

# A note on the Euro Crisis (Latin American Lessons?)

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## I. The fiscal compact and Greece's loan 2.0

II. Lessons from Latin America?

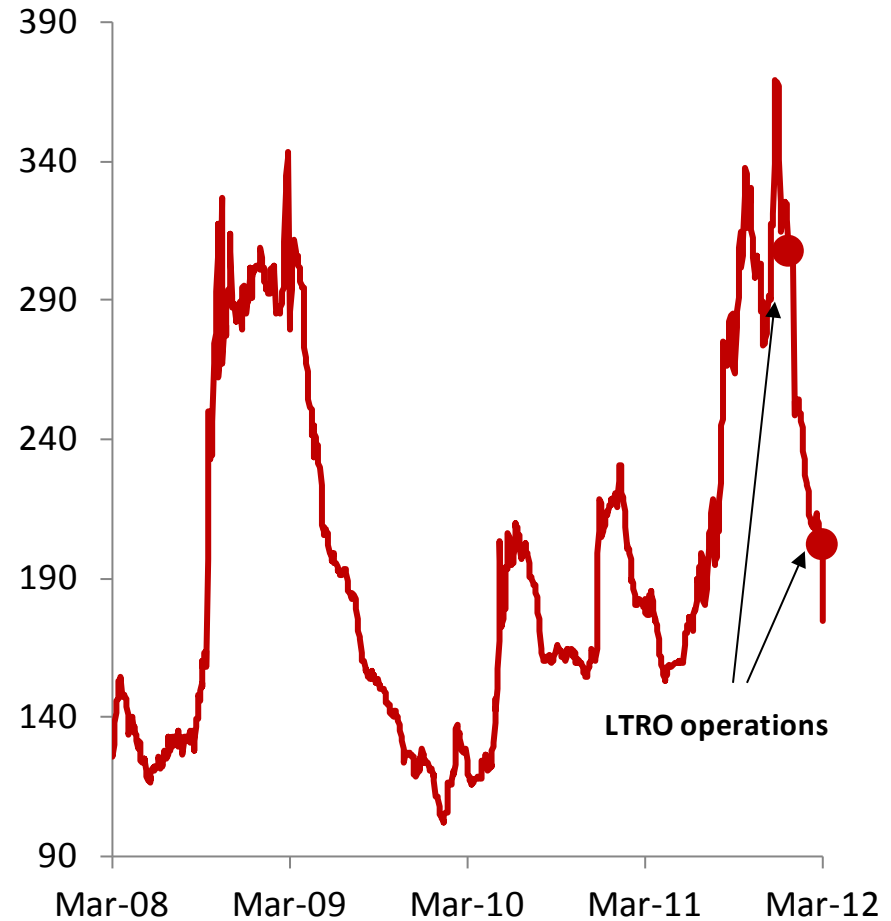
III. The Future of the European Monetary Union

# European authorities have constantly been “behind the curve”

- ▶ Policy measures implemented mainly as a reaction to episodes of market stress
- ▶ What started as funding pressures for Greece has now morphed into the question of the existence of the euro
- ▶ The handling of the sovereign-debt crisis has been disastrous

## Credit Conditions in Europe\*

(basis points)



\*OAS level for AAA banks in Europe. Source: Bloomberg and Banorte IXE

# The tail risk of a credit crunch was reduced... What is next?

- ▶ The 3Y LTROs were a **game changer** for Europe that:
  - ❖ **Bought time** (how much?);
  - ❖ Reduced the likelihood of **tail events**; and,
  - ❖ Increased the **scope for action**...
- ▶ However, the supply of credit within the real economy will not automatically increase
- ▶ What is next?

➤ **Reformed Stability and Growth Pact → Fiscal compact**

➤ **The second Greek bailout**

# The fiscal compact

- ▶ Some of the **benefits and rules**:
  - ❖ More rigorous surveillance
  - ❖ Structural deficit lower limit = 0.5% of GDP
  - ❖ Automatic correction mechanism
  - ❖ Rules must take effect in national laws
  - ❖ Reduce debt that exceeds 60% of GDP by 1/20 each year
  - ❖ Report ex-ante on public debt issuance plans to the Council and the European Commission
  
- ▶ Some of the **problems**:
  - ❖ It needs ratification of at least 12 eurozone member states
  - ❖ Ireland referendum → uncertainty at national levels

