

## The 2002 Uruguayan Financial Crisis: Five Years Later<sup>1</sup>

John B. Taylor  
Hoover Institution  
Stanford University

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Thank you for inviting me to Montevideo today. It is a pleasure to be here to participate in this five-year anniversary of the resolution of the financial crisis of 2002, and the remarkable recovery since then. Indeed, the resolution of this crisis is an accomplishment that everyone should want to celebrate; it marks an international collaboration that has had favorable economic and political effects in Uruguay and around the entire world.

### What Was It Like Five Years Ago?

I will never forget my visit here in early August 2002. Real GDP was plummeting—ultimately falling by 12 percent that year. Firms were closing, workers were being laid-off, and unemployment was rising. The peso had depreciated sharply and pumped up the dollar denominated debt well beyond safe levels. Risk spreads were over 20 percent. People were losing confidence in the banking system, and a run on deposits had just forced the government to declare a bank holiday causing people to begin rioting in the streets. The *Financial Times* reported that Uruguay “will need a miracle similar to its World Cup victory in 1950 to survive” and quoted 100 to 1 odds at that.<sup>2</sup> The crisis could be traced to a much larger, eight-year old global financial crisis that, in its latest turn, had spread from Russia to Argentina and then to Uruguay.

How different things are now. As the IMF<sup>3</sup> recently put it, “Uruguay’s recovery from the crisis of 2002 has exceeded all expectations.” Yes, Uruguay did beat those 100 to 1 odds.

My visit to Montevideo in 2002 followed on the heels of a series of marathon meetings in my office in the U.S. Treasury in late July when I was serving as Under Secretary. Uruguayan and American financial experts worked feverishly together in order to find a plan to end that crisis. I can still see the concerned faces of my Uruguayan friends, Isaac Alfie, then macroeconomic adviser at the finance ministry, and Carlos Steneri, then financial adviser at the Uruguayan embassy in Washington, as they sat across the mahogany table in my office pouring over tables and charts. Alfie later

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<sup>1</sup> Written version of remarks given at the “Conference on the 2002 Uruguayan Financial Crisis and Its Aftermath,” Montevideo Uruguay, May 29, 2007

<sup>2</sup> Mark Mulligan, “Struggling Uruguay Finds Back Against the Wall” *Financial Times*, July 29, 2002.

<sup>3</sup> International Monetary Fund, “Uruguay—Fifth and Sixth Reviews under the Standby Arrangement,” December 7, 2006, p.3

described<sup>4</sup> what it was like: “a temperature of 105 degrees...the humidity, truly unbearable.” He reminded me that I had “a really gigantic attack of the flu,” and kindly added that “In spite of all, you and your team spent the whole of Saturday and Sunday with us, looking for solutions. And the Monday and Tuesday you kept meeting with us waking up before dawn for conference calls. We met with your team at 6 am, at 8 am, at 10 am and then at 1 am the next day.” He told us that if Uruguay defaulted on its debt “‘it would mean going back to the stone age...’ and that is truly what we felt.”

## **Looking For and Finding a Solution**

So, for the entire weekend of July 27-28 we met with the Uruguayan finance experts in my Treasury office. You might ask why they were in my office and not over at the IMF. Well, the reason is that the IMF staff had told the Uruguayans that the IMF could not help them unless Uruguay agreed to default on its debt and convert their bank deposits into bonds. The Uruguayans did not think this was necessary. Indeed, they thought that such actions would disrupt the payments system and severely harm Uruguay’s reputation, so important for a financial center. They therefore came to the U.S. Treasury to ask for help. We agreed to work with them to find a solution. We had the complete support and strong encouragement from the White House. As is so often in my experience, good relations between the presidents of two countries, led to good cooperative relations between the experts.

What was the solution that we worked out that weekend? The immediate need was to stop the bank run and prevent a breakdown in the payments system, which would compound the damage already done to Uruguay's economy by the Argentine situation. Unlike the IMF, we felt that a debt exchange to re-profile Uruguay’s debt could be better handled later after the economy was stabilized. We diagnosed the bank run as due to an increasing recognition by depositors that that the central bank's foreign reserves totaled less than the amount of dollar deposits in the system. Hence, people were rushing to get their money out before the banks ran out of dollars. In our talks with the Uruguayans that weekend, we concluded that the only way to convince people to keep their money in the banks was to back dollar deposits by 100 percent. Backing all deposits in the system was not feasible because Uruguay would have had to borrow an immense amount. Going line-by-line through the various categories of deposits in the banking system, we worked with the Uruguay team to develop a plan to fully back dollar checking and savings deposits while rescheduling the time deposits. This precise line-by-line calculation reminded me of a surgical operation, a term which I later used to describe the plan.

