

**Lessons of the Financial Crisis for the
Design of the New International Financial Architecture**

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Thank you for inviting me to give this keynote address. In my remarks at the policy panel earlier today (“The 2002 Uruguayan Financial Crisis Five Years Later”) I spoke about the details of the Uruguayan crisis from my perspective at the time serving at the United States Treasury. In these remarks I would like to put the Uruguayan crisis in the broader context of the many other emerging market crises that occurred around the world starting in the 1990s. In other words I want to consider the Uruguayan crisis as part of a bigger, longer, “mega” crisis. And I would like to draw some lessons from this mega crisis, which Uruguay eventually became part of in 2002.

The Eight-Year Crisis

The mega crisis I am referring to started with the financial crisis in Mexico in 1994, and continued through 2002. Guillermo Calvo, a close friend of mine and former colleague at Columbia University, gave a famous lecture about this 1994-2002 period at Princeton University two years ago. Guillermo is probably the world’s greatest expert on financial crises. He referred to all the individual country crises during this crisis period from 1994-2002 in the following dramatic terms: “Their frequency and global spread set them apart from anything else that we have seen, at least since World War II.”

If you look through the following table you can get a good understanding of the magnitude of the stress in the international system during this unusual period. The table lists some of the major countries experiencing crises during the eight years from 1994 to 2002. But rather than eight years of crises, I think it is more helpful to view this period as one “eight-year crisis.”

Eight Years of Crises or One Eight-Year Crisis?

• Mexico: 1994-95	}	Tequila effect
• Argentina: 1995-96		
• Thailand 1997-98	}	Asian Crisis Contagion
• Indonesia 1997-98		
• Malaysia 1997-98		
• Korea 1997-98		
• Russia: 1998	}	Russian Contagion
• Brazil: 1998-2002		
• Romania: 1998-99		
• Ecuador: 1998-99		
• Argentina: 1999-2001		
• Turkey: 2000-2001		
• Uruguay: 2002		
• No Major Crises or Contagion: 2002 - present		

TABLE 1

The list starts with Mexico, which the then director of the IMF called the “first crisis of the 21st Century.” He used this terminology because of the capital account nature of the crisis. It was a capital account crisis in comparison to so many crises in the past, which were current account crises. Indeed, it was to help countries deal with current account crises that the IMF was established; the IMF was to provide loans to

countries to help get them through balance of payment crises in a fixed exchange rate world. The Mexico crisis was different.

Following Mexico, there were many more similar crisis of the capital account variety. First there was the “tequila effect” or the contagion from Mexico which hit Argentina and other countries of Latin America. Of course the tequila effect was felt in Uruguay too. The “tequila effect” was also something new about the period. Soon after the Mexican crisis, the Asian crisis began: Thailand, Indonesia, Malaysia, Korea, and there was obviously a connection between those, sometimes called the Asian contagion.

And the crises continued. There was a real big one in Russia, which sent shock waves around the world. Brazil was hit. Romania was hit. Ecuador was hit, and, of course, Argentina’s ultimate movement towards crisis was initially set off by that contagion from Russia. I have not listed all the countries that seemed to be in crisis during this particular period. Note that there was also a crisis in Turkey; it is hard to prove that was related to these other crises, but it was a big one which must be on the list.

Last on the list is Uruguay’s crisis in 2002, which came on the heels of Argentina. It is last because, somewhat amazingly, there has been no major emerging market crisis in the five years since then. So in essence the eight year crisis ended in 2002 with Uruguay.

Now, despite what Table 1 suggests, it would be foolish to say that emerging market crises are a thing of the past, and I certainly would not claim that there will be no more crises in the future. There may be one next year, perhaps the beginning of a ten-year crisis or a one-year crisis, I don’t know. I am not forecasting that. Nevertheless one can usefully think about this 1994-2002 period as “The Eight-Year Crisis.” It is not the most imaginative name. I hope that someone can come up with a better name for

this period, because it seems to me that it is quite unique in its severity, its capital account origins, and its contagion. It is also unusual in that it ended so abruptly. The world quickly transitioned from a crisis-prone period to a complete absence of emerging market crises. It also transitioned from a period of contagion to one with little contagion

The Decline in Contagion

One can begin to understand the dramatic change in contagion by comparing the global contagion following the Russian crisis with that following the Argentine crisis. Figure 1 is a picture of the contagion that followed Russia. It is a picture of EMBI spread for Latin America following the crisis in Russia in 1998. You can see the Latin America EMBI spread going up by 1,000 basis points at the time of the Russian default. That's what we mean by contagion. There is not much of a direct connection between the Russian and the Latin American economies but there was still this amazing contagion.

