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

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I. Europe: the fiscal compact and Greece's loan 2.0

Since 2009 European authorities have constantly been "behind the curve", implementing policy measures mainly as a reaction to episodes of market stress. As a result, what started as funding pressures for some countries (mainly Greece) has now morphed into the question of the very existence of the euro. In short, Europe's handling of its sovereign-debt crisis has been disastrous.

Let's fast forward to today. The situation seems to have momentarily improved. The tail risk of a credit crunch in Italy, Spain and France has been significantly reduced thanks to the EBC's three-year long-term refinancing operations (LTROs).The 3Y LTROs were a game changer for Europe that bought time, created confidence in the financial system and in the economy at large, and increased the scope for action .After December's and February's auctions, total ECB refis now stands at an all-time high of EUR1.2 trillion. Nonetheless, the supply of credit within the real economy will not automatically increase, and for any recovery to occur in 2012, bank lending needs to restart.[1]

What is next? There are basically two arrangements in the pipeline. The first one is the reformed Stability and Growth Pact—the so-called "fiscal compact"—that would bring a more rigorous surveillance and would trigger corrective measures earlier than under the previous regime. For instance, countries are obliged to limit the structural deficit at 0.5% of GDP, except under "exceptional circumstances" outside their control. Under regular circumstances, if significant deviations are observed a correction mechanism is automatically triggered. These rules must take effect in the national law of the different countries (preferably by amending constitutions). Additionally, countries must reduce any debt that exceeds the 60%-of-GDP benchmark by 1/20 each year, and to report ex-ante on their public debt issuance plans to the Council of the EU and to the European Commission.

However, for the fiscal compact to enter into force, it needs ratification of at least 12 eurozone member states. Ireland already decided to put this deal to a referendum. A lot of uncertainty may still emerge at national levels during the transition towards the new fiscal architecture in the euro area. Moreover, the effectiveness of the new system will depend

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[1] On March 6 ECB overnight deposits rose to a fresh record after the second round of three-year loans. Financial institutions deposited 827.5 billion euros.

crucially on whether a sufficient number of governments support the European Commission in implementing it.

The second plan that is underway is the new Greek bailout. On February 21, Europeans managed to reach a provisional agreement to provide a second loan programme to Greece. Default seems to have been averted, at least for now. Nonetheless, markets are still nervous as the risk of the new programme going off track remains high. Markets are not the only ones with doubts; the IMF itself described the Greek program on the last *debt sustainability analysis* as "accident-prone" and with "questions about sustainability hanging over it".[2]

In my view, the programme is too fragile to work. First of all, even if Greece manages to reach the 120% debt-to-GDP target (helped by a "successful" PSI)[3], this is still a very challenging level that does not guarantee that the country will be able to return to the markets in 2020. An interesting question is why the 120% target was chosen to begin with. Because it is close to where Italy's debt currently is and agreeing on a lower target would automatically imply that Italian debt is unsustainable? 120% is a political number that lacks economic justification.[4]The truth is that no one yet knows what constitutes sustainable debt or what Greece's "real" GDP is. What is more, by the end of this year the cumulative decline in real Greek GDP may hit 20%. And obviously, recovering growth is essential for lowering the debt-to-GDP ratio and eventually achieving sustainability of fiscal stance.

In addition, the programme is brutally intrusive. The IMF has always sought that programs are "owned" by the countries implementing them. This is not the case with the Greek deal. First, the Eurogroup has "invited" the Commission to strengthen on-site monitoring, and work in close and continuous cooperation with the Greek government. Second, a mechanism to ensure that the next quarter's debt payments are in a segregated account under the monitoring of the Troika was established. The IMF probably should have stayed on the sideline of this programme that is truly controlled by the Troika. It is only risking damaging its reputation by intervening in a package in which it does not even have faith.

This programme is set to fail. It is only a matter of time for a new bailout to be needed. Then, what should a successful package contain?

