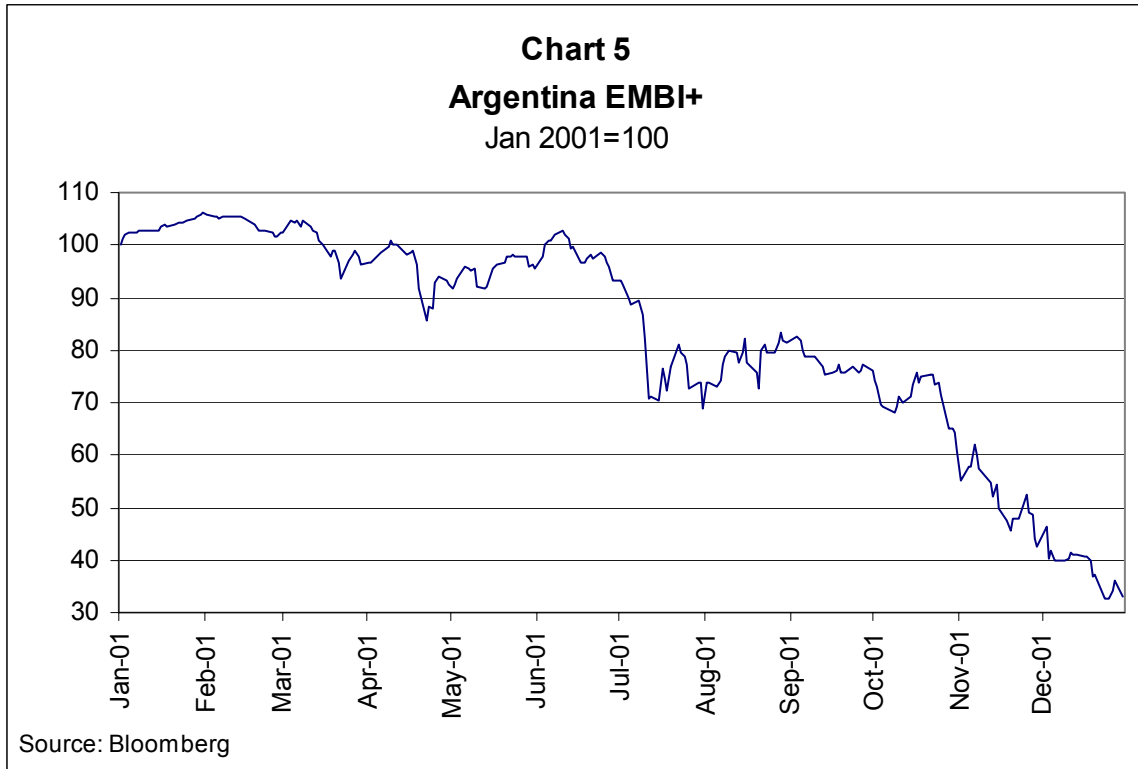
**Table 2**  
**Argentina: Banking Soundness Indicators by Ownership of Banks**  
(in percent)

<b>Public Banks</b>	Dec-97	Dec-98	Dec-99	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01
Past-Due Loans / Total Credits	15.97	14.03	16.76	18.08	20.37	13.30	15.70	16.86
Loans Loss Reserves / Past Due Loans	52.00	68.89	59.31	58.36	59.50	61.46	70.97	68.57
Liquid Assets / Deposits	15.40	13.26	12.61	11.15	10.14	13.43	14.08	7.49
Net Interest Margin	3.03	3.38	3.29	3.71	0.67	2.04	2.84	3.36
Equity / Assets	11.84	9.64	8.77	9.51	9.58	9.42	10.52	9.50
ROA	0.53	-0.03	0.10	0.19	-0.57	0.02	0.01	-0.48
Loans in dollars / Total Loans	63.95	70.42	71.54	73.37	74.11	68.95	70.25	77.50
<b>Private Domestic Banks</b>	Dec-97	Dec-98	Dec-99	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01
Past-Due Loans / Total Credits	6.97	6.29	6.52	8.17	8.82	8.28	9.86	9.68
Loans Loss Reserves / Past Due Loans	75.52	89.14	83.41	75.11	71.42	77.78	75.21	76.25
Liquid Assets / Deposits	18.60	17.33	12.89	9.54	11.39	18.51	22.63	17.54
Net Interest Margin	4.03	5.06	4.57	4.21	4.42	4.75	5.33	3.50
Equity / Assets	18.23	17.44	16.73	13.26	13.80	15.13	16.63	18.53
ROA	1.30	1.39	1.31	-0.96	1.27	1.41	1.41	0.55
Loans in dollars / Total Loans	61.53	62.60	63.05	67.61	66.95	67.05	63.77	75.65
<b>Private Foreign Banks</b>	Dec-97	Dec-98	Dec-99	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01
Past-Due Loans / Total Credits	3.83	4.29	4.41	5.59	5.66	5.80	6.19	5.89
Loans Loss Reserves / Past Due Loans	64.67	85.40	89.94	85.51	84.91	85.88	83.79	100.56
Liquid Assets / Deposits	18.73	10.96	10.75	9.09	10.86	19.80	17.44	22.50
Net Interest Margin	4.01	3.97	4.17	4.26	4.47	4.55	5.25	5.66
Equity / Assets	13.19	8.61	8.20	8.33	8.24	8.53	10.20	9.91
ROA	1.21	0.64	0.61	0.87	0.92	0.87	0.86	0.01
Loans in dollars / Total Loans	69.42	68.85	68.86	55.60	67.13	68.50	48.29	70.65

