

# Systemic Bank and Corporate Distress From Asia to Argentina: What Have We Learned?

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## I. Introduction: A Different Crisis

After Mexico's meltdown in 1994–95, the markets and the policy establishment braced for the next big crisis – widely expected to feature external sovereign bonds. However, the next crisis turned out to be altogether different.

A year after the fall of the Thai baht in August 1997, 65% of Thailand's companies were illiquid, and nearly a quarter were insolvent; non-performing bank loans approached 30% of GDP. The figures were comparable for Korea and even worse for Indonesia, where nearly 80% of all firms were illiquid and 65% were technically insolvent. Yet Asian governments had been running budget surpluses and managed relatively light debt loads. Asia's was a crisis unlike its Latin American predecessors. With no concern for government debt default, this new kind of crisis manifested itself in widespread runs and defaults on direct cross-border debts of Asian banks and companies.

Systemic bank and corporate distress can take different forms and come about in different ways. Bank and corporate crises need not even coincide. For example, in an economy where banks mostly finance the government and companies rely on non-bank funding sources (securities markets, retained earnings or private capital), pervasive corporate failure need

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\*This paper includes a review of the main papers presented at the conference 'Systemic Financial Distress: Containment and Resolution' held by the World Bank in Washington DC, October 8–9, 2003. Full details of these papers are available at [http://www.worldbank.org/finance/html/sfd\\_home.html](http://www.worldbank.org/finance/html/sfd_home.html)

not lead to a banking collapse, nor would bank failure shut off corporate credit.

A crisis might start with one or several troubled entities, infecting the whole system through contagion. It could also come about through a common, simultaneous shock to all institutions. For example, a falling exchange rate may trigger defaults by firms that borrowed in foreign currency against local currency revenues. Asset prices and bank balance sheets deteriorate system-wide, deposits run, interest rates skyrocket and credit dries up. A banking crisis can first appear on the liability side – as a deposit run – or on the asset side, with large-scale defaults on private loans or government debt. Although its effects must be felt across the banking and/or corporate sector, a systemic crisis need not put every bank and firm out of business. Failure of a dominant institution, such as a state bank that holds the overwhelming majority of deposits, can qualify as systemic.

Bank and corporate distress on such a vast scale is fundamentally different from individual failure, and requires different policy tools. Macroeconomic factors figure prominently among its causes and consequences. Poorly managed and healthy firms alike can find themselves technically insolvent. Resolving a crisis may involve restructuring a huge volume of private loans (many owed by unsophisticated consumers and small firms), and maintaining or restarting credit where intermediation has collapsed. Perhaps most challenging of all, it involves allocating financial losses among bank and corporate shareholders, depositors and taxpayers who are already suffering the effects of economic contraction and exchange rate depreciation.

While unquestionably important, bankruptcy laws and traditional bank regulatory tools are patently insufficient to address systemic crises. For example, the threat of liquidation central to most insolvency regimes is simply not credible when applied to 65% of a country's corporate sector; nor can even the best judicial or administrative system handle this volume of cases. Bankruptcy law offers little guidance to distinguish well-run firms made technically insolvent by the shock from those that are poorly run and would have perished in any event. A dramatic, pervasive drop in asset prices makes it virtually impossible to value collateral for lending of any kind, including by the lender of last resort. In this environment, strict enforcement of bank capital adequacy standards without offsetting measures could exacerbate a credit crunch, trigger closure of well-run banks that would be sound but for the extreme shock, and undermine confidence further. The traditional tools have similarly little to say on the macroeconomic implications of systemic distress – credit supply, exchange and interest rates, and allocating losses, including the costs of bank recapitalization, among taxpayers and other stakeholders.

Most importantly, even though bankruptcy regimes addressing individual firm failure are often devised with political goals in mind (e.g., employment preservation), the political economy of systemic failure is qualitatively different. In the simplest example, resolving 65% of the corporate sector in a country where the top ten families control over half of total market capitalization (as was the case in Indonesia going into the crisis) could amount to property redistribution on a revolutionary scale – not the typical stuff of a liquidation chapter. Even in less extreme cases, managing a systemic crisis melds high-stakes politics and economics in the process of allocating massive financial losses among different constituencies.