What is required is a programme that recognizes that the process of adjustment and reform will extend over a long time horizon (probably around ten years). This gradual adjustment needs to be supported by the European Union, and should acknowledge that markets are likely to remain shut to Greece and that lots of long-term official finance will be required. Also the debt-exchange should include all debt (private and official) and should, of course, be conditioned on the attainment of fiscal goals and structural reforms. The plan should be similar to the debt relief observed under the Heavily Indebted Poor Countries (HIPC) Initiative. Of course, the income level and many other features of those countries are not comparable to Greece. However, the structure of the program is what is relevant here.

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[2] International Monetary Fund 2012.

[3] Greece announced that it will activate the collective action clauses (CACs) forcing some investors to take part in the exchange, and allowing it to clear a 90% target rate for participation.

[4] Münchau, Wolfgang (2012).

The HIPC program was launched in 1996 by the IMF and the World Bank. The objective was to enable each country to exit the process of constant rescheduling and resume normal relations with its creditors, the true measure of debt sustainability.[5] The initiative involved a two-step process. First, the IMF and the World Bank provided interim debt relief; then, when a country met certain commitments, full debt-relief was provided (including reductions of debt owed to official multilateral institutions—the Fund, the World Bank, and the regional and sub-regional development banks).[6] The same should have been sought for Greece: a debt-exchange program that includes both private and official creditors and leaves the country with a sustainable level of debt (around 30% or 40% of GDP).

The truth, though, is that Europeans from the North are not feeling too "European" lately and are inclined to expel Greece from the Monetary Union. Some countries seem convinced that Greece is dragging its feet on implementing the economic and fiscal reforms and want it out of the eurozone. Among the German population, bailing out Greece is increasingly unpopular. A recent poll published in the *Bild am Sonntag* newspaper shows that 62% of Germans were against the €130bn rescue package while 33% were in favor. In a similar poll last September, 53% were opposed and 43% in favor.

II. Lessons from Latin America?

In light of the current European debt crisis, it is revealing to analyze how Latin American countries faced the debt crises of the 1980s. Basically, they took three steps:

1. Fiscal adjustment;
2. Structural reforms; and,
3. Debt relief.

In the 1980s, the first response to the debt crisis was to implement IMF-sponsored stabilization programs—the so-called IMF Stand-By Programs. These conditioned additional access to international finance on a significant level of fiscal adjustment, tighter monetary policy, and slimmer public sectors. The adjustment resulted in higher primary surpluses. But this response was not enough. Deep recessions were triggered by fiscal adjustments, debt-to-GDP ratios continued to rise, while lower creditworthiness led to capital outflows and higher interest rates.[7]

So, in order to complement the fiscal consolidation, Latin American countries implemented structural reforms that would eventually enhance growth. Mexico, for instance, transformed itself into a much more open economy through extensive trade reforms, the privatization of most public sector enterprises, and financial market liberalization. In a few years, Mexico went from being mainly an oil exporter to a country focused primarily on manufacturing exports. Brazil, Argentina and Peru followed similar strategies.

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[5] Birdsall, Nancy and John Williamson (2002).

[6] For instance, Angola went from having a debt-to-GDP ratio of 222% in 1995 to 89.9% in 2000 and to 59.8% in 2003.

[7] Ortiz, Guillermo (2011).

Clearly, the real exchange rate depreciation helped to recover competitiveness. Also, devaluation and inflation were instrumental in realizing external transfers. This was a vital step for eventually achieving medium and long-term debt sustainability; however, it is not an avenue open today to European countries. In addition, external demand conditions were then favorable for export growth; this is not the case today.[8]

The third step taken in Latin America was debt relief. But debt relief took place when fiscal adjustment was already realized and a credible structural reform program was underway. The Brady Plan was the closure that market participants needed to set the stage for higher growth in the ensuing years.[9] More than the haircut by itself, it was the change of regime that allowed Latin American countries to restore creditworthiness and debt sustainability.

Even if the Latin American experience is relevant for today's European dilemmas it is not the model for Greece. First, debt-to-GDP ratios in Latin America were considerably lower than Greece's: for instance the average debt-to-GDP ratio during the 80s was 45% for Argentina, 32% for Brazil, 46% for Mexico and 67% for Peru.[10] Second, Latin American countries did the required adjustment, including both the fiscal consolidation and the structural reforms. And third, the Brady Plan relieved the debt burden of countries whose indebtedness was primarily commercial. It did not cover countries whose outstanding debt was mainly official creditors.[11]

On fiscal adjustment, Greece has a long way to go. Greece managed to reduce its primary deficit from 10.4% of GDP in 2009 to 5.0% in 2010, and probably to 2.4% in 2011 (*this number is a projection from the IMF*). But it still needs to achieve ambitious fiscal consolidation targets and return to a primary surplus as from 2013 according to the new programme.