Source: Salomon Smith Barney and Central Bank of Argentina

The combination of a growing stock of public debt, increasing overall fiscal deficits and no signs of economic recovery during 2001 fueled perceptions of government default and abandonment of convertibility. As these perceptions threatened to expose the risks in the banks' balance sheets, a significant withdrawal of deposits took place during that year. Consistent with quality differentials between categories of banks, the deposit outflow was especially large in the two major public banks, which accounted for a large fraction of the deposit base. By the end of 2001 the banking system lost about 20 percent of deposits. As a response to the deposit loss, in December 2001, the government imposed limits on withdrawals of deposits to 250 pesos (dollars) per week per account. This measure came to be known as the "corralito".

It is interesting to note that although the market price of sovereign debt sharply decreased in market value during 2001 (see Chart 5), this was not reflected in banks' balance sheets because of accounting practices that did not require registering public debt in banks' books at "market value". The truth of the matter is that, from an economic—rather than accounting-- perspective, bank capital significantly decreased in value throughout 2001.



Depositors' fears were validated during January 2002 when the government declared default and devalued the peso by 29 percent. In February 2002, a "dirty floating" exchange rate regime was implemented.

Thus, in early 2002, Argentina found itself with a currency crisis, a debt crisis and a banking crisis. On top of the economic and financial difficulties, the country was in the middle of a severe political crisis that had manifested, among many other events, in the resignation of President de la Rúa in December 2001. This complex situation meant that any process of banking crisis resolution was to face unusually severe constraints. The funding constraint was particularly severe as the default on its external obligations implied a total exclusion of Argentina from the international capital markets. The sharp recession, which further accentuated during 2002, reaching a decline in the rate of growth of economic activity of over 10 percent, added to the funding constraint as the government was unable to collect sufficient revenues to allocate to the resolution of crisis.

As will be discussed below, the initial steps taken by the authorities after the default further tightened the constraints for banking crisis resolution, especially with regards to the treatment of foreign banks, which in the past (Argentina 1995 and Chile 1984) had played an important role in bringing the system back to solvency. Moreover, regulatory independence, a necessity for credible restructuring programs had been significantly weakened during 2001 with the limitations imposed to the autonomy of the central bank and the dismissal of its President.

The effects of the crisis in Argentina had adverse consequences on Uruguay's banking system, mainly because about 40 percent of the banks deposits in Uruguayan banks were held by Argentines. Following the imposition of the "corralito" in Argentina, Argentine depositors in need of cash began to withdraw their funds in Uruguay. This led to a fall of about 12 percent of total deposits during the first two months of 2002.

While the withdrawal of deposits by Argentines was a severe shock to the Uruguayan system, a full-fledged crisis might not have erupted if the shock had hit a stronger banking system. Table 3 shows some indicators of banking soundness by end-2001, at the eve of the Argentine shock. While liquidity and capital ratios appear adequate for both public and private banks, the ratio of non-performing loans was extremely high for the group of public banks (almost 40 percent) and these loans were severely under-provisioned. As discussed above, this means that the economic value of capital for the group of public banks was much lower than the reported accounting capital. Public banks' share in total assets of the banking system was 41 percent at the end of 2001<sup>20</sup>. As in the case of Argentina, foreign banks were the best performers among banks in the private sector.