Figure 2 shows what happened after the crisis in Argentina. The vertical line marks the date of the default in Argentina. In this case I look at the reverse effects: the evidence of contagion from Argentina to emerging Europe. You can see that in this case there is no contagion. The same dramatic change in contagion is observed in many other comparisons for other part of the world. Figure 3 shows what happened to Asia after the Russian default in 1998; huge contagion. Figure 4 shows what happened to Asia after the Argentine crisis in December 2001; no contagion. Figure 5 shows the effect on Africa (this is mainly South Africa and the Northern Africa countries) after the Russian default; again huge contagion. In contrast in Figure 6 you see no contagion. So no matter how you look at it there was a dramatic change in contagion.

Now, just so that we don't get carried away with the idea that a crisis in one country cannot affect other countries I want to show you Figure 7. It shows the growth rate of real GDP in Argentina and Uruguay going back to the period just before the Russian financial crisis. The first observation is 1997. You can see growth in both countries at the start. Then you see the effects of the Russian financial crisis in 1998 on Argentina and Uruguay. Then you see the crisis in Argentina causing the growth to fall to negative 11 per cent in both Argentina and Uruguay. So there is a close connection in the chart between Argentina and Uruguay. The correlation coefficient of the growth rates is .92. Clearly the Uruguayan and Argentine economies remain closely connected to each other. The reduction in contagion I am referring to is between countries and regions that have little or no fundamental economic connection—such as Russia and Argentina.

The Predictability Problem and the IMF

What are the reasons for the decline in contagion? In my view, a major problem during the eight year crisis was in the operations of the official sector and in particular the IMF. I call this the problem of “unpredictability.” The unpredictability was mainly in the response of the official sector. There was uncertainty about what the international institutions would do in the case of a crisis. Would they provide exceptional access to the IMF or wouldn't they? What would the IMF shareholders, including the United States, do in a situation of crisis? In my remarks at the policy panel this morning I mentioned the uncertainty surrounding the IMF's decisions in the July-August period in Uruguay. The resolution worked out well in the end, thanks to good work by economists here in Uruguay and politicians and other officials working together with the United States. But there was a great deal of uncertainty about the IMF. The process

being used at the IMF and elsewhere to make these decisions was not very clear or transparent.

Similar unpredictability occurred at the time of the Russian crisis and how it would be handled. In July 1998, the IMF, working with the United States and other countries, started a new loan support program for Russia. One month later, a decision was made to stop that program; the change in policy occurred in a very short period of time. That was certainly a sudden kind change in policy that was unpredictable. What would have caused such a change in policy only a month or six weeks? In my view the unpredictability had a lot to do with the contagion, because it was a surprise to the market. People had to adjust their portfolios in ways they couldn't anticipate. In contrast, in the Argentine case, when the crisis occurred, when they defaulted, it was so well-anticipated in the market, that there was no surprise element. And thus there was no contagion.

There was also unpredictability in the Asian crisis. The Asian countries complain that the official sector was willing to make large loans to some of them, but not to others. To this day, many of the Asian countries are upset with this unpredictability of the response. Mexico, which was the first in the eight-year crisis period, got a big support package. The question then was what would happen next time and it was hard to predict. The policy response to the Mexican crisis caused a great debate in the United States. The US Congress was very upset about using the funds in that crisis. The debate added considerable uncertainty about future IMF responses that, in my view, added to the unpredictability.

Why was it so uncertain? I mentioned this morning that decisions about Uruguay at the IMF may have been influenced by criticism about its decision on Argentina just a few months before. The decisions about IMF loan support for Russia

could have been affected by changing perceptions of the degree to which Russia was a threat on the nuclear side; it may have had little to do with financial issues. Thus political issues complicate and interfere with the financial decisions and add uncertainty. And personalities matter a great deal: What is the power structure? Will the Secretary of the Treasury or the Secretary of State have more effect on the decision? In my view this unpredictability added risk, kept interest rate spreads high, and actually made the system more crisis-prone.