## **Implementing the Solution**

To finance the deposit-backing plan, we had to go to the IMF and make the case that this plan would work. We figured we would need about \$1.5 billion. If the IMF agreed to the \$500 million, the remaining amount, we hoped, could be lent by the World

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<sup>4</sup> Isaac Alfie, Remarks at the Embassy of Uruguay, Washington D.C., December 2004.

Bank and the Inter-American Development Bank (IDB). We argued that this plan was far superior to the original IMF idea, and in the end we persuaded the IMF management and staff. Quite candidly, it took a lot of arm-twisting, but the case was debated professionally. Once the IMF was on board, I placed calls to Enrique Iglesias and Jim Wolfensohn, then presidents of the Inter-American Development Bank and the World Bank. They both readily agreed to provide the remaining support.

Following the IMF management decision, the G7 and ultimately the entire IMF board went along. To get the banks open as soon as possible, we decided that the U.S. Treasury would provide a short-term, \$1.5 billion loan from the Exchange Stabilization Fund to the government of Uruguay. This loan would provide a bridge to the disbursement of funds from the IMF, the World Bank, and the IDB, which would take a few days to officially authorize. This was the first time that the Bush administration used the Exchange Stabilization Fund, and it has turned out to be the last time.

As they say, the rest is history. The bank rescue package and bridge loan were an enormous success, and, yes, it all seemed like a miracle—a highly unlikely underdog had persisted against all odds and had won. The rapid provision of financial support bolstered confidence and enabled Uruguay to reopen the banks without a resumption of the bank run. The bridge loan from the U.S. Treasury was repaid in just four days. Eventually, the IMF was completely paid back. Uruguay followed through on its commitments to sound monetary and fiscal policy. The economy started growing again in 2003 and by 2004 was growing at 11 percent. The government ran primary surpluses as envisioned in the plan.

With the end of the crisis, the government of Uruguay worked cooperatively with their creditors to execute a voluntary debt exchange in May 2003. The exchange was a success. Payments were stretched out without a change in net present value, much different from the aggressive exchange that the IMF had recommended.<sup>5</sup>

## **Why?**

Many have asked me over the years why the United States government and the U.S. Treasury in particular got so involved in this crisis. “Why did you help Uruguay?” they ask. “It was so risky. With the IMF so against this policy, if it failed all the blame would be focused on you, because you twisted the arm of the IMF and made the case to the G7.”

First, while yes, the plan was risky, I was confident that it would work. As I said, each part was worked out with surgical-like precision. The 100 percent backing of the demand and savings deposits was the key. The \$1.5 billion loan from the exchange stabilization fund added to the publicity and added confidence. In other words, the economics underlying the plan were sound.

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<sup>5</sup> Steneri, Carlos (2003) “Voluntary Debt Reproiling: The Case of Uruguay,” paper prepared for UNCTAD, November

Second, it was consistent with our new policy to deal with contagion—help countries who were following good policies and who were not the cause of the crisis. Well, if there was ever a case where a country was directly hit by a crisis in another country and was also following good policies, Uruguay was it. We were “helping Uruguayans help themselves,” which is the title of the section of my book on the crisis.<sup>6</sup>

Third, and perhaps most important, we felt that it was the right for the United States to get involved and to help friends in need. We wanted to help. That is how the President of the United States and every one else in the Administration felt.

## **Lessons Learned**

One of the most valuable lessons from this experience is that countries can and should take actions to prevent crises: avoiding currency mismatches, keeping debt low, accumulating reserves in good times. I think many countries including Uruguay have learned such lessons. But the organizers of this conference have asked me to go beyond the lessons learned for individual countries and to look at the implications for the international financial system more broadly.