The gap between the assets and liabilities of the banking sector generally can be filled from three sources: depositors (and other creditors), bank equity and the taxpayers. First, a bank that cannot pay its depositors can simply default on them. From the policy perspective, this could be the simplest but also the most disruptive and politically costly manoeuvre. Second, shifting losses to bank owners would appear to create the best ex ante management incentives. However, firm mismanagement is rarely the necessary cause of systemic distress, unlike individual failure. As a rule, government action or other causes beyond management control are at least partly to blame. Moreover, allocating large losses to equity requires the capacity to secure new capital contributions from the old owners or new investors that step in to assume control; few governments have this capacity in crisis and so they often proceed to fill the hole in the banking sector with sovereign debt – shifting losses to the taxpayer.

East Asia was not the first case of systemic bank-corporate distress. Among upper income countries, Japan, Sweden and the USA all had relatively recent episodes affecting significant parts of their financial sectors. Chile in 1982, Mexico and, to a lesser extent, Argentina in the mid-1990s, also suffered systemic crises. However, when the Asian crisis hit, there was little academic or policy literature on the subject – particularly of the sort that compared different countries' experiences and extracted general lessons for a policy response.

Immediately after the crisis, a flurry of studies emerged to fill the gap, many written by World Bank staff and erstwhile management intimately involved in the Asian experience (Claessens 1998; Miller and Stiglitz 1999). Policy prescriptions ranged from across-the-board government intervention to market-based case-by-case negotiation. They also varied depending on the authors' view of what caused the crisis. Some focused on external shocks; others stressed domestic institutional weakness: pervasive, opaque links among banks, companies and the government, weak credit cultures, scant shareholder rights and corrupt judiciaries.

Just as the public focus on systemic distress began to subside in 2001, along came Argentina. Its tragic implosion neatly combined aspects of every

other emerging market crisis in recent memory: a currency collapse, the world's largest sovereign debt default, and pervasive bank and corporate failure. Compared to the debt, exchange rate and fiscal aspects of the crisis, systemic bank and corporate failure in Argentina has received relatively little attention. Yet its scale is enormous – by some counts, the entire financial system is technically insolvent – as are its implications for the country's recovery and growth prospects. This latest episode of systemic bank and corporate distress also offers an important prism for evaluating the analytic and policy lessons learned since Asia.

## II. The Papers

The World Bank's conference on systemic financial distress was held last October, about six years after the onset of Asia's crisis and two years into Argentina's. The papers and commentary from the conference would fill the first volume devoted entirely to the problem of systemic financial distress. The collection pulls together a remarkable range of opinions and methodologies, and surveys nearly all systemic crises of the past century in rich, poor and middle-income countries. It also brings a sharp policy focus to the latest academic thinking on such crises. Conference organizers were careful to address both the macro and microeconomic aspects of the problem, with some of the most thoughtful work exploring the relationship between the two. Finally, the papers' emphasis on the policy trade-offs involved in containing and resolving systemic distress serves as an effective organizing device.

As often happens, the collection's assets are also at the root of its disappointments. The first dedicated volume on systemic distress offers a rare opportunity to define the issue and the terms of the debate from here on. Yet this collection spends relatively little time framing the problem, spelling out its elements and distinguishing features. Most papers delve right into the policy response, which might leave a reader new to the subject feeling like he walked into the middle of a conversation.

Definition and differences among crises also matter a great deal for the policy response, especially in the early containment phase of a crisis. For example, a systemic crisis that starts with one or several failures and spreads through contagion might be contained through an aggressive bank closure policy. On the other hand, where a crisis comes from a common shock to all or most institutions, across-the-board closure may not be feasible. In another example, economies where bank credit is over 200% of GDP may demand resolution techniques different from those where credit is under 10% of GDP.

Finally, despite their geographic and methodological breadth, the papers break little new theoretical or policy ground; they primarily provide

analytical and empirical support for earlier insights. Most of the recommendations can be found in some form in earlier works, especially among the best papers published shortly after the Asian crisis (Claessens 1998). On the other hand, one could reasonably argue that searching for snazzy alternatives to rule of law, good institutions and sound macroeconomic policies may be akin to searching for miracle diets – one is inevitably stuck with salad and exercise.

These general concerns – and some of the specific ones raised later with respect to individual papers – should not detract from the fact that this collection is a tremendously valuable, long-overdue effort to shine the spotlight on a problem that is becoming more apparent especially as governments lift restrictions on capital flows and private actors borrow directly on international capital markets. Many of its authors have been involved in managing recent crises, have written extensively on the subject, and are uniquely equipped to provide the authoritative analysis of systemic distress and the policy tools to address it.