Regarding growth, the slow progress so far in delivering politically unpopular structural reforms is not reassuring. According to the Global Competitiveness Index (GCI) published by the World Economic Forum (WEF), Greece fell 12 places in 2010 and another 7 places in 2011 in the ranking, remaining the lowest-ranked country of the European Union.

The GCI is, in turn, an average of twelve sub-indexes that point to the main culprits responsible for the low levels of competitiveness of Greece.

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[8] Ortiz, Guillermo (2011).

[9] Japan's help during the Brady Plan preparation was extremely valuable. The debt reduction packages involved "enhancements", both the principal and the interest payments for 18 months were guaranteed by money set aside by the IMF, World Bank and Japan (Mexico also dedicated $1.3bn of its own reserves to the funds providing the guarantees). The enhancements are not gifts but loans.

[10] Also, when the Brady Deal was announced in the different Latin American countries, their debt-to-GDP ratios were all below 85% while Greece's currently is above 160%. In 1989, in México and Costa Rica the debt-to-GDP ratios were 59.8% and 77.0%, respectively. In 1990, Uruguay's and Venezuela's debt was 56.1% and 55.6% of GDP. In 1992, Brazil's and Argentina's was 84.0% and 38.5%. Finally, in 1995, Panamá's and Peru's debt was 60.6% and 36.8% of GDP, respectively.

[11] Birdsall, Nancy and John Williamson (2002).

- Of course due to the ongoing sovereign debt crisis and investors' low confidence, Greece continues to fall in the macroeconomic environment and financial markets sub-indexes.
- Two other major areas of concern for the country are its inefficient labor market, which continues to constraint Greece's ability to emerge from the crisis, and its public institutions (e.g., government efficiency, corruption, undue influence).

However, Greece has also a number of strengths to build upon, like a rather well-educated workforce, skilled at adopting new technologies that could help increase productivity.

Some analysts suggest that, given the grim outlook, it would be better for Greece to exit the eurozone and reinstate the drachma. They often cite Argentina's exit from its currency board in 2002 as evidence of the benefits that would accrue to Greece if it reintroduced its own currency. However, an analysis of the costs incurred by Argentina after it abandoned the currency board strengthens the case for Greece to remain within the eurozone. Some of those costs were:

- A bank run, that would be much more destructive and widespread for Greece given European financial integration.
- A collapse of large private corporations with access to international financial markets, because their foreign-currency liabilities could not be redenominated.
- Endless violations of contracts that left an enduring stain on the investment environment.[12]

Devaluating, and thus exiting the EMU, is not an option for Greece. This strengthens the case for establishing a ten-year programme and a coordinated official debt relief (like in the HIPC Initiative) that effectively leaves Greece with sustainable public finances and a stronger foundation for continued economic growth.

III. The Future of the European Monetary Union

If the European leaders succeed in healing Greece and other periphery countries, what will happen next? Will the euro zone survive? In my view, the euro zone needs, besides tighter fiscal integration (that apparently is already underway), convergence. Unless sustained convergence of productivity and growth is reached, the composition of the European Union will probably change.

Another serious issue for Europe is that institutions, with the exception of the ECB, are not designed to make decisions, but to deal with processes. Thus, they are ill-equipped to face a financial crisis. Only the ECB has the power and ability to make decisions, but the mandate and scope of the bank is limited to monetary policy and financial stability.

The question regarding the effectiveness of policy making—or lack of it—in the eurozone has to do with the absence of political mechanisms (and perhaps political leadership and political will) designed to tackle problems which are essential to its viability. This

[12] Ortiz, Guillermo and Mario Blejer 2012.

dysfunctional decision-making process, lack of political union and lack of productivity and growth convergence, unless corrected, will most likely put an end to the European Union as we know it. For me, the survival of the euro zone in its present form is today a big question mark.

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