### ***Predictability and the Exceptional Access Framework***

The most important international lesson learned from the crisis, in my view, was the need for the IMF to change the way it responds to financial crises—most important to be more deliberative and “predictable” about when it would exceed normal limits and provide large scale assistance. The initial refusal to provide additional funds to Uruguay, to encourage a massive default and effectively disrupt the payments system was not good policy, in my view at the time and certainly in retrospect. Perhaps the IMF did not realize that the payments system could continue to operate by backing the demand and savings deposits while re-profiling the time deposits at the banks. Perhaps the IMF’s debt sustainability analysis did not adequately distinguish between liquidity and solvency, simply reflecting that the debt to GDP ratio was high. Perhaps the resistance came from criticism that the IMF had kept supporting Argentina for too long. Yet another possibility was that the IMF staff was trying out the dictates of a new centralized sovereign debt restructuring mechanism (SDRM). Indeed, the IMF did try to push the SDRM in the case of Uruguay.

In my view, the lack of predictability in the case of Uruguay was also evident in some earlier episodes in the crises of the 1990s. Most significant was the case of Russia where the IMF increased support in July 1998 and then one month later in August 1998 indicated that it would remove support. This surprise was in my view one of the reasons for the global contagion at the time. There was also a lack of predictability of IMF

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<sup>6</sup> *Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World*, W.W. Norton, 2007

responses in other crises. The Asian countries still feel that the IMF was not as responsive to their crises as it was in the case of Mexico.

This assessment is not meant to be critical of individual people in the IMF staff or management, either in the case of Uruguay or in the other examples. Indeed, the lack of predictability was due to a lack of a clear framework about how the IMF should operate in such situations; it reflected considerable disagreement among the shareholders about how the IMF should operate.

Fortunately, since the time of the Uruguay crisis, the shareholders of the IMF have come into agreement on this issue; they asked that the IMF introduce such a framework into its operations and the IMF has done so. The reform is aimed at improving IMF operations in the case of exceptionally large-sized loans in crisis situations such as Uruguay. Called the *exceptional access framework* (EAF) it was put in place at the IMF in early 2003, following the crisis in Uruguay. The EAF represents a significant change in policy for the IMF, and it reflected a change in position by the G7 countries, and in particular by the United States. In an action plan in April 2002 the G7 said “we are prepared to limit official sector lending to normal access levels except when circumstances justify an exception....Limiting official sector lending and developing private sector lending are essential parts of our Action Plan.” The EAF stated exactly what the exceptions were. It lists a set of principles or rules that determine whether IMF support will be provided. Its aim, again in the words of the G7, was to “to increase predictability and reduce uncertainty about official policy actions in the emerging markets.”

### ***More Predictable Restructurings of Sovereign Debt***

A second lesson learned from the Uruguay crisis was the need for a framework for countries to engage with their private sector creditors if and when sovereign debt had to be restructured. Recall that the lack of such a framework was a reason that the IMF was suggesting that a new framework, its SDRM, should be used for Uruguay. It was not clear to either the Uruguayan authorities or the IMF how best to proceed, but it was clear that Uruguay did not want to use a centralized procedure like the IMF was pushing. Instead, Uruguay used a voluntary mechanism and ultimately put new collective action clauses (CACs) in its bonds. Here I believe that the lessons from the Uruguay crisis re-enforced the idea that collective action clauses were a good way to restructure debt. (In fact, during the Uruguay negotiations, the government discovered that collective action clauses were in the bonds issued in Japan and it used the clauses successfully in the case of the voluntary exchange).

As in the case of the Exceptional Access Framework, this second lesson learned from the Uruguay financial crisis has already affected the international financial system. Indeed, in February 2003, Mexico issued bonds in New York with collective action clauses. Many other countries have followed, including Uruguay in its May 2003 restructuring. These clauses represent a great improvement in the process of

restructuring debt, as the Uruguay experience tells us. In fact they go along with the EAF: one reason that the EAF was acceptable to IMF shareholders, management, and staff was that there was a procedure (the CACs) that countries could use to restructure their debt without large-scale borrowing from the IMF.

### ***Accountability at the International Financial Institutions***

A final lesson for the international financial system applies not only to the IMF but also to the World Bank and the other development banks, and this is the need for greater accountability and transparency. One of the reasons that this conference is so useful is that it allows those who participated in the crisis to compare notes. What is most striking is how much went on that each of us who participated in the crisis did not know about at the time. Years later we learn that other meetings occurred or that secret side letters are written.

It is good that we are learning about this now, and that the World Bank, the IMF, and many others are participating. With more accountability and transparency, I believe that many crises can be avoided. Indeed, that we have not seen a major financial crisis anywhere in the world since the Uruguay crisis in 2002 suggests that we have all learned something.