The remainder of this review offers a brief summary of Argentina's experience and how it has differed from the relatively pure bank-corporate crises in Asia. It then examines the authors' conclusions through the Argentine prism. Inevitably, a new case of Argentina's complexity brings unexpected twists to our conception of the problem, reveals fresh (if sometimes unintended) policy solutions, and offers both new hope and new doubts about governments' and private actors' capacity to manage systemic distress and prevent its recurrence.

### **III. The Argentine Prism**

By the end of 2001, Argentina had suffered four years of recession, an escalating run on deposits and capital flight to the tune of \$20 billion.<sup>1</sup> Within weeks, it had gone through four presidents, defaulted on nearly \$100 billion in foreign debt and abandoned convertibility – the currency board system that kept the peso at par with the US dollar for a decade since 1991. In early 2002, the Argentine authorities adopted a series of emergency measures including a freeze on term and demand deposits, capital controls (among them a bar on converting pesos without prior authorization and a surrender requirement for export receipts), a freeze on utility tariffs, and an asymmetric conversion of domestic dollar contracts into pesos at subsidized rates. 'Pesification' redenominated bank loans at the rate of 1:1, some indexed to wages, others to the CPI, while bank deposits were converted at 1:1.4 and indexed to the CPI. The peso continued to decline, approaching

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<sup>1</sup>Mussa offers a gripping and comprehensive account of Argentina's demise (Mussa 2002).

4:1 US dollar. To help to fill the resulting hole in bank balance sheets and restructure prior domestic holdings of government debt, Argentina has issued over \$20 billion in new domestic sovereign debt to financial institutions, depositors and provinces. The authorities have effectively designated this a priority debt and are servicing it while in default on most external obligations. Finally, the government has exercised regulatory forbearance, including allowing banks to book government debt at face value and deferring repayment of Central Bank liquidity support extended during the 2001 deposit run.

Despite their many differences, the various Asian crises of the late 1990s have many elements in common among themselves, and with the latest crisis in Argentina. All share the basic pattern – as asset prices plummet, a run on deposits and the collapse of the fixed exchange rate help to bring on a cycle of bank and corporate defaults along with credit contraction. The resulting hole in the banking sector left governments in both cases grappling with the political challenge of allocating losses among depositors, equity holders, taxpayers and foreign investors.

However, the differences between Asia and Argentina are even more revealing. First, by the time it abandoned convertibility, Argentina's domestic deposit base was 70% dollarized. Across Asia, depositors lost real value with currency depreciation. In Argentina, it took government action to impose losses from depreciation on the average depositor.

Second, in Argentina, bank credit to the private sector was small relative to GDP and total bank assets. Credit to the private sector approached 200% of GDP in parts of Asia; in Argentina, it was about 20% before the crisis, falling under 10% during the crisis. For most Asian countries, the crisis followed a period of rapid expansion, credit growth and rising asset prices. Leverage ratios for Asian companies were among the highest in the world – reaching 500% in Korea. At the opposite end of the spectrum, Argentina entered the crisis after four years of deep recession and shrinking credit to the private sector. Even going into the recession, through, Argentina's companies had been among the least leveraged in the world (Claessens et al. 2000). Corporate loans were a much larger part of bank assets across Asia than in Argentina. As a result, even though the ratio of non-performing loans to all loans was similar across Asia and Argentina, in many parts of Asia, corporate defaults alone could sink the banking sector and ultimately impose a significant fiscal burden. In Argentina, corporate defaults would account for only about a ninth of the system's assets and at most a few per cent of GDP.<sup>2</sup>

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<sup>2</sup>This system-wide picture is somewhat misleading since the banking sector was quite segmented, as discussed below. Foreign-owned banks did more corporate lending; Argentine-owned banks had more government debt.

Third, in contrast to Asia, the amount of sovereign debt in the Argentine financial system, even before the crisis, was so high that a government default could bring it down. The magnitude of the eventual default and the weakness of the government's fiscal position were unique to Argentina. The debt load and fiscal deficit limited the government's crisis response options in ways that did not apply in Asia, particularly with respect to bank recapitalization and closure (it could not afford to pay off the depositors).

Fourth, unlike most other cases of systemic distress, Argentina had large-scale foreign ownership, both in its financial and corporate sectors going into the crisis. For example, before 2001, foreign-owned banks held 50% of all deposits, followed by state-owned banks with 33% and privately owned Argentine banks with 16% (Lagos 2002). Foreign-owned utilities, whose tariffs were frozen during the crisis, are among the biggest borrowers from foreign-owned banks – and virtually all their debt is in default. As a result, foreign direct investment, which had been the prime pool of new investment capital in other crises, is exhausted, antagonized and presumptively unavailable to fund Argentina's recovery. Large-scale presence of foreign investors has also made for new tensions and alliances: Argentina's external bondholders compete for resources with foreign shareholders in Argentine banks and pension funds stuffed with government debt; foreign equity investors in banks and utilities both want to see tariff adjustments to help utilities pay. Unlike past crises where foreign investors displaced failing domestic firms, with so many foreign-owned firms under water in Argentina, domestic depositors and ratepayers would no longer look to foreign investment as a cure-all. In contrast to Asia, in Argentina, systemic failure had acquired a foreign face.