**Table 3**  
**Uruguay: Banking Soundness Indicators, 2001**  
(In percent)

	<b>Total</b>	<b>Public</b>	<b>Private</b>
Non-Performing Loans / Total Loans	17.9	39.1	5.6
Provisions / Non-Performing Loans	49.7	39.2	91.7
Assets / Capital	16.7	12.2	22.3
Capital / Risk adjusted assets	11.8	17.5	7.6
ROA (After-tax)	-2.3	-4.5	-0.9
Liquid assets / Deposits	15.9	20.9	13.6
Loans in dollars / Total Loans	80.6	56.0	93.0

*Source: IMF (2003)*

In terms of fragilities, while the Uruguayan banking system did not have a significant exposure to government risk (government debt as a ratio of total assets was less

<sup>20</sup> The two large state banks were Banco de la República Oriental de Uruguay (BROU) y Banco Hipotecario del Uruguay (BHU).



then 3 percent in 2001), it suffered from the same problem of currencies mismatches discussed for the Argentine case. About 80 percent of total loans were dollar-denominated and half of the dollar-loans were extended to borrowers with Uruguayan peso-denominated income. An additional source of fragility was the large political interference in the lending practices of the two large state-owned public banks, who also had the largest credit exposure in dollar loans to non-tradable sectors, such as the agriculture and the mortgage sectors. The weak indicators of bank soundness for this group of banks reported above are consistent with lending practices motivated by political decisions rather than by market assessments of borrowers' quality. Finally, unexposed malpractices in a segment of the private sector banks added to the financial fragilities.

The initial withdrawal of deposits resulting from contagion in Argentina was followed by additional withdrawals from Uruguayan residents who feared that the banking system was experiencing solvency rather than liquidity problems. These fears were exacerbated by Uruguay's downgrade from investment grade status and by the depreciation of the exchange rate that followed the capital outflows associated with the withdrawals by Argentine depositors. The exchange rate depreciation, in turn, curtailed borrowers' capacity to repay dollar-denominated loans, further weakening the banking system. During April-May 2002, the system lost an additional 20 percent of deposits. By end-July, total withdrawal of deposits had reached 42 percent.

Did the Uruguayan authorities face constraints as severe as those in Argentina for implementing a banking crisis resolution program? The major differences were not in terms of traditional macroeconomic indicators. For example, by end 2001 both countries were in the midst of a sharp recession and had severe fiscal imbalances (by end-2002, the consolidated fiscal deficits as percentage of GDP in Argentina and Uruguay were 5.9 and 4.1 respectively; in addition, during that period, the ratio of public sector debt to GDP was about 60 percent in Argentina and 54 percent in Uruguay). This data indicates that neither country was in a sound position to allocate fiscal funds to the resolution of the banking crisis. However, the crucial difference between Argentina and Uruguay regarding their access to sources of funds for crisis resolution lied in the willingness of the multilateral organizations to provide financial support to Uruguay. There were two major reasons for this outcome. The first is that the crisis in Uruguay was perceived as contagion from Argentina. The second, and perhaps more important reason, is that Uruguay did not default on its external debt obligations with the private sector and instead kept a market-friendly approach to creditors that eventually culminated in a successful debt exchange in May 2003.

An additional important difference in terms of funding constraints is that, as will be discussed below, the Uruguayan authorities were able to persuade the headquarters of foreign banks to recapitalize their branches and subsidiaries, while policy decisions by the Argentinean authorities penalized foreign banks. Moreover, constraints for effective resolution of banking problem were eased somehow in Uruguay by reinforcing regulatory and supervisory institutions soon after the eruption of the crisis. In contrast, they were weakened in Argentina.

## 2. Initial Responses to the Banking Crises: Did they Adhere to the Principles?

As has been forcefully stated in this paper, the payments system is at the core of banks' businesses and defines the franchise value of banks. Policy actions in Argentina in the pre-devaluation/default period weakened significantly the effective functioning of the payments system by freezing deposits and imposing tight controls on cash withdrawals (the *corralito*). Banks' soundness was also hampered by an exchange of government bonds held by banks for illiquid government bonds in November 2001.<sup>21</sup>

As a full-blown banking crisis became apparent following the devaluation/default, policy actions further accentuated the problem and violated all principles for effective crisis resolution.<sup>22</sup> First, the government imposed an asymmetric pesification of bank assets and liabilities. Dollar-denominated loans were converted into pesos at the pre-devaluation exchange rate of 1 to 1 while dollar-denominated deposits were converted into pesos at the rate of 1.4 pesos per dollar. This policy had severe consequences for banks' capital and drastically violated principle 3 by exacerbating the potential costs of crisis resolution. Moreover, since foreign obligations remained in foreign currency, while loans were pesified, a large foreign currency exposure was introduced in banks' balance sheets.<sup>23</sup>

Second, a tighter freeze was imposed on time deposits since the authorities focused on containing deposit losses rather than restoring the solvency of the banking system. In the so-called "corralon" the use of time deposits in transactions was limited and their maturity was forcefully restructured. These actions violently contradicted principle 2 as they severely penalized depositors, who had no part in the development of the crisis. In addition, banks completely lost their franchise value as the payments system became totally impaired. The freezing of deposits and pesification brought about tremendous public discontent and major disputes between the Executive Branch and the Supreme Court.