The Road to Reform: New Bond Clauses and the Exceptional Access Framework

The good news is that the process has been reformed in order to fix the unpredictability problem. The reform is analogous to the more familiar policy reform at central banks. Several years ago—during the high-inflation days and the great volatility days—monetary policy was very discretionary and unpredictable in many countries. There was little emphasis on rules, or systematic ways in which interest rates or money growth were changed. There was little transparency. But all that has changed in central banking, and the change has been for the good. The better inflation and overall economic performance in many countries is due to that improvement in domestic monetary policy. In many cases, flexible exchange rates were a part of this.

The question then became: Would a similar kind of reform applied to the IMF as an international financial institution increase predictability? This was a much more difficult reform than domestic monetary policy, because many countries are involved and because financial crises are frequently unpredictable themselves. It is harder to specify good rules or guidelines.

Moreover, there is a time inconsistency problem here, and it is a more difficult problem than monetary policy. It might be easy to announce that “we will provide loan

support but not above some particular limits, some share of GDP.” But it would not be easy to adhere to the guideline in the case of a real world crisis. One thing we learned from the Uruguay crisis, and that this time inconsistency problem could be made less severe if there is a way for a country to work out its debt problem with its creditors on an orderly basis. So a reform to deal with time inconsistency was simply to reform the debt renegotiation process.

There were two alternative approaches to reform, one called the “sovereign debt restructuring mechanism”, which is like a world bankruptcy court. The other approach was more decentralized, which involved adding collective action clauses (CACs) to the bonds. Either way it would be possible to have a sensible workout with creditors. In the end the CAC approach was the reform that was used. By 2003, only one year after Uruguayan crisis, Mexico had issued debt with CACs in New York and that became a template with Brazil, Chile, Panama, Colombia, Costa Rica, Venezuela, Turkey, Belize, Guatemala, Korea, Italy, Peru, Poland, South Africa, Uruguay joining in.

Now, with the progress on the clauses, there is an alternative to harmful, devastating defaults, and, as a result, some predictable loan guidelines have been put in place at the IMF. These guidelines are called the Exceptional Access Framework. They are not perfect but I think they are pretty good. The basic idea is that countries have to satisfy some criteria in order to get large scale loans as Uruguay got in 2002. It is very much like describing the situation under which Uruguay would or would not have been granted the loan by the IMF in August 2002. The main advantage is that it would have been more predictable.

Conclusion: The Results

So, what has happened? For one thing the exceptional access limits have held. Of course there have been no crises since 2002 to test them, but the IMF is doing stress test scenarios to see how the exceptional access framework would be used. The IMF has done reviews of the exceptional access framework in April 2004 and in May 2005 and it remains a key pillar of the fund's access policy. At the time of the reviews, the Directors said that the framework "lent clarity and predictability" to the funds response to capital account crises; they also felt that the exceptional access criteria remained appropriate and given the limited experience no change was warranted.

Finally, there has been a remarkable decline in risk spreads as shown in Figure 8. In my view this is not a coincidence. The more predictable response of the international financial institutions (the IMF in particular) has reduced risk. The clarity of the response has also provided incentives to countries to take actions to reduce the chance of crises by, for example, accumulating reserves and following better monetary, fiscal and exchange rate policies. So perhaps it is not so surprising that the Eight Year Crisis ended so abruptly.