#### **IV. Lessons Learned**

Argentina illustrates the increasing complexity of systemic crises where public, private, domestic and foreign actors wear multiple hats and appear on both sides of negotiations. Its crisis path and policy response validate many conclusions in the World Bank papers. It also reveals surprising possibilities where one might have expected to find binding policy constraints. Argentina's most interesting lessons may end up being its use of across-the-board debt forgiveness, its capacity to issue new debt while in default, the financial and political constraints on bank closure, and the complexities of managing a domestic bank-corporate crisis involving a large number of foreign-owned institutions. Although the collection does not address it in depth, systemic corporate restructuring also merits brief mention in the Argentine context.

### A. Debt Forgiveness

Pesification was essentially a debt forgiveness measure – reducing domestic dollar contract obligations by as much as 75%. The aim was to prevent what could be a fourfold rise in private debt burdens for borrowers without dollar revenues. Because it was asymmetric, pesification left a 40% gap between redenominated bank assets (converted at 1:1) and liabilities (converted at 1:1.4). The decision to use asymmetric rates seems to have come from a genuine if mistaken belief that the peso would settle at 1.4/USD, the social and political imperative of making depositors whole, and unsystematic concessions to various debtor groups. The policy was haphazardly designed and deployed at the height of the crisis in a manner that inspired little confidence – including the seemingly random conversion rate, mismatched indexation and financing flip flops.<sup>3</sup> Pesification won few fans and has been roundly denounced as a flagrant violation of rule of law and sanctity of contract – which it was.

Among the World Bank conference papers, though, pesification finds unexpected (if unintentional) support in an encyclopaedic survey of policy responses to systemic distress going back all the way to the US Civil War. The survey's authors, Calomiris, Klingebiel and Laeven recommend that emerging market countries consider debt forgiveness ahead of half a dozen other policy approaches they discuss in a series of case studies – including regulatory forbearance and government-sponsored loan loss write-offs, asset management companies (AMCs), bank recapitalization initiatives and sales to foreign banks.

Most of the approaches that Calomiris et al. survey are technically complex and vest considerable discretion with regulatory authorities. On the plus side, complex programs can be selective, minimizing fiscal costs and unnecessary subsidies. However, selectivity creates opportunities for corruption, particularly where authorities have discretion in triage to separate firms worthy of state support from ones that would be allowed to fail. For emerging market countries with weak institutions prone to capture, the authors recommend simple across-the-board solutions that minimize discretion. Across-the-board debt forgiveness is foremost among these. Relying in large part on Kroszner's study of abrogating gold clauses in US contracts during the Great Depression (Kroszner 1999), Calomiris et al. praise debt forgiveness for its speed, simplicity and effectiveness in returning borrowers to financial health and rebuilding bank balance sheets.

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<sup>3</sup>Initially, the financing would have come from bank capital, though under pressure from the banks and the IMF, the authorities issued debt to the banks to make up for the 40% gap, shifting more of the subsidy's costs to taxpayers.

Experience with pesification so far illustrates the authors' argument and adds to it. As in the gold clause example, debt relief in Argentina was achieved by redenominating private contracts. Shortly after the measure was enacted, many borrowers resumed payment on pesified loans, often bringing recoveries for Argentine banks above the 25 cents on the dollar that Indonesia's AMC yielded five years into the crisis (Arnold 2003). Moreover, AMCs generally require considerable capital and management resources, risk concentrating most bank and corporate assets in the hands of the government, and raise thorny questions about the price at which assets are taken off bank books (often face value) and sold (usually a fraction of face). Pesification enabled Argentina to avoid many of these costs. Because it was automatic and generalized, pesification was less vulnerable to corruption.