Penalizing of depositors through freezing of accounts is not new. Mexico used a similar strategy with dollar-denominated deposits (known as *petro-dollars*) during the debt crisis of 1982. The financial disintermediation that followed contributed to a series of consecutive crises that culminated in the major disruption in 1995, the so-called "Tequila crisis." In contrast, also in the early 1980s, the Chilean program attempted to recover depositors' confidence in the banking system by preserving the real value of the deposits.

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<sup>21</sup> For an analysis of policies affecting the banking system in the pre and post devaluation period, see LASFRC (2002)

<sup>22</sup> This paper does not discuss all policy actions taken during this period. A comprehensive analysis of measures taken from 2001 to 2003 is contained in Gutierrez and Montes-Negret. De la Torre and Schmukler (2002) discuss the situation of the banking system prior to the crisis and the measures taken during 2001.

<sup>23</sup> This contrasts significantly with the policy actions of the Chilean authorities in 1984-85 and the Brazilian authorities in the pre-devaluation period of 1999. In both cases, the authorities placed large amounts of dollar-denominated or dollar-linked bonds in the banks in order to cover the foreign-currency exposure created by the devaluation.

Because of the high costs on depositors, the initial policy responses to the Argentina crisis of 2001 look quite similar to Argentina crisis of 1982<sup>24</sup>.

Third, on February 2003, the government introduced exchange and capital controls in their additional attempts to contain deposit losses and limit the effect of the outflows on the exchange rate. This further complicated banks operations as payments abroad needed the approval of the Central Bank. The combinations of all the measures described above implied a breaching of existing contracts and significant legal uncertainty and prompted headquarters of foreign banks to deny financial support to their branches and subsidiaries.

By mid-2002, the payments system was completely inoperative and bank loans portfolios continued to deteriorate as no restructuring program was in place.<sup>25</sup> Adhering to principle 1 was not among the authorities' priorities.

In contrast to developments in Argentina, since the beginning of the crisis the Uruguayan authorities gave priority to preserving the payment system and containing depositors' loss of confidence. However, an important mistake of the initial policy response was to treat the crisis as a "liquidity" rather than as a "systemic solvency" problem. As such, the main efforts focused on the provision of liquidity by the central bank to the banks through the wide variety of instruments at the disposal of the Central Bank to perform its role as a lender of last resort.<sup>26</sup>

During the three waves of bank runs from February to June 2002, the central bank provided significant liquidity assistance, especially to those banks identified as critical for the functioning of the payments system<sup>27</sup>. This group of banks included the two public banks (BROU and BHU), four private banks (Banco de Crédito, Banco de Montevideo, Caja Obrera y Comercial) and some cooperatives. Foreign banks self-financed their deposit outflows with liquid assets held abroad.

However, in spite of a widening of the crawling exchange rate band, the provision of liquidity translated into large losses in foreign exchange reserves, a weakened exchange rate and an increase in the inflation rate. As international reserves experienced a sharp fall, markets fears of a potential outcome similar to Argentina intensified. Moreover, the

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<sup>24</sup> See Rojas-Suarez (2004).

<sup>25</sup> In early 2002, Congress suspended for 6 months legal actions by creditors to collect on their debts. This further undermined the value of contracts and creditors' rights.

<sup>26</sup> These instruments included advances in pesos, an automatic overdraft facility, rediscount of central bank certificate of deposits and sales of government and central bank paper.

<sup>27</sup> During the first wave of bank runs, Banco de Galicia-Uruguay, a subsidiary of an Argentinean bank was not able to respond to deposit withdrawals due to the constraints on the movement of flows by its headquarters imposed by the Government of Argentina. The Uruguayan authorities suspended the operations of Banco de Galicia-Uruguay. During the same period, Banco Comercial, the largest private bank in the country, was also subject to massive deposit withdrawals due to its financial relations with a liquidated Argentinean bank and the uncovering of irregularities in managerial practices. This bank was recapitalized with funds provided by the Government of Uruguay and the three foreign shareholders (Chase Manhattan, Dresdner Bank and Credit Suisse First Boston)

credibility of the central bank as an effective lender of last resort lost credibility since the ratio of international reserves to deposits plummeted. Throughout this period, the Uruguayan authorities made significant efforts in differentiating their policies from those in Argentina. Thus, pesification, “corralito” and default on external debt were not among the options considered.