1998-99 Latin America

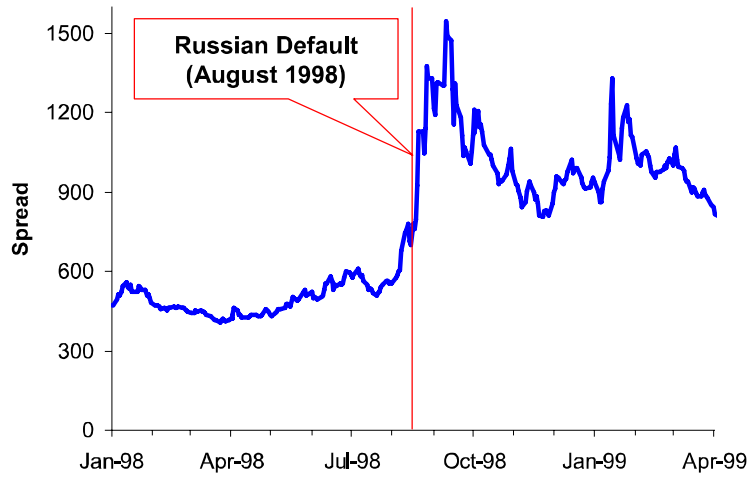


Figure 1

2001-02 Emerging Europe

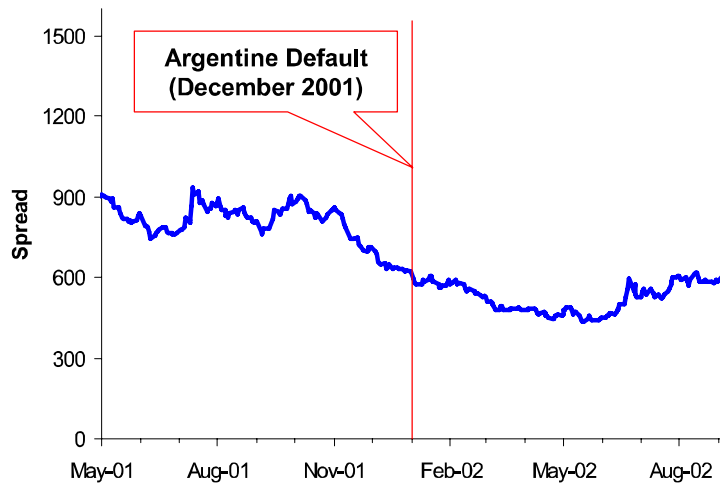


Figure 2

1998-99 Asia



Figure 3

2001-02 Asia

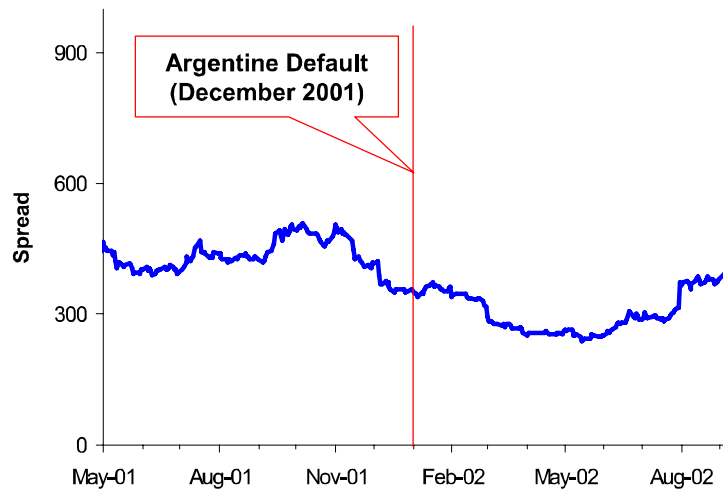


Figure 4