Across-the-board pesification was also unexpectedly selective; it enabled payment by smaller companies and individuals that had no access to offshore borrowing, since these actors saw all of their liabilities pesified. Large foreign-owned firms did not benefit as much from pesification. They had borrowed offshore under foreign-law contracts, which remained in dollars and did not allow them to pay the pesified debt selectively. In Argentina, these firms had borrowed from large foreign-owned banks, which then suffered disproportionately from corporate defaults. On the other hand, Argentine-owned banks lent more to the government and less to companies; their corporate lending was to smaller companies that had no access to offshore funds. Without pesification, these banks might have seen vastly more defaults on dollar loans to small companies and individuals. Resolving these defaults would have overwhelmed the already stretched court system. Pesification quickly resolved the debts of many small actors historically least able to engage in complex debt restructuring, and concentrated defaults with a relatively small number of actors with the greatest capacity to engage in complex financial negotiations – large foreign-owned banks and corporations.<sup>4</sup>

Citing the case of the USA during the Great Depression, Calomiris et al. point out that debt forgiveness works best if it is generally believed to be an exception, rather than part of the government's routine financial management toolkit. However, the Argentine authorities decreed debt forgiveness in

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<sup>4</sup>Elsewhere in the paper Calomiris et al. blame asymmetric pesification for driving foreign banks out of Argentina. In fact, few foreign banks have left. The major players have all stayed behind, and Citigroup has recently announced a new investment. This may reflect the fact that they have written off all losses under home country regulations and stand to gain substantially from debt restructuring – they may leave yet but now is not the time. It is also worth noting that most significant defaulted corporate loans on foreign banks' books are to large borrowers whose debts were *not* pesified across-the-board because some were booked offshore under foreign law.

the midst of a massive debt default, currency collapse, policy and political confusion that have been increasingly rare in mature financial markets like the USA. On the other hand, Argentina is hardly atypical for the emerging markets, where countries face periodic meltdowns unable to convince creditors to refinance their debts or hold on to their currencies. Since this is the world for which the authors recommend debt forgiveness, for purposes of testing this policy tool, one must assume that Argentina is as good as it gets. It is hard to imagine investors trusting that a country with Argentina's history of crises and defaults would resort to private debt haircuts 'just this once'.<sup>5</sup> Nor should it.

The lesson is not to rule out debt forgiveness for the emerging markets, but to discard unrealistic assumptions of government credibility and chaste rule of law. This would bring the authors closer to the Asia-inspired Miller and Stiglitz proposal for a 'super Chapter 11'. Also citing Kroszner (1999), Miller and Stiglitz advocate across-the-board debt reduction triggered by devaluation in excess of specified thresholds – effectively creating a presumption that such devaluation imparts a common shock that triggers systemic distress (Miller and Stiglitz 1999).

### *B. New Debt and Bank Recapitalization*

After pesification, the biggest surprise of Argentina's crisis is the government's issuance of over \$20 billion in 'senior' new debt, much of it to banks, while clearly over-indebted and in default on about \$100 billion in external obligations. The new debt's credibility stems not from the promise of growth or additional fiscal effort, but rather from the authorities' capacity to subordinate prior creditors without their consent and with relative impunity. Some of these same old creditors are buying small amounts of the new debt, effectively ratifying the subordination.

Although it does not address the case of a government with virtually no new market borrowing capacity, Patrick Honohan's paper on the fiscal, monetary and incentive implications of bank recapitalization holds useful lessons for Argentina. The author argues against conflating bank restructuring and macroeconomic objectives in designing recapitalization instruments – government debt injected into banks. Governments are often tempted to reduce the fiscal burden of a bank bail-out by placing zero-coupon unmarketable debt with the financial system and allowing it to count at face value for regulatory purposes. However, this strategy may raise the

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<sup>5</sup>It may be no coincidence that Calomiris et al.'s sole example of 'successful' debt forgiveness comes from the USA, while most of their emerging market case studies feature the more complex measures.

ultimate fiscal costs of recapitalization because it eats into profitability, deepens the capital hole and delays recovery.

Argentina's case generally supports Honohan's argument. The yield on its compensation bonds is in the low single digits, with inflation adjustment capitalizing over time. The gap between the low yield on these bonds and the deposit rates banks must pay eats into bank capital. Yet, without big improvements in growth or fiscal performance, or much deeper concessions by foreign creditors already facing a 75% write-down, the government's promise of higher yields may have no credibility. In the end, the 'miracle' of Argentina's new debt issuance hinges on three factors: first, acceptance by the holders of defaulted external bonds of Argentina's imperative to recapitalize banks and limit depositor losses; second, depositors' willingness to keep money in the banks after the deposit freeze was lifted; and third, regulatory forbearance, which has allowed financial institutions to hold government debt at face value on their books.