Still under the assessment of a liquidity crisis, the authorities created in June 2002 the Fund for Fortifying the System of Banks (FFSF). This fund, initially funded with IMF resources, aimed at complementing the liquidity provision of the central bank. As some banks were experiencing solvency problems, the fund was also designed to provide capitalization support. However, soon after its creation, it became apparent that the size of the FFSF was not sufficient to deal with the problems at hand. With international reserves at levels below US\$ 1 billion, it finally became apparent that the banking system was experiencing a systemic solvency crisis. In July 2002, the Central Bank had to intervene el Banco Comercial, Banco Montevideo/Caja Obrera and Banco de Credito. On July 30, 2002 a bank holiday was declared and the beginning of a comprehensive restructuring program (to be discussed below) was set in place.

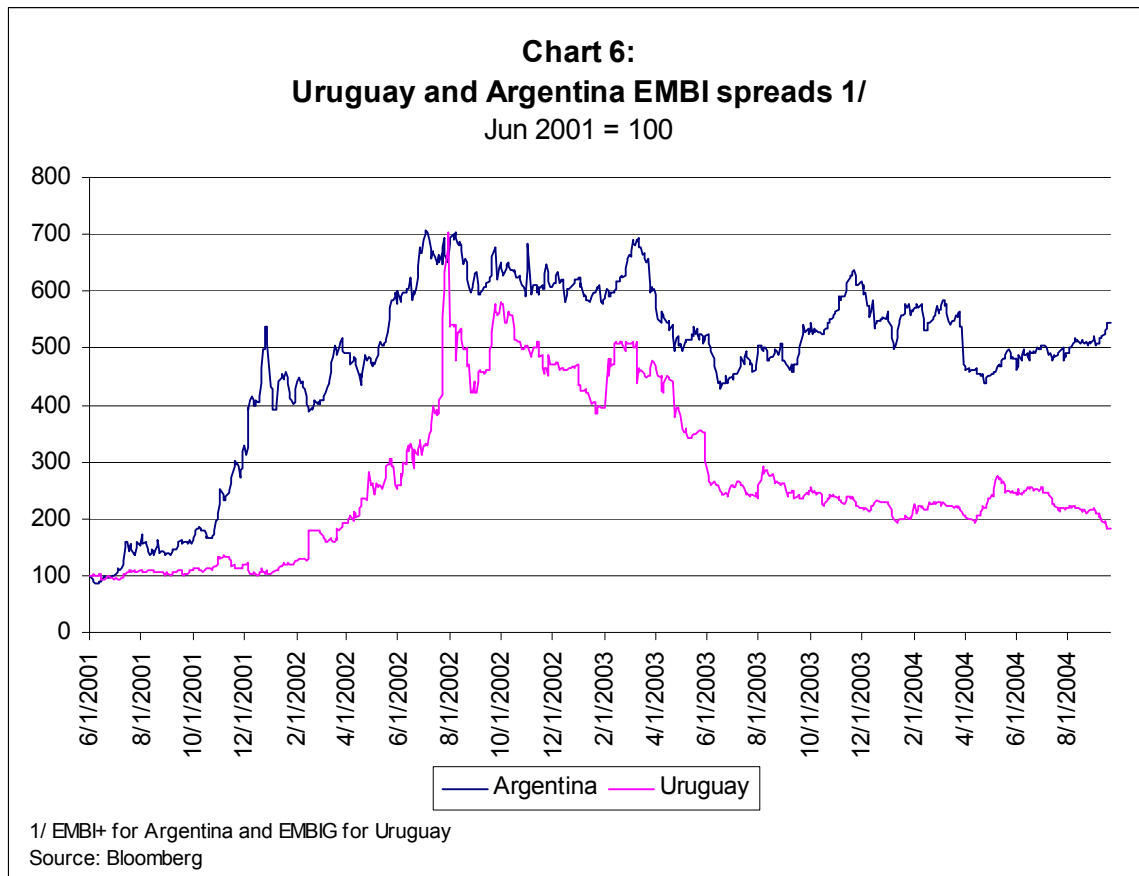
### **3. The Implementation of the Restructuring Program in Uruguay and the (lack of) Program in Argentina**

As discussed above, initial measures taken by the Argentinean authorities aggravated rather than improved the solvency of banks. Moreover, by means of challenges on constitutional grounds, the so called “amparos”, many depositors whose time deposits had been reprogrammed were able to obtain compulsory repayment by banks at the prevailing market exchange rate (which had reached levels above 3 pesos to the dollar at times in 2002) rather than the initial rate that was used for the reprogramming (1.4 pesos to the dollar). The exchange rate differential generated further losses for banks that remain to be compensated.