# The new Greek bailout

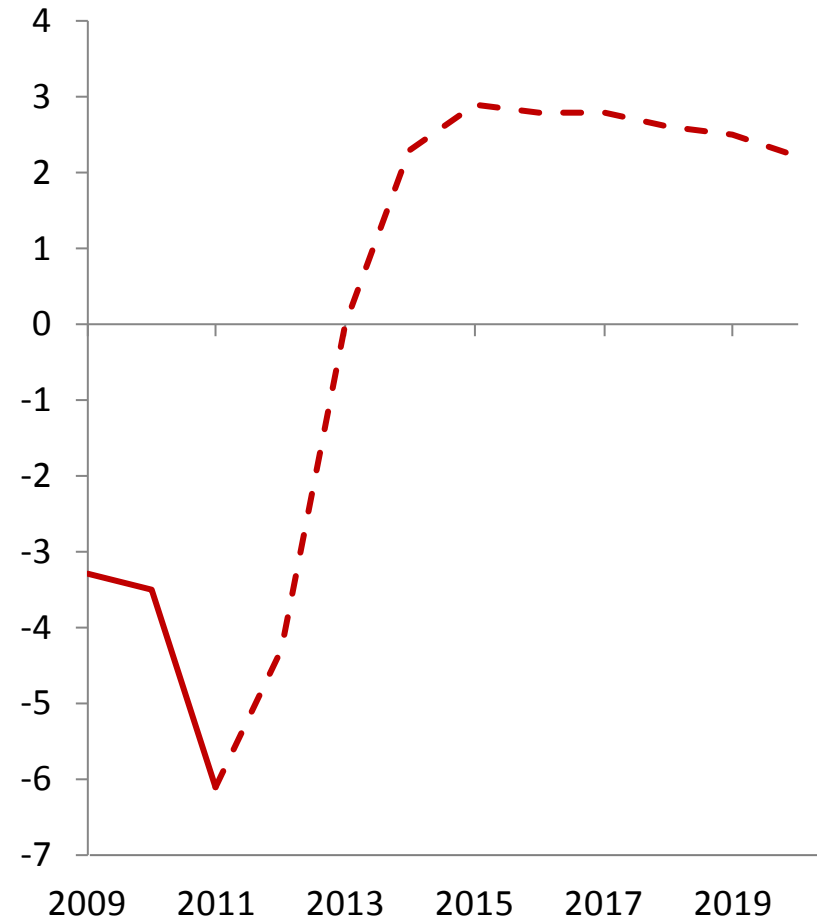
## ▶ The programme is too fragile to work:

- ❖ A debt of 120% of GDP is still a very challenging level
- ❖ No one knows what constitutes sustainable debt
- ❖ Or what Greece's "real" GDP is

## ▶ The programme is highly intrusive

## ▶ No ownership

**Real GDP**  
(%, annual growth)



Source: IMF

# What should a successful package contain? ... more like the HIPC

- ▶ A programme that recognizes that the process of adjustment and reform will extend over **a long time horizon**
- ▶ Adjustment **supported by the EU**
  - ❖ Markets are likely to remain shut
  - ❖ Lots of long-term official finance will be required
- ▶ Debt relief of **ALL debt** (private and official)
  - ❖ Of course, conditioned on the attainment of fiscal goals and structural reforms
  - ❖ Similar to **Heavily Indebted Poor Countries** debt relief

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# How did Latin American authorities faced the debt crises of the 80s?

- ▶ They basically took three steps:
  1. Fiscal adjustment (IMF Stand-by Programs);
  2. Growth stimulus (Structural reforms); and,
  3. Debt relief (Brady Plan).



## Fiscal adjustment

- ▶ The first response: IMF stabilization programs
- ▶ But this was not enough...
- ▶ Deep recessions were triggered

## Growth stimulus

- ▶ Another important ingredient for solving the Latin American debt crises was growth stimulus
- ▶ Growth and structural reforms are essential for achieving medium- and long-term debt sustainability

- ▶ Real exchange rate **depreciation**:
  - ❖ Helped to recover competitiveness
  - ❖ Devaluation and inflation → external transfers
  - ❖ Not an avenue open today to European countries