### *C. Regulatory Forbearance, Intervention and Closure*

Because government debt dominates Argentine bank assets, its valuation has been the focus of regulatory forbearance debates after convertibility. Argentine regulators have allowed banks to carry this debt on their books at face value, with mark-to-market requirement to be phased in over a number of years. Many commentators have pointed out that the net worth of the financial system would be negative if the sovereign debt were marked to market (although since only a fraction of the senior new debt trades, valuation is anyone's guess).

In their contribution for the World Bank conference, Claessens, Klingebiel and Laeven use regression analysis to establish that forbearance – more than any other accommodative measure – increases fiscal cost without advancing recovery. The authors use country and industry-level data to evaluate accommodative measures, including forbearance, blanket guarantees and liquidity support for their contribution to fiscal cost, the speed of recovery and growth. They also assess the role of institutional factors such as corruption, rule of law and judicial efficiency. Much like Calomiris et al., this paper distils policy trade-offs implicit in different crisis management tools, though Claessens et al. apply very different methodology to data of comparable geographic and historical breadth.

Claessens et al.'s broad conclusion – that '[t]he best approach for a country to resolve a systemic crisis appears to be to implement strict resolution policies and improve its institutional framework' – does not do justice to the depth of their analysis. After all, once a systemic banking crisis

has arrived, 'strict resolution' requires both financing and political consensus on distribution of losses among depositors, shareholders and taxpayers – neither of which is apparent in Argentina more than two years into the crisis. In this context, the best approach is idealistic at best.

Resolution is a particular challenge where the government has no resources to close banks and abide by its imperative to limit further losses to depositors. This imperative also stands in the way of requiring bank owners to contribute new capital as a condition to government recapitalization, as sensibly suggested by Honohan. Argentine bank owners simply do not believe the government can afford to close their banks. As one regulator asked pointedly, what would the Central Bank do with all the keys to failed banks left on its doorstep? In the end, even though some regulatory forbearance in the form of phasing in mark-to-market treatment of government debt is undesirable, it seems inevitable in the absence of real alternatives.

Similarly, it is hard to argue with the proposition that less corruption, a competent bureaucracy and efficient courts help to manage and forestall crises – but the authors' prescriptions in this area are much too general to be helpful. Focusing on institutional reform at this level of generality is hardly focused.

Claessens et al. offer better policy guidance for the initial 'containment' phase of the crisis – in Argentina, the year preceding the end of convertibility. Their analysis and that of Carl-Johan Lindgren for the same conference might argue against the provision of liquidity support to banks facing a deposit run, and in favour of quickly shutting down those hit the hardest before resorting to the generalized deposit freeze. This prescription implies a view of systemic crisis as developing through contagion, rather than a common shock. A contagion-style crisis may spread from individual failure. A common shock affects all institutions simultaneously. The problem with using an aggressive closure policy to contain individual failure is that all else being fragile, it might trigger a broader run (as was the case in Indonesia in the fall of 1997). To manage this risk, governments must project tremendous credibility – including resources for a credible deposit guarantee – which Argentina's lacked. Earlier in 2001, when the deposit run was more focused on a few institutions that were supplying the government with emergency liquidity, the authorities refused to close these and opted for a generalized deposit freeze later.

Beyond making the case for early closure, Lindgren stresses the importance of cross-country distinctions that are universally acknowledged but rarely reflected in the other papers. For example, it is plausible that Argentina, where bank credit to the private sector has dropped under 10% of GDP, has less to learn from East Asia, where some economies boasted ratios approaching 200% of GDP, than from Russia, where the banking

sector was unimportant. Oil notwithstanding, Russia's recovery suggests that a robust banking sector may not be necessary to finance a rebound and near-term growth – which could come via retained earnings and non-bank credit.<sup>6</sup> Inasmuch as Argentina had a real banking sector going into the crisis, though its credit to the private sector was closer to Russia's than any of the Asian countries, its case lies somewhere between the two.

Finally, in discussing regulatory responses to systemic crises, none of the conference papers addresses the implications of dollarization for resolving bank-corporate distress – critical in analysing Argentina, even if its authorities have decided to cultivate a peso banking system from now on. A recent IMF paper begins to fill the gap (Gulde et al. 2003). Without passing on the broader merits of dollarization, this short and thoughtful piece catalogues the challenges of managing crises with a dollar deposit base, including the limited scope for liquidity support and guarantees. It helps to explain why regulators in dollarized systems often resort to administrative measures such as deposit freezes to manage crises. The IMF analysis is particularly poignant for Argentina, where so much of the debate is still about how convertibility might have survived rather than how to manage the exit or what to do in its aftermath. It certainly suggests that the deposit freeze and capital controls were likely even if convertibility had stayed.