As discussed in Gutierrez and Montes-Negret (2004) the run on the banks stabilized in mid-2002 due to a number of measures including the capital controls, the gradual lifting of the “corralito” and voluntary swaps of time deposit for government bonds (BODEN). However, a serious and comprehensive program for bank restructuring has not yet been put in place to address the solvency issues still faced by banks. In sharp violation of principle 2, treatment to banks has not been discriminated according to quality. Indeed, the early provision of liquidity and rediscounts by the Central Bank favored public banks, which, as shown in Table 2 were the weakest group of banks in the system at the onset of the crisis.

While the story of the current banking crisis in Argentina is still unfolding, two crucial pieces of evidence indicate that, in spite of the stabilization of deposits, the banking system remains in serious condition. The first is that holdings of government bonds by banks are not measured at market value, artificially inflating the value of their assets. As long as the public external debt problem remains unsolved, it would be very difficult to restore bank solvency. The reason is that the deteriorated perceptions of risk as reflected by

the extremely high spreads on sovereign debt (Chart 6) will keep the market value of bonds at very depressed levels. This is true for domestic and foreign public bonds since both are liabilities of the same borrower: the Argentine government. Moreover, as the process of “compensation” for bank losses associated with the asymmetric pesification and the “amparos” advances, banks’ exposure to government risk would increase. Thus, from the perspective of this analysis, no permanent resolution to the banking crisis can take place without a resolution of the external debt crisis.



The second fact is that there has been a significant and steady shift, in terms of market share, of deposits from private foreign banks to public banks (see Table 4)<sup>28</sup>. This indicates that depositors are not exercising market discipline in their choices of financial institutions. Instead, based on the recent experience, depositors are basing their actions on the belief that the government will favor public banks. The lack of a restructuring program is therefore leading to an adverse selection problem and intensifying the moral hazard problem typical of banking systems where adequate regulatory and supervisory practices are not in place.

<sup>28</sup> This point is also advanced in Gutierrez and Montes-Negret (2004).

**Table 4**  
**Argentina: Composition of Deposits by Ownership of Banks**  
(In percent)

	Dec-01	Dec-02	Dec-03	Jun-04
Public Banks	35.73	45.51	50.66	51.03
Private Domestic Banks	17.83	14.64	13.32	18.79
Private Foreign Banks	46.44	39.85	36.02	30.18
Total	100.00	100.00	100.00	100.00