1998-99 Africa

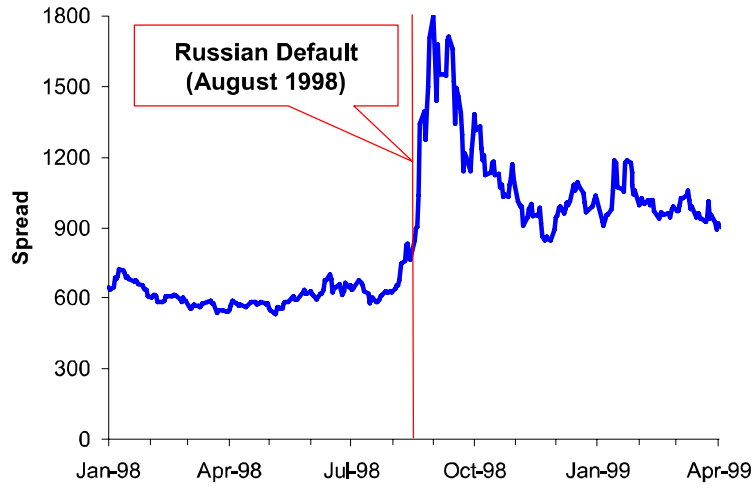


Figure 5

2001-02 Africa

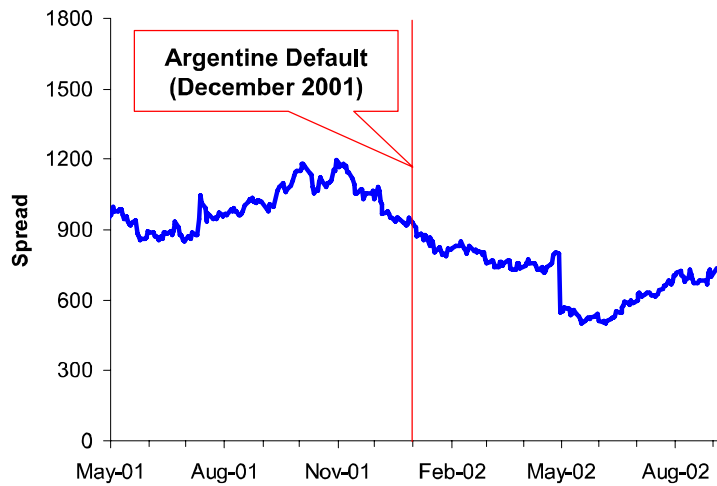


Figure 6

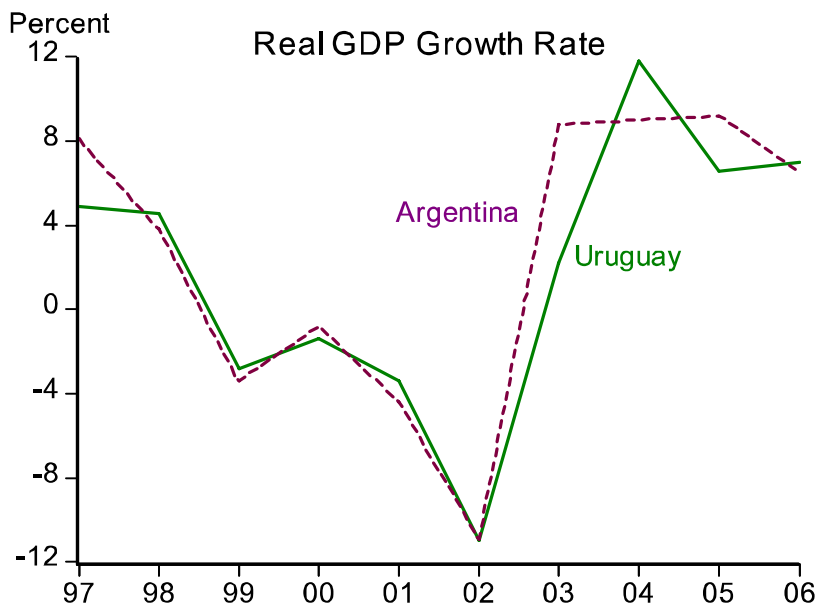


Figure 7

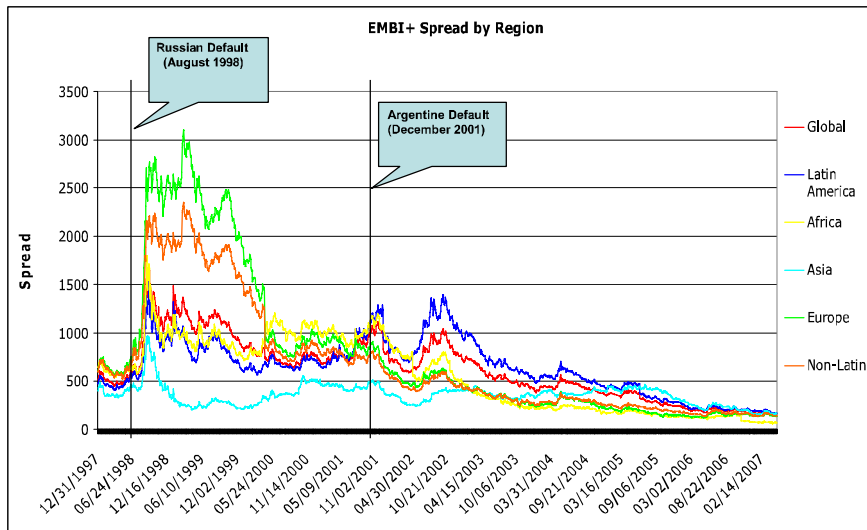


Figure 8