#### *D. Foreign Banks*

Studies of foreign banks in emerging economies often focus on their entry in the aftermath of a crisis. Calomiris et al. even devote a section to foreign bank entry as a means of crisis resolution. Argentina's case is rare for the scale of foreign ownership in both its financial and corporate sectors *before* the crisis.

Adrian Tschoegl's contribution to the World Bank collection suggests that over time, foreign banks tend to gravitate to wholesale business. However, in Argentina, they had long been active, sometimes dominant, in retail deposits, mortgage and credit card operations. Research also suggests that foreign banks prefer larger-scale, low-risk lending to blue chip foreign conglomerates, not to small businesses. Foreign-owned banks followed this strategy

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<sup>6</sup>Peek and Rosengren's study of credit allocation in Japan lends further support to this proposition, and militates against efforts by the Argentine authorities to jump start bank lending without addressing the risk of gambling for resurrection. Their paper concludes that misallocation of credit to unproductive firms threatens growth more than too little overall credit. In Argentina, where the decline in bank credit comes on a very low base and may be offset with financing from other sources, the credit crunch concern is diminished further.

in Argentina, where the blue-chip firms had peso revenues and were poorly positioned to survive substantial devaluation. Once convertibility ended, the best credits of the old era became the worst of the new. Defaults by utilities and other large firms with dollar debts and no export revenues were a key source of problems for foreign banks in Argentina. In retrospect, their decisions to finance large companies in sectors that benefited from favourable regulation despite the currency mismatch do not look conservative, but rather resemble those of some Asian banks in the run up to the 1997 crisis.

Popular sentiment against foreign banks is widespread in Argentina – many Argentines say that foreign bank subsidiaries had implied the parent institutions would serve as a quasi-lender of last resort by injecting new liquidity and capital in crisis. Not surprisingly, once the crisis hit, the parents did no such thing. Tschoegl points out that for the parent, the limited liability of a foreign subsidiary ‘is an option to abandon with the strike price being the loss of reputation if it walks away’. In Argentina, recapitalization and abandonment were not the only choices available to banks. A deposit freeze, regulatory forbearance, pesification and new debt issuance effectively offered both domestic and foreign-owned banks an option to wait and see whether the recovery values on their bad assets might improve with time. While forbearance and pesification did not help foreign banks, those that did not leave right after they first wrote down the assets under home country rules would be abandoning the upside by leaving now.

It is too early for the post-mortem on the role of foreign banks in Argentina. Tschoegl argues that the presence of foreign banks in emerging market economies is ultimately self-limiting: they help to improve the local banking sector through competition and better regulation, but then have no comparative advantage to stay once the environment has improved. In today’s Argentina, foreign and domestic institutions alike need to find a new business model to generate profits in a peso-denominated world. Argentine-owned banks maintain that they have the advantage with their existing links to smaller local enterprises poised to benefit from currency devaluation and export potential. The business model is less apparent for foreign-owned banks in view of the studies, including some cited by Tschoegl, suggesting that foreign banks have trouble lending to smaller, less transparent companies that may emerge as the winners after convertibility.

### *E. Corporate Restructuring*

The World Bank collection offers rather skimpy treatment of systemic corporate distress – the only paper dedicated to corporate restructuring

does not deal directly with systemic crises. This gap in coverage is particularly unfortunate since recent literature on the subject is scarce. The IMF published a useful cross-country survey last year (Hagan et al. 2003), but key questions remain unanswered, including how country conditions affect the choice of policy tools, how to effect triage, and what are the restructuring options for countries whose governments lack fiscal and technical capacity.

Much of the work on systemic corporate restructuring has focused on the relative merits of across-the-board government-driven and case-by-case market-based approaches – with most authors favouring a mix of the two; see Calomiris et al. and Hagan et al. (2003). Argentina's approach to corporate restructuring may well be a textbook combination. As noted earlier, across-the-board pesification quickly restored the payment capacity for some of the smaller debtors, who are now paying. It was also selective, though not in the conventional sense of targeting relief to the best-managed firms. It focused instead on blanket relief for large numbers of the least capable debtors whose defaults could have clogged the administrative system if treated case by case. In a country with a bigger export sector, one might have worried more about windfalls for companies with pesified debts and dollar revenues – but with pre-crisis exports under 10% of GDP, Argentina could afford to dispense with most such worries. That said, as noted earlier, no science went into determining the level of subsidy in pesification, and there is no evidence that Argentina chose a level that was optimal or the minimum necessary to restore payments. Further empirical work in this area would be useful.