Source: Central Bank of Argentina

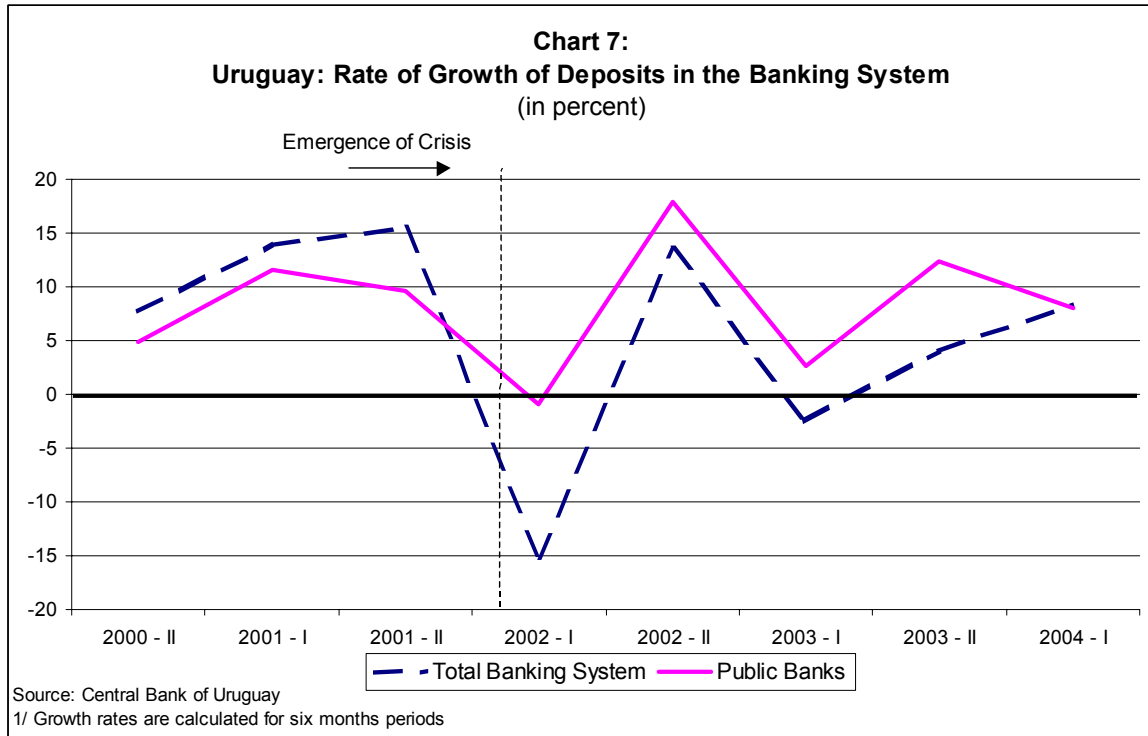
In contrast to the Argentinean “corralito”, which failed to stop deposit withdrawals and brought about riots and generalized public discontent, the bank holiday imposed in Uruguay on July 30<sup>th</sup>, 2002 was short-lived (only four business days) and allowed sufficient time to secure “credible funds” to finance the implementation of a comprehensive restructuring program. The success of the strategy to stabilize deposits was rooted in the ability of the Uruguayan authorities to quickly negotiate an IMF Program for the purpose of: (a) funding the Fund for the Stability of the Banking System (FSBS) with sufficient resources to fully back US dollar sight and saving deposits of major domestic banks, (b) reprogramming the maturities of US dollar time deposits of the public banks, and (c) restructuring intervened domestic banks<sup>29</sup>

The “shift in gears” in the policy actions of the Uruguayan authorities from a program designed to use central bank liquidity as a major source of funding to a program aimed at restructuring the banking sector with non-inflationary funds was in compliance with principle 1 for successful crisis resolution. In addition, the actions taken to liquidate insolvent banks without unduly penalizing depositors were a strict adherence to principle 2. In early 2003, the *Nuevo Banco Comercial* was created with the good assets of three liquidated banks. The new bank was designed as a fully commercial bank, temporarily owned by the Government, but under private management. If, as planned, the bank is successfully privatized in the near future, principle 2 would be reinforced.

The extent to which principle 3 is fully achieved will depend on the pending issues regarding the restructuring of the public banks and the disposal of the remaining assets from the liquidation of insolvent banks. A plan for restructuring BROU, the major public bank, was finalized in December 2003. The plan aims at increasing the viability of the bank

<sup>29</sup> The reprogramming of US dollar time deposits at public banks involved increasing maturities of up to three years. Repayment of 25 percent of principal was to take place in the first year, another 35 percent after two years and the remaining 40 percent after three years. Programmed deposits of BHU were placed at BROU.

through a decrease in operating costs and a redirection of its activities towards business segments where it has a comparative advantage. The importance of improving the soundness of public banks in Uruguay cannot be overstated. As shown in Chart 7, the rate of growth of deposits in the banking system has recovered from the sharp plunge in 2002 and has remained highly positive since 2003. However, public banks had gained market share in terms of deposits. It is, therefore imperative to consolidate the viability of these banks if the restoration of the banking system is to become a permanent achievement.



In the meantime, the markets have rewarded Uruguay's compliance with the principles for effective crisis resolution. As shown in Chart 6, after skyrocketing during mid-2002, spreads on sovereign bonds have decreased significantly and are approaching the pre-crisis levels. Moreover, in October 2003, Uruguay regained access to the international capital markets and was able to place a US\$200 million issue of three-year, peso-denominated, inflation indexed bond. These developments sharply contrast with those in Argentina, where spreads remain at extremely high levels. A brief summary of the differences in constraints and program implementation in Argentina and Uruguay is presented in Annex I.

## V. Concluding Remarks

After reviewing the contrasting experiences of banking crisis resolution in Argentina and Uruguay in the early 2000s, five major lessons emerge. First, a good banking crisis management must begin with three basic principles: muster the political will to channel non-inflationary funds to solve the crisis, ensure that parties responsible for the crisis bear most of the costs of restructuring; and take prompt action to prevent problem banks from expanding credit to delinquent borrowers. The key for a successful program is a strong commitment to adherence to the three principles, even under stringent constraints, including loss of access to the international capital markets. The Uruguayan experience evidences this.

