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## **Argentina's Banks on the Road to Collapse**

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Argentina long recognized that the design of a banking system and the set of financial regulations that rule it should not be taken as separate from the monetary and exchange rate arrangement of choice. Regulators knew about the strong connections between currency crises, much more frequent under fixed exchange rate regimes, and banking collapses.

Regulators also knew of a growing set of crises where government financing and liquidity provision were at the core and responded with “enhanced” prudential regulations. Many of the chosen instruments were:

- High reserve requirements
- Those high reserves were remunerated through an innovative scheme. Banks held much of their liquidity abroad in top rated interest bearing banks and securities.
- Banks paid for a “novel” repo line of credit with foreign banks that would provide liquidity of last resort. Specially when the sovereign bonds dropped much in price and precluded the access of the Republic to international financial markets.
- There were stepped up capital requirements that were subject to credit ratings.

- There even were regulations to dissuade banks from paying excessive interest rates to depositors to avoid potential moral hazard problems.
- Argentina was amongst the first emerging markets to introduce the Calomiris suggestion of market evaluation and supervision. It required banks to secure financing through mid-term commercial paper.
- The country introduced effective instruments that allowed the Central Bank to deal with troubled banks without triggering a systemic panic and protecting the payments system during these focused interventions.

The banking system and set of prudential regulations in place were considered a model for emerging markets. Indeed, Argentina was regarded as a country with a very sturdy banking system, only trailing behind a few developed nations. The consensus was held at home and abroad.

The local debate over banking policy was focused on second order issues. As with many other aspects of economics, professional economists were in agreement over 95% of the issues but debated hotly about the remaining 5%. The discussions were over issues such as:

- Had the Central Bank become overly restrictive in terms of the development of the banking industry? Many of the latest innovations had been introduced to avoid “regulation jumping” by banks and were recognized as distortive by some.
- Should the Central Bank use some type of state contingent regulation to try to smooth out the development of deep business cycles? That is, should the implicit tax implied by some regulations such as reserve requirements, be moved in a counter-cyclical fashion?
- The Central Bank had pull out of the domestic repo-market through which it had regulated high frequency liquidity. This had created a market for short term government securities and the new Central Bank actions were producing

both a drop in the appetite for such securities –at a time of volatile expectations and much signaling taking place through interest rates- and increased the intra-month volatility of interest rates.

The reform of the Central Bank charter of early 2001, which unfortunately coincided with a number of other difficult expectational factors -such as the change to the currency board backing, the political attacks on the President of the Central Bank- were geared towards addressing these second order issues. The motivation was, mainly, to be able to use the very limited margins granted by convertibility to operate a mildly expansionary financial policy.

While the measures are disputable, certainly with hindsight they appear ill-timed, the fact of the matter is that what was being recognized was that the strength of a banking sector is only as good as that of the debtors. And this last one had to be restored as the economy had already been immersed in deep recession for three years.

But the real difficulties lurching ahead were somewhere else and nobody, domestically or abroad, had truly recognized the potential danger to induce the proper and timely actions to avert them. Let us quickly overview some of them:

- I. On and off balance sheet effects arising not just from a devaluation but from relative price movements. In particular, when those relative price movements have to be sizable.

Perhaps Argentine economists were to blame for overlooking the magnitude of relative price adjustments that would be necessary to bring the economy back to equilibrium. Typically, estimates of potential real exchange rate overvaluation indicated numbers close to 10-15% and many acute observers emphasized that, in the past, the economy had shown to be fairly elastic to adjust to challenges of that magnitude. In recognition of losses associated to this type of shocks, the Central Bank required Argentine banks to be “heavily” capitalized relative to the typical Basle standards.

Yet, by mid 2001 it was increasingly recognized that the level of capitalization might not be enough to withstand a larger relative price change. In the joint World Bank-IMF Financial Sector Appraisal missions several structural strength tests of the capacity of system to withstand a devaluation were run. These were tests not just of the capacity to withstand a relative price change under the normal operation of the currency board but of devaluation. The system was found somewhat wanting.

Perhaps an important lesson to other emerging markets and Argentina alike is that state contingent market instruments must be created to better isolate banks from fluctuations in credit quality and better share the risk between depositors and bank shareholders. It is important that these instruments fluctuate little during normal times to replicate as much as possible the fix income property of traditional term deposits. But it is also crucial that they have a price that can adjust to bring the system to equilibrium when a depositor run develops or when the quality of bank assets deteriorates above and beyond the banks' capital.

- II. Excessively lax treatment of government securities in bank's portfolios. Many of the banking regulations treated government securities as risk-free. They obviously weren't.

By late May 2001, the system had a ratio of government securities (National and Provincial) to total assets slightly below 20%. By December the number was 24%. A non-performing government sector could easily destroy the banks balance sheet. Not only that, but also the pension system, which was loaded with government securities and bank deposits, created a threat on the liability side of banks. As they perceived the bank solvency deterioration because of sovereign credit difficulties, they would have an incentive to withdraw deposits from banks and trigger a run.

Depositors saw through the banks' veil. The first significant run of July-August'01 was associated with the perception of public sector insolvency much more than anything else. The banks that lost most deposits were those more exposed to sovereign risk (either on their asset side or because of the shareholder composition). In particular, public banks that jointly accounted for close to 35% of deposits were seriously affected.

The second run is even more remarkable. Neither Banco Provincia de Buenos Aires nor Banco Nación had ever recovered. Foreign banks had stabilized (though a gradual drainage continued) and local private banks only suffered significant losses in the week leading to the Corralito. Perhaps thanks to the leakage of news that a deposit freeze was coming.

In any event, the lesson for other emerging markets is to exercise much caution and harshly regulate domestic bank exposure to sovereign risk. Once again not just considering on and off balance sheet potential factors (such as pension plans mentioned).

- III. Exposure to sovereign risk doesn't end with bond holdings. We had frequently thought that foreign banks would ensure fewer crisis and shallower ones. Argentina's experience illustrates that indeed foreign banks produce a sense of safety in local investors that makes them more resilient to bad news. Fewer runs are the natural outcome.

But this is a false sense of security. Foreign banks appear to have been:

- a) More cyclical in their lending
- b) Faster to reduce their exposure to international credit lines
- c) Not significantly more willing or able to raise liquidity under stress

- d) Perhaps less inclined to remain engaged and help find a solution to domestic macro problems (Though I wonder if this is actually bad)

The lesson for other emerging markets is that the system should not go out of its way to attract foreign banks to operate in retail. The role of the regulator is more to make sure that whomever plays the game will have proven ample liquidity and capital strength.

- IV. Finally, Argentina had not advanced enough in the design of an efficient payments system. In particular, one that would be less affected by interventions in banks. That is, a set of rules that would not bring the payments system to a standstill, out of concern for counterparty risks, every time a significant bank or number of banks had to be dealt with.

In short, Argentina's banking sector had advanced much but, as the events of the last year and half showed us, there were areas where the regulations were lacking. Of course, none of these shortcomings amount to a grain of sand compared to the mountain of difficulties created by the pesification, the asymmetric treatment of bank assets and liabilities, political maneuvering against banks, instability of rules, and many of the other brutal attacks the system is suffering today.

But the relevant lesson for other countries lies more in the grain of sand since the other atrocities are much more easily avoided!