Compared to Asia, case-by-case restructuring of larger companies has also proceeded briskly. Argentina has generally eschewed government facilitation programs inspired by the Bank of England experience in the 1980s. Its key innovation has been an IMF-inspired bankruptcy law amendment enabling court approval of 'pre-packaged' reorganizations, which facilitated half a dozen deals within months of its introduction. The relative success of this approach has everything to do with country conditions. Unlike Asia, Argentina had a reasonably functional insolvency regime going into the crisis, along with a cadre of private sector professionals skilled in its use. A centralized government-driven alternative was unavailable: Argentina's government had no fiscal resources or moral standing with the business community to subsidize or sway deals. Where corporate restructuring has depended on the Argentine government, it has stalled. For example, in the case of foreign-owned utilities, the authorities' refusal to define a new regulatory regime threatens to obscure successes elsewhere in the corporate sector.

## V. Conclusions

Since the Asian experience, international institutions and national regulators have redoubled reform efforts to prevent new systemic bank and corporate crises, only to see them return in Turkey and Argentina. Coming on the heels of these episodes, the World Bank collection offers a rich and timely treatment of systemic distress. The geographic and methodological breadth of the papers is impressive, as is the vast amount of recent research they synthesize, much of it unpublished. Disappointments are few, and many of those stem from the high expectations that a first comprehensive volume on the subject would inevitably face.

Perhaps the biggest gap is the authors' reluctance to offer a broad framework for thinking about systemic distress that could also reveal directions for further research. A recent essay from BIS research staff (Borio 2003) suggests some possibilities. Its author reviews the scope for regulating financial systems against systemic risk.<sup>7</sup> But his framing of 'macroprudential' and 'microprudential' approaches is useful beyond financial regulation, revealing the core challenge of systemic restructuring.<sup>8</sup> Few if any systemic crises can be attributed entirely to common external shocks or contagion from individual firm failure – most have elements of both. A successful policy response must meld both the 'macro' and 'micro' aspects, but few do. For example, across-the-board restructuring measures tend to strain confidence in the rule of law; this, in turn, makes case-by-case market-based resolution more difficult. Moreover, pure case-by-case approaches require time, resources and political power that few economies can muster. Insurance against systemic crises would be expensive and exceptionally prone to moral hazard.

Argentina's ongoing crisis offers useful testing grounds for the conclusions in the World Bank papers, and finds support for many. The papers also cast a new light on some of the most controversial aspects of the crisis, such as the asymmetric pesification and the role of foreign investors. In the end,

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<sup>7</sup>Rafael Repullo's essay in the World Bank volume is a thoughtful challenge to conventional wisdom on bank regulation and the role of the lender of last resort (LOLR), but it does not address systemic crises as such. In modelling interaction between a bank and the LOLR, Repullo suggests that a bank's choice of portfolio risk is unaffected by the presence of the lender of last resort, and that contrary to Badgehot's wisdom, penalty rates create perverse incentives for the LOLR.

<sup>8</sup>Borio argues for a greater focus on 'macroprudential' regulation – distinct from the dominant 'microprudential' approach by addressing itself to system-wide distress and avoiding output costs, rather than individual bank failure and consumer protection. Note that a microprudential approach may still be useful in managing systemic crises that develop by contagion from individual institutions or a small segment of the financial sector.

while Argentina offers some answers to the collection's open questions – including the seeming dearth of policy options for over-indebted governments facing systemic distress – none of these are easy, and few are fully satisfactory.

On a recent visit, winter weather in Buenos Aires was balmy. Shopping malls and ski resorts were packed with vacationing teenagers, and there were few outward signs of the massive upheaval that threatened to obliterate the middle class and shatter for good Argentina's hopes of escaping the cycle of crises that have come to seem inevitable. Yet even the briefest of conversations revealed a deep and pervasive anxiety – few cared to talk about the future; instead, everyone was eager to relive the few days or weeks in 2001 that in their minds could have saved convertibility and forestalled the crisis. In an odd parallel, the Washington policy world often seems stuck in the same mental loop – endlessly relitigating the what-ifs of the last crisis. In the end, whether an August or December IMF package should have been withheld or doubled is beside the point. One lesson of Argentina – and Asia before it – may be the critical importance of allocating losses from the last crisis quickly, transparently and decisively so that the country can move beyond it, and the painful limitations on doing it well in a political environment transformed by crisis.

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