Second, the experiences show that attaining sufficient political will to give priority to a prompt and effective resolution of the banking crisis is the most difficult challenge to overcome. As the recent experience in Argentina demonstrates, political pressures tend to impede the implementation of a successful restructuring program. The delays and failures of implementation simply raise the cost of crisis resolution.

Third, large holdings of government debt in banks' balance sheets introduce an important source of fragility in the banking systems of emerging markets. This is because an increase in the government default risk lowers the market value of government debt, weakening the asset value of banks. As the Argentina case demonstrates, the resolution of its banking crisis can not take place without a resolution of the country's external debt crisis.

Fourth, a crisis should be used as an opportunity to strengthen supervision and improve the quality of bank management. This was the strategy followed by Chile in 1984 and by Argentina in 1995. In this regard, the backslide of depositors' confidence associated with the current process of resolving financial difficulties in Argentina is extremely disappointing. In contrast, the improvement in supervisory practices under an IMF program is benefiting the long-term stability of the banking system in Uruguay.

Fifth, foreign banks can play an important role during systemic banking crisis in two forms: First, to the extent that they are perceived as relatively stronger than local banks bank runs might be contained to a shift of deposits from local to foreign banks, limiting capital flight. Second, experience demonstrates that if the policies of the local authorities aim at preserving the payments system and achieve a rapid resolution of the crisis, headquarters of foreign banks can provide lender of last resort facilities to their subsidiaries and even capitalization funds, limiting the cost of the crisis. The experience in Uruguay is a case in point. In contrast, Argentina's adverse policies towards foreign banks have further tightened the country's financing constraint to resolve its banking difficulties.

A policy question that comes out of these conclusions is what authorities can do to ease constraints in order to reduce the cost of resolving banking crises. The only certain



means of loosening constraints in Latin America is to build credibility in policies and institutions, which takes time. Even policies that are designed to reduce constraints directly, such as forced savings schemes, can only work when authorities pursue policies to build credibility. For example, mandatory pension funds can be useful as a means of relaxing funding constraints. However, these programs will work only if investors have some confidence in the economy. If policies are volatile and institutions weak, some investors will react to forced savings plans by removing funds from voluntary savings vehicles, such as, bank deposits. Nonetheless, forced savings can improve funding options if introduced when institutions and markets are clearly becoming more stable.

How can authorities know that the constraints for resolving banking difficulties have been eased? A clear market signal for regulators is that funds markets do not dry up in a crisis --a feature present today primarily in industrial countries.

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## Annex I

<b>Similar Beginnings, Opposite Endings: A summary of Program Implementation in Argentina and Uruguay in the 2000s</b>		
	<b>Argentina</b>	<b>Uruguay</b>
<b>Similar Financial Fragilities at the Eve of the Crisis</b>	<ul style="list-style-type: none"> <li>- Currency mismatches: dollar loans to borrowers with peso-denominated incomes</li> <li>- Underprovisioning</li> <li>- Weak Public Banks</li> </ul>	
<b>Most Serious Constraints for Banking Crisis Resolution</b>	<ul style="list-style-type: none"> <li>- High fiscal deficits and large external debt</li> <li>- Recession</li> <li>- Lack of regulatory independence</li> <li>- Default on external debt</li> </ul>	<ul style="list-style-type: none"> <li>- High fiscal deficits and large external debt</li> <li>- Recession</li> </ul>
<b>Sharply Different Programs for Crisis Resolution</b>	<ul style="list-style-type: none"> <li>- Lack of political will to solve the crisis</li> <li>- Policies discriminating against foreign banks, including exchange and capital controls</li> <li>- Weakening of regulatory and supervisory institutions</li> <li>- Asymmetric pesification of bank deposits and liabilities</li> <li>- Deposits freeze for an extended period of time</li> </ul>	<ul style="list-style-type: none"> <li>- Strong political determination for crisis resolution</li> <li>- Policies to persuade foreign banks to contribute to solve the crisis</li> <li>- Strengthening of regulatory and supervisory institutions</li> <li>- Comprehensive IMF program for bank restructuring</li> </ul>
<b>Outcome</b>	<ul style="list-style-type: none"> <li>- Bankrupt banking system when measured at market prices</li> </ul>	<ul style="list-style-type: none"> <li>- On its way to recovery</li> </ul>