# The Brady Plan was the closure that market participants needed

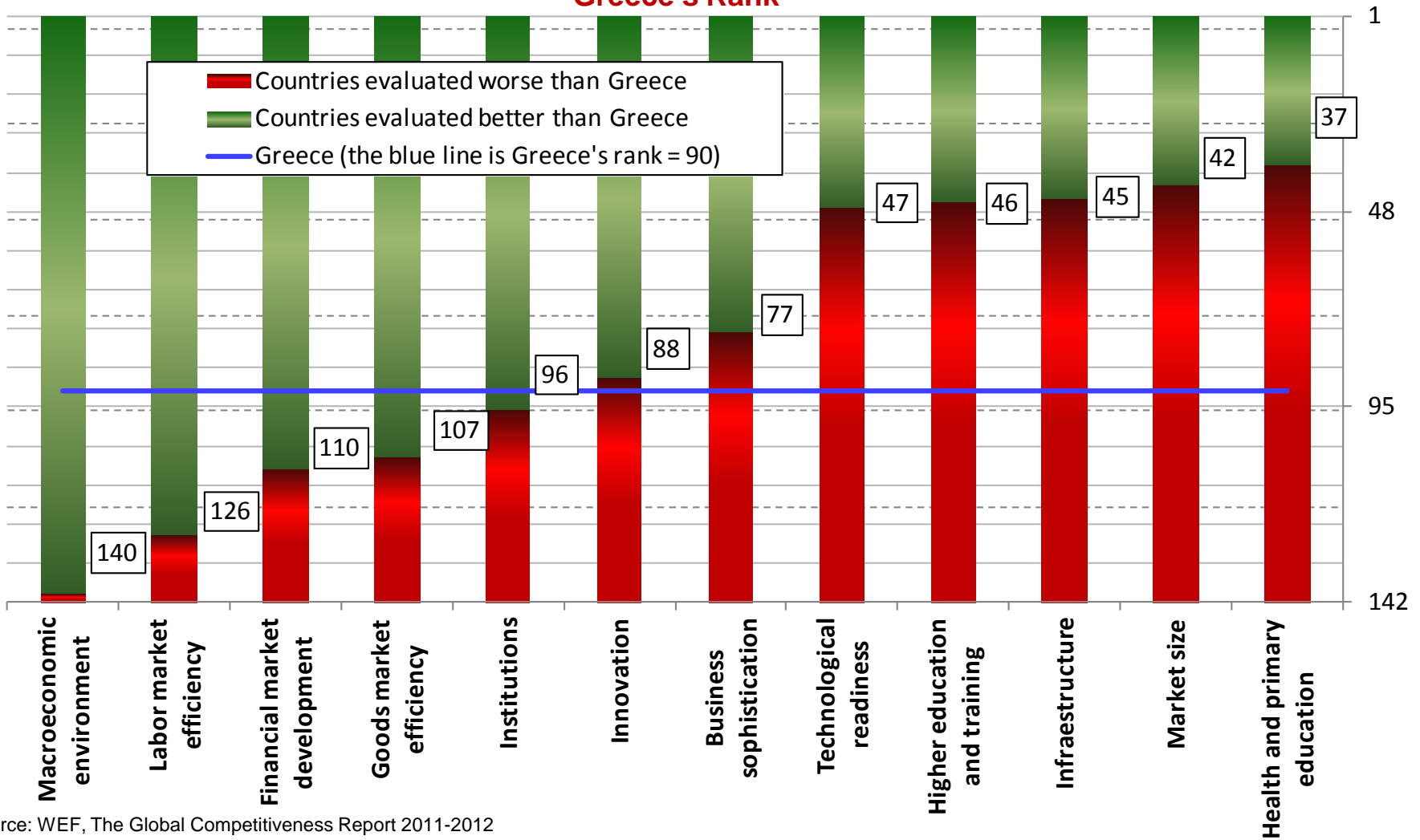
## Debt relief

- ▶ Fiscal adjustment was already realized
- ▶ A credible reform program was underway
- ▶ More than the haircut by itself → the change of regime made the difference
  
- ▶ Even if the Latam experience is relevant...  
... it is **not the model for Greece**
  1. Debt-to-GDP ratios were considerably lower
  2. Latam countries did the required adjustment
  3. The Brady Plan relieved commercial debt burden

# Greece has a long way to go, on fiscal adjustment and growth stimulus

## Global Competitiveness Index, WEF

Greece's Rank



Source: WEF, The Global Competitiveness Report 2011-2012

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# Will the eurozone survive?

- ▶ The eurozone needs:
  - ❖ Tighter **fiscal integration**
  - ❖ **Convergence** → of productivity and growth
- ▶ Another issue... institutions are not designed to make decisions
- ▶ Effectiveness of policy making (or lack of it) → absence of political mechanisms, political leadership and political will
- ▶ The survival of the eurozone in its present form is